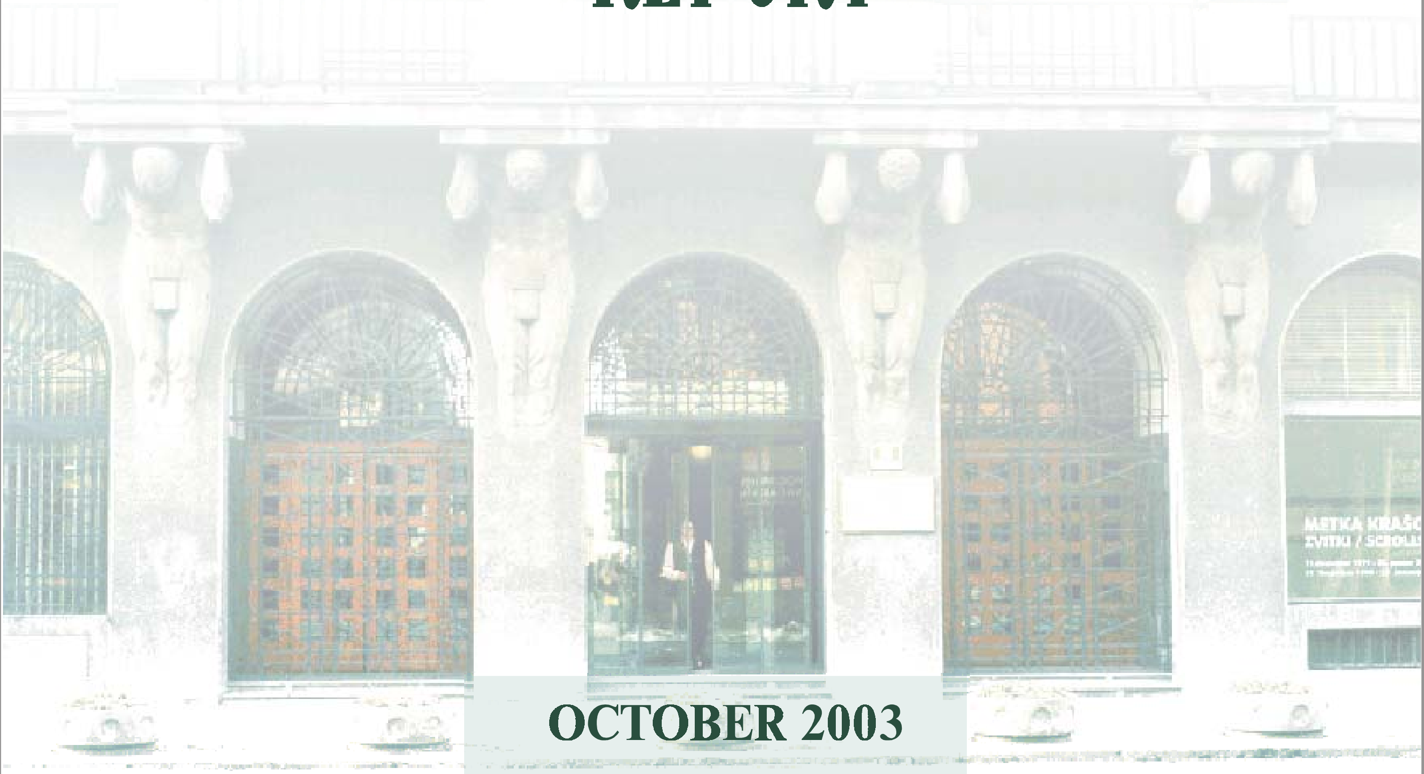
BANKA SLOVENIJE

BANK OF SLOVENIA

MONETARY POLICY IMPLEMENTATION REPORT



OCTOBER 2003

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1. INTRODUCTION AND SUMMARY[1]

Monetary policy strategy has remained unchanged in 2003. It is oriented towards bringing inflation down and is based on achieving an appropriate level of real interest rates, money supply control and a gradual stabilisation of the exchange rate while following the principle of uncovered interest parity. The conditions for monetary policy action in 2003 have been significantly better than in 2002. Given the sustained fall in inflationary expectations and with coordination of other economic policies, the Bank of Slovenia lowered nominal interest rates several times and adjusted exchange rate movements accordingly. Moderate domestic consumption and lending and declining inflationary expectations enabled the Bank of Slovenia to gradually bring down real interest rates.

This year has seen a marked fall in inflation. The average year-on-year price growth rate in the last quarter will be around 5%, which is in line with expectations and results primarily from the coordinated action of the economic policies of the Bank of Slovenia and the Slovenian Government. The gradual and sustained downward trend in inflation is forecast to continue in the coming years, with the rate falling to 3.5% at the end of 2004 and stabilising below 3% at the end of 2005.

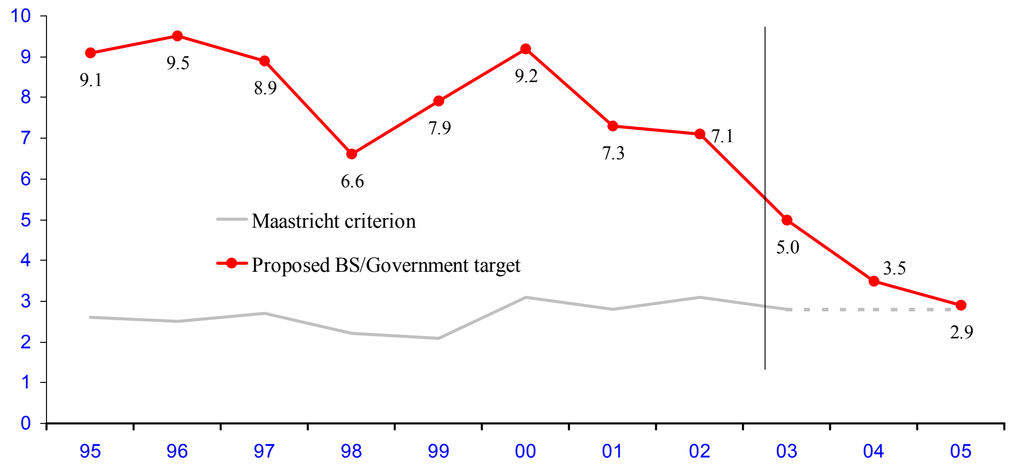
Economic growth in the next few years will remain below its long-run equilibrium rate. The main reason for the slow growth of GDP has again been the weakness in the international economy, although domestic demand is set to pick up gradually. As the global economy recovers the conditions will be created for more stable economic growth, although for Slovenia this is strongly linked to the increased risk concerning sustainability of demand from the markets of the former Yugoslavia. Nevertheless, our projections indicate that domestic consumption will again be the main engine of economic growth (albeit weak) in the coming period, while foreign trade will have a negative impact on economic activity through both weak demand from abroad and also unfavourable terms of trade. Although certain risk factors could significantly accelerate the anticipated gradual increase in domestic final

[1] In November 2001 the Governing Board of the Bank of Slovenia approved and announced a clear-cut medium-term policy orientation: to put in place the conditions for joining the European Economic and Monetary Union (EMU) at the earliest opportunity. Pursuit of this aim is the most effective way for the Bank of Slovenia to fulfil the task of achieving price stability laid down for it in the Bank of Slovenia Act. The Bank also undertook to prepare regular inflation reports as a way of reporting publicly on the implementation of its short-term monetary stance. This will contribute to greater transparency in the implementation of monetary policy. This report is part of a regular series of reports that the Bank of Slovenia publishes on inflation together with forecasts of macroeconomic trends and explanations of short-term monetary policy orientations. The next inflation report will be prepared in spring 2004.

consumption we are not anticipating substantial demand-side inflationary pressures in the future.

Preparing the conditions for adoption of the euro at the earliest opportunity remains the Bank of Slovenia's basic policy orientation. The Bank of Slovenia considers that the preparations can be put in place for early entry into ERM2, which is a prerequisite for adoption of the euro at the earliest opportunity, and that it would be appropriate to join the exchange rate mechanism by the end of 2004. When Slovenia joins the EU in May 2004 its monetary policy independence will be reduced and consequently the Bank of Slovenia sees no advantage in delaying entry to ERM2 either for monetary policy or fiscal policy. But before Slovenia joins ERM2 the conditions need to be put in place for stabilisation of the exchange rate.

Figure 1.1: Inflation target necessary for early entry to ERM2 and early adoption of the euro (percentage annual growth rate at year's end)



Source: Analysis and Research Department

Early adoption of the euro (in 2007) will require inflation being brought down to the rate set by the Maastricht criteria by mid-2005 at the latest. The Bank of Slovenia considers a suitable inflation target enabling fulfilment of the Maastricht criteria to be:

- a year-on-year rate of 3.5% at the end of 2004, as set out in previous Bank of Slovenia documents,[2] and
- from mid-2005 onwards sustaining a year-on-year inflation rate at the level of the Maastricht criterion, which is currently 2.8%,

if Slovenia wishes to adopt the euro at the start of 2007.

[2] See *Monetary Policy Implementation Report*, May 2003, p.65.

The Bank of Slovenia and the Slovenian Government have to coordinate their efforts to meet the Maastricht criteria. The Bank of Slovenia believes these targets are achievable with coordinated action by the Bank of Slovenia and the Slovenian Government. This approach will enable the Bank of Slovenia to gradually reduce interest rates in the direction of nominal convergence, which will also ensure the maintenance of suitable real interest rates and enable a gradual stabilisation of the tolar by the end of 2004. Independent monetary policy action and coordination with the policies for which the Slovenian Government is responsible will be possible until Slovenia joins the European Union and for a relatively short period thereafter. Subsequently, monetary policy independence will disappear and the focus of achieving the conditions for adoption of the euro will shift in full to policies for which the Slovenian Government is responsible. If entry to ERM2 is delayed then the risks of Slovenia remaining within the mechanism for more than two years will increase.

The conduct of economic policy has to take account of the following elements that are important both on entry to ERM2 and for achieving the conditions for adoption of the euro:

- a gradual lowering of Bank of Slovenia interest rates, thereby creating the conditions for gradual stabilisation of the tolar exchange rate by the end of 2004;
- consistency in the implementation of the administered price policy and the policy on prices under the indirect influence of the Slovenian Government;
- coordinated management of policies on excise duties and tariffs;
- active application of the solutions envisaged in the Budget Implementation Act concerning flexibility of budget spending;
- the complete elimination of wage indexation;
- coordinated action by the Ministry of Finance and the Bank of Slovenia in the procedures for selling assets to nonresidents and in management of the public debt.

These elements require not only the coordinated action of the Bank of Slovenia and the Slovenian Government but also the cooperation of the social partners.

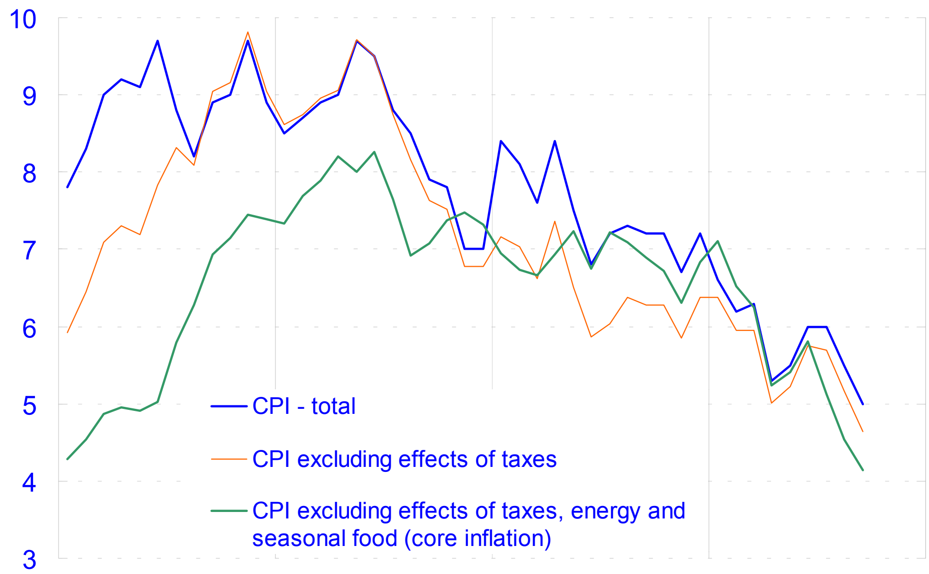
2. INFLATION TRENDS

Inflation has been falling appreciably this year at a rate which is fully in line with our expectations, and sustainable because all the basic equilibria in the economy have been largely maintained. The reduction in the rate of price growth has resulted primarily from appropriate Government policies and coordination of Government action with the Bank of Slovenia. The absence of demand-side pressures has also helped to produce favourable disinflation trends, and there have been no significant price pressures from abroad. Furthermore, several indicators point to a positive outlook for continuing inflation reduction in the coming period.

2.1 Sustainability of the reduction in inflation

Inflation has fallen appreciably this year, with year-on-year price growth dropping to the lowest level in recent years. The year-on-year growth rate of consumer prices in September was 5.0%, a fall of more than two percentage points on the end of last year, while year-on-year core inflation fell by even more, from 7.1% in January to 4.1% in September.

Figure 2.1: Overall and core inflation (percentage annual growth rate)



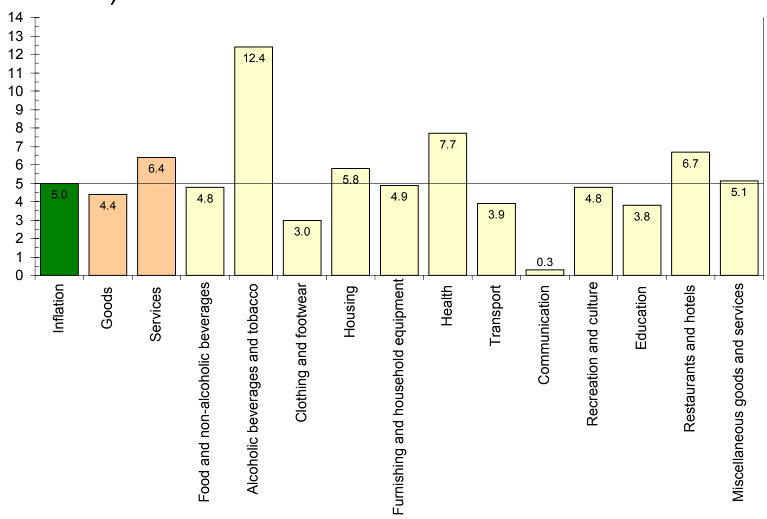
Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department

The rate of reduction of inflation is almost fully in line with our expectations. The rapid fall at the start of the year to a year-on-year rate of 5.3% in April was followed by a rise to 6.0% in June as a result of seasonal factors and the statistical presentation of year-on-year growth rates because of last year's low basis. The rate of slowdown in price growth thus declined somewhat in the second quarter. In line with expectations the rate of price growth then fell again to a year-on-year rate of 5.0% in September.

Disinflation was achieved at a sustainable level. All the basic macroeconomic equilibria were maintained, meaning that this reduction in inflation rates will not give rise to new inflationary pressures in the future. Several aspects point to the sustainability of the inflation reduction:

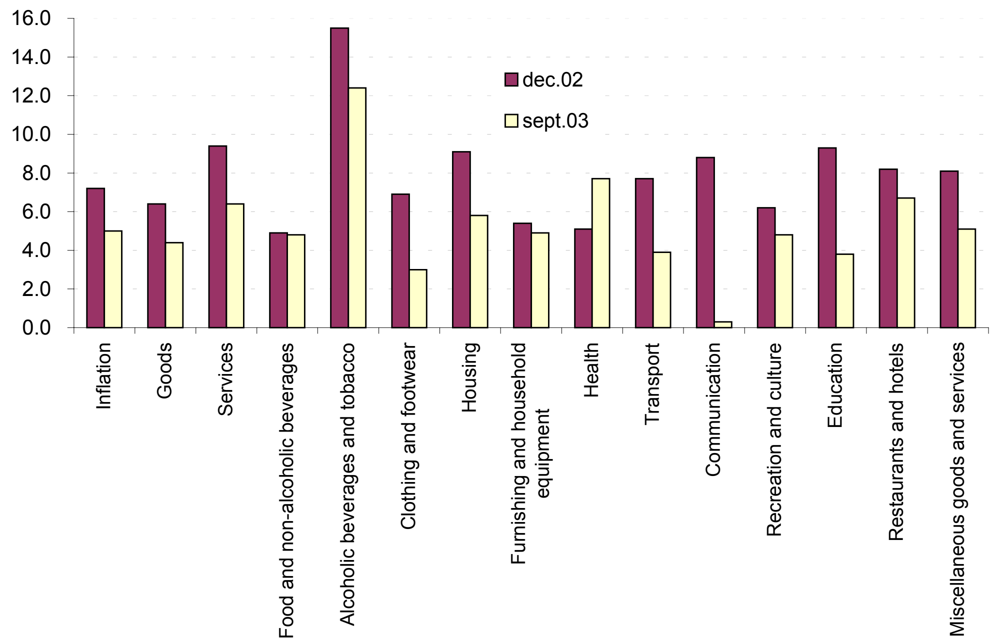
- Price growth rates have come down proportionally in most of the groups comprising the consumer price index. Exceptions are groups in which prices have risen owing to tax and administrative measures or because of unfavourable weather. Thus prices of alcoholic beverages and tobacco grew by 12.4% in the year to September, mainly reflecting excise duties being brought into line with EU requirements, while price growth in health care was 7.7%. Weather factors have had a highly unfavourable effect on the prices of seasonal food products this year. In September this year the year-on-year growth in the prices of seasonal products was 14.7%, compared with a fall of 2.8% in the year to September 2002. The unfavourable weather conditions also caused substantial pressure on the prices of fruit and vegetables, affecting the prices of both domestic and foreign producers.

Figure 2.3: Composition of consumer price growth (percentage year-on-year growth rates for September 2003)



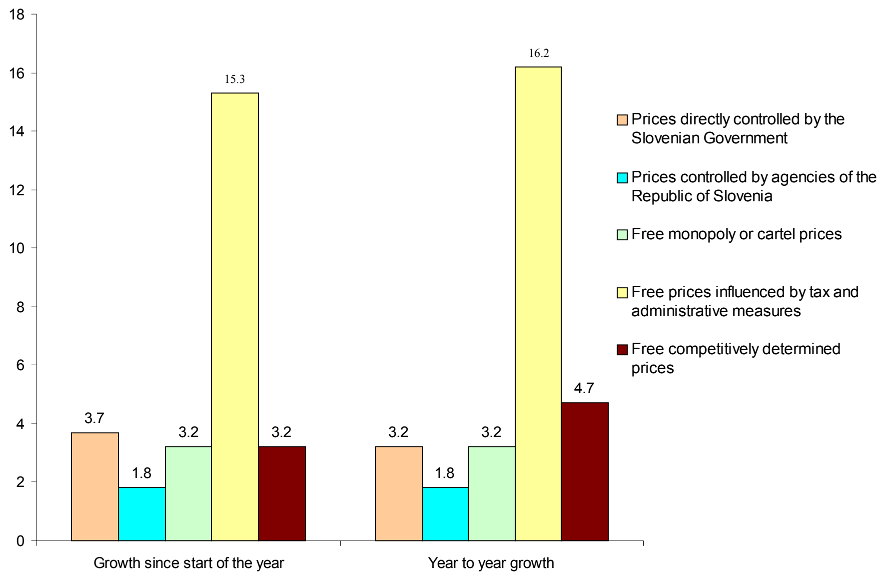
Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department

Figure 2.4: Comparison of percentage year-on-year inflation by main groups



Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department

Figure 2.5: Consumer price growth by mode of price setting (September 2003)



Note: Prices that were directly influenced by tax and administrative measures this year were excluded from the group of prices formed freely and competitively. We included the following products in this group: cigarettes, wine, non-profit rents and medicines, which account for 6% of all the products in the consumer price index. These changes have meant a corresponding reduction in the share of products whose prices are formed freely from 79% to 73%. The composition and shares of the remaining indices remained unchanged.

Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department

- Movements in **free and administered prices** were notably more even than they have been in the past. In the first nine months of the year both free prices and administered prices grew in cumulative terms by 4.0%, while the corresponding year-on-year growth figures were 5.5% and 3.5% respectively. Free prices here include the effects of higher excise duties on tobacco and increased VAT rates on wine as well as the administrative measures of raising rents and medicine prices.

- There was also a reduction in the difference between growth in **prices of goods and services**, which represent an approximation for prices in the tradable and nontradable sectors. This difference fell by three percentage points in the first nine months of the year compared to the corresponding period last year. Year-on-year growth in service prices in September was 6.4%, while goods prices rose by 4.4% year on year. While the indications are that service activities are responding to the slowdown in economic activity and moderate household consumption, the consistent implementation of the Government's administered price policy has also made a major contribution to the slower growth in service prices.

2.2 Inflation factors in 2003

Notable among the factors that have made the biggest contribution to lower inflation this year is the coordinated action of the Bank of Slovenia and the Slovenian Government. Government policies this year have been more coordinated in the fight against inflation than in previous years and have not differed significantly from the measures outlined at the beginning of the year. In addition, weak domestic consumption and the absence of inflationary signals in the international environment have helped to reduce inflationary pressures.

The Bank of Slovenia has pursued the goal of achieving a gradual and sustained reduction in inflation. Its monetary policy continues to be based on bringing nominal interest rates yinto line with inflationary expectations and closing the uncovered interest parity using both interest rates and exchange rate movements. An appropriate level of real interest rates, money supply control and gradual stabilisation of the exchange rate have helped to ensure that **again this year there have been no inflationary pressures of a monetary nature.**

A more active monetary policy has not been possible in 2003 despite the fact that the conditions for monetary policy action have been substantially better this year than in 2002. Action by the Bank of Slovenia has been constrained by the lowering of foreign interest rates and the reduction in the risk premium for Slovenia, as well as by the need to maintain a high rate of sterilisation of capital flows from last year.

More appropriate Government policies have also contributed to the reduction in the price growth rate. The Slovenian Government implemented a comprehensive price control plan designed to ensure that the average growth in administered prices in 2003 does not exceed the general inflation rate, which for 2003 is forecast at 5%. All the taxation measures were already announced last year and we took account of them in the previous projections. Nevertheless, this year there have also been a number of price rises of an administrative nature.

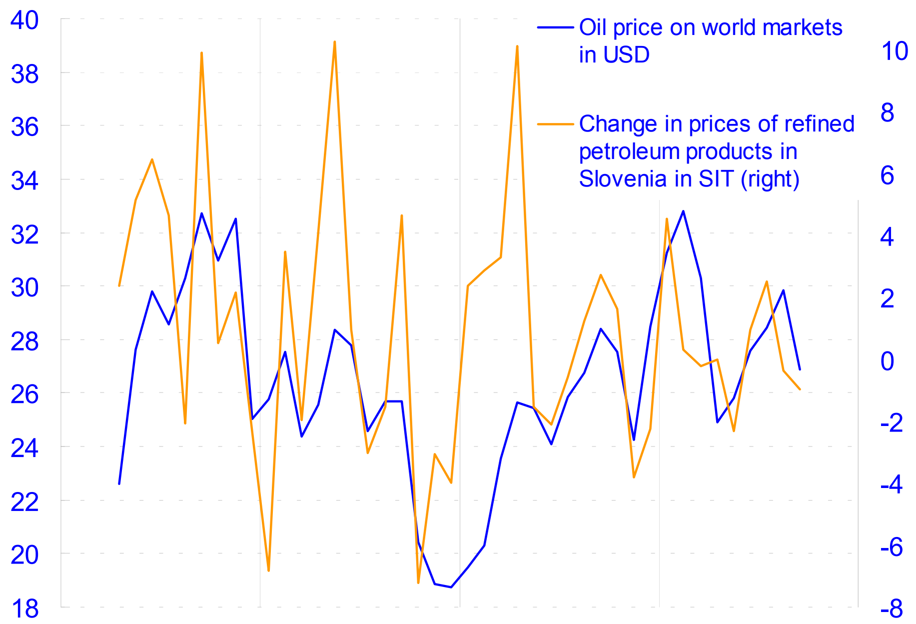
- Discretionary Government measures of a tax nature this year have contributed 0.5 percentage points to inflation, which is less than last year. Important **tax measures** this year have included increases in the excise duty on cigarettes to bring it into line with EU requirements and in the VAT rate on wine from 8.5% to 20%.
- At the same time the Government effectively adjusted **excise duties on refined petroleum products** to prevent large fluctuations in the prices of these products resulting from fluctuations in oil prices on world markets. It reduced the excise duties at the beginning of the year when oil prices rose on world markets before raising them again in the second half of the year to make up for the fall in budget revenues resulting from the lowering of excise duties in previous months.
- **Administrative measures** for which the Government is not responsible have contributed 0.3 percentage points to this year's inflation. The main administrative measures that have contributed to price growth this year have been rises in the prices of medicines, which contributed approximately 0.1 percentage points to inflation, and the rise in non-profit rents irrespective of when the rental contract was signed, which contributed around 0.2 percentage points to this year's inflation.

Inflationary pressures from the international environment were present mainly in the first half of the year but are cooling off in the second half of the year. The most important factors influencing movements in domestic prices are the price of oil on world markets and the EUR/USD exchange rate.

In the past year **oil prices** on world markets have fluctuated strongly, and despite expectations to the contrary they have persisted at relatively high levels. In the first half of the year, following the attack on Iraq, the price of oil did fall somewhat but it remained at a high level primarily on account of the United States renewing its oil stocks. In the second half of the year oil prices are slightly lower, although partly because of Opec's decision to reduce the agreed quotas they remain in the upper part of the Opec target band of between 22 and

28 US dollars per barrel. The fall in the value of the US dollar had a favourable impact on import prices via lower commodity prices and thus on movements in imported inflation.

Figure 2.6: World oil prices in USD and changes in prices of refined petroleum products in Slovenia in SIT

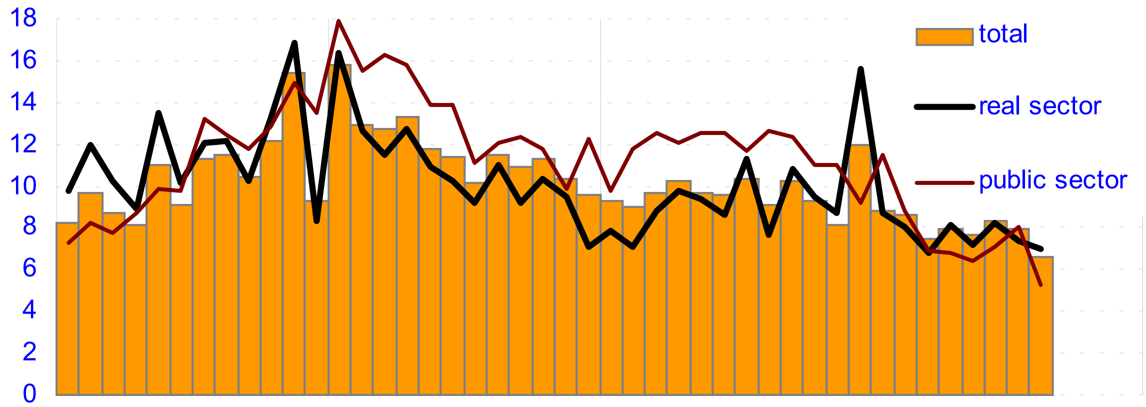


Source: Reuters, Petrol; Analysis and Research Department

Domestic demand has also not been a source of upward pressure on prices. We see the gradual recovery of domestic final consumption and, in particular, investment spending as a consequence more of the exceptionally low level of consumption in the last few years than of the start of a new consumer cycle. Moreover, the majority of domestic demand is import oriented so that the increased domestic consumption is reflected for the time being more in an increased trade deficit than in inflationary pressures. In spite of the steady fall in interest rates in the most recent period the maintenance of relatively low household consumption has been assisted by both difficult labour market conditions and also structural factors forcing households into longer-term saving. The most significant of these structural factors have been the National Housing Savings Scheme and the need for supplementary retirement saving.

The tougher economic conditions are being reflected this year on the labour market, which has been characterised by slower wage growth and employment stagnation. Labour costs have effectively adjusted to the deterioration in the economic situation. **Wages** this year have risen at a relatively slow pace, and by less than productivity growth measured in terms of value added per employee. Manufacturing enterprises have responded most flexibly in adjusting labour costs to the weaker economic situation.

Figure 2.7: Average wages (percentage nominal growth, m.a. 3)



Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department

The abolition or modification of the existing system of indexation in the public sector is a structural change in the labour market which will not yet this year have a direct impact on inflation. However, not only will this change have the effect of limiting inflationary pressures in the coming years but it will also have an important signalling effect for unions in negotiations over wages in the private sector, where an agreement has yet to be reached. On the basis of an **agreement between the social partners** a number of important changes have occurred this year in the area of wages adjustment, or indexation. As a result, basic wages in the public sector were not increased in August and instead a supplementary pension insurance premium was paid. In addition, the social partners also agreed a **new method of indexation** of basic wages, with the new formula taking account of EU inflation and the growth in the euro exchange rate as well as past domestic inflation.

2.3. Favourable outlook for a reduction in inflation

We believe the outlook for a further reduction in inflation in the next few years is good. This position is based not only on the low core inflation figure, which is down to around 4%, and movements in producer prices, which have been rising at less than 3% for almost the entire year, but also on a number of other facts:

- The achievement of sustained disinflation means the possibility of an inflation jump is very small;

- Core inflation is markedly lower than headline inflation;
- We are not anticipating major shocks from fiscal policy or administered prices;
- Joining the EU means not only increased competition but also the abolition of customs duties on certain consumer goods, including food products;
- Monetary policy will continue to focus on maintenance of suitably high real interest rates and gradual stabilisation of the exchange rate until entry to ERM2.

Figure 2.8: Consumer price growth and producer price growth (twelve-month percentage change)

Source: Analysis and Research Department

3. MONETARY POLICY IN 2003

3.1. Mechanisms and instruments for conduct of monetary and exchange rate policy

The Bank of Slovenia pursues its monetary policy within the framework of a managed floating exchange rate. This exchange rate regime allows it to pursue a relatively independent monetary policy even in conditions in which restrictions on capital flows have been relaxed. It is very important for this approach that it is able to sterilise the effects of net foreign currency inflows.

With the aim of ensuring moderate money supply growth, the Bank of Slovenia's monetary policy conduct targets two variables: the exchange rate (its rate of change) and the interest rates on its instruments. As a rule the rate of growth of the tolar/euro exchange rate should close the difference between domestic and foreign interest rates, except for that part of the difference reflecting a supplement for country risk. Only in this way is it possible to defend effectively against unwanted, particularly short-term, inflows or outflows of money.

The basic mechanism for exchange rate intervention is an agreement between the Bank of Slovenia and the commercial banks to cooperate in foreign exchange markets. Under this agreement the Bank of Slovenia can signal the exchange rate at which the banks conclude deals in particular sectors of the foreign exchange market. At the same time the banks have available a permanent option to temporarily buy or sell foreign exchange for seven days at the Bank of Slovenia.

As well as using currency swaps the Bank of Slovenia achieves the desired level of base money, or bank liquidity, through interventions in the money market. The structural position of the money market is in surplus so the use of liquidity supply instruments (such as lombard loans and seven-day temporary purchase of Bank of Slovenia bills) by the banks is insignificant compared to the use of instruments for investment of surplus liquidity (such as overnight deposit, 60-day and 270-day tolar-denominated central bank bills).

The basis for setting the interest rates on Bank of Slovenia instruments is the refinancing rate at the Bank of Slovenia. This is determined as the sum of the price of the temporary purchase of foreign currency from the banks and the ECB interest rate on its basic refinancing instrument (temporary purchase of non-risk claims from banks for 14 days). As a rule the upper and lower limits of the band within which interest rates on Bank of Slovenia instruments fluctuate are the interest rates on overnight deposits and on lombard loans.

The Bank of Slovenia's monetary policy conduct has been unchanged in 2003. It is oriented towards bringing inflation down and is based on achieving an appropriate level of real interest rates, money supply control and a gradual stabilisation of the exchange rate. In the implementation of this policy the Bank of Slovenia is restricted by considerations of uncovered interest parity.

3.2. Monetary policy context

Given the sustained fall in inflationary expectations and with coordination of other economic policies, the Bank of Slovenia lowered nominal interest rates several times and adjusted exchange rate movements accordingly. The factors enabling the Bank of Slovenia to gradually bring down real interest rates were moderate domestic consumption and lending, greater coordination of economic policies, a more stable balance of payments situation, tougher labour market conditions and declining inflationary expectations.

A more active monetary policy has not been possible in 2003 despite the fact that the conditions for monetary policy action have been substantially better this year than in 2002. Action by the Bank of Slovenia has been constrained action by the lowering of foreign interest rates and the reduction in the risk premium for Slovenia, as well as by the need to maintain a high rate of sterilisation of capital flows from last year.

The restrictiveness in the Bank of Slovenia's scope to set interest rates and exchange rate policy in 2003 has been reflected primarily in the ensuring of an appropriate level of uncovered interest parity. Falling interest rates abroad and the reduction in the risk premium for Slovenia have significantly reduced the space for monetary policy action in 2003:

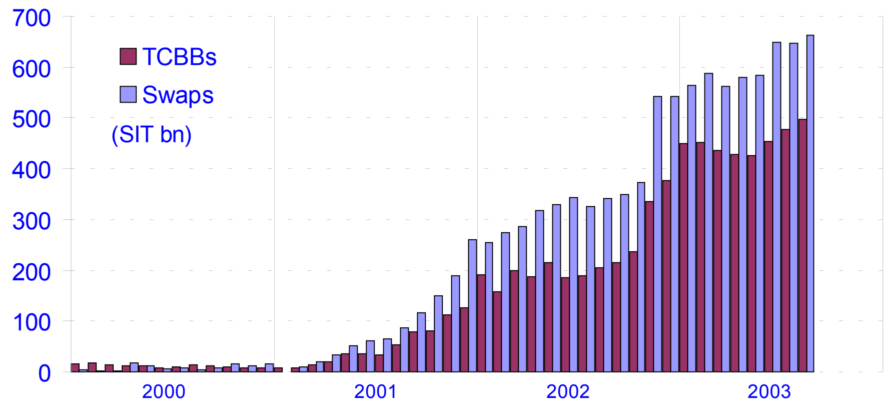
- Worsening economic conditions in some of the largest members of EMU have led to ECB interest rates being lowered twice, by a total of 0.75 percentage points, which foreign financial markets have viewed as a long-term change. The ECB first reduced its refinancing rate in March by 0.25 percentage points, and then again in June by 0.5 percentage points. Since August the rate has been set at 2.0%.
- Slovenia's risk premium is coming down as its EU integration process moves forward, and particularly with the signing of the agreement on EU entry. Consequently, Slovenia's

attractiveness as a destination for foreign financial flows is increasing. The increase in capital flows from abroad has come about not only because of Slovenia's improved credit rating as a result of signing an accession agreement but also because of foreigners' expectations of a fall in the rate of growth of the tolar/euro exchange rate, which has coincided with the Bank of Slovenia ending its intervention in the foreign money market after intervening continually for a year and a half. These two factors have contributed to a fall in the risk premium for investments by foreigners in government securities and other tolar investments.

The Bank of Slovenia has thus had to at least match, or even slightly exceed, the lowering of interest rates by the ECB in order to achieve an additional closing of the interest parity. With consumer prices growing more or less in line with expectations this has contributed to the reduction in real interest rates. The Bank of Slovenia closed part of the uncovered interest parity partly through a depreciation of the tolar against the euro. If the Bank of Slovenia had not additionally closed the interest parity the volume of interest elastic capital flows from abroad would have increased even further, at the same time as even stronger foreign currency lending in the domestic banking market, which would have made control of the money supply even more difficult.

Monetary policy conduct this year has also been restricted by the need to maintain a high rate of sterilisation of capital flows from last year, which represent a potentially large surplus liquidity. The equilibrium in the balance of payments means that the level of sterilised liquidity is absorbed only slowly, which is reflected in the high level of foreign currency temporarily sold to the Bank of Slovenia and the high level of tolar-denominated central bank bills.

Figure 3.1: Balance of swaps at the Bank of Slovenia and of central bank bills



Source: Bank of Slovenia

At the end of 2002 the balance of Bank of Slovenia sterilisation papers, i.e. tolar-denominated central bank bills, rose to 28% of the total assets of the Bank of Slovenia, and by the middle of this year it had risen by a further six percentage points to 34% of the total assets. This rapid rise in the balance of sterilisation papers was a result of financial inflows from abroad. In the second half of last year alone net financial inflows totalled 10.7% of GDP, compared with just 2.8% of GDP between January and July this year. The Bank of Slovenia was forced to sterilise over a relatively short period foreign direct investments based on the selling of equity to nonresidents, which it accomplished using currency swaps and by offering 360-day and 270-day tolar-denominated central bank bills at the end of 2002 and in the first few months of 2003.

In order to ensure a gradual and controlled redemption of sterilised assets in line with the desired rate of growth of the money supply the Bank of Slovenia had to maintain a large balance of sterilisation securities. This also increased the need for prudence in setting interest rates and in taking account of other restrictions such as the principle of uncovered interest parity.

3.3. Bank of Slovenia activities in 2003

In 2003 the Bank of Slovenia has lowered the interest rates on its instruments four times: in March, May, June and October. Since the beginning of the year the interest rate on lombard loans has come down by 2.5 percentage points and on overnight deposits by 0.5 percentage points, which has had the effect of narrowing the band of maximum possible variability in interest rates on shortest-term lending. Interest rates on 270-day tolar-denominated central bank bills were lowered by 0.25 percentage points more than on 60-day bills, which produced a reduction in the steepness of the yield curve on TCBBs similar to that which occurred in the treasury bill market.

In March the Bank of Slovenia adjusted its monetary policy in two steps. First it reduced the interest rate and then it stopped intervening in the money market. The interest rate adjustment was based on two elements:

- the closing of the interest parity because of the lowering of ECB interest rates;
- the Bank of Slovenia's forecast of a sustained reduction in inflation and favourable inflation expectations. This reduction in inflation reflected the impact of import price components on internal inflation, while reduced uncertainty over inflationary pressures caused by the conflict in Iraq was also important.

Once interest rates were established at the new level the Bank of Slovenia also stopped intervening in the foreign exchange market, thus ending 18 months of exchange rate intervention. Intervention was no longer necessary as conditions on the foreign exchange market stabilised at the beginning of the year following a period of large capital inflows from the euro cash changeover, the privatisation of NLB and the takeover of Lek and a number of other domestic companies by nonresidents. With the aim of signalling the desired rate of growth of the exchange rate the Bank of Slovenia, which closes uncovered interest parity, intervened for a short period in April.

In May the Bank of Slovenia lowered the interest rates on certain monetary policy instruments. This had three objectives:

- adjusting the structure of interest rates on monetary policy instruments to conditions in the money market, where favourable inflationary expectations were producing a gentler interest rate curve. This was made possible also by the favourable structure of tolar-denominated central bank bills, which are strongly dominated by longer-term bills;
- reducing interest rate volatility in the money market;
- further closing the uncovered interest parity. Interest among nonresidents in investing in government securities has grown strongly and interest rates on treasury bills have begun to fall as demand has increased.

In June the Bank of Slovenia brought interest rates down following the lowering of ECB rates and further closed the interest parity because of the intensity of interest elastic capital flows. The ECB rate cut was a full half a point, which was bigger than normal. The need to reduce the uncovered interest parity was reflected primarily in the large increase in investments by nonresidents in treasury bills, the rapid growth in the balance of foreign currency sold under forward contracts and the increase in the banks' tolar liabilities to nonresidents. In July and August the pressure on the uncovered interest parity abated, partly because of difficulties in Hungary and partly also because the interest rates on treasury bills had fallen to relatively low levels.

In July and August the Bank of Slovenia intervened in the money market on several occasions in order to slow down the rate of growth of the exchange rate. This time the interventions were shorter, lasting just a few days, and aimed at slowing down the rate of exchange rate growth, whereas money market interventions at the start of the year were to support exchange rate growth. From January to October this year the Bank of Slovenia intervened on a total of 106 days, which is 39% of the observed period. The bulk of this intervention was carried out at the beginning of the year in the period until 24 March, and was targeted at stabilising market conditions and absorbing liquidity from the previous year's direct investments.

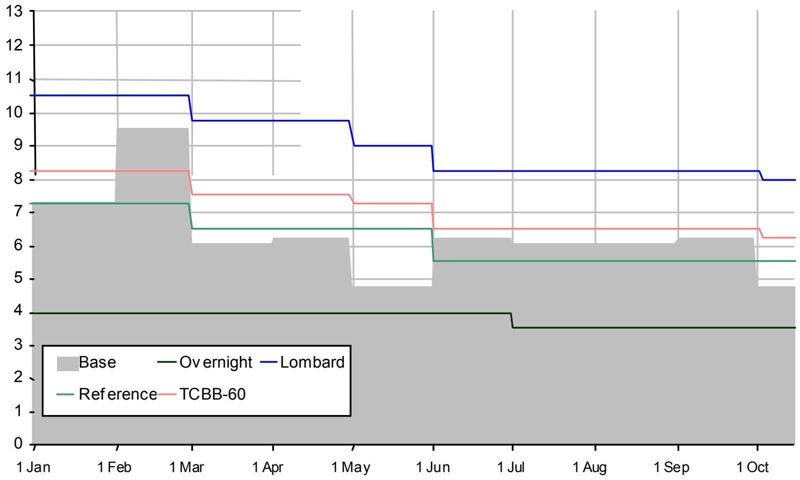
In October 2003 the Bank of Slovenia again reduced the interest rates on its instruments. This adjustment was based on the following two elements:

- the Bank of Slovenia's forecast of a further sustained reduction in inflation and favourable inflationary expectations;
- the need for a further closing of the interest parity.

By mid-October the Bank of Slovenia had reduced the interest rates four times and further closed the interest parity. The following adjustments were made to the most important interest rates:

- a reduction of two percentage points in the interest rate on 60-day tolar-denominated central bank bills;
- a reduction of one percentage point in the interest rate on temporary purchases of foreign currency;
- a reduction of 1.75 percentage points in the refinancing interest rate, which is a synthetic indicator based on the interest rate for temporary purchases of foreign currency and the refinancing rate at the ECB;
- the indicated growth of the exchange rate on the foreign exchange market was reduced by one percentage point from 3.8% at the beginning of the year to its current level of 2.8%.

Figure 3.2: Bank of Slovenia interest rates



Source: Bank of Slovenia

The lowering of nominal interest rates also led to a lowering of real interest rates, which had the effect of reducing monetary policy restrictiveness to the extent permitted by domestic macroeconomic circumstances. These circumstances included a moderate growth in private consumption, moderate demand for credit and a small deficit in the balance of payments current account in the first half of 2003. The growth in monetary aggregates and bank loans thus remained modest until the middle of the year. Nevertheless, the structure of investments of the commercial banks (securities make up a third of their total assets) has meant that the reduction in interest rates by the Bank of Slovenia has been reflected to a large extent in an indirect lowering of the banks' deposit rates and a somewhat slower reduction in tolar lending rates, but the latter will follow the former as a result of increasing price competition in the foreign currency and tolar lending market.

Monetary policy independence is declining. This year's monetary policy action, and in particular the June episode, provides a clear signal that the monetary policy situation is increasingly being formed endogenously, as the Bank of Slovenia was unable to avoid lowering interest rates.

In its efforts to regulate the money supply the Bank of Slovenia maintained a large balance of sterilisation securities in order to achieve a gradual and controlled redemption of sterilised assets. A more intensive use of "active" monetary policy instruments (repo foreign currency central bank bills, lombard loans, etc.) was therefore not possible as a large part of the supply of base money originated in the extensive temporary sale of foreign currency to the Bank of Slovenia with compulsory repurchase seven days later. Through the temporary purchase of foreign currency the Bank of Slovenia issued a net total of SIT 120.5 billion in base money in the first eight months of this year, but at the same time withdrew a net total of SIT 121.7 billion from circulation through tolar-denominated central bank bills. The net growth in base money in the eight months to August 2003 was just 4.6% (11.7% year on year).

* * *

The Bank of Slovenia conducted an appropriate monetary policy oriented towards a gradual and sustained reduction in inflation. This strategy continues to be based on bringing nominal interest rates into line with inflationary expectations and closing the uncovered interest parity using both interest rates and exchange rate movements. Again this year a suitable level of real interest rates, money supply control and a gradual stabilisation of the exchange rate have been key to **avoiding inflationary pressures of a monetary nature**.

Table 3.1: Application of the principle of uncovered interest parity in 2002 and 2003

	Change				Rate			
month	**TCBB 60 day**	**swap rate**	**signalled ER dynamic**	**ECB refinanc. rate**	**TCBB 60 day**	**swap rate**	**signalled ER dynamic**	**ECB refinanc. rate**
	Application of principle of uncovered interest parity in 2002							
January					7.5	5.0	4.0	3.25
January	0.25	0	0	0	7.75	5.0	4.0	3.25
March	0.25	0	0	0	8.0	5.0	4.0	3.25
April	0.25	-0.25	-0.25	0	8.25	4.75	3.75	3.25
May	0.5	0	0	0	8.75	4.75	3.75	3.25
December	-0.5	-0.25	-0.25	-0.5	8.25	4.5	3.5	2.75
	Application of principle of uncovered interest parity in 2003							
March	-0.8	-0.5	-0.5	-0.25	7.5	4.0	3.0	2.50
May	-0.3	0	0	0	7.25	4.0	3.0	2.50
June	-0.8	-0.5	-0.2	-0.5	6.5	3.5	2.8	2.0
October	-0.3	0	0	0	6.25	3.5	2.8	2.0

Source: Bank of Slovenia

Box 3.2.

Chronology of monetary actions by the Bank of Slovenia during 2003

13 January 2003

- The Bank of Slovenia passes a decision to stop selling 360-day TCBBs.

29 January 2003

- The offer of temporary purchase of central bank bills in foreign currency with compulsory repurchase after two months is temporarily withdrawn.

12 March 2003

- The Bank of Slovenia lowers the rate of growth of the intervention rate from 3.5% to 3.0%. The interest rate on refinancing at the Bank of Slovenia is lowered from 7.25% to 6.75% and the interest rate on placements with the Bank of Slovenia from 5.25% to 5.00%. The price of temporary purchase of foreign exchange from banks is also reduced from 4.5% to 4.0% and the price of temporary sale of foreign exchange from 2.5% to 2.0%. The Bank of Slovenia also lowers the interest rate on 60-day TCBBs from 8.25% to 7.50%, on 270-day TCBBs from 9.5% to 8.75%, on 7-day repo foreign currency central bank bills to 8.25% and the lombard rate to 9.75%.

25 March 2003

- The Bank of Slovenia ends its intervention in the foreign currency market through the setting of the rate of growth of the intervention exchange rate.

3 – 7 April 2003

- Reacting to interest parity considerations, the Bank of Slovenia intervenes in the foreign currency market by setting the rate of growth of the intervention exchange rate.

14 May 2003

- The Bank of Slovenia lowers both the deposit rates and lending rates on its instruments. On the deposit side the interest rate on 60-day tolar-denominated central bank bills is cut from 7.50% to 7.25%, and on 270-day tolar-denominated central bank bills from 8.75% to 8.25%. On the lending side the interest rate for temporary purchase of central bank bills in foreign currency is cut from 8.25% to 8.0% and on lombard loans from 9.75% to 9.0%.

11 June 2003

- The Bank of Slovenia again lowers both the lending and deposit rates on its instruments. The interest rate on lombard loans is cut from 9.0% to 8.25%, and for temporary purchase of central bank bills in foreign currency from 8.0% to 7.25%. The interest rate on 60-day TCBBs is also cut from 7.25% to 6.50% and on 270-day TCBBs from 8.25% to 7.50%. The Bank of Slovenia also lowers the interest rate on temporary purchase of foreign currency from 4.00% to 3.50%, reducing the gap between domestic and foreign interest rates by 0.25 percentage points.

30 June 2003

- The Governing Board of the Bank of Slovenia amends its resolution on the minimum liquidity levels for commercial banks, the purpose of which is to allow the banks more effectively to use domestic foreign currency sources for lending to businesses.

1 July 2003

- The Bank of Slovenia cuts the interest rate on overnight deposits with the central bank from 4.0% to 3.5%.

9 – 23 July 2003

- The Bank of Slovenia intervenes in the foreign currency market by reducing the rate of growth of the intervention exchange rate.

26 – 28 August 2003

- By intervening in the foreign exchange market the Bank of Slovenia lowers the exchange rate but leaves the rate of growth of the intervention exchange rate unchanged.

2 October 2003

- The Bank of Slovenia lowers the interest rate on 60-day TCBBs from 6.50% to 6.25% and on 270-day TCBBs from 7.50% to 7.25%, for temporary purchase of central bank bills in foreign currency from 7.25% to 7.0% and for lombard loans to from 8.25% to 8.0%.

4. ECONOMIC PROJECTIONS TO THE END OF 2005[3]

Economic growth this year and in the next few years will be relatively low. In 2003 GDP will grow by around 2.5%, and with slow growth in the global economy and domestic demand picking up only gradually, GDP growth too will rise only gradually until 2005. We anticipate a continuation of the gradual decline in inflationary pressures. The forecast rate of price growth at the end of this year is around 5%, 3.5% at the end of 2004 and at the end of 2005 close to 3%.

The first section of the forecasts presents the anticipated trends in selected variables from the international environment. This is followed by an account of the projections of economic activity, employment and wages. The third section shows the trend in domestic demand broken down by expenditure components. The external balance and conditions of financing are analysed in sections four and five. The final section presents forecast price movements. A summary of the forecasts and a comparison with the May estimates are presented in Table 4.8 at the end of the section.

4.1 International environment

The signals coming from the international environment are relatively unfavourable in terms of the slow growth in the global economy but favourable as far as inflationary pressures from abroad are concerned. Uncertainty persists in the international environment but to a lesser degree than at the time the previous projections were compiled. A certain degree of optimism prevails in the international environment, but it differs from region to region. A relatively pessimistic mood is particularly evident in the EU countries, the most important market for Slovenian exporters. The slow growth in the global economy means we are not anticipating significant demand-side price pressures from

[3] The forecasts were made on the basis of data available as of 5 September 2003 and the statistical methodologies then in force. The projections of macroeconomic factors contained in this section rest on assumptions about the movement of international economic variables and on certain domestic factors that are linked to economic policy decisions. Factors that can be influenced by domestic macroeconomic policy are determined separately from the forecasting exercise and are thus liable to vary from past or expected economic trends. The forecasts should therefore be treated as a scenario that may change depending on the outturn of these exogenous influences from the international environment or as a result of changes in domestic economic policy. Domestic factors that are influenced by economic policy and exogenously included in the forecasting exercise include the exchange rate of the domestic currency, government spending and investment, public sector wages, administered price inflation and other variables of a fiscal nature. The forecasts are therefore drawn up on the assumption of monetary and exchange rate policy unchanged from that set out in previous documents on monetary policy orientations.

abroad. Forecasts also point to declining price trends for oil and commodities, despite the fact that commodity prices will grow significantly faster this year than we anticipated. Some of the factors that could delay a fall in oil prices (political conditions in the major oil producers, supplies of oil) or that are not yet fully reflected in commodity prices (weather conditions and food prices) represent the most important risk factor that could cause significant inflationary pressures from abroad.

Table 4.1: Exogenous variables in the international environment and comparison with earlier forecasts

				2003			2004			2005		
	2000	2001	2002	May 03	Oct 03	chg.	May 03	Oct 03	chg.	May 03	Oct 03	chg.
Foreign demand	9.8	4.5	2.7	6.1	4.0	-2.1	7.6	6.0	-1.6	…	6.0	…
USD/EUR	0.924	0.895	0.944	1.050	1.100	0.050	1.060	1.100	0.040	…	1.100	…
Oil price USD/barrel	28.5	24.4	25.0	29.0	28.5	-0.5	25.0	27.0	2.0	…	27.0	…
Commodities	3.2	-6.5	4.6	4.5	8.0	3.5	3.0	3.0	0.0	…	3.0	…
Inflation in EMU	2.3	2.6	2.2	1.7	2.0	0.3	1.6	2.0	0.4	…	2.0	…
PPI Germany	3.3	1.3	-0.3	0.8	1.3	0.5	1.2	0.6	-0.6	…	0.6	…
EURIBOR 3m	4.4	4.3	3.3	2.4	2.4	0.0	2.7	2.4	-0.3	…	3.0	…

Note: Foreign institutions have not yet published their 2005 forecasts for most of the variables presented in the table. Therefore for these variables we have assumed the same values as for 2004.

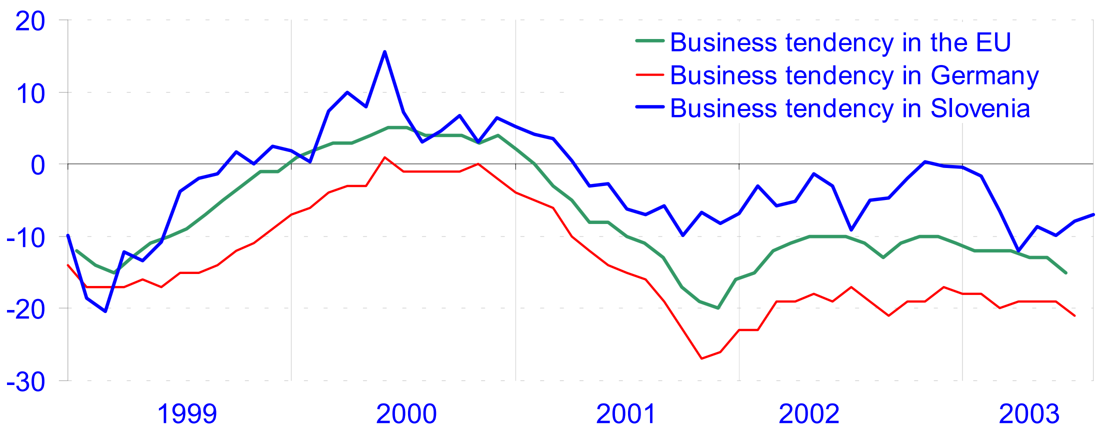
Source: Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, Analysis and Research Department

Demand in Slovenia's main trading partners will pick up only slowly this year and a more marked recovery is not expected until 2004. The appreciably lower forecast of foreign demand this year and next year is a consequence primarily of the slow growth in the European Union countries and somewhat subdued demand in the countries of Eastern and South-Eastern Europe.

The rise in the value of the euro and growth in real household incomes are expected to provide the main contribution to gradual growth in the EU countries. These two factors are expected to boost domestic consumption. Furthermore, increased export demand, triggered by relatively rapid growth in both final consumption and investment spending in the United States, should also contribute to higher growth. Despite this, growth in Western Europe is not yet as visible as in the United States and Asia – some EU countries even recorded negative GDP growth in the first half of 2003 – and the results of surveys on the economic climate also still paint a relatively gloomy picture. The main obstacle to the process of increasing economic growth in the EU at the moment is the constraint on government spending in order to fulfil the provisions of the Stability and Growth Pact. And the countries coming under the strongest pressure to restrict budget spending are the biggest countries (Germany, France, Italy), where economic activity levels are among the lowest in the EMU countries.

Risks connected with the countries of the former Yugoslavia are increasing. Croatia is facing large current account and budget deficits, while the other countries of the former Yugoslavia are experiencing increasing difficulties in financing relatively high levels of consumption. Meanwhile the Russian market, helped by high oil prices, remains relatively stable. Consequently, we believe that demand in the countries of Eastern and South-Eastern Europe will slow somewhat compared with the last few years, but it should remain at a relatively high level.

Figure 4.1: Business tendency abroad and in Slovenia

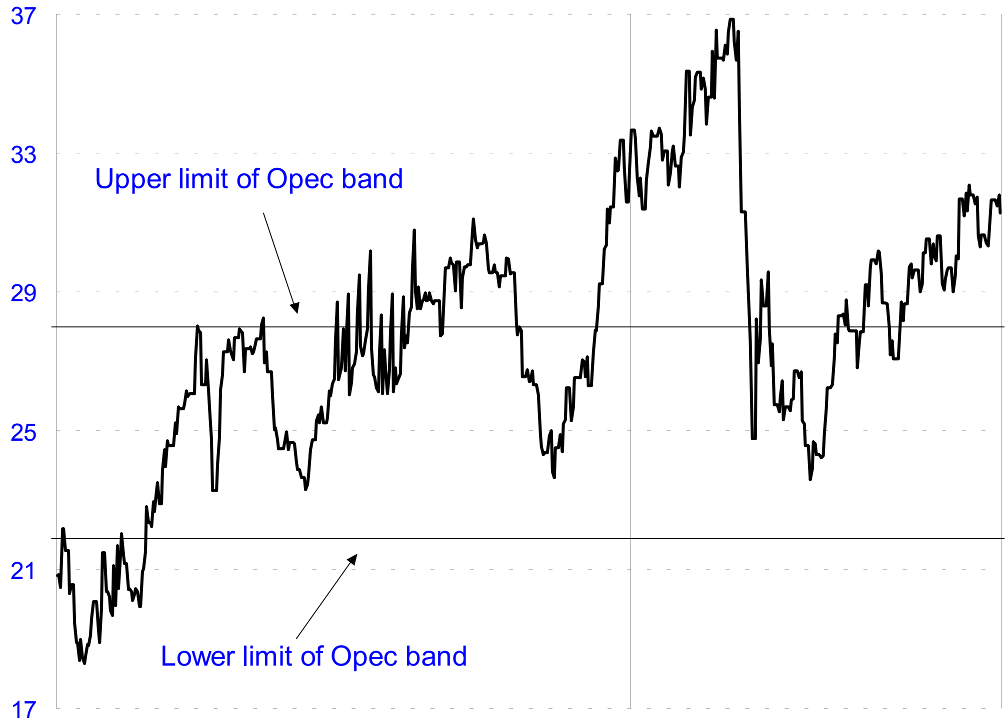


Source: Statistical Office of the Republic of Slovenia, Analysis and Research Department (seasonally adjusted for Slovenia)

The euro has strengthened appreciably this year but expectations about future movements in the EUR/USD rate remain relatively uncertain. In the first eight months of 2003 the euro gained almost 18% more against the dollar than in the corresponding period in 2002. Major geopolitical tensions and related uncertainties meant that at the start of the year investors were unwilling to finance deep imbalances in the United States. However, improved prospects for economic growth in the US compared with the eurozone saw the dollar pick up in value in the second half of August. Because of the uncertainty over future exchange rate movements we used the technical assumption that exchange rates will remain unchanged from the average of the last month (August) before the forecast was drawn up until the end of the forecast period.

This year neither the pessimistic nor the optimistic scenario for oil price movements as a result of the war in Iraq have been fully realised. Even after the official end of hostilities and an initial fall from highs of over USD 35 a barrel, the oil price remains at a high level within the Opec band. The persistence of high prices reflects primarily the low levels of oil reserves and the slower increase in Iraqi oil production than analysts had anticipated prior to the start of the war. With the upturn in global economic activity the oil price in 2004 and 2005 will be around USD 27 per barrel, which is in the upper part of the Opec band and is in line with the most recent reduction in production quotas.

Figure 4.2: Changes in oil prices (Brent oil, USD/barrel)



Source: Reuters

The growth in commodity prices will remain at a relatively high level. Commodity prices have been rising quite fast this year, continuing on from the end of last year, but the rate of growth has fallen. The rapid growth at the end of last year resulted from political circumstances and weather conditions in the producer countries. Last year's poor weather conditions have not yet fully shown up in commodity prices, particularly food prices, and therefore we expect commodity price growth to remain high.

Inflation in the eurozone will be close to the ECB target value of 2%. The two main reasons for the relatively low price growth in EMU are a) forecasts that economic growth will be slow to recover, and b) the higher value of the euro compared to last year in combination with a decline in the prices of energy sources. The ECB published its latest inflation forecasts in June (1.8%-2.2% in 2003 and 0.7%-1.9% in 2004). The December 2002 forecasts have been revised downwards slightly, mostly on account of lower oil prices and the rise in the value of the euro. At the same time, however, foreign institutions have raised slightly their German producer price forecasts for 2003. Foreign producer prices in the first half of the year were rising faster mainly on account of high prices of energy sources.

Euro interest rates have been very low this year. At the start of the second half of the year interest rates were reduced to a relatively low level. On account of slightly higher than expected inflation in the eurozone the assumption regarding interest rates in 2003 remains unchanged. We expect average interest rates in 2004 to remain at the same level as in the second half of 2003. We also expect foreign interest rates in 2005 to rise slightly on account of faster economic growth and increased inflationary pressures.

4.2 Activity, employment and wages

Domestic economic activity will be relatively low over the whole forecast period. We have revised downwards our domestic economic growth forecasts for this year and next year mostly on account of expectations of smaller foreign demand. In 2003 domestic economic activity will grow somewhat more slowly than last year, rising by just 2.5%. Reflecting the gradual increase in foreign demand, the recovery in domestic activity will also be a gradual process, rising by 3.3% in 2004. Thus the economy will continue to grow, although at a slower rate than in the past decade, but still approximately two percentage points higher in Slovenia than in the EU.

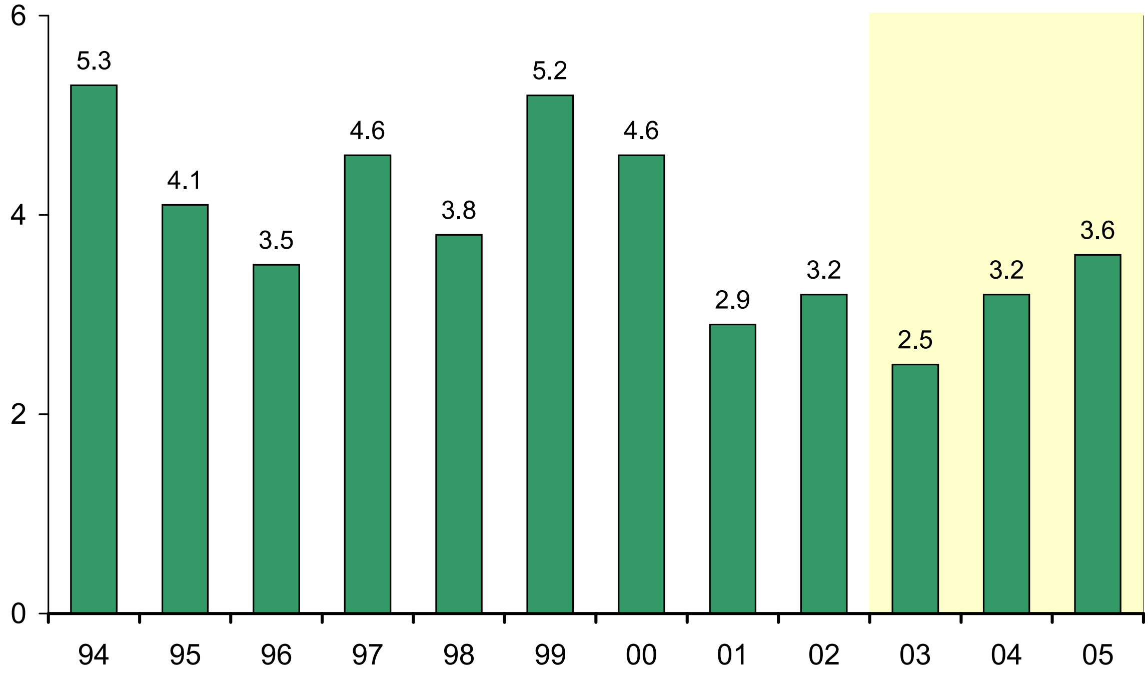
Table 4.2: Economic activity, employment and wages

				Forecast			2003			2004			2005		
							Forecasts			Forecasts			Forecasts		
	2000	2001	2002	2003	2004	2005	previous	new	chg.	previous	new	chg.	previous	new	chg.
	annual percentage changes in real terms unless indicated														
Real GDP	4.6	2.9	3.2	2.5	3.2	3.6	3.0	2.5	-0.5	3.9	3.2	-0.7	...	3.6	...
GDP per capita (USD)	9,438	9,666	10,901	13,428	14,041	14,954	12,348	13,428	1,080	13,365	14,041	676	...	14,954	...
Employment	1.1	1.0	0.4	-0.4	0.1	0.1	0.3	-0.4	-0.7	0.5	0.1	-0.4	...	0.1	...
Net w ages	1.4	3.1	2.1	2.2	2.3	2.3	2.2	2.2	0.0	2.4	2.3	-0.1	...	2.3	...
Productivity	3.5	2.0	2.8	2.9	3.1	3.4	2.7	2.9	0.2	3.4	3.1	-0.3	...	3.4	...

Source: Analysis and Research Department

We anticipate tougher labour market conditions this year and for the next two years. This will show up primarily in slower employment growth resulting from the rather uncertain economic conditions and the delayed impact of unfavourable conditions abroad on the domestic economy. Employment growth this year has been very low and has improved only slightly since the end of 2002. Although the results of surveys of expectations of future employment opportunities are relatively optimistic the figures have yet to confirm this optimism. Therefore in our employment growth forecasts this time we are somewhat more pessimistic, in line with the slow rate of growth of the economy. This is the case for both the private sector and the public sector, where such movements are in line with the Government's planned restrictive measures concerning public sector employment.

Figure 4.3: Economic activity (real annual percentage growth of GDP)



Source: Analysis and Research Department

We anticipate quite modest wage growth over the next few years. Real wage growth will be a little over 2%, while the nominal growth rate will fall from an average of 7.9% in 2003 to around 5.6% in 2005. This will mean wages growing more slowly than anticipated productivity growth. The biggest contribution to subdued wage growth will come from the economic downturn and two agreements with the public sector unions, one of which was for a payment to be made into the pension insurance fund in August 2003 in place of a wage increase and the other, concerning future wage increases, removes some of the rigidity in the previous indexation system. By taking this approach the social partners are allowing the restrictive incomes policy to continue, which is particularly important given the anticipated reduction in monetary policy independence as a result of Slovenia’s participation in European economic integration.

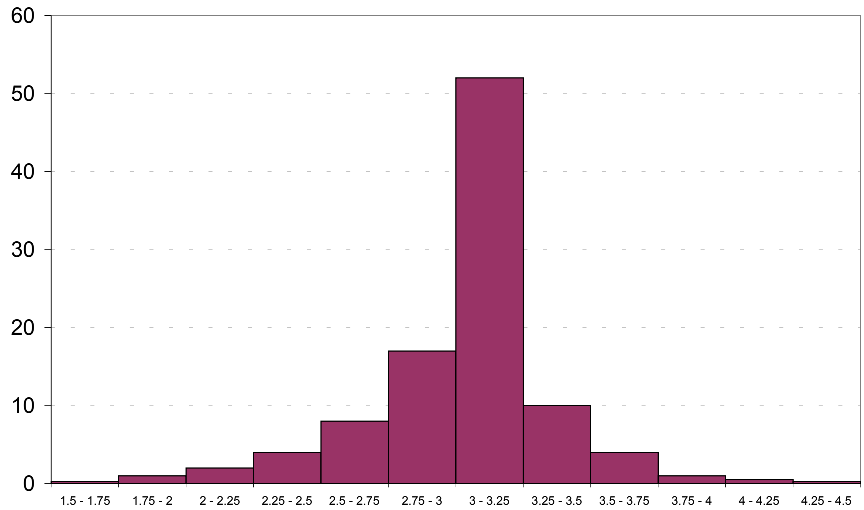
Box 4.1 Risk factors in the forecasts

We estimate that with the given assumptions and risks the probability of GDP growth in 2004 being between 3% and 3.25% is greater than 50%, while the probability of economic activity growing at between 2.75% and 3.25% is almost 70%. The most important risk factors that could cause economic growth to deviate appreciably from these forecasts are:

- A delay in demand picking up in Slovenia's most important trading partners, which would put back the revitalisation of the Slovenian economy on account of slower export growth and consequently an incomplete investment cycle;
- Interest rate movements and the inclusion of interest income in income tax calculations, and the related possibility of a substantial increase in domestic consumption in combination with a freeing up of part of the National Housing Saving Scheme funds;
- Incomes policy, particularly in the public sector, deviating from the planned restrictiveness in the year before and after parliamentary elections and enabling excessive household consumption;
- Excessive household consumption before EU entry resulting from the end of tax benefits (tax rebate) and after EU entry as a result of the abolition of administrative procedures at the border;
- Fiscal policy action in potentially poorer economic conditions restricting investment spending or increasing taxation;
- Unfavourable movements in oil and commodity prices affecting import prices and reducing the competitiveness of the domestic economy;
- An inability to cofinance projects and hence make use of transfers from the EU, which would worsen the current account balance and limit the potential growth of the Slovenian economy.

According to our estimates the risks outlined above point to an increased probability of the actual growth in GDP in 2004 being somewhat lower than the base case value of 3.2%, primarily because of the possibility of a delay in the recovery of foreign demand and the possibility that most of the excessive consumption will be import oriented.

Figure: Risk distribution of GDP forecast in 2004 (% probability)



4.3 Components of GDP expenditure

Domestic consumption will become the main generator of economic growth in the coming years. With the drop-off in demand from abroad, domestic demand has been the main impetus for economic growth since the second half of 2002. The contributions of household consumption and investment spending have been approximately equal, although investment spending growth rates in the most recent period have been relatively high. We anticipate a similar growth in the components of domestic demand continuing over the next few years, but at a somewhat slower tempo and hence not leading to significant inflationary pressures. Foreign trade will make a negative contribution to economic growth in the next few years but with the expected economic recovery in the trading partners the negative effect will gradually diminish. The biggest revisions compared to the most recent forecast in May have been to the levels of investment expenditure and general government expenditure.[4]

Table 4.3: Components of demand

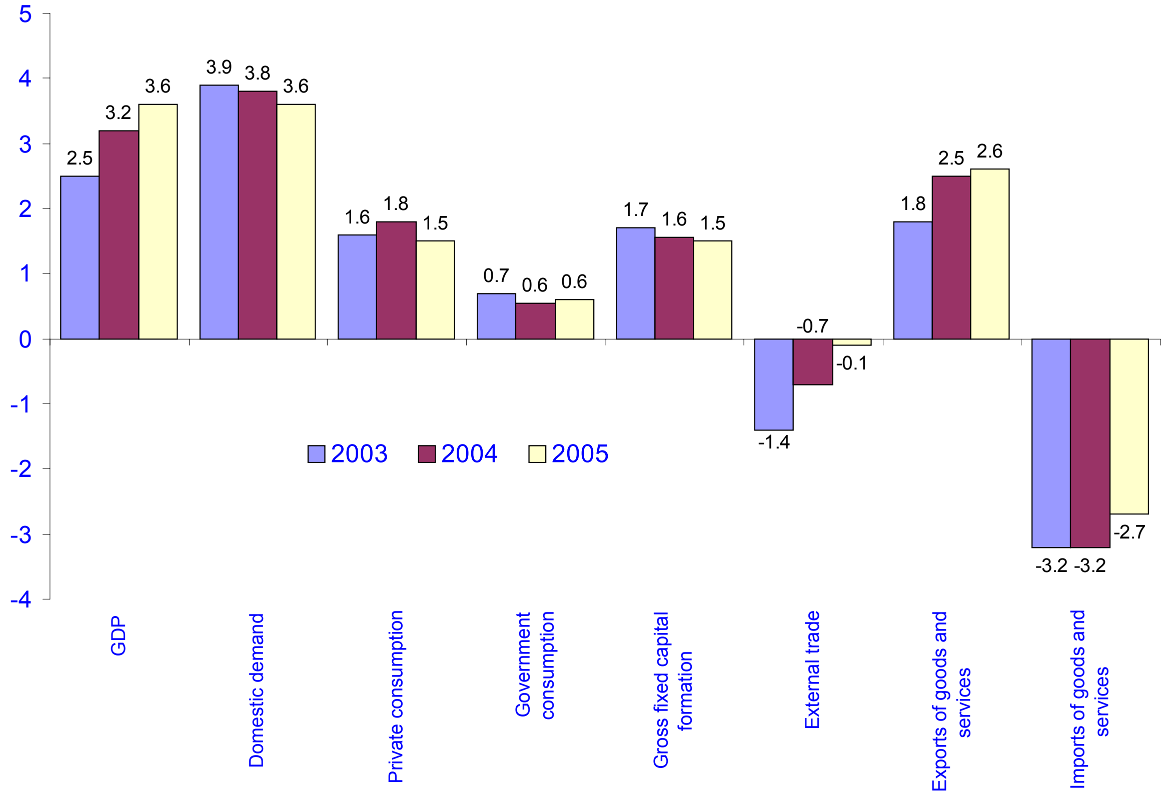
				Forecast			2003			2004			2005		
							Forecasts			Forecasts			Forecasts		
	2000	2001	2002	2003	2004	2005	previous	new	change	previous	new	change	previous	new	change
	real annual percentage change														
Gross domestic product	4.2	2.9	3.2	2.5	3.2	3.6	3.0	2.5	-0.5	3.9	3.2	-0.7	…	3.6	...
Domestic demand	0.6	1.0	2.5	3.9	3.8	3.6	3.2	3.9	0.7	4.2	3.8	-0.4	…	3.6	...
Household consumption	0.8	2.6	2.0	2.9	3.1	2.9	2.8	2.9	0.1	3.3	3.1	-0.2	…	2.9	...
Government consumption	3.1	4.0	2.7	3.3	2.8	2.7	1.9	3.3	1.4	2.3	2.8	0.5	…	2.7	...
Gross fixed capital formation	-1.5	-4.6	3.7	6.8	6.1	5.7	5.2	6.8	1.6	7.4	6.1	-1.3	…	5.7	...
Exports of goods and services	12.7	6.4	6.1	3.0	4.1	4.2	6.4	3.0	-3.4	6.0	4.1	-1.9	…	4.2	...
Imports of goods and services	6.1	3.0	4.8	5.3	5.1	4.2	6.6	5.3	-1.3	6.5	5.1	-1.4	…	4.2	...

Source: Analysis and Research Department

In the coming period the relatively high level of government investment will be accompanied by increased private sector investment. We expect general government investment to continue to dominate investment spending, particularly in 2003. But private sector investment will also be given impetus in the next few years primarily from the favourable conditions of financing, the indirect impact of government investments in infrastructure, a partial freeing up of National Housing Saving Scheme funds and a gradual upturn in the investment cycle. Increased demand from abroad, requiring companies to build additional production capacities, will also contribute to an upturn in the investment cycle. Furthermore, low interest rates at home and abroad will also contribute to more favourable conditions for financing investment expenditure. In the next few years the contribution of general government expenditure to economic growth, despite real growth close to 3%, will be somewhat lower than in the last few years.

[4] The upward revision of general government expenditure results primarily from the revised assumption about public sector wage growth. Strong growth in general government expenditure in the first half of 2003 (3.5%) also mostly reflects the low deflator, i.e. both the low growth in consumer goods prices and also the low public sector wage growth. In the first half of 2003 the general government expenditure deflator grew by 5.6% year on year, compared with 9.3% in the first half of 2002. Our projections also determine movements in the deflator for general government expenditure based on weighted movements in consumer goods prices and public sector wages.

Figure 4.4: Contribution of individual components of expenditure to GDP growth in the period 2003 - 2005 (percentage points)



Source: Analysis and Research Department

We are anticipating increased household consumption in the next few years. Growth rates of household consumption were rising in the first half of 2003 but although we anticipate a further rise in consumption we expect the rate of growth to drop slightly in the future. Thus given the assumptions about the effects of economic policy we do not consider the relatively modest growth in private consumption in the next few years to represent a significant threat of a demand explosion. Strong growth in household consumption is unlikely for the following reasons:

- low wage growth;
- uncertain economic conditions abroad, which are transmitted to the domestic economy and the labour market, where we are anticipating worse conditions than those set out in the previous forecasts;
- the need for long-term saving because of structural changes (supplementary pension savings, National Housing Saving Scheme).

Nevertheless, specifically in the area of household consumption, institutional changes and expected changes in the effects of economic policy mean that certain risks exist which could cause a significant acceleration of household consumption in the future:

- the lowering of interest rates as a consequence of nominal convergence with the EU countries, which will make yields on bank deposits less attractive, could cause savings to be diverted into increased household consumption;
- the expected inclusion of interest income in income tax calculations;
- expectations of an upturn in the durables cycle, which last peaked in 1999 and in the past was mostly triggered by income and fiscal policy factors;[5]
- the freeing up of the first tranche of funds from the National Housing Saving Scheme will mean an increase in households' disposable income.

4.4 Balance of payments

The current account balance will deteriorate in the next few years. We have strongly revised downwards our projections of the current account balance for 2003 and 2004 compared with the previous forecasts. The projections also point to the possibility of a further deterioration of the current account balance in 2005. This year the terms of trade have had a negative effect on movements in the current account and have not therefore been the factor contributing most to the maintenance of a surplus as we assumed in May. Slow growth in foreign demand has also contributed to our projection of the current account deficit, and import-oriented domestic demand is rising in line with the earlier projections.

Table 4.4: Balance of payments current account

				Forecast			2003			2004			2005		
							Forecast			Forecast			Forecast		
	2000	2001	2002	2003	2004	2005	previous	new	chg.	previous	new	chg.	previous	new	chg.
Exp. goods and services	12.7	6.4	6.1	3.0	4.1	4.2	6.4	3.0	-3.4	6.0	4.1	-1.9	...	4.2	...
Imp. goods and services	6.1	3.0	4.8	5.3	5.1	4.2	6.6	5.3	-1.3	6.5	5.1	-1.4	...	4.2	...
Current account: USD m	-548	31	375	-67	-204	-294	595	-67	-662	760	-204	-964	...	-294	...
as % of GDP	-3.0	0.2	1.8	-0.3	-0.7	-1.0	2.4	-0.3	-2.7	2.8	-0.7	-3.5	...	-1.0	...
Terms of trade	-5.2	0.9	1.9	-0.7	0.3	0.1	1.5	-0.7	-2.2	1.3	0.3	-1.0	...	0.1	...

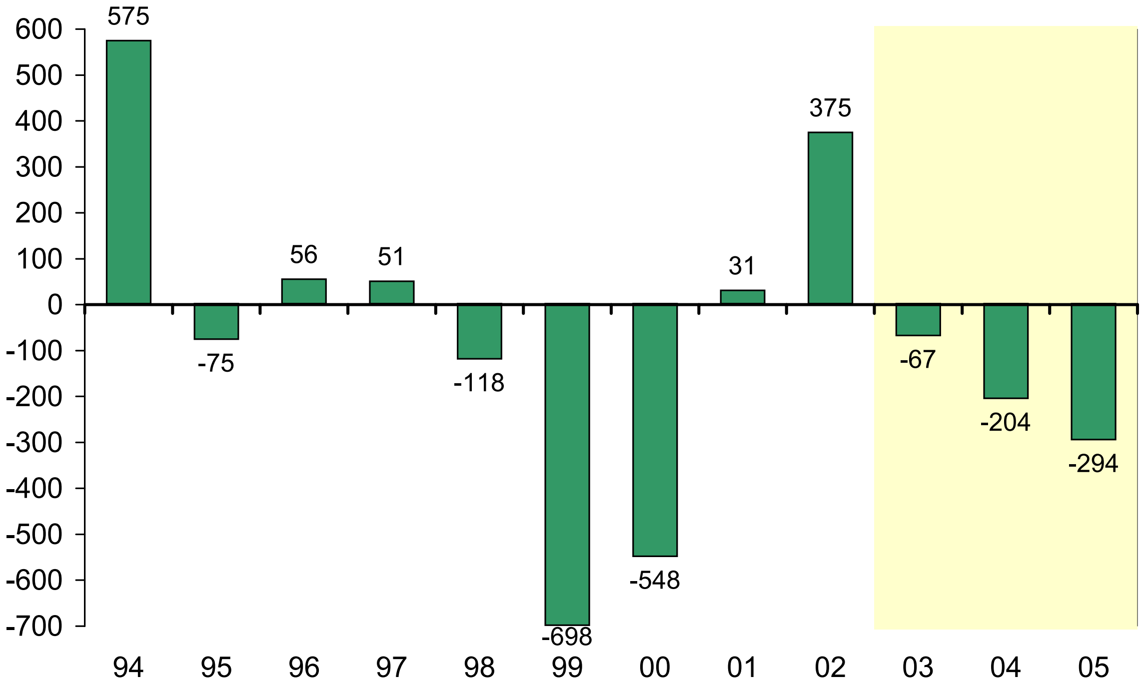
Source: Analysis and Research Department

We estimate that the USD 375 m surplus in current account transactions in 2002 will be turned around into a deficit of around USD 70 m in 2003. As a proportion of GDP this will mean a surplus in current transactions of 1.8% in 2002 being converted into a deficit of

[5] See Box 4.1 in the *Monetary Policy Implementation Report*, May 2003.

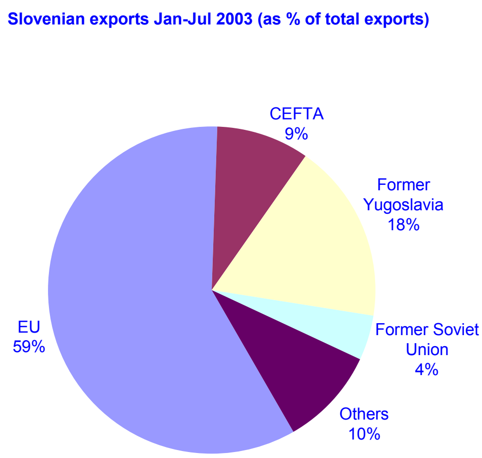
0.3% this year. In 2004 the deficit will increase to approximately USD 210 m, which corresponds to 0.7% of GDP, and then widen to USD 290 m, or 1.0% of GDP, in 2005.

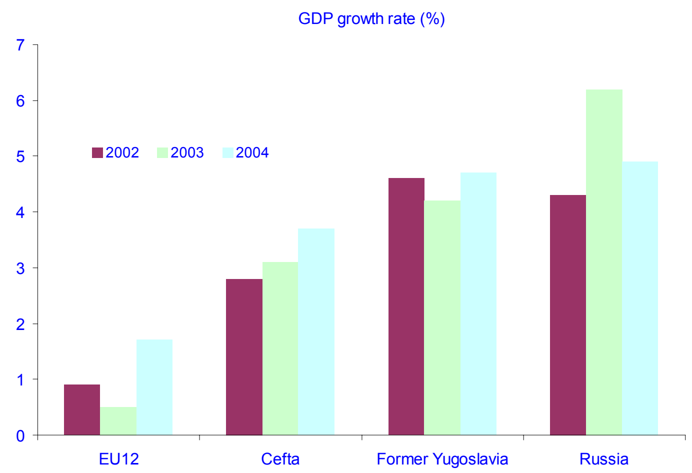
Figure 4.7: Balance of payments current account (USD m)



Source: Analysis and Research Department

Export volumes will continue to be very modest. Real export volumes will grow by 1.6% in 2003, which is almost five percentage points lower than originally forecast in May, and in 2004 by 4.2%, some two percentage points lower than the May forecast. In 2005 the growth in export volumes will recover to around 6% with a full recovery in demand in Slovenia's trading partners. The main reason for the degree of pessimism in these forecasts of export volume growth in 2003 and 2004 is the very weak growth in the global economy. Import demand in the EU partners, to which Slovenia exports by far the biggest proportion of its total exports, will only slowly pick up in 2003. In the coming years above-average growth in visible trade with the countries of CEFTA, the former Yugoslavia and the former Soviet Union will continue, although at an appreciably slower rate than in the past few years. A significant degree of uncertainty persists concerning both a





further downward revision of economic growth forecasts in the EU countries, particularly France, Italy and Germany, and question marks over the sustainability of demand in the CEFTA countries and the countries of the former Yugoslavia. All these countries are facing budget deficits, while the countries of CEFTA and the former Yugoslavia are also having difficulties financing large current account deficits.

Despite a gradual increase in domestic demand goods imports will be slow to pick up. In 2003 and 2004 real growth in imports of goods will be very similar at a little over 4%. The rate of growth of import volumes will slow primarily on account of the slower growth in imports of intermediate goods in line with the slow growth in GDP and subdued growth in export volumes. Imports of capital goods will increase somewhat faster than in the last two years. In 2003 they have grown quite strongly, particularly in the first two quarters. But although growth will remain at a relatively high level we expect it to decline gradually. And in line with movements in household consumption, imports of consumer goods will continue to strengthen slightly.

The terms of trade will have a negative impact on the current account balance. We project dollar export price growth of 16.5% and dollar import price growth of 17.3% in 2003. Thus export prices in 2004 and 2005 will again grow slightly faster than import prices. The main reason for the discrepancy in the movements of export prices and import prices in 2003 compared to the original forecasts is the strong growth in commodity prices and other prices in the international economy. Furthermore, we anticipate higher oil prices in 2004 which will also increase import prices compared to the earlier forecasts. These movements will result in a deterioration in the terms of trade this year of around 0.7%. This represents a deterioration compared to the actual figures for 2002 of 2.6 percentage points and a deterioration compared to the most recent forecasts of 2.2 percentage points. We project an improvement in the terms of trade in 2004 of just 0.3%, which is one percentage point worse than the terms of trade figure we projected in the most recent forecasts. According to our projections the difference in the current account balance resulting from the changed terms of trade in 2003 will be around one percentage point of GDP, and in 2004 around 0.4 percentage points of GDP.

The balance and structure of trade in services will remain similar to previous years. The balance of trade in services in 2003 will improve a little compared to the 2002 figure, but then worsen slightly over the next few years. The structure of trade in services will also remain relatively unchanged, while the balance of transport services will be somewhat worse on account of the slower growth in goods trade. The deficit in other services will see the biggest deterioration as a result of increased investment activity and faster imports of computer and other technical business services.

Movements in the balance of transfers are highly dependent on actual transfers from the EU. As far as transfers are concerned we are not anticipating major changes from the previous forecasts. Actual receipt of transfers from the EU of between USD 90 m and USD 100 m a year depends largely on the ability to cofinance projects using domestic sources, which have not yet been secured and are therefore open to question.

4.5 Conditions of financing and saving

Forecast trends in the real sector and the current account of the balance of payments will also affect the means and conditions of financing of the different sectors of the economy. Net financial inflows from the rest of the world in the next few years will be appreciably smaller than in previous years. In 2003 they will amount to around 1% of GDP, after which inflows will match outflows. Gross inflows and outflows will both increase in line with Slovenia’s increasing integration in the common European market. The main reasons for the reduction in net financial inflows compared to previous years will be the reduction in net inflows from foreign direct investments and increased outflows of households.

Table 4.5: External financial flows

				Forecast			2003			2004			2005		
							Forecast			Forecast			Forecast		
	2000	2001	2002	2003	2004	2005	previous	new	change	previous	new	change	previous	new	change
	as % of GDP														
Net financial flow	5.3	8.0	4.6	1.0	-0.2	0.1	2.1	1.0	-1.1	1.8	-0.2	-2.0	…	0.1	…
foreign direct investment	0.4	1.9	8	0.2	0.9	1.5	3.4	0.2	-3.2	3.0	0.9	-2.1	…	1.5	…
	balance at year's end														
Forex reserves (USD m)	4,376	5,747	8,152	8,804	8,700	8,658	9,330	8,804	-526	10,231	8,700	-1,531	…	8,658	…
- as % of GDP	23.2	29.7	37.5	32.8	30.9	28.8	37.8	32.8	-5.0	40.7	30.9	-9.8	…	28.8	…
External debt (USD m)	6,217	6,717	8,799	10,397	11,107	11,835	9,229	10,397	1168	9,508	11,107	1,599	…	11,835	…
- as % of GDP	32.9	34.7	40.4	38.7	39.4	39.4	37.4	38.7	1.3	37.4	39.4	2.0	…	39.4	…

Source: Analysis and Research Department

The conditions of financing are favourable. The relatively low foreign interest rates and the reduction in the risk premium accompanying EU entry mean easier access to foreign sources of financing. The Slovenian economy is becoming increasingly integrated financially with other economies, which is further stimulating an increase in foreign financing of residents.

Companies are also increasingly accessing foreign sources indirectly via banks. And in light of the strong inflows in the first half of 2003 we revised upwards the projected inflows via banks by around USD 200 million on an annual level, while company loans remained at a similar level. We have reduced slightly the foreign lending item – gross outflows are significantly smaller than inflows – on account of expectations of somewhat weaker economic conditions in the countries of the former Yugoslavia.

Lending abroad through commercial credits remains an important outflow item because of the low interest rates and easier access to sources of finance, but means an accumulation of risks for Slovenian companies. Nevertheless, the projected deterioration in the current account balance means that commercial credits are no longer the most important outflow in the capital account. Figures from the first half of the year indicate that the growth in outflows in 2002, when commercial credits were 1.5 times larger than in 2001, will not continue. This is also a result of the fact that the strong growth in activity by Slovenian companies in the markets of the former Yugoslavia will not maintain the same tempo as in the past few years.

Because of the smaller number of takeovers and privatisations there will be fewer sources of finance available from ownership transformation. Net inflows from direct investments will be considerably smaller than in the previous two years, given the very low level in the first half of the year, on account of the slow process of privatisation of state-owned assets (there is no prospect of new sales by the end of this year) and the assumption that there will be no major sales of companies to foreigners in the next two years. This will result from both smaller inflows of foreign investments in Slovenia as well as increased outflows in the form of investments by residents abroad.

Despite a deterioration in the current account balance and projections of lower net financial inflows, **foreign currency reserves** will grow further in 2003 before falling slightly in 2004 and 2005, although the decline will not significantly exceed USD 100 million per year. The **external debt** will also rise, but as a proportion of the volume of exports of goods and services it will remain relatively unchanged, and as a percentage of GDP it will even fall.

Total domestic and foreign financing of enterprises in 2003 and 2004 will grow. This is in line with the expected gradual increase in economic activity based on a gradual recovery of domestic demand and against a background of falling inflation. We expect enterprises to meet a substantial proportion of their investment financing needs by raising loans abroad, while the growth in domestic borrowing will result mainly from increased domestic debt accumulation by the Government.

The forecasts presume that there will not be a net effect from government financing from abroad. Therefore the entire deficit will be financed through borrowing in the domestic market. Domestic borrowing by the Government will remain at a high level in the coming years, growing at a rate similar to the May forecast figure of around 18%. In 2003 the Government continued the process of restructuring the debt in favour of domestic sources of finance. At the end of 2002 domestic debt made up 58.9% of total government debt but by the end of the second quarter of 2003 this share had risen to 59.9%. We expect the Government to continue the restructuring of the currency make-up of the debt in the future. Eurobond obligations of approximately EUR 200 million will fall due for payment in mid-2004, and a further EUR 500 million in mid-2005. This will partly be reflected in the sustaining of a high level of domestic debt contracting and partly in an increase in investment in securities.

With a gradual rise in private consumption we expect borrowing by households and enterprises to increase over the next few years. This is indicated both by the relatively high level of borrowing by enterprises in the first half of 2003 as well as the increased household consumption. Indicators show that net borrowing (the ratio of loans to deposits) among enterprises in particular will begin to rise again in 2004, while the falling trend in net household borrowing will come to an end in the next few years.

In line with the restructuring of the maturity of deposits, we expect a continuation of the realignment from short-term borrowing towards long-term borrowing over the next few years. The major contribution to demand for credit will come from the continued gradual growth in investment spending.

Because of the revised projections for the current account and net financial inflows we do not expect balance of payments flows to have a major impact on the issuance of broad money. At the same time domestic borrowing will be somewhat higher and therefore the broad money growth forecast is relatively unchanged form the earlier forecasts.

Broad money aggregates are growing at a slower rate this year and we expect such trends to continue, at a somewhat lower intensity, in the coming years. The reduction in the growth rates will be particularly pronounced for the broad M3 and M2 aggregates, for which the growth rates are expected to halve compared to 2002. The slower growth is primarily a result of the better balance in international flows. The decline in the growth rate of M1 narrow money, however, will be a little slower.

Table 4.6: Monetary system

				Forecast			2003			2004			2005		
							Forecast			Forecast			Forecast		
	2000	2001	2002	2003	2004	2005	previous	new	change	previous	new	change	previous	new	change
M1	7.0	12.8	14.8	13.3	11.4	8.8	13.6	13.3	-0.3	10.9	11.4	0.5	…	8.8	…
M3	16.5	23.9	22.4	12.5	10.7	9.5	11.6	12.5	0.9	9.8	10.7	0.9	…	9.5	…
Total credits	17.8	19.3	17.0	14.0	13.1	13.2	12.2	14.0	1.8	11.6	13.1	1.5	…	13.2	…

Source: Analysis and Research Department

The biggest influence on the **M3 growth** projection this year will come from the growth of tolar deposits, while in the following years tolar and foreign currency deposits will make a more equal contribution. Foreign currency deposits will nevertheless grow more slowly than tolar deposits because the yield on foreign currency deposits will fall compared to tolar deposits both because of lower nominal interest rates and also because of an anticipated stabilisation of the domestic currency compared to the inflation trend.

A somewhat slower decline in **M1 growth** over the next two years will be caused primarily by increased demand for M1 transaction money, which is in line with anticipated slower growth in domestic economic activity. The commencement of lending from the National Housing Saving Scheme will also have an important influence on M1 growth. However, the anticipated inclusion of interest income in income tax calculations represents an important risk factor in determining the rate of M1 growth. This will further reduce the returns on tolar deposits, which will fall on account of the anticipated rapid reduction in tolar interest rates. In fact, tolar interest rates could even be negative in real terms because of a reduction in the amount by which they exceed anticipated inflation.

We expect a continuation of the realignment in the **maturity composition** of tolar deposits towards long-term deposits. Changes in relative returns mean we will also see a widening of the gap between growth in long-term deposits and shorter-term deposits in the next two years, so that by the end of 2005 long-term deposit growth will be approximately double short-term deposit growth. These projections are made on the assumption that tolar interest rates will come down in the next few years in line with the nominal convergence of the Slovenian economy.

4.7 Inflation

We expect the lowering of inflation to continue. Based on data currently available about the inflation trend in 2003 and taking into account the exogenous variables in the next two years, we expect annual inflation in the final quarter of 2003 to be 5.0%, and 3.5% in the final quarter of 2004. These projections do not differ significantly from our May forecasts. By the end of 2005 the inflation rate is expected to have fallen below 3%.

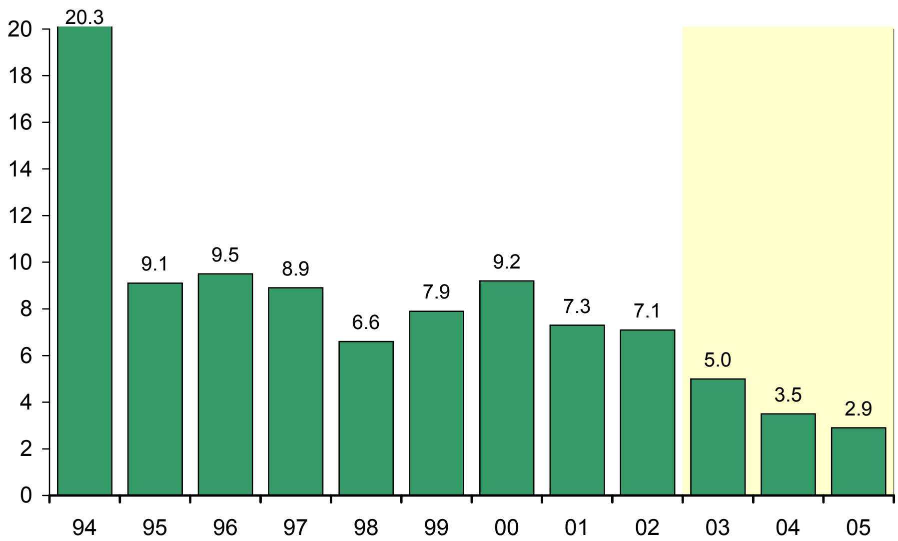
Table 4.7: Price developments

				Forecast			2003			2004			2005		
							Forecast			Forecast			Forecast		
	2000	2001	2002	2003	2004	2005	previous	new	change	previous	new	change	previous	new	change
average annual percentage changes															
Consumer prices	8.9	8.5	7.5	5.6	4.0	3.0	5.5	5.6	0.1	4.1	4.0	-0.1	…	3.0	…
Free prices	7.0	7.7	7.6	5.8	3.9	3.0	5.4	5.8	0.4	3.9	3.9	0.0	…	3.0	…
Administered prices	18.9	12.2	7.5	5.1	4.1	3.2	6.2	5.1	-1.1	4.9	4.1	-0.8	…	3.2	…
annual percentage changes (last quarter)															
Consumer prices	9.2	7.3	7.1	5.0	3.5	2.9	5.0	5.0	0.0	3.7	3.5	-0.2	…	2.9	…
Free prices	6.9	7.9	6.9	5.1	3.5	2.9	4.9	5.1	0.2	3.4	3.5	0.1	…	2.9	…
Administered prices	21.7	5.0	8.8	4.8	3.5	3.0	5.5	4.8	-0.7	5.0	3.5	-1.5	…	3.0	…

Source: Analysis and Research Department

We anticipate a falling growth trend for free prices and administered prices in the coming years with both sets of prices growing at similar rates. We project year-on-year growth in free prices of 5.1% in the last quarter of 2003, 3.5% at the end of 2004 and 2.9% at the end of 2005.

Figure 4.8: Inflation – average year-on-year price growth to final quarter (%)



Source: Analysis and Research Department

Box 4.2: Difference between forecast and actual growth in free prices in 2003

Administrative measures which directly affect free prices but not administered prices are the main reason for **free prices** rising faster this year than in our May projections. These measures have contributed approximately 0.4 percentage points to the growth of free prices in 2003, and approximately 0.3 percentage points to overall inflation.

Also included among free prices are **products and services whose prices are formed within predominantly or wholly monopolistic market structures** even though the Slovenian Government does not directly control them. Free prices which are influenced by tax and administrative measures grew by 16.2% in the year to September, while competitively determined free prices rose in the same period by just 3.2% (see Figure 2.5). In addition to the tax measures announced in advance (increase in VAT rates on wine and an increase in excise duties on tobacco products), this rapid growth in free prices influenced by tax and administrative measures was brought about primarily by **administrative measures** such as price rises for medicines and rises in rental costs for the purpose of harmonising non-profit rents irrespective of when the rental contract was signed. We estimate that the rise in medicine prices has contributed 0.1 percentage points to overall inflation in 2003, while the rises in rental costs have contributed 0.2 percentage points.

The difference in the free price growth projections is most notable as an annual average (0.4 percentage points); the projections of year-on-year growth rates at the end of the year differ only by half as much (0.2 percentage points). The main reason for this is that the administrative measures referred to above, which we were not able to take into account in our earlier projections, actually came into effect in the first half of 2003. There were no such unexpected measures in the second half of the year.

In the coming years the slowdown in the growth of free prices will be assisted not only by monetary and exchange rate policy but also by the strength of the euro against the US dollar. By compensating for the negative impact of the strong growth in commodity prices both factors helped to maintain relatively subdued growth in import prices in 2003. Relatively high growth in import prices in 2004 will result mainly from higher oil prices – this should be neutralised by the Government's policy on excise duties and so should not directly affect free prices – and an unchanged euro/dollar exchange rate, which will thus not be able to compensate for unfavourable price impacts from abroad to the same extent as in 2003.

Provided the Government continues its policy of adjusting excise duties on refined petroleum products in order to prevent fluctuations in world markets having a domestic impact, oil prices will not have a major impact on domestic prices. At the beginning of the year the Government prevented high oil prices on world markets affecting domestic prices of refined petroleum products by lowering excise duties, and when oil prices rose it began to increase the excise duties. We anticipate that even in the event of higher oil prices in 2004 the Government will persist with its policy of using excise duties to neutralise oil price fluctuations.

Administered price growth in the future must not be allowed to exceed the general price growth. Therefore the growth of free and administered prices in the next two years will be more evenly matched than has been the case in recent years.

Box 4.3: Assumptions underlying the inflation projection which are subject to other economic policies

Besides the exogenous variables in the international environment presented in Table 4.1 – these directly affect movements in import prices – the most important assumptions which we took into account in the present price projection are:

- An absence of substantial financial inflows or shocks in the balance of payments financial account.
- Administered prices growing on average by 4.1% in 2004 and 3.2% in 2005. If administered prices grow at the same rate as the Government's consumer price growth projection (4.9% on average in 2004 and 4.0% on average in 2005) the overall inflation forecast for year-on-year price growth to the last quarter of 2004 would be 3.7% and 3.1% to the last quarter of 2005.
- Increases in excise duty on tobacco products in January and July 2004 and July 2005 in line with EU requirements for bringing excise duties in Slovenia into line with European Union levels. We estimate that these measures will contribute between 0.3 and 0.4 percentage points to overall annual inflation in 2004 and between 0.1 and 0.2 percentage points in 2005.
- The Slovenian Government will not introduce discretionary tax policy measures to increase taxes if revenues are insufficient to meet budget expenditures. We estimate that the effect of increasing budget revenues by 1% of GDP through an increase in direct taxes would be to add approximately two percentage points to annual inflation.
- Wage increases will be modest and will be in line with the slowdown in economic activity. Real wage growth will be around 2%, while nominal wage growth will be 6.3% in 2004 and 5.4% in 2005.

In view of the existing risk factors all the price forecasts should be taken only as a most likely scenario. On account of administered prices there is still a risk that the actual rate of price growth could be higher than our forecasts. However, over the next two years we anticipate a further reduction in the rate of growth of free prices. These expectations result primarily from the favourable trend in core inflation, which, in the absence of administered price shocks and with tax and administrative measures remaining at current low levels, will be joined by overall inflation, as well as the anticipated positive effects of the full elimination of customs duties and increased competition on joining the European Union.

We consider the most likely price growth rates to be 5.0% at the end of 2003 and 3.5% at the end of 2004. These projections reflect the continuing gradual and sustained process of disinflation based on the nominal convergence of the Slovenian economy and are in line with the risk factors outlined above as well as the commitment to coordinated economic policy-making.

Table 4.8: Selected main indicators

				Forecast			2003			2004			2005		
							Forecast			Forecast			Forecast		
	2000	2001	2002	2003	2004	2005	previous	new	change	previous	new	change	previous	new	change
Activity, employment, wages	*real percentage change*														
Real GDP	4.2	2.9	3.2	2.5	3.2	3.6	3.0	2.5	-0.5	3.9	3.2	-0.7	…	3.6	…
Per capita GDP (USD)	9,438	9,666	10,901	13,428	14,041	14,954	12,348	13,428	1,080	13,365	14,041	676.0	…	14,954	…
Employment	1.1	1.0	0.4	-0.4	0.1	0.1	0.3	-0.4	-0.7	0.5	0.1	-0.4	…	0.1	…
Net wages	1.4	3.1	2.1	2.2	2.3	2.3	2.2	2.2	0.0	2.4	2.3	-0.1	…	2.3	…
Productivity	3.1	2.0	2.8	2.9	3.1	3.4	2.7	2.9	0.2	3.4	3.1	-0.3	…	3.4	…
Domestic demand	*real percentage change*														
Domestic demand	0.6	1.0	2.5	3.9	3.8	3.6	3.2	3.9	0.7	4.2	3.8	-0.4	…	3.6	…
Private consumption	0.8	2.6	2.0	2.9	3.1	2.9	2.8	2.9	0.1	3.3	3.1	-0.2	…	2.9	…
Government consumption	3.1	4.0	2.7	3.3	2.8	2.7	1.9	3.3	1.4	2.3	2.8	0.5	…	2.7	…
Gross fixed capital formation	-1.5	-4.6	3.7	6.8	6.1	5.7	5.2	6.8	1.6	7.4	6.1	-1.3	…	5.7	…
Balance of payments	*real percentage change*														
Exports of goods and services	12.7	6.4	6.1	3.0	4.1	4.2	6.4	3.0	-3.4	6.0	4.1	-1.9	…	4.2	…
Imports of goods and services	6.1	3.0	4.8	5.3	5.1	4.2	6.6	5.3	-1.3	6.5	5.1	-1.4	…	4.2	…
Current account: USD m	-548	31	375	-67	-204	-294	595	-67	-662	760	-204	-964	…	-294	…
as % of GDP	-3.0	0.2	1.8	-0.3	-0.7	-1.0	2.4	-0.3	-2.7	2.8	-0.7	-3.5	…	-1.0	…
Terms of trade	-5.2	0.9	1.9	-0.7	0.3	0.1	1.5	-0.7	-2.2	1.3	0.3	-1.0	…	0.1	…
													…		…
Net financial flows (as % of GDP)	5.3	8.0	4.6	1.0	-0.2	0.1	2.1	1.0	-1.1	1.8	-0.2	-2.0	…	0.1	…
of which: foreign direct investment	0.4	1.9	8.0	0.2	0.9	1.5	3.4	0.2	-3.2	3.0	0.9	-2.1	…	1.5	…
Foreign exchange reserves (USD m	4,376	5,747	8,168	8,804	8,700	8,658	9,330	8,804	-526.0	10,871	8,700	-2,171	…	8,658	…
- as % of GDP	23.2	29.7	37.5	32.8	30.9	28.8	37.8	32.8	-5.0	40.7	30.9	-9.8	…	28.8	…
External debt (USD m)	6,217	6,717	8,799	10,397	11,107	11,835	9,229	10,397	1,168	9,992	11,107	1,115	…	11,835	…
- as % of GDP	32.9	34.7	40.4	38.7	39.4	39.4	37.4	38.7	1.3	37.4	39.4	2.0	…	39.4	…
Monetary system	*annual percentage change (Q4/Q4)*														
M1	7.0	12.8	14.8	13.3	11.4	8.8	13.6	13.3	-0.3	10.9	11.4	0.5	…	8.8	…
M3	16.5	23.9	22.4	12.5	10.7	9.5	11.6	12.5	0.9	9.8	10.7	0.9	…	9.5	…
Total credits	17.8	19.3	17.0	14.0	13.1	13.2	12.2	14.0	1.8	11.6	13.1	1.5	…	13.2	…
Prices	*annual percentage change (last quarter)*														
Consumer prices	9.2	7.3	7.1	5.0	3.5	2.9	5.0	5.0	0.0	3.7	3.5	-0.2	…	2.9	…
Free prices	6.9	7.9	6.9	5.1	3.5	2.9	4.9	5.1	0.2	3.4	3.5	0.1	…	2.9	…
Administered prices	21.7	5.0	8.8	4.8	3.5	3.0	5.5	4.8	-0.7	5.0	3.5	-1.5	…	3.0	…
International factors	*annual percentage change*														
Foreign demand*	9.8	4.5	2.7	4.0	6.0	6.0	6.1	4.0	-2.1	7.6	6.0	-1.6	…	6.0	…
EUR/USD	0.924	0.895	0.944	1.100	1.100	1.100	1.050	1.100	0.050	1.060	1.100	0.040	…	1.100	…
Oil price (USD/barrel)	28.5	24.4	25.0	28.5	27.0	27.0	29.0	28.5	-0.5	25.0	27.0	2.0	…	27.0	…
Commodities	3.2	-6.5	4.6	8.0	3.0	3.0	4.5	8.0	3.5	3.0	3.0	0.0	…	3.0	…
Inflation in EMU	2.3	2.6	2.2	2.0	2.0	2.0	1.7	2.0	0.3	1.6	2.0	0.4	…	2.0	…
PPI Germany	3.3	1.3	-0.3	1.3	0.6	0.6	0.8	1.3	0.5	1.2	0.6	-0.6	…	0.6	…
EURIBOR 3m (%)	4.4	4.3	3.3	2.4	2.4	3.0	2.4	2.4	0.0	2.7	2.4	-0.3	…	3.0	…

* Volume of imports of a basket of goods from foreign partners.

Source: Analysis and Research Department, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, Statistical Office of the Republic of Slo

5. MONETARY AND EXCHANGE RATE POLICY ORIENTATION

5.1. Preparing the conditions for entry into EMU and adoption of the euro at the earliest opportunity remains the Bank of Slovenia's basic policy orientation.

The loss of monetary policy independence on joining the EU makes it imperative to join EMR2 and EMU as soon as possible and thereafter to adopt the euro. This will be made possible by the balance of payments and public finance equilibrium that has been achieved, on condition that the restrictive orientation of fiscal and other public finance policies is maintained and strengthened. Therefore the Bank of Slovenia will be seeking to achieve ERM2 entry by the end of 2004. Within the constraints of its operating conditions the Bank of Slovenia will endeavour to maintain the macroeconomic balances and achieve a low level of inflation, which is the only way of enabling sustainable participation in ERM2 and at the same time meeting the nominal convergence criteria necessary for the earliest possible entry into EMU and adoption of the euro. Given the reduction in monetary policy independence the Bank of Slovenia sees no advantage in delaying entry to ERM2 either for monetary policy or fiscal policy.

Before it can adopt the euro Slovenia must meet the Maastricht criteria, which means that assessment of their fulfilment is an important process. Under the regular procedure the European Commission could make its assessment of Slovenia's readiness to adopt the euro and its conformity with the Maastricht criteria in January or February 2006, or following an extraordinary procedure at Slovenia's request in the autumn of 2006. In the first case the period for assessing fulfilment of the Maastricht criteria would last from September 2004 to August 2005, and in the second case from June 2005 to May 2006. The Bank of Slovenia considers the second option to be more appropriate as fulfilment of the Maastricht criteria will be possible in mid-2005.

Box 5.1: Basic elements for calculating the Maastricht price stability criterion

Maastricht price stability: inflation must not exceed by more than 1.5 percentage points the rate of inflation in the three EU countries with the lowest inflation.
- Price stability is calculated using the 12-month average of the annual rates of the harmonised consumer price index.
- The assessment of fulfilment of the criterion is made by the EU Commission and the ECB, and is adopted by the European Council at the level of heads of state and government. Prior to this the European Council is informed of the opinions of the Council of Ministers of ECOFIN and the European Parliament.
- The Maastricht inflation criterion is currently 2.8% (August 2003).

If Slovenia wishes to adopt the euro at the start of 2007 inflation must be brought within the Maastricht price stability criterion by the middle of 2005. This plan presupposes entry to ERM2 by the end of 2004. Before this a nominal convergence of interest rates must be achieved to enable exchange rate stabilisation before the central parity is determined. At the same time, by the first half of 2005 a low inflation policy will need to be applied to the structural adjustment of relative prices and the structuring of tax and administrative effects on prices. Inflation from mid-2005 to mid-2006 must be on average within the Maastricht price stability criterion (currently 2.8%) as fulfilment of the criterion is calculated on the basis of a 12-month average of year-on-year inflation rates.

Box 5.2 Risk factors for inflation forecasts

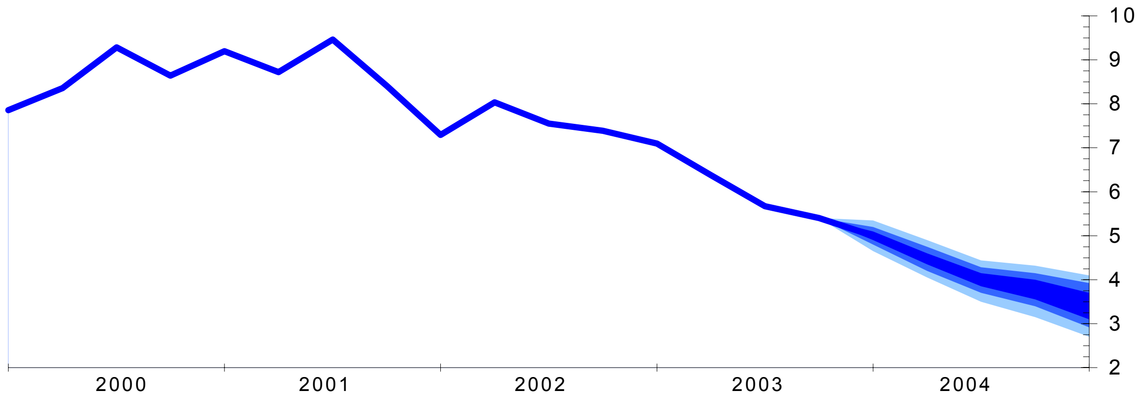
Among the factors that could bring about an inflation level higher than forecast in our projections, and which we were not able to incorporate, are:

- A failure to control administrative prices so that they grow faster than planned;
- Excise duties not being adjusted and a relaxation of administrative measures concerning price-setting;
- One-off administrative measures and a rise in the prices of goods and services of public companies majority-owned by the Slovenian Government;
- Unfavourable movements in the prices of oil and other commodities on world markets;
- The introduction of new excise duties (e.g. on electricity, coke and natural gas), or the adjustment of existing excise duties (e.g. on refined petroleum products) in line with EU directives. If the European Parliament introduces new excise duties the Government will have to negotiate a transitional period for their introduction in order to defer the direct impact on prices;
- The ending of bilateral free trade agreements with the countries of the former Yugoslavia after EU entry;
- The indirect effects on food prices of unfavourable weather conditions.

In addition to the factors which we took into account in the base case, the following could also make a significant contribution to further reducing inflation:

- the lowering of customs duties and increased competition following entry to the EU;
- an appropriate agreement among the social partners over private sector wage increases.

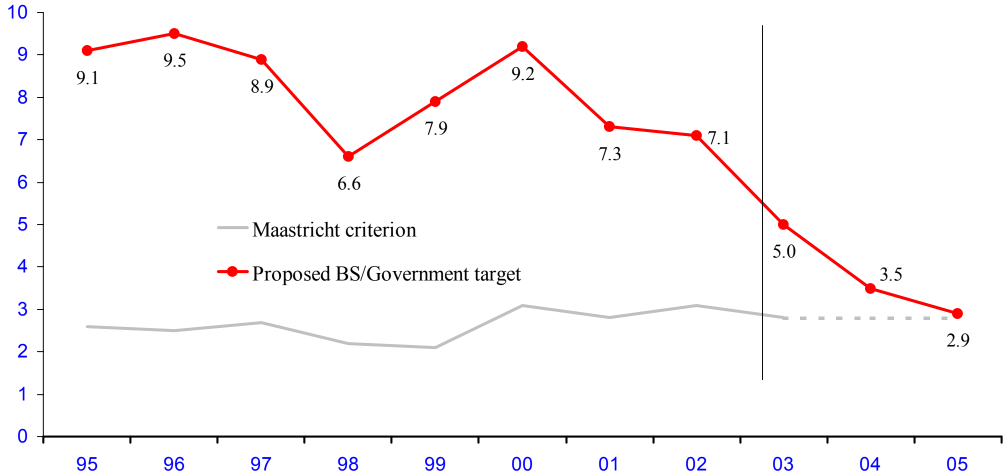
Figure: Risk distribution for inflation forecast in 2004



The Bank of Slovenia forecasts price growth for 2004 of 3.5%, which is unchanged from the May forecast. By the end of 2005 the Bank of Slovenia expects the price

growth rate to be within the Maastricht criterion, which is currently 2.8%. These inflations forecasts are in line with the goal of early entry to ERM2 and early adoption of the euro. A prerequisite for achieving these forecasts and for meeting the inflation targets necessary for early adoption of the euro is that the actions of the Bank of Slovenia and the Government are coordinated. Only through coordinated action will it possible to sustain an inflation rate in line with the Maastricht criterion without significant deviations in the macroeconomic balances, which are also elements of the Maastricht assessment.

Figure 5.1: Inflation target necessary for early entry to ERM2 and early adoption of the euro (percentage annual growth rate at year's end)



The Maastricht price stability criterion changes over time and will depend on inflation movements in the EU, specifically in the three EU countries with the lowest price growth rates in the period in which fulfilment of the Maastricht criteria is assessed.

Source: Analysis and Research Department

5.2. Elements of economic policy action necessary for early adoption of the euro

Five Maastricht criteria need to be met for adoption of the euro. Only one of the criteria – the inflation measure – is Slovenia still some distance from meeting. Most of the other accession countries are in the reverse position – they meet the inflation criterion but are a long way from fulfilling the other criteria reflecting budgetary and balance of payments stability. The existence and sustainability of macroeconomic equilibria is an advantage for Slovenia in terms of adoption of the euro, the route to which leads via the European exchange rate mechanism. But as far as maintaining this position is concerned it is important to recognise that on entry to the EU the circumstances for conducting policies which create equilibrium will change. This is why EMU entry has to be accelerated.

Monetary policy independence will be lost. The ability to use exchange rate policy to close the uncovered interest parity will diminish as soon as Slovenia joins the EU because at that point the provisions of the Europe Treaty stipulating that the exchange rate is a matter of common interest for the member state concerned and the other members of the EU begin to apply. Thus in the event of shocks the Bank of Slovenia will be unable to react using interest rates differing significantly from ECB rates. Otherwise, in conditions of free flow of capital, the Bank of Slovenia independently setting interest rates would only exacerbate the shocks instead of easing them.

Other economic policies will need to respond to potential shocks, both internal and external, which threaten macroeconomic stability. In the period following EU entry the biggest burden will be on the public sector policies for which the Slovenian Government is responsible, and fiscal policy in particular. But other economic policies, in the short run, do not provide the flexibility offered by monetary policy in terms of the way in which they are applied and their effect. Hence the period in which Government policies operate under the decisive influence of the ECB, although while Slovenia still retains its own currency, has to be reduced to the minimum period required under EMU rules. Inappropriate responses from other economic policies will be directly reflected in inflationary pressures in the event of a lack of coordination in structural policy, and in losses and high unemployment in the tradable sector in the event of an artificial strengthening of the tolar, causing an increase in structural budget expenditures to deal with the resulting social consequences and ultimately instability in the financial sector as a whole. Delaying the adoption of the euro (and in this context early entry into ERM2 and fulfilment of the Maastricht criteria) only increases the likelihood of such scenarios.

Independent monetary policy action and coordination with the policies for which the Slovenian Government is responsible will be possible up until EU entry and for a relatively short period thereafter. Subsequently, monetary policy independence will disappear and the focus of achieving the conditions for adoption of the euro will shift almost wholly to policies for which the Slovenian Government is responsible. If entry to ERM2 is delayed then the risks of Slovenia remaining within the mechanism for more than two years will increase.

Box 5.3: Potential external and internal shocks after EU entry and during the period in ERM2

1. Sustaining macroeconomic equilibrium in the period after EU entry, during participation in ERM2 and following adoption of the euro will depend primarily on fiscal and incomes policy. The task of fiscal policy is to eliminate the effects of structural rigidities in public spending and to maintain flexibility in its adjustment. An approach whereby these rigidities are compensated for by an increase in public revenues could potentially lead to an increased burden on the economy, to the emergence of cost pressures on prices and consequently increased public expenditure, to an increased budget deficit and, because of inflation differences, to a balance of payments deficit. And all of this threatens the exchange rate equilibrium and the stability of the exchange rate. Because capital can flow freely the Bank of Slovenia will no longer be able, in the absence of exchange rate support, to take effective action in such circumstances by raising interest rates.
2. Speculative pressures on the currency generally originate in opportunities for interest gains and are connected with uncovered interest parity between domestic and foreign interest rates. The Bank of Slovenia's task is to prevent such motives for inflows of speculative capital by closing the interest parity.
3. Increased privatisation can cause the domestic currency to appreciate as a result of the increased supply of foreign exchange. The Bank of Slovenia can only intervene to prevent the effects of these activities on the exchange rate in the first phase. In the next phase it is faced with the problem of surplus liquidity in the banking system, which, on account of Slovenia's integration in the European monetary environment, it is no longer able to withdraw from circulation with the aid of higher interest rates and which could thus cause an excessive expansion of credit and demand-side inflationary pressures. This means it is essential to reach an agreement with the Government on action to neutralise such potential developments.
4. The large surplus structural position in the money market is a result of the sterilisation of strong net financial inflows in the last few years. The composition of the Bank of Slovenia's monetary policy instruments was also tailored to these circumstances. In the period until entry to ERM2 and during participation in ERM2 the composition of monetary policy instruments will need to be brought into line with ECB requirements. A reduction in the supply of tolar and foreign currency central bank bills could be achieved on the basis of an agreement with the Government concerning management of the external government debt, particularly in 2005. This reduction will have to be achieved in a way that does not threaten the stability of the exchange rate and does not cause excess liquidity in the banking system which would threaten macroeconomic stability.

1.) Monetary policy until Slovenia joins ERM2

Bank of Slovenia monetary policy will continue to be oriented towards bringing down inflation. The Bank of Slovenia will take account of current macroeconomic factors in determining movements in nominal interest rates and the exchange rate. Decisions on interest rates and euro exchange rate growth are largely influenced by the fact that in the period until ERM2 entry we are not anticipating significant supply-side or demand-side inflationary pressures or an excessive growth in bank loans.

Interest rate policy until ERM2 entry will be oriented towards a gradual reduction of nominal interest rates. The rate of reduction of domestic nominal interest rates is limited by the still relatively high domestic rate of inflation. Even a reduction in nominal interest rates can lead to increased credit activity. But if this also means a large drop in real interest rates then the increase in bank lending will be even greater. In order to avoid an excessive reduction in domestic real interest rates the Bank of Slovenia will take account of the reduction in inflation, or inflationary expectations, in lowering nominal interest rates.

Exchange rate policy will seek to secure an appropriate closing of the interest parity along with the gradual reduction in nominal interest rates. An appropriate differential between interest rates in Slovenia and in the eurozone equalises the conditions for borrowing at home and abroad and allows domestic lending rates to be brought into line with lending conditions abroad. This policy is oriented towards maintaining a stable long-term external equilibrium without increasing the inflation risk over the long run. On the investments side the adjusting of uncovered interest parity helps to equalise expected rates of return on investments in financial instruments of equivalent value (financial assets or securities) in tolars and euros or other foreign currencies. Thus it works to restrain the motives triggering inflows of speculative capital, which in the short term could destabilise the financial market and consequently the stability of prices.

The gradual convergence of nominal interest rates will narrow the gap between interest rates at home and abroad to the extent that stabilisation of the exchange rate will be possible on entry to ERM2. With approximately equal levels of nominal interest rates monetary policy will be oriented towards maintaining interest parities within bands that do not give rise to speculative movements in short-term capital and consequently do not cause large fluctuations in the exchange rate.

2.) Monetary policy during participation in ERM2

In ERM2 monetary policy will be most influenced by elements that will be relatively independent of Bank of Slovenia decisions. Three elements in particular should be mentioned:

- interest rates in the eurozone, which are set on the basis of ECB monetary policy;
- the risk premium, which results from the perception of country risk and currency risk by foreign investors and foreign creditors;
- inflationary pressures.

The biggest impact of these elements will be on the monetary policy instruments, i.e. the exchange rate and interest rates.

When Slovenia is participating in ERM2 the rate of convergence of nominal interest rates will depend on how quickly the risk premium falls and on ECB interest rate policy.

- As far as ECB interest rate policy is concerned we can assume two things: that nominal interest rates on average will remain unchanged and that as economic growth in the EU picks up the ECB will gradually raise nominal interest rates.
- We can assume that the rate of reduction of the risk premium will vary. Those countries that have adopted the euro have achieved a considerable reduction in their risk premium; in fact it has been reduced almost to zero. We can assume therefore that the risk premium will fall, and we estimate that a faster reduction is more probable given that the risk premium fell rapidly even at the time of the referendum on joining the EU.

3.) Economic policies of the Slovenian Government

1. **Consistency from the Government in the implementation of the administered price policy and the policy on prices under the Government's indirect influence will be crucial in the period until adoption of the euro.** The Bank of Slovenia considers prices under the indirect influence of the Slovenian Government to be:
   - prices controlled by Government agencies,
   - prices which can be influenced by various tax and administrative measures,
   - the prices of goods and services which are set by public companies in which the Government is the majority owner.

   Directly and indirectly administered prices must not be allowed to rise faster than the maximum inflation rate enabling entry to ERM2 and adoption of the euro. With this policy and also, in the short run, by controlling **prices which are formed monopolistically or administratively insofar as the law allows**, the Slovenian Government would make an important contribution to fulfilment of the inflation criterion. In order to meet the inflation target enabling early adoption of the euro it is also important that new inflationary pressures are not caused by inappropriate policies on excise duties and tariffs. In the long run, however, structural reforms will be needed to control prices formed under non-competitive conditions. And these reforms will need to be supported by increased competition in sectors that are still insufficiently competitive.

2. **As far as the formation and implementation of budget policy in the coming years is concerned, budget expenditure will need to be adapted to the prevailing economic**

situation. Therefore in the period until adoption of the euro the relevant solutions which the Government envisaged in the Budget Implementation Act for 2004 already will need to be actively applied.

3. **The social partners** will have to contribute to reducing cost pressures and pressures on budget expenditure by **taking a stance in favour of the complete elimination of wage indexation**, and supporting an inflation target that will enable fulfilment of the inflation criterion of nominal convergence.

4. Because of the potential negative effects of strong inflows of capital causing a greater appreciation of the tolar and consequently affecting the stability of the financial sector and the economy as a whole, it is desirable **that procedures for selling state-owned assets to nonresidents and management of the public debt are coordinated between the Ministry of Finance and the Bank of Slovenia.**