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BANK OF SLOVENIA

EUROSYSTEM

PRICE STABILITY REPORT

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Abbreviations used in the Price Stability Report

ARC	Bank of Slovenia Analysis and Research Centre
EC	European Commission
ECB	European Central Bank
EIPF	Faculty of Law Economic Institute
ESA95	European system of accounts (1995)
ESCB	European System of Central Banks
EU25	European Union (of 25 member-states)
EUR	euro
GDP	gross domestic product
HICP	harmonised index of consumer prices
ILO	International Labour Organisation
IMAD	Institute of Macroeconomic Analysis and Development
IMF	International Monetary Fund
M3	monetary aggregate M3, broad money
ME	mean error
NCB	national central bank (of a eurozone member-state)
OECD	Organisation for Economic Cooperation and Development
OFO	other financial organisations
Opec	Organisation of Petroleum-Exporting Countries
RMSE	root mean squared error
RS	Republic of Slovenia
RULC	real unit labour costs
SORS	Statistical Office of the Republic of Slovenia
USD	US dollar
VAT	value added tax

Executive Summary

The average inflation rate as measured by the harmonised index of consumer prices (HICP) remained unchanged in 2006 at 2.5%, although core inflation began to gradually rise from the low levels seen in 2005. Even though it remained at the same level overall, year-on-year inflation was rather volatile, one-off factors causing it to fluctuate between 1.5% and 3.4% last year. High oil prices temporarily put upward pressure on inflation in the second quarter. Brent crude reached USD 78 per barrel on world markets, and was one-third higher in the first half of 2006 than in the same period of the previous year. In the second half of the year the trend reversed, while an additional temporary fall in inflation was brought about by seasonal shifts in price cuts for clothing and footwear, and the basis effects of the rise in energy prices the previous year. The trend of decline in core inflation ended and reversed last year. Core inflation was 0.5 percentage points higher on average last year at 1.2%. The rise had been anticipated in previous projections, and was partly the result of the extremely low level in 2005, and partly a reflection of the relatively high economic activity. Inflationary pressures were again restricted by labour costs growing more slowly than productivity, and by the implementation of the programme of administered prices and tax measures. The introduction of the euro was estimated by the SORS to have brought a rise in prices of between 0.2 and 0.3 percentage points, the most notable changes being recorded by prices of some services at the end of last year and the beginning of this year.

In the international environment the favourable economic performance in the rest of the world seen in 2006 has slowed slightly, but an upturn in foreign demand is expected in 2008. The outlook for the rest of the world is thus better than had been assumed in previous projections. Price pressures from the international environment are expected to be less prominent, both oil prices, which should stand at around USD 60 per barrel, and growth in other commodities prices, which reached record levels in 2006.

Economic growth in Slovenia was 5.2% in 2006, the highest level since 1999, while unemployment fell to 5.6% according to the ILO definition, the lowest level since measurements began in 1995. Projections indicate that economic growth will remain good: the baseline scenario is 4.6% for this year, 4.4% for next year, and 4.0% for 2009. Productivity growth will also fluctuate at a relatively high level between 3.5% and 4.0%, while the favourable economic climate could see a cumulative rise in employment of approximately 2.0%. Projections of economic activity were again revised slightly upwards, partly as a result of the increasingly good growth in domestic demand, and partly as a result of the improved climate in some of Slovenia's important trading partners. On the expenditure side, the majority of economic growth will come from domestic demand, but net trade is also expected to make a positive contribution. Gross investments are likely to continue growing faster than GDP. In the baseline scenario growth in the former is projected at between 5% and 6% for the next three years. The growth projections for private consumption indicate a slight acceleration in 2007, which accords with the favourable conditions on the labour market and resulting high consumer optimism, and partly from an increase in disposable income following a tax reform. The increase in disposable income will mostly be seen in the higher income brackets, which generally have a lesser inclination to spending.

The current account deficit stood at 2.6% of GDP in 2006, as forecast by the Bank of Slovenia's October projection. The current account deficit is projected to decline to approximately 2% of GDP. This is a smaller deficit than previously projected, primarily as a result of favourable trends in merchandise trade with the EU. Both imports and exports of goods are expected to grow strongly, while the deficit in merchandise trade is expected to decrease further as a result of increased foreign demand and increases in exports from the car industry. The projection for trade in services remains similar, with the surplus expected to gradually increase further from 2.9% of GDP. The indicators of price competitiveness as measured by labour costs were favourable in 2006, labour costs recording moderate growth only, while the real effective exchange rate rose slightly, primarily *as a result of the euro's appreciation against the American dollar. Given the accumulated stock of net debt, the assumed rise in interest rates in the rest of the world will widen the deficit in factor income, which will exceed 1.5% of GDP.*

Portfolio investments continued to prevail in the financial account in 2006, but trade credits and loans to the rest of the world recorded the largest increase from the previous year. Bank borrowing in the rest of the world stood at 8.6% of GDP in 2006, down just under 4 percentage points, primarily as a result of the maturing off Bank of Slovenia bills. The projection of private sector borrowing points to a gradual decline in the cyclical portion of growth in loans to companies and households. Overall growth in loans is expected to decline from more than 26% in 2006 to close to 20% in 2009, indicating a continuation of the deepening of financial intermediation, which is structural in nature.

The macroeconomic projections are in line with the maintenance of price stability. Under these assumptions, the inflation (HICP) forecasts are 2.7% for 2007 and 2008, and 2.6% for 2009. The projection of the general growth in prices remains unchanged, the revisions since October 2006 relating merely to reallocations between different price groups. The revisions are primarily associated with the realisation of the changes in 2006, in particular the slightly higher growth in certain non-administered prices in the second half of the year, and a different assumption about the movement of energy prices. The still-favourable growth in aggregate demand is expected to slightly exceed the output potential, but the projections are that this will not be reflected in inflation, primarily because growth in labour costs is expected to remain moderate in the baseline projection. Given the information available, a direct inflationary effect of 0.7 percentage points has been assumed for Government measures, primarily as a result of the rise in excise duties and price rises following the liberalisation of the electricity market.

The risks associated with the inflation projections are assessed as moderate. On the aggregate demand side the risk is lower than in previous projections, as the indicators point to a slight decrease in the gap by which output potential is exceeded, and also as a result of output potential growing more quickly in the context of faster growth in investments in production assets and growth in employment. The monetary policy stance is also more restrictive than had been assumed in previous forecasts. Conversely the risk of labour costs growing faster than assumed in the baseline projection is increasing. The excess demand has not for the moment been reflected in growth in wages or labour costs, but mainly in growth in employment and a fall in unemployment. However, unemployment has already reached a relatively low level, and is probably close to the level of structural unemployment. The chances of further declines in unemployment are much more limited, which could trigger a rise in labour costs. Similar trends have arisen in the euro area, which could exacerbate these developments in Slovenia. The model simulations indicate that a rise of 1 percentage point in wage growth in the next three years could cause an increase in inflation of approximately 0.5 percentage points in 2008 and 2009. The movement of oil prices remains another risk in the projections, as they can affect not only the level of inflation, but also its volatility. In the medium term there is a risk of an increase in the direct effects of fiscal policy on prices, such as a rise in VAT or an alternative rise in excise duties, should the Government fail to consolidate the budget on the expenditure side.

In economic policy it makes sense to retain the framework of the Programme for ERM II Entry and Adoption of the Euro,[1] *which was adopted together by the Slovenian Government and the Bank of Slovenia in November 2003, and has proved successful to date in creating the conditions for Slovenia to join the eurozone. In 2006 the pitch of macroeconomic policies was mostly in line with the maintenance of sustainability in good macroeconomic results. The Government upheld its plan of rises in administered prices, which excluding energy prices actually recorded growth of 1 percentage point less than non-administered prices. The gradual abolition of the payroll tax and the low growth in average public sector wages also contributed to the low growth in labour costs in the private sector. By limiting growth in labour costs, incomes policy helped to maintain the price competitiveness of the economy, and prevented price movements from responding more strongly to the upturn in the economic cycle. In the movement of labour costs, it should be remembered that the direct effects of price shocks on the cost side (higher oil prices or commodities prices, inflationary tax effects, etc.) that reduce labour productivity must not be allowed*

[1] http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=1570

to be built in or indexed to an increase in nominal labour costs. In the event of such shocks, it is sensible to keep growth in labour costs behind growth in output per employee, as this productivity indicator overstates actual labour productivity.

December 2006's Stability Programme envisages a decline in the structural deficit in public finances in 2009. In its assessment of the Stability Programme drawn up by the Slovenian Government, the European Commission stated that the measures to reduce the deficit to 1% of GDP in 2009 should be defined more precisely. In the opinion of the Commission, this applies in particular to the measures on the expenditure side aimed at compensating for the loss of revenue following the tax reform in 2007 and 2008, and the measures that the Government is aiming to take to reduce public finance expenditures by 2 GDP percentage points in 2009, and to meet the medium-term objective of a decrease in the general government deficit by 0.25 GDP percentage points per year between 2006 and 2009. In its assessment of the programme the European Commission also assessed the public finance position in the longer term as unsustainable, as Slovenia is one of those countries classed as high-risk with regard to the ageing of the population and its associated public finance consequences. A counter-cyclical and longer-term pitch in fiscal policy, as seen in incomes policy in recent years, is one of the essential factors that could contribute to the maintenance of the macroeconomic equilibria, to the competitiveness of the economy, and thus to price stability in the future.

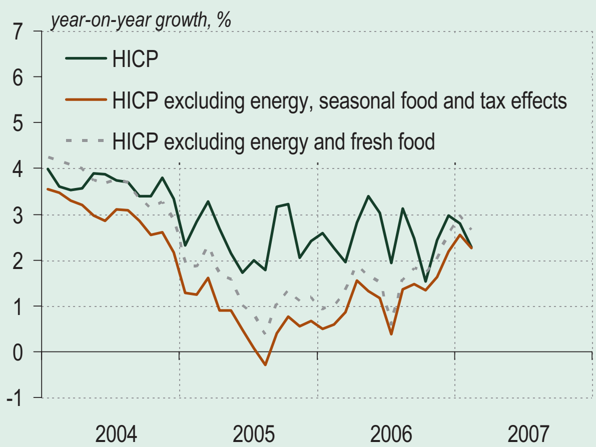
						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	**March**	Δ	**March**	Δ	**March**	Δ
Activity, employment, wages	*real growth, %*										
Real GDP	3,5	2,7	4,4	4,0	5,2	**4,6**	0,4	**4,4**	0,5	**4,0**	…
Employment	1,5	-0,2	0,4	0,7	1,2	**1,1**	0,5	**0,6**	0,1	**0,5**	…
Net wages	2,1	1,8	0,8	3,6	2,6	**4,0**	0,0	**2,8**	-0,1	**2,7**	…
Gross wages	2,1	1,9	1,0	2,2	2,3	**2,7**	0,1	**2,8**	-0,1	**2,7**	…
Productivity	2,0	2,9	4,0	3,2	4,0	**3,6**	0,0	**3,8**	0,4	**3,5**	…
Domestic demand	*real growth, %*										
Domestic demand	2,4	4,7	4,9	2,0	5,5	**4,5**	0,3	**3,9**	0,3	**3,8**	…
Private consumption	1,3	3,4	2,6	3,4	3,3	**3,5**	0,1	**3,4**	0,3	**3,2**	…
Government spending	3,2	1,6	3,4	2,2	3,8	**3,2**	0,4	**2,7**	-0,1	**2,7**	…
Gross investment	4,0	10,1	11,4	-1,1	11,4	**6,0**	-0,2	**5,4**	0,3	**5,2**	…
Balance of payments	*real growth, %*										
Exports of goods and services	6,7	3,1	12,5	10,5	10,0	**8,4**	0,6	**9,7**	2,5	**7,8**	…
Imports of goods and services	4,8	6,7	13,4	7,0	10,4	**8,1**	0,6	**9,0**	2,3	**7,3**	…
Current account (EUR millions)	247	-196	-720	-547	-773	**-600**	250	**-700**	110	**-630**	…
as % of GDP	1,1	-0,8	-2,8	-2,0	-2,6	**-2,0**	0,7	**-2,1**	0,3	**-1,8**	…
Terms of trade*	0,5	1,3	-1,0	-2,7	0,1	**0,0**	0,5	**-0,1**	0,0	**0,0**	…
Prices	*average annual growth, %*										
Consumer prices (HICP)	7,5	5,7	3,7	2,5	2,5	**2,7**	0,0	**2,7**	0,0	**2,6**	…
Free prices	7,6	5,9	3,0	1,1	1,7	**3,1**	0,3	**2,9**	-0,2	**3,0**	…
Administered prices	6,7	4,6	6,9	9,1	6,2	**0,5**	-2,0	**1,7**	0,8	**0,7**	…
International environment	*annual growth, %*										
Foreign demand**	3,2	6,4	7,7	5,2	8,9	**6,8**	0,3	**7,3**	1,3	**6,5**	…
Oil (USD per barrel)	25,0	28,8	38,3	54,2	64,9	**60**	-10,0	**63**	-7,0	**63**	…
Commodities	4,6	11,3	16,0	6,0	27,7	**17,0**	7,0	**5,0**	0,0	**5,0**	…
EMU inflation	2,3	2,1	2,1	2,2	2,2	**1,9**	-0,5	**1,9**	-0,1	**1,9**	…
PPI Germany	-0,6	1,7	1,6	4,6	5,5	**2,4**	-0,3	**1,8**	0,1	**1,8**	…

* On the basis of national accounts deflators.
** Quantitative imports from basket of foreign partners.
Source: ARC, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook.

1 Price Developments

The average annual rate of inflation in consumer prices as measured by the HICP in 2006 remained unchanged from the previous year at 2.5%. The relatively stable average annual inflation was mainly brought by developments in three main factors, whose effects cancelled one another out. First, the trend of decline in core inflation[2] ended and reversed last year. Evidence of this comes from all the core inflation indicators. The annual average HICP excluding energy prices, food prices and tax effects was up 0.5 percentage points from extremely low level at 1.2% in 2005, while the year-on-year rate had reached 2.2% by the end of the year. Second, following a period of adjustment after Slovenia joined the EU, growth in food prices began to pick up again, the average rate of growth increasing by 2.5 percentage points on 2005 to 2.7%. Third, oil prices acted to reduce inflation, having begun to ease last year after two years of relatively rapid growth. Average growth in energy prices was down by more than 3 percentage points last year, from 11.9% in 2005 to 8.5% in 2006.

Figure 1.1: Headline inflation and core inflation



Source: Eurostat, SORS, ARC calculations

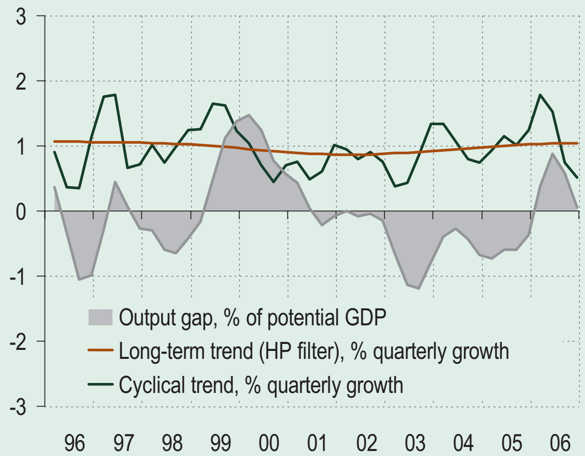
Year-on-year inflation was significantly more volatile last year, fluctuating between 1.5% and 3.4%. This volatility was primarily the result of one-off events. The rise in year-on-year inflation in the second quarter was a consequence of faster growth in oil prices and prices of refined petroleum products. At the beginning of the third quarter there was a rise in inflation because of a shift in the timing of seasonal sales for clothing and footwear, while at the end of the quarter a sharp fall in oil prices again brought a significant decline in the year-on-year inflation rate. The rise in year-on-year inflation in the final quarter was primarily the result of the basis effect of the fall in oil prices at the end of 2005.

Indicators of the domestic economic environment point to a gradual strengthening of inflationary pressures last year. With the economy growing significantly more quickly last year than potential output, after three years aggregate demand was slightly higher than potential supply overall, the output gap[3] turning positive. The slightly positive output gap probably contributed to the gradual rise in core inflation, but from an extremely low

[2] Core inflation is measured by the HICP, which does not include energy prices, seasonal food prices or tax effects
[3] The output gap indicates a deviation in real growth in GDP from its long-term trend. As the latter can be estimated using a variety of methods that usually give different results, the estimation and movement of the output gap can also vary. The ARC bases its estimate of the long-term trend in GDP on the HP filter statistical method

basis after the first half of 2005. In assessments of the effect of aggregate demand, consideration also has to be given to its structure. The majority of growth originates from investment in housing and other buildings, and investment in plant and equipment, and not from an increase in final consumption. Growth in final consumption remained moderate last year, with government spending up 3.8% and household spending up 3.3%. In addition, part of the increase in investment could be non-cyclical in nature, which entails an expansion in output capacity, and thus also a higher level of potential supply in the economy in the future.

Figure 1.2: Output gap



Source: ARC estimates

The relatively low growth in labour costs was a supply-side factor behind the moderate inflation level. It again lagged the productivity growth, despite the favourable conditions on the labour market. Real growth in gross wages in 2006 was slightly more than 1.5 percentage points behind productivity growth, in the context of a year-on-year increase of approximately 1.2% in employment. Another factor in the moderate growth in labour costs last year was the gradual abolition of payroll tax, while the risk of faster growth was also limited by the wage agreements for 2006 in both the public and private sectors.

As in 2005, factors in the international environment brought the major pressure on the price index last year. After oil prices continued to grow relatively strongly in the first half of the year, they eased in the second half of the year. The average price of a barrel of Brent crude rose from USD 49 in the first half of 2005 to USD 65 in the first half of 2006. Year-on-year growth in oil prices averaged approximately 33% in the first half of the year, but just under 9% in the second half of the year. The average annual growth in the US dollar price of Brent crude was one-half less last year than in the previous year at just under 20%, while the effect on tolar oil prices was additionally reduced by the tolar's 1% appreciation against the US dollar. The average growth in the tolar price of Brent crude thus stood at just under 19%. With domestic energy prices having grown by 8.6% last year, the pass-through of oil prices was approximately 45%.

Alongside oil, rapid growth in prices of other commodities, zinc, copper and gold in particular, continued last year. At 62%, last year's average growth in dollar metals prices was the highest in the last 15 years. Unlike the growth in oil prices, which have had a direct impact on consumer prices, growth in other commodities prices only had an indirect impact via higher growth in producer prices of manufactured goods on the domestic and foreign markets.

Figure 1.3: Producer prices of manufactured goods

Source: SORS, ARC calculations

However, no major pressure on inflation from producer prices on the domestic market could be discer-

Table 1.1 Breakdown of HICP and price movement indicators

	2006 weighting	average annual growth, %					year-on-year growth in quarter, %				
		2002	2003	2004	2005	2006	05Q4	06Q1	06Q2	06Q3	06Q4
HICP	*100,0%*	7,5	5,7	3,7	2,5	2,5	2,6	2,3	3,1	2,5	2,3
Breakdown of HICP:											
Energy	*12,7%*	4,7	3,4	7,0	11,9	8,5	10,8	11,9	12,4	7,7	2,3
Food	*22,3%*	8,7	6,1	1,3	0,2	2,7	1,7	0,9	2,4	3,6	3,9
processed	*14,7%*	11,5	7,3	2,7	0,6	2,5	0,9	1,7	2,4	2,3	3,5
unprocessed	*7,6%*	3,8	3,8	-1,4	-0,8	3,1	3,4	-0,6	2,3	6,3	4,7
Other goods	*31,7%*	4,9	4,8	1,8	-0,3	-0,9	-0,6	-1,2	-0,7	-1,4	-0,4
Services	*33,2%*	10,2	7,1	5,8	3,3	3,5	3,1	3,1	3,6	3,5	3,8
Core inflation indicators											
HICP excluding energy, seasonal food and tax effects	*83,4%*	...	6,0	3,0	0,7	1,2	0,7	0,6	1,4	1,1	1,7
HICP excluding energy and unprocessed food	*79,7%*	8,4	6,3	3,7	1,3	1,5	1,2	1,1	1,7	1,3	2,1
HICP excluding energy, food, alcohol and tobacco	*64,9%*	7,6	6,0	3,9	1,5	1,3	1,3	1,0	1,5	1,1	1,8
Administered prices and non-administered prices:[1]											
Administered prices	*17,5%*	6,7	4,6	6,9	9,1	6,2	8,2	9,0	9,2	5,8	1,3
Non-administered prices	*82,5%*	7,6	5,9	3,0	1,1	1,7	1,4	0,9	1,8	1,8	2,5
Other price indicators:											
Producer prices of manufactured goods		5,1	2,5	4,3	2,7	2,3	1,8	1,6	2,3	2,7	2,7
GDP deflator		7,9	5,8	3,3	1,5	2,3	0,9	1,5	2,3	2,7	2,7
Import prices[2]		2,5	2,0	4,1	5,0	4,7	3,8	4,5	4,2	5,2	4,7
Macroeconomic indicators:											
Output gap (HP trend)		-0,1	-0,9	-0,4	-0,6	0,5	-0,4	0,4	0,9	0,6	0,1
Unit labour costs[3]		7,7	4,4	0,7	1,1	0,8	1,2	1,0	1,0	-0,2	1,4
Labour costs per employee[3]		9,8	7,6	4,6	4,9	4,8	4,9	5,3	4,8	4,0	5,1
Productivity[3]		1,9	3,1	3,9	3,7	4,0	3,6	4,3	3,8	4,2	3,7
Profit indicator[4]		0,2	1,3	2,6	0,4	1,5	-0,3	0,5	1,3	2,9	1,4

Notes: [1] ARC methodology, [2] National accounts data, [3] Gross wages only, [4] Calculated as difference between GDP deflator and unit labour costs.
Source: SORS, Eurostat, ARC calculations

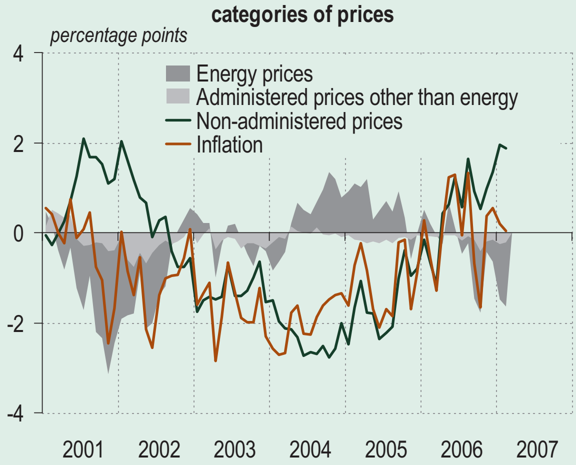
ned last year. Producer prices of manufactured goods rose by 2.3% on average last year, 0.4 percentage points less than the previous year. Prices of intermediate goods recorded the fastest growth, followed by prices of consumer goods, with prices of capital goods recording the slowest growth. That growth in prices of intermediate goods was again significantly faster was primarily the result of base effects in the first half of the year, and high growth in commodities prices. Growth in energy prices fell sharply last year, to stand at 0.1% year-on-year in December. By contrast, growth in prices of durable consumer goods remained slow, averaging 1.5% during the year. After adjusting for base effects from 2005, growth in prices of capital goods was significantly slower last year.

Economic policies were coordinated last year in line with the goal of introducing the euro, and acted to curb inflationary pressures. With its policy of gradual interest rate convergence, the Bank of Slovenia maintained interest rates at a level above those of the ECB, but still in line with the maintenance of the stability of the nominal tolar exchange rate against the euro. It thus held real interest rates at a level that did not additionally encourage domestic demand, lead to a deterioration in the macroeconomic equilibria, or encourage price growth.

The Slovenian Government also consistently implemented its administered price policy in line with its plan for managing regulated prices. In its *Report on the Realisation of the Plan for Managing Regulated Prices for 2006 and 2007*[4], the Ministry of the Economy states that there was a rise of 1.6% in prices under various

[4] http://193.2.236.95/dato3.nsf/OC/0701202118509/$file/105v1_15.doc (available only in Slovene)

Figure 1.4: Pressures on inflation stemming from individual categories of prices

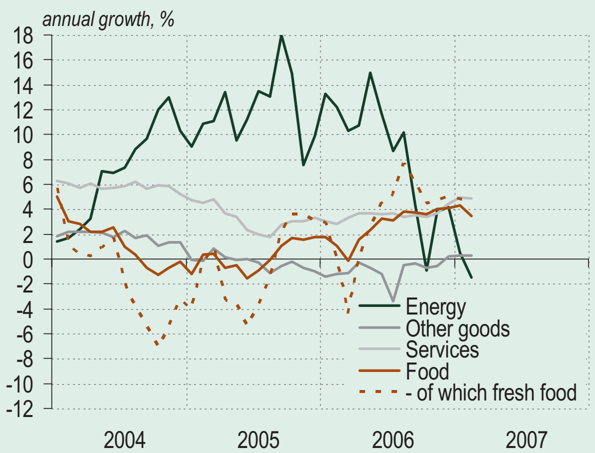


Source: ARC

forms of regulation in the first eleven months of 2006, which contributed 0.3 percentage points to inflation. Growth in these prices did not differ significantly from the planned rate of 1.2% and the planned contribution of 0.2 percentage points to inflation. According to the Ministry, a faster than planned growth in regulated prices was a result of higher growth in prices under indirect forms of regulation, and lower-than-forecast growth in prices under the direct control of the Government. Higher margins and excise duties on transport fuels meant that changes in the former contributed 0.3 percentage points more to inflation in the first eleven months of the year, while the decline in prices of water supply meant that changes in the latter contributed approximately 0.2 percentage points less. In general, administered prices in 2006 were in line with the principles of formulating regulated prices. Non-administered prices rose by 2.4% in the first eleven months of last year, and regulated prices by 1.6%. Neither did the increases in individual prices under various forms of control differ significantly from the increase in prices formed in the market. The only exceptions were prices of remote heating and certain municipal services, where there were notable price decreases and price increases.

Taking EU directives and the Excise Duties Act into consideration, the Government continued raising excise duties on tobacco products last year. This had an inflationary effect of approximately 0.2 percentage points, 0.1 percentage points less than in the previous year. The effect on inflation could have been even smaller, had producers not decided to further increase the sales prices of tobacco products in October following the price rises in July. The later price rise was probably a rounding measure connected to the limitations in technical solutions for vending machines before the introduction of the euro. In the area of excise duty policy, the Government again updated the Excise Duties Act at the end of the year by changing the method for calculating excise duties on electricity and making changes connected with the introduction of the euro. Between May 2004 and January 2007, Slovenia exercised the right to a transitional period in adjusting the level of excise duties on electricity to those in the EU. During this period there was zero duty, but since 1 March 2007 companies have had to pay excise duty on electricity of EUR 0.5 per MWh, and households EUR 1 per MWh. The Ministry of the Economy forecasts that this increase in excise duty will bring a rise of approximately 1.1% in electricity prices, and add approximately 0.03 percentage points in inflation.

Figure 1.5: Individual categories of prices



Source: SORS, ARC calculations

Analysis of the contributions of individual price categories to overall inflation indicated that there were

significant changes in key inflation factors last year. Growth in energy prices, which for the previous year and a half had been putting upward pressure on inflation, has acted to reduce year-on-year inflation since the second half of the year. Conversely, growth in non-administered prices has been increasing since the second quarter, which mostly neutralised the effects of the slowdown in oil prices and other energy prices. Nevrtheless, growth in regulated prices did not give rise to any significant pressures on inflation last year, and was even counter-inflationary.

Growth in energy prices slowed again at the end of last year, after more than a year and a half of rapid growth. Year-on-year growth stood at just 4.2% in December, while the average annual growth fell 3.4 percentage points to 8.5% The slowdown in energy prices has continued into this year. Year-on-year growth fell all the way to 0.5% in January, and reached -1.5% in February. The slowdown in energy prices was primarily the result of a decline in oil prices and prices of refined petroleum products on international markets after the end of the hurricane season and the decline in additional demand for oil during the holiday season, and also following the easing of tensions over the Iran nuclear question. A minor correction followed in November, after Opec decided to cut pumping quotas at its October meeting.

The growth dynamics in food prices picked up again last year. After a one-off adjustment in 2004, and a period of slow growth in 2005, year-on-year growth doubled last year to stand at approximately 4% at the end of the year. Average growth was also higher, rising by 2.5 percentage points from the previous year to 2.7%. Growth in prices of both processed and unprocessed food increased in 2006. Prices of processed food in particular recorded an accelerating trend last year, although this ceased in February 2007, the year-on-year rate having fallen to 4.1% in January and 2.7% in February. It indicates that the faster growth in food prices last year was to a great extent linked to the deferred feed-through of higher energy costs into retail prices. Most probably the pass-through of energy prices from 2004 and 2005 was deferred because of the adjustment in food prices during EU enlargement. Food price developments during this period varied considerably among EU countries, and the estimates of the equilibrium food prices for retailers were in all likelihood more important than the changes in energy prices.

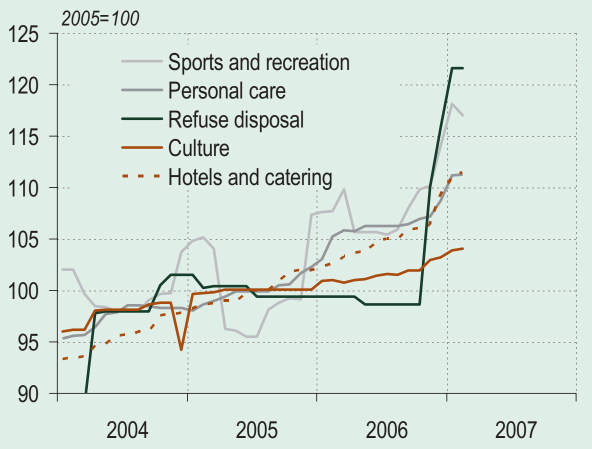
Figure 1.6: Food prices

Source: Eurostat, ARC calculations

In contrast to food prices, prices of services last year were significantly more stable, with a slight trend of increase at the end of the year. Year-on-year growth fluctuated slightly below 4% for the majority of the year, while average growth was down 0.6 percentage points from the previous year at 3.9%. There were only two notable increases in year-on-year growth, the first at the beginning and the second at the end of the year. The increase in the year-on-year rate at the end of the first quarter and the beginning of the second was partly the result of basis effects from the previous year and changes in methodology in the formation of health insurance prices, and partly the result of a rise in certain prices of services at the beginning of dual pricing.

Initial estimates are that the effect of the euro introduction was relatively small. The Statistical Office of the Republic of Slovenia recorded slightly higher growth in prices of certain services in March 2006 than in previous years, in particular services such as hairdressing and catering. Statistical Office figures and analysis show that the largest rises in prices in the hotels and catering sector came last December and this January. Some in the sector raised their prices because it had been some time since the most recent rise, while some could be seen to be adjusting their prices for the introduction of the euro.[5] Some price rises because of adjustments to the new currency and rounding up were also seen in January 2007 in sport and recreation, personal care, shoe repair services and the repair of domestic appliances. Although these deviations were larger than those previously seen in the same months of the year, they did not have any significant effect on inflation in January. According to Statistical Office estimates, the effect on inflation of the introduction of the euro was between 0.2 and 0.3 percentage points, similar to estimates in other countries in the eurozone.[6] Another factor in price rises at the end of 2006 and beginning of 2007 alongside the introduction of the euro was price rises in certain monopoly sectors.

Figure 1.7: Prices of selected categories of services



Source: SORS, ARC calculations

The trend of declining prices in the category of other manufactured goods ended last year after more than two years. Although average annual growth in these prices was negative at -0.9%, year-on-year growth had become positive by the end of the year. It stood at 0.2% in December, rising a further 0.1 percentage points in January, and remained at 0.3% in February 2007. The rise in the year-on-year rate at the end of the year was primarily the result of a base effect. This ended the period of adjustments in the prices of certain products, clothing and footwear in particular, that in recent years have come under additional competitive pressure from China, particularly in 2005.

[5] For more, see http://www.stat.si/eng/evro_spremljanje_analize.asp

[6] Eurostat calculations indicate that the introduction of euro cash brought an increase in year-on-year inflation in the eurozone of no more than 0.2 percentage points. Studies made by individual countries have similar findings: the price effect was estimated at 0.3 percentage points in Germany, 0.2 percentage points in Belgium, 0.4 percentage points in Spain, and between 0.1 and 0.6 percentage points in Italy. For more on the impact of the introduction of the euro in other eurozone countries see Box 4.1 in the Monetary Policy Report of May 2006

2 International Environment and Projection Assumptions

Economic growth in the eurozone was higher than the estimated potential growth also in the second half of 2006. After recording high rates in the first two quarters, economic growth in the eurozone slowed in the third quarter of 2006, but picked up again in the final quarter to stand at a quarterly rate of 0.9%. This took the eurozone's economic growth in 2006 to 2.7%, higher than the estimated potential growth, despite a more restrictive monetary policy, the appreciation of the euro and the growth slowdown in the USA. The increase in economic activity in the second half of 2006 was again based primarily on an improvement in domestic demand, while export growth was also strong. In December 2006 unemployment in the eurozone reached its lowest level of the last decade at just 7.5%, down 0.9 percentage points from the previous year, while growth in employment stood at 1.5%. The improvement in labour market conditions increased consumer confidence, which also accelerated private consumption. The extremely high investment spending seen in the first half of the year slowed slightly towards the end of 2006, but investment remained at a high level owing to the high level of resource utilization rates, the still-relatively-favourable terms of financing, the low growth in labour costs and the improvement in private demand. After the rather slow growth in the first half of the year, economic activity in the USA slowed further in the third quarter, but picked up again in the final quarter, primarily as a result of the higher growth in private consumption brought by the favourable conditions on the labour market and the decline in oil prices. Growth in foreign demand last year exceeded the assumptions used in previous projections, primarily as a result of the extremely high economic growth in certain important trade partners in the final quarter of last year.

This year economic growth in the most important trade partners is expected to slow, but will nevertheless remain on a relatively high level. A slight slowdown in economic growth is expected in the eurozo-

Table 2.1 Assumptions for factors in international environment

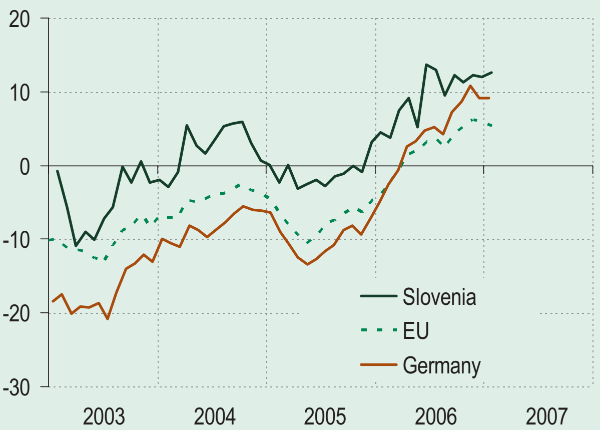
						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	**March**	Δ	**March**	Δ	**March**	Δ
	annual growth, %										
Foreign demand*	3,2	6,4	7,7	5,2	8,9	**6,8**	0,3	**7,3**	1,3	**6,5**	…
Oil (USD/barrel)	25,0	28,8	38,3	54,2	64,9	**60**	-10	**63**	-7	**63**	…
Commodities prices	4,6	11,3	16,0	6,0	27,7	**17,0**	7,0	**5,0**	0,0	**5,0**	…
EMU inflation	2,3	2,1	2,1	2,2	2,2	**1,9**	-0,5	**1,9**	-0,1	**1,9**	…
PPI Germany	-0,6	1,7	1,6	4,6	5,5	**2,4**	-0,3	**1,8**	0,1	**1,8**	…

** Basket of foreign partners import volumes.*
Source: ARC, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, SORS

ne in the first quarter in particular, but the pace of economic activity is then expected to gradually pick up. The deterioration in the first quarter was assumed primarily as a result of the rise of 3 percentage points in the general VAT rate in Germany at the beginning of 2007. The indicators of confidence in the eurozone at the beginning of 2007 remained encouraging, but there were nevertheless deteriorations in certain eurozone countries. The main deteriorations were in confidence in industry, probably as a result of the global decline in growth in industrial production, the appreciation of the euro and the deferred effects of last year's high oil prices, while in Germany indicators also showed the impact of the anticipated effect of the rise in VAT. Indicators of confidence nevertheless remain above their long-term average. In the structural breakdown of GDP, domestic demand in the euro area is expected to remain the main driving force of economic growth this year. Factors that will encourage household spending are the slight decline in inflation and the improved conditions on the labour market, while investment will grow as a result of the still-favourable financing conditions, the increasing utilization rates and the relatively solid expectations of foreign demand. Trade partners in eastern Europe are expected to see a decline in their high economic growth as a result of the deterioration in their trade volumes, which follow the slowdown in economic growth in the euro area, while domestic demand and imports remain strong. This year's growth in the countries of south-eastern Europe is expected to be similar to last year's, which averaged close to 4.7%. A potential risk of an additional slowdown in growth is the unstable political climate, which is bringing uncertainties in doing business with this region. Economic growth in Russia is expected to be slower this year, after the extremely good rate of 6.7% recorded in 2006. The main factor in the slowdown is expected to be lower export growth, while domestic consumption will remain relatively strong.

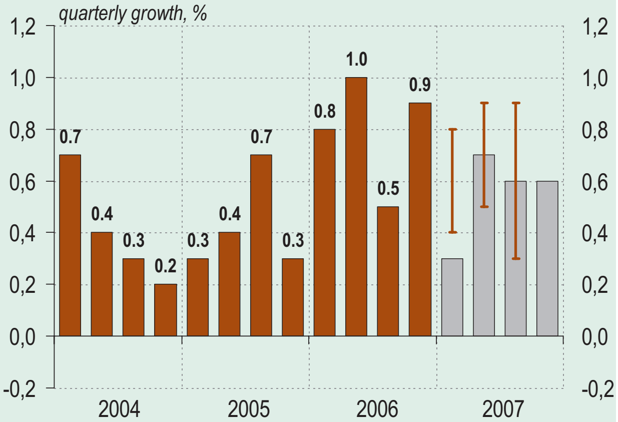
The current assumptions for growth in foreign demand have been revised upwards from previous projections. Although economic growth and growth in demand in the most important trade partners is expected to be slower this year, the assumptions for foreign demand have been revised upwards from last October's projection. The main reason for this revision were changes in economic growth forecasts for the aforementioned countries, which have been raised significantly since last autumn. The average economic growth forecast for Germany in 2007 as published by Consensus was 1.2% in September last year, but raised to 1.7% this February. The European Commission similarly raised its economic growth forecast for the euro area. Economic growth in 2007 was forecasted at 2.1% last November, but this was revised to 2.4% by the European Commission this

Figure 2.1: Business confidence in Slovenia and abroad



Source: Eurostat

Figure 2.2: Eurozone GDP growth and European Commission (EC) projections

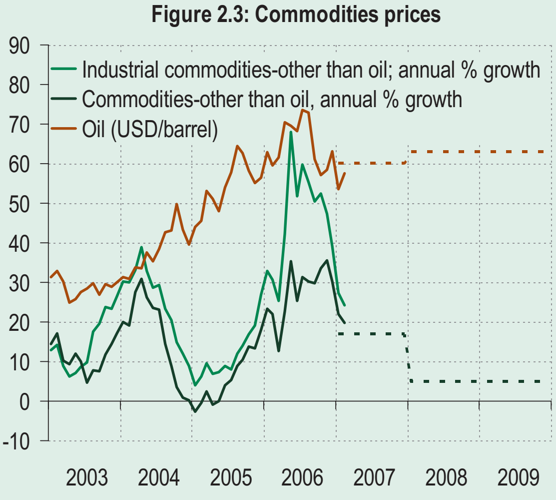


Source: Interval forecast: EC, March 2007; projections for three quarters
Point forecast: EC February 2007; projections for four quarters

February. The improvement in the economic growth forecasts for this year was the result of the economic results in the final quarter being better than expected. A further increase in economic growth in Germany is forecasted for 2008, while demand should improve as well in Italy and in the USA. There has also been an increase in the assumption for foreign demand next year as a result of the improved forecasts for economic growth in 2008 in the most important trade partners.

On international commodities markets the rapid growth in commodities prices continued in the second half of last year, while oil prices eased towards the end of the year. In particular there was an increase in growth in metals prices throughout the year, where a year-on-year rate in excess of 70% was reached in the second half of 2006. The high growth in metals prices was the result of increased demand, from China and India in particular. Growth in commodities prices slowed slightly at the beginning of 2007, with the exception of food, owing to a seasonal effect. Growth in commodities prices other than oil did not differ significantly from the assumptions used in previous projections. Oil prices increased in the first half of last year, with the Lebanon-Israel conflict bringing a high of USD 78 per barrel in the middle of the year. They fell significantly towards the end of the year to USD 53 per barrel, primarily as a result of good weather conditions in the northern hemisphere. Average growth in oil prices last year was slightly lower than the assumption used in the previous projections, primarily as a result of the favourable weather conditions at the end of the year.

Figure 2.3: Commodities prices



Source: The Economist, Reuters

A slowdown in oil prices and commodities prices is expected this year and next year, although they will remain high. One factor in the slowdown in commodities prices other than oil will be the slight slowdown in the world economy, which many analysts (such as JP Morgan) feel is likely to be followed by the withdrawal of speculative investors from commodities markets as well. At the same time the gap between supply and demand for commodities will remain the main factor behind the high level of prices. The current assumption for growth in commodities prices other than oil was revised upwards primarily as a result of growth remaining high in recent months (prices of industrial commodities recorded year-on-year growth of almost 40% on average during the three months up to this January). By the end of February oil prices had risen to a higher level than they had been at the end of last year, primarily as a result of the cut in production announced by Opec. The average oil price is expected to be slightly higher this year (USD 60 per barrel) than during the first two months of the year (USD 56 per barrel), as a result of seasonal factors that take effect during the summer and then towards the end of the year. In addition further cuts in oil production could be made by Opec, which is trying to prevent an excessive fall in prices. The assumed oil price for 2008 is slightly higher (USD 63 per barrel) than the one for this year, owing to the anticipated renewed improvement in world economic growth. The oil price assumptions for this year and next year have been revised significantly downwards from the previous projections because of the decline in oil prices at the end of last year and the beginning of this year.

Inflation in the eurozone in 2006 was mainly under the influence of energy prices, and remained at the 2005 level of 2.2%. Inflation in the eurozone moved above the average for the year in the first eight months of 2006 in line with the high energy prices, but then declined with the sharp fall in energy prices to finish the year at 1.9%. The decline in oil prices at the end of the year was also the main reason that our assumptions for inflation in the eurozone in the previous projections were slightly above the actual inflation last year. Low oil prices pushed inflation down to 1.8% in January 2007, despite the VAT increase in Germany. Core inflation as defined by the ECB was 0.1 percentage points higher in the second half of 2006 than the average in the first half of the year, and averaged just 1.5% over the whole year, which indicates that the feed-through of high energy prices into other prices is limited for the moment. After increased price pressures in the first half of the year, producer prices eased slightly in the second half of the year, with strong competition continuing to limit the feed-through of higher energy prices into prices of final products. High productivity growth is contributing to unit labour costs remaining low, which is currently mitigating inflationary pressures. Inflation in the USA in 2006 was also under the strong influence of oil prices, standing at 3.8% in the first eight months of the year, but it had fallen to an average of 2.0% by January. In particular, producer prices for industrial comodities have eased since September 2006, even falling in certain months, while the increase in core inflation continued in the second half of 2006. In the USA core inflation stood at 2.7% in January 2007, its average level during the second half of 2006.

Inflation is expected to be lower in both the eurozone and the USA this year, primarily as a result of declining expectations considering the oil prices. In the forecasts by foreign institutions for this year's inflation in the eurozone in comparison with last year, and in comparison with the assumptions used in previous projections, the effect of lower oil prices prevails over the effect of the VAT increase in Germany. Initial figures for this year indicate that the effect of the VAT increase in Germany will be slightly lower and will be distributed over a longer period than had originally been estimated. Lower oil prices will also have a beneficial effect on lower growth in producer prices in Germany, which will also be put on a downward pressure by the slightly reduced domestic demand after the VAT increase. Inflation is also expected to ease in the USA, where a slight decline in economic growth will act alongside low oil prices to slow growth in prices.

ECB monetary policy became more restrictive in 2006. Owing to increased inflationary pressures and the upturn in the economic cycle in the eurozone, the ECB began normalising the interest rate level in December 2005, raising the rate five times in 2006 to reach 3.50% in December 2006. By contrast, the Federal Reserve last raised its interest rate in June 2006, since when it has remained at 5.25%. The end to interest rate rises in the USA followed the downturn in the economic cycle, which was partly the result of the previous tightening of monetary policy and cooling on the real estate market. The technical assumption in the projections is that interest rates in the eurozone will move in line with the expectations of the financial market that prevailed in the middle of February 2007.

The financial markets' expectations of the movement in interest rates and the actual movement of the interest rate spread between the ECB and the Federal Reserve affected the movement of the euro exchange rate against the dollar. In the second half of 2006 the euro mostly gained against the dollar, primarily as a result of the increase in the ECB's interest rates while the Fed's rates were unchanged, and the acceleration of economic activity in the eurozone and economic slowdown in the USA. The euro fell slightly against the dollar in the early part of 2007, mainly as a result of the more favourable picture presented for the American economy, after real estate market tentatively stabilized and oil prices lowered. The technical assumption in the projections is that the euro exchange rate against the dollar this year and in the next two years will remain at the average of the three months up to January 2007 inclusive, which corresponds to USD 1.30 to the euro. This entails a slight appreciation against the dollar in comparison with last year, and in comparison with assumptions used in previous projections.

3 Outlook for Economic Activity and Labour Market

GDP grew by 5.2% in 2006, and projections point to the economy activity remaining dynamic throughout the projection period. Economic growth was higher than expected in 2006, while forecasts are that GDP growth overall in 2007 to 2009 will be similar to the estimated long-term trend of just over 4%. High investment activity and employment growth will contribute to an expansion in the economy's potential supply capacity during the projection period. The current forecasts for economic growth in 2007 and 2008 have been revised upwards from previous projections. The upward revisions are primarily the result of the pass-through of the high growth in individual components of domestic demand from 2006, and the forecasts of improved growth in countries that are important trade partners of Slovenia, which will allow the high export cycle to continue. Other factors in the maintenance of high domestic demand alongside the incentives from the external environment will include the still-reasonably-favourable terms of financing, the high level of confidence in industry and the construction sector, high profits, the anticipated end of the transitional period for lower VAT rate on housebuilding and house repairs, high growth in disposable income due to changed tax legislation in 2007, and favourable conditions on the labour market. Economic growth of more than 4% will continue to facilitate the process of real convergence with the wealthier EU countries, with Slovenia recording faster GDP growth than the EU overall. At the same time expectations are that average GDP growth at the level of the long-term trend will maintain the slightly positive output gap, where aggregate demand is slightly in excess of potential supply.

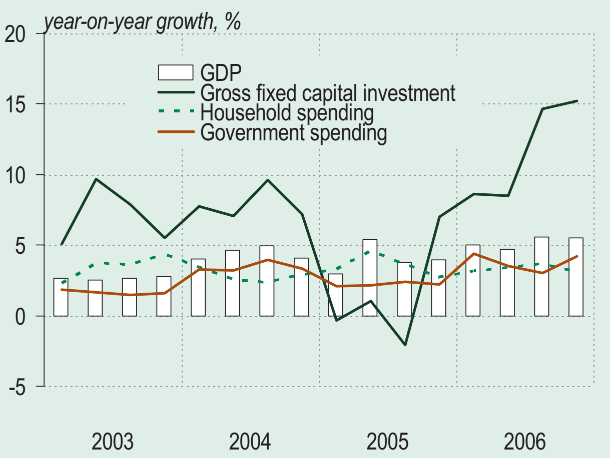
Economic activity picked up further in the second half of 2006, despite a slight slowdown at the end of the year. Economic growth, at a real year-on-year rate of 5.5% again outstripped the estimated growth in the economy's supply capacity in the second half of 2006. The

Table 3.1 Activity, employment and wages

						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	March	Δ	March	Δ	March	Δ
	real growth, %										
Real GDP	3,5	2,7	4,4	4,0	5,2	**4,6**	0,4	**4,4**	0,5	**4,0**	…
Employment	1,5	-0,2	0,4	0,7	1,2	**1,1**	0,5	**0,6**	0,1	**0,5**	…
Net wages	2,1	1,8	0,8	3,6	2,6	**4,0**	0,0	**2,8**	-0,1	**2,7**	…
Gross wages	2,1	1,9	1,0	2,2	2,3	**2,7**	0,1	**2,8**	-0,1	**2,7**	…
Productivity	2,0	2,9	4,0	3,2	4,0	**3,6**	0,0	**3,8**	0,4	**3,5**	…

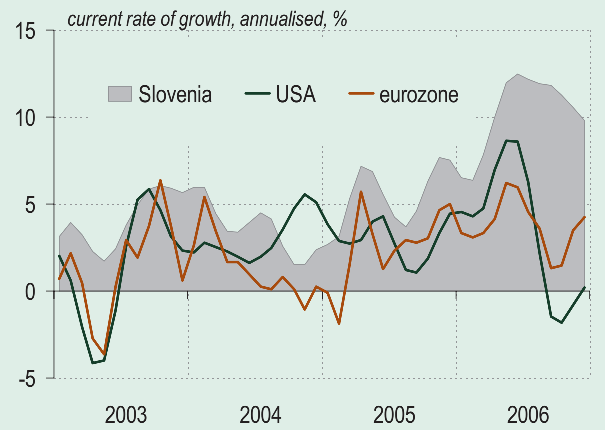
Source: SORS, ARC calculations

Figure 3.1: Domestic demand and GDP



Source: SORS; ARC calculations

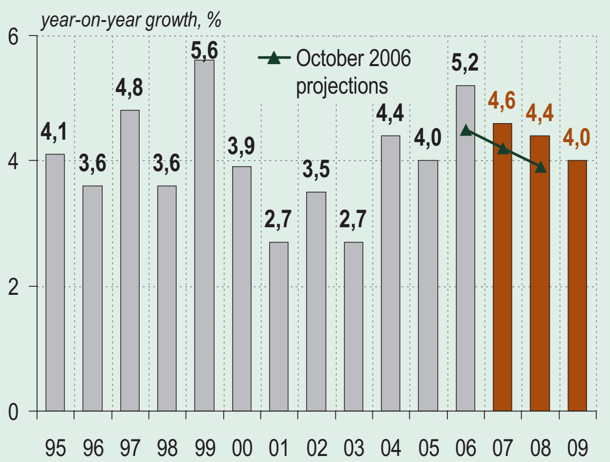
Figure 3.3: Industrial production



Source: Slovenia and eurozone - Eurostat; USA - Board of Governors of the Federal Reserve System; ARC calculations

greatest impetus to growth in value-added in 2006 came from the financial intermediation, construction and manufacturing sectors. Industrial production grew by 7% in 2006. This high growth in industrial production stood out from the rates recorded in the eurozone, but nevertheless slowed at the end of the year as in the US and the eurozone. The breakdown of economic growth points to a favourable business cycle inside and outside Slovenia, as a sharp increase in growth in value-added was recorded both by companies producing mainly for domestic market and by companies producing primarily for foreign markets.

Figure 3.2: GDP growth projections



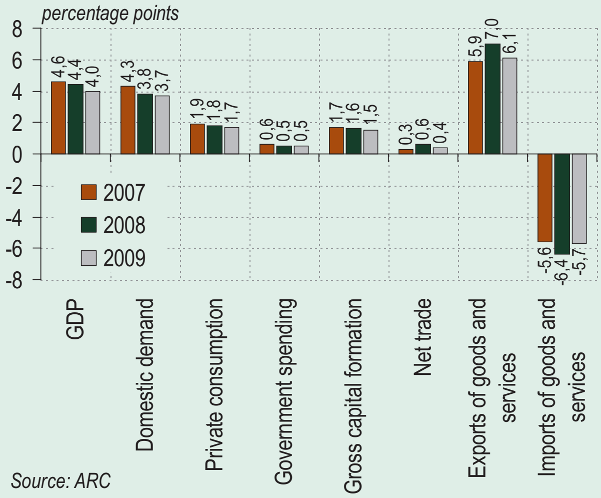
Source: ARC

Domestic demand is expected to remain the main factor driving the business cycle throughout the projection period.[7] Domestic demand will continue to make an important contribution to aggregate demand mainly due to relatively rapid growth in investment. Both the expected high employment growth and the rapid growth in investment will contribute to an increase in the economy's supply capacity, which provides the basis for more persistent and sustainable economic growth in the medium term. Net trade will make a slightly more favourable contribution to economic growth in 2007 than in the previous year. The slight slowdown in export growth as a result of lower foreign demand will be tracked by a slowdown in import growth, in line with the slowdown in domestic consumption and the high import component in exports. Domestic demand will continue to account for the majority of

[7] The projections were made on the basis of information available and the statistical methodology accessible until 9 March 2007. The projections of macroeconomic series in the Price Stability Report rest on assumptions for movements in variables in the international environment and certain domestic factors conditioned by economic policy decisions. The domestic factors under the influence of economic policies and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumptions used in the projections are not the same as those used in its projections by the ESCB (see Appendix 1)

aggregate demand overall during 2007 to 2009, while the contribution made by net trade will be positive. The most likely reason for economic growth in Slovenia being slower in the projection period than currently forecast could be a significant slowdown in the acceleration of economic activity in the most important trade partners.

Figure 3.4: Projections of composition of growth



Source: ARC

The contribution made to aggregate demand by domestic demand will nevertheless decline slightly during the projection period. The decline in the contribution made by domestic demand will mostly be the result of the partial cooling of investment spending after the sharp increase in total investment in 2006. The fastest-growing component of domestic demand in 2006 was investment in equipment, which recorded average year-on-year growth of more than 12% during the year, partly as a result of the low basis from 2005, but primarily as a result of the high level of saturation of production capacity. The main factors driving the strong investment spending in 2006 were the still-relatively-favourable terms of financing during the nominal convergence of interest rates, the anticipated growth in domestic and foreign demand, certain one-off events, and the anticipated end of the transitional period of lower VAT rate for housebuilding and house repairs at the end of 2007. Investment in housing and, in particular, in non-residential buildings picked up further in the second half of 2006.

Household spending grew by 3.3% in 2006, and is expected to remain at a high level in the future. Growth in household spending in 2006 was 0.2 percentage points lower from the forecast in the previous projections. Growth in household spending is expected to be relatively high in the future primarily as a result of the favourable conditions on the labour market, which raise consumer optimism. Another factor contributing to high household spending is the increase in disposable income as a result of the changes in income tax legislation, and, to a lesser extent, the continuing relatively favourable terms of lending. However, certain expected changes in the taxation and an appropriate monetary policy in the eurozone will prevent excessive consumer spending. Households will continue to be encouraged to use longer-term savings schemes by institutional changes already made in pension insurance and new alternative forms of saving. The contribution made to economic growth by household spending will increase only slightly compared with 2006.

Table 3.2 Components of domestic demand

						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	**March**	Δ	**March**	Δ	**March**	Δ
		real growth, %									
Domestic demand	2,4	4,7	4,9	2,0	5,5	**4,5**	0,3	**3,9**	0,3	**3,8**	…
Private consumption	1,3	3,4	2,6	3,4	3,3	**3,5**	0,1	**3,4**	0,3	**3,2**	…
Government spending	3,2	1,6	3,4	2,2	3,8	**3,2**	0,4	**2,7**	-0,1	**2,7**	…
Gross capital formation	4,0	10,1	11,4	-1,1	11,4	**6,0**	-0,2	**5,4**	0,3	**5,2**	…

Source: ARC

Household spending will remain at a high but sustainable level, behind GDP growth, and will not give rise to any inflationary pressures. The main risks affecting household spending are the undefined package of tax reforms (e.g. real estate tax, VAT), and price rises, which could encourage additional wage increases in the event of substantial wage growth allowed by the favourable economic environment. Because pension increases have been tied to gross wages since the middle of 2005, the disposable income from pensions is also a risk to the forecast for household spending. Any changes in indirect taxation, in particular changes to the current VAT rates, could change the assumptions on which the household spending forecast is based. Such an event would in all likelihood trigger a change in the intertemporal substitution of consumption, similar to that in 1999, with a rapid increase in household spending in the year before the change to VAT rate and very slow growth in household spending in the year of the change. In particular, these could be the consequences if the measures to raise VAT were not thoroughly elaborated at the right time.[8]

The contribution made to aggregate demand by government spending will remain at the average level of the last few years during the projection period. There was a notable increase of 3.8% in government spending in 2006, which was primarily the result of high expenditure on goods and services. Given the relatively high rate of growth last year, the forecast for government spending for this year has been revised upwards, although the difference from the previous projection is less than 0.5 percentage points. The forecast for nominal growth in government spending remains unchanged. The forecast for real government spending in 2008 is unchanged from the previous projections, and points to a slowdown in government spending. Growth in government spending should settle above 3% in the next two years.

Gross fixed capital investment increased by 11.9% in 2006, significantly in excess of the previous projections. The current rate of growth in investment was strong throughout last year, and even picked up at the end of the year. The fastest-growing components of gross fixed capital investment were residential buildings and investment in transport equipment. The high growth in investment in residential buildings was primarily the result of intertemporal substitution, i.e. an increase in housebuilding before the anticipated end of the transitional period of lower VAT rate, which is due to happen at the end of 2007. The high growth in investment in transport equipment in the first half of 2006 was at least partly the result of one-off factors, but it picked up pace again at the end of the year. In the first half of the year it was primarily a shift of timing in the purchase of certain types of transport equipment forward from 1 April, when new rules for certain types of transport equipment came into force, while at the end of the year the current rate of growth picked up because of certain one-off transactions. Growth in investment in transport equipment is thus expected to by slightly slower in the future.

The fastest-growing component in gross fixed capital investment is expected to be investment in residential buildings. Despite the slight increase in investment in machinery and equipment owing to the favourable outlook and the high level of saturation of production capacity, and the increase in government investment spending on road infrastructure, the highest growth will be recorded by investment in residential buildings. The pace of housebuilding will remain high as a result of the anticipated end of the transitional period of lower VAT rate. During the transitional period, Slovenia has been able to apply a lower VAT rate to housebuilding with the agreement of the European Commission.[9] The exceptionally good weather conditions at the start of 2007 will also contribute to maintaining the pace of activity in the construction sector. An additional factor having a beneficial impact on

[8] An example of prompt and adequate information and timetabling for measures involving VAT is Germany, where there were no major shocks before or after the rise in tax rates at the beginning of 2007
[9] The renovation, repair and maintenance of residential buildings will be subject to a lower VAT rate until 2010 at least

private sector investment will be the gradual reduction of corporate income tax, which will be cut in stages from 25% in 2006 to 20% by 2010. Conversely, investment spending in 2007 will be restricted primarily by the slight downturn in the economic environment in the rest of the world, the anticipated tightening of terms of financing, and the abolition of investment relief for corporate income tax that came into force at the beginning of this year.

The projections indicate continuing favourable conditions on the labour market and overall employment growth of more than 2% between 2007 and 2009. Should the economic environment remain favourable, the high rate of growth in employment seen in 2006 would be maintained. The employment figures from the national accounts show that employment grew on average by 1.2% overall in 2006, and at a year-on-year rate of 1.7% in the final quarter. The largest increases in employment were recorded by the construction sector and the real estate sector, while agriculture, mining and manufacturing recorded declines. In the manufacturing sector, as in previous years the largest declines in employment came in labour-intensive sectors, the textiles, foodstuffs and leather industries in particular, and, in the second half of 2006, in some predominantly export-oriented sectors, despite relatively high export growth. The relatively high pace of economic growth was thus positively reflected in developments on the labour market in 2006, although the figures from late 2005 and early 2006 still showed a potential stagnation. The continuation of the positive employment dynamics during the projection period will be the result of increased employment in both the public and private sector. The favourable economic environment and projected moderate growth in labour costs will provide the basis during the projection period for solid growth in private sector employment, although growth in employment in the private sector will trail the assumed growth in employment in the public sector. In the context of the structural shifts in the economy, the contraction of employment in labour-intensive sectors will continue to hinder faster growth in private sector employment.

Unemployment fell sharply in 2006. The number of unemployed in December 2006 was down by 14,270 or 15.4% from the same month of the previous year, while the registered unemployment rate stood at 8.6%, down 1.6 percentage points from a year earlier. There was also a sharp fall in unemployment as measured by the Labour Force Survey, which in the final two quarters of 2006 fell to 5.6%, its lowest level since surveying began. About half of those unemployed in 2006 were classed as long-term unemployed (more than one year), approximately 2 percentage points more than in 2005. In the breakdown, the largest relative increase in long-term unemployment was recorded by the 24 to 39 age group, but the 40 to 64 age group continues to account for the largest proportion of the long-term unemployed. According to the Labour Force Survey, the participation rate increased by 0.1 percentage points in 2006 to 59.3%, while the proportion of persons in employment in the working-age population increased by 0.4 percentage points to 55.8%.

Figure 3.5: Unemployment

Source: SORS, ARC calculations

Despite the favourable economic environment, growth in labour costs remained moderate in 2006. Growth in labour costs did not give rise to any inflationary pressures in 2006. Last year's growth in the average nominal gross wage remained almost unchanged from its level in the preceding two years at 4.8%, despite the increase in economic growth. The growth in the average gross wage remains a reflection of the good business cycle conditions for the private sector in the environment of an as-yet-unsaturated labour market, the restrictive income policy in the public sector and the statistical effect of a decline in numbers of low-paid jobs in certain parts of the private sector. As a result unit labour costs have remained sustainable in the environment of an increased estimated labour productivity, and for the moment are not giving rise to any inflationary pressures. The yearly average of year-on-year growth rates points to a real increase of 2.4% in the average gross wage in 2006. With estimated productivity having increased by 4.0% during the same period, the medium-term gap by which average real gross wage growth trails estimated productivity growth was just over 1.5 percentage points. Another factor in the low growth in the average nominal gross wage in the second half of 2006 was the below-average year-on-year growth in public sector wages, which rose by 3.3%, less than the 4.9% wage growth recorded by the rest of the economy. Growth in labour costs per hour worked also remained low in 2006, although it picked up slightly in the second half of the year to stand at 5.4%. There was a decline in labour costs per hour worked in public administration, but increases of just over 10% were recorded by the financial intermediation, agriculture and fishing sectors.

Labour costs are forecast to continue growing moderately during the projection period, with disposable income not expected to give rise to excessive, inflationary households demand . The changes in personal income tax legislation mean that there is expected to be a significant gap between the rates of growth in gross and net wages in 2007, as in 2005. Net wages are forecast to grow at a rate almost 1.5 percentage points higher than gross wages. Given the one-off nature of the change in tax legislation, which will mostly effect the disposable income of a small number of high-income earners, it is not expected to have any impact on estimated household consumption. The growth in labour costs other than gross wages will remain similar to gross wages, while the contribution made to total labour costs by payroll taxes will shrink owing to the gradual reduction of the respective tax rate and its final abolition in 2009. The gradual abolition of payroll tax will be the most important factor in the reduction of labour costs in the private sector, alongside the increase in external competition. While the social agreement for the 2006 to 2009 period has not yet been adopted, the social partners have agreed on one of its basic precepts, namely that real wage growth should not exceed the productivity growth.

After low growth of 0.9% in average real public sector wages in 2006, on the basis of budget documents for the coming years growth in real wages can be expected to rise. Public sector wages are set to rise by 1.5% in real terms in 2007, and by 2.0% in 2008. Under the Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in 2007-2009, public sector wages will be adjusted for inflation during these years. On top of that they will be adjusted for a certain proportion of productivity growth, 14% in 2007, 30% in 2008 and 50% in 2009. The actual wage increases will amount to 62% of 2.56% in 2007, 50% of 3.13% in 2008 and 50% of 3.75% in 2009. The shortfall with inflation and the portion for increased productivity will be earmarked for a special fund for reducing wage discrepancies.

Given the favourable economic environment, wage growth in the private sector will continue to outstrip that in the public sector by 1.0 to 1.5 percentage points. The exact wage increases have not yet been elaborated for the majority of employees (see Box 7.3). According to these estimates, the movement of total labour costs in the coming years will be in line with the expected movement in productivity, and will therefore not give rise to inflationary pressures of a cost nature. Should this not happen, excessive growth in the element representing the majority of costs at companies could be reflected in inflationary pressures, a decline in competitiveness and a slowdown in employment.

4 External Balance and Competitiveness

The current account projection points to a likely narrowing of the deficit, which is expected to fluctuate around 2% of GDP in the coming period. With the current account deficit having reached 2.6% of GDP in 2006, the narrowing of the deficit in comparison with the previous projections will take place in the context of higher projected growth in both imports and exports, continuing adverse movements in factor income, and favourable transfers with the EU. The current account deficit should thus narrow from EUR 773 million in 2006 to EUR 600 million in 2007, but will then widen to EUR 700 million in 2008. The current account deficit is projected to amount to 2.0% of GDP in 2007, and 2.1% of GDP in 2008. The current account deficit in 2009 is projected to narrow to approximately EUR 630 million, or 1.8% of GDP. The decline in the current account deficit to close to 2% of GDP derives almost entirely from the forecasts for the merchandise trade and the adjustment of transfers with the EU. Imports and export dynamics have been revised upwards from the previous projections, with the revision to the 2008 rate significantly greater than that for 2007 because of the larger revision to the forecast for foreign demand in 2008, and additional exports by the car industry that were not taken into consideration in the previous projections. Alongside the assumption of higher foreign demand, another factor in the increased import forecast is the projection of slightly higher growth in domestic spending in 2008. New information and the actual realisation in 2006 suggest that net transfers with the EU will be approximately EUR 100 million higher in 2007, with revisions of approximately EUR 40 million for the remainder of the projection period.

The current account deficit in 2006 was 0.6 GDP percentage points wider than that in 2005. The main factors in last year's current account deficit were the net outflows of factor income and the widening of the deficit

Table 4.1 Current account

						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	March	Δ	March	Δ	March	Δ
			real growth, %								
Exports of goods and services	6,7	3,1	12,5	10,5	10,0	**8,4**	0,6	**9,7**	2,5	**7,8**	…
Imports of goods and services	4,8	6,7	13,4	7,0	10,4	**8,1**	0,6	**9,0**	2,3	**7,3**	…
Current account (EUR millions)	247	-196	-720	-547	-773	**-600**	250	**-700**	110	**-630**	…
as % of GDP	1,1	-0,8	-2,8	-2,0	-2,6	**-2,0**	0,7	**-2,1**	0,3	**-1,8**	…
Terms of trade*	0,5	1,3	-1,0	-2,7	0,1	**0,0**	0,5	**-0,1**	0,0	**0,0**	…

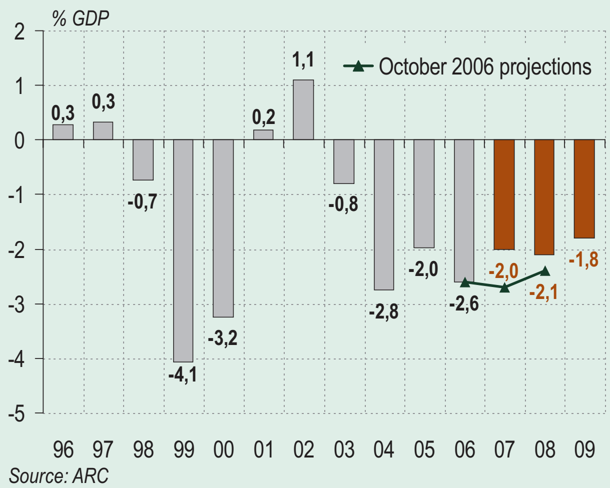
** Based on national accounts deflators.*
Source: ARC

in transfers. With the surplus in trade in services almost unchanged, the merchandise trade develoments also contributed to the current account deficit, particularly in the second half of the year when a slight increase in domestic spending meant that import dynamics has accelerated. The increase in import growth coincided with higher import prices. While the current account deficit in the first half of 2006 was almost identical to that in the first half of 2005, the deficit in the second half of 2006 was approximately EUR 200 million, or 0.5 GDP percentage points, wider than in the same period of 2005.

The favourable export dynamic will also allow for economic growth in line with the maintenance of the external balance. Although the relatively strong domestic demand will encourage the pace of imports, the persistence of a good climate in the rest of the world will also allow the growth of exports to be maintained at a favourable level. Both real imports of goods and services and real exports of goods and services increased at rates close to 10% in 2006. Growth in merchandise trade strongly outstripped growth in trade in services. Given the projected temporary decline in growth of foreign demand in 2007 and the renewed increase in growth in 2008, a similar dynamics is projected for real exports of goods and services. Another factor in the high pace of exports will be increased production and exports by the car industry,[10] which, like the majority of exporting industries, is closely associated with imports of equipment and material, and will thus also contribute to maintaining the high pace of imports. According to estimates, the additional exports by the car industry not taken into consideration in previous projections will add an extra 0.5 percentage points to growth in total exports of goods and services in 2007, and 0.9 percentage points in 2008. The increased imports of intermediate goods brought by the additional exports by the car industry will also add 0.3 percentage points to growth in total imports of goods and services in 2007, and 0.6 percentage points in 2008.

The deficit in merchandise trade is expected to narrow compared with 2006. With foreign demand growing strongly and domestic demand relatively strong, the deficit in merchandise trade will fall below EUR 1 billion. In the coming years, growth in merchandise exports is projected to exceed growth in merchandise imports by between 0.6 and 1.2 percentage points. The high growth in merchandise exports seen between 2004 and 2006, associated with the final abolition of customs duties when Slovenia joined the EU, high growth in exports by the car industry and the favourable climate in the most important trade partners, is expected to fluctuate around 9% in the future. Overall growth in merchandise exports in 2007 and 2008 has been revised upwards by more than 1.5 percentage points from the previous projections, the revision being made in line with the improvement in economic activity in Slovenia's major trade partners and the additional exports by the car industry, which account for approximately 0.5 percentage points of the revision. Growth in merchandise imports is linked to growth in domestic demand because of the high import component in consumption, but is also linked to growth in merchandise exports because of the high content of intermediate goods in final products. Growth in merchandise imports in the coming years is expected to be lower than in 2006, in

Figure 4.1: Current account projections



Source: ARC

[10] Revoz will begin full production of its new model in June 2007, with the additional production amounting to 400 cars per day, mostly for export (Delo, 7 March 2007)

the context of the projected movement in exports linked to foreign demand, and in line with slowing domestic demand. The increase in growth in merchandise imports in comparison with previous projections primarily derives from the increase in the forecast for domestic demand and the improvement in export projections. Overall growth in merchandise imports in 2007 and 2008 will be approximately 1 percentage point higher than forecast in previous projections, at just over 8%.

The services position will be positive throughout the projection period, and the surplus could gradually increase. The main factors in the increase in the surplus in trade in services are projected to be favourable foreign demand and the slightly faster growth in export prices of services compared with import prices. Growth in trade in services was slower than growth in merchandise trade in 2006. Growth in exports of services was 4 percentage points behind year-on-year growth in merchandise exports, while growth in imports of services was 1 percentage point slower than growth in merchandise imports. The most significant factor in the slower growth in service exports was the slowdown in the tourism sector, with tourism revenues recording a year-on-year increase of just 3.7% in 2006. Despite these developments, trade in services remained in surplus in the amount of 2.9% of GDP, and the surplus is expected to gradually increase in the context of the projected growth in service exports in keeping with the forecast for strong foreign demand. This indicates that imports and exports of services will grow at a similar pace.

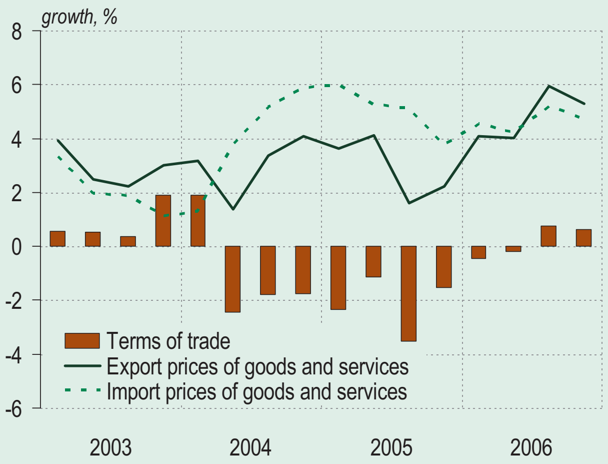
The deficit in factor income is expected to widen further, exceeding 1.5% of GDP. These projections are primarily the result of the rise in interest rates in the context of the past and projected stock of external debt. There was a net outflow of EUR 347 million in factor income in 2006, which accounted for just under one-half of the current account deficit. The main factor in the deficit in factor income in 2006 was the deficit in capital income. High lending activity in previous years and the rise in interest rates on world financial markets brought a significant increase in interest income in 2006, while payments of dividends and distributions of profit to the rest of the world also increased sharply last year. Dividends and profit distributions paid to the rest of the world amounted to EUR 134 million in 2005, but rose to EUR 366 million in 2006. The widening of the deficit in capital income is assesed to be mainly responsible for the increase in the deficit in factor income, while the position of labour income is expected to remain almost unchanged. The main factors in the widening of the deficit in capital income, which is expected to amount to approximately 2% of GDP during the projection period, are the increasing interest payments and the rising expenditure on dividends and reinvested earnings.[11] An increase is expected in interest payments primarily as a result of the increasing accumulation of debt via loans and deposits from the rest of the world, and the assumed increase in interest rates. The high and increasing expenditures on dividends and reinvested earnings are partly, in terms of volume, a reflection of the inward FDI realised in the past in Slovenia, and also, in terms of dynamics, a reflection of the projected growth in inward FDI in the future. Increasing income from investments in foreign debt securities, which are expected to significantly exceed expenditure on foreign investments in domestic debt securities, will act to reduce the deficit in factor income in the coming period.

There will be deficits in both private and official transfers. The deficit of EUR 171 million in current transfers in 2006 was more than double that in 2005, and was a major factor in the deterioration of the current account. The largest deterioration came in private sector transfers, while the main improvement in official transfers was in the use of funding available from the EU budget. Receipts from the EU budget amounted to 78% of the planned value in 2006, compared with 63% in 2005, while expenditure was 92% of the planned value. The result of these

[11] Reinvested earnings are an outward balance sheet item in the current account, which is disclosed in the financial account as an inward FDI by non-residents

flows was a net inflow of EUR 62 million in transfers from the EU budget. There will be a sharp increase in all types of transfer during the projection period, official transfers in particular, but both official and private transfers will remain in deficit. The expectation is that the surplus in receipts and expenditure in association with the EU budget will increase further in 2007, to approximately EUR 140 million, and then the surplus in flows with the EU will settle at around EUR 40 million in the next two years. The amounts forecast by the Ministry of Finance and the proportions of the planned flows actually realised in 2006 have been taken into consideration in the projections for EU budget flows.

Figure 4.2: Terms of trade

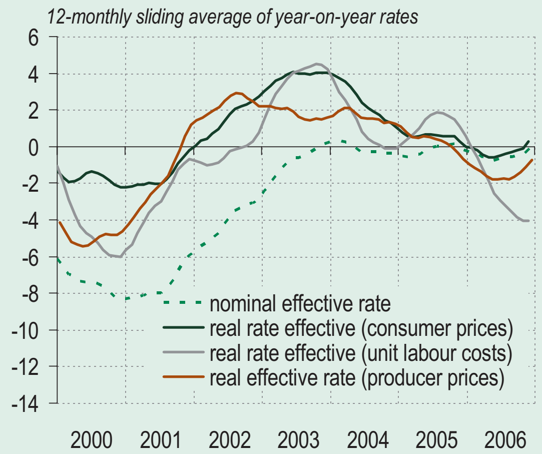


Source: SORS national accounts, ARC calculations

Given the assumptions made for import and export prices, the terms of trade will have a neutral effect on the current account position in the coming years. Growth in export prices exceeded growth in import prices by 0.1% overall in 2006, the terms of trade improving significantly at the end of the year. Export prices were up 4.8% overall during the year, and import prices were up 4.7%. This movement in import and export prices was significantly more favourable than that seen in 2005, when the terms of trade deteriorated by 2.1%. The terms of trade in 2007 will improve by 0.4 percentage points from previous projections owing to lower oil prices, despite commodities prices remaining at high levels. Part of the improvement in the terms of trade can be expected thanks to the increased exports by the car industry, but the revision is also the result of the improvement in the terms of trade at the end of 2006. As measured by the national accounts deflator, imports prices recorded a year-on-year increase of 4.7% in the final quarter. The increase in export prices measured in the same way in the final quarter of 2006 was 5.3% from the same period the previous year. The slowdown in import prices at the end of the year was primarily the result of lower oil prices on world markets, which was also followed by a slowdown in export prices. Growth in import prices and export prices is expected to be almost identical in 2007 and 2008, and the terms of trade are thus expected to have a neutral effect on the current account position.

The slow growth rates in domestic prices and in labour costs were important factors in the maintenance of the price competitiveness of the economy. Price competitiveness as measured by consumer prices deteriorated by 0.7% overall in 2006, while price competitiveness as measured by producer prices improved by 0.7%. Despite a deterioration at the end of last year, the biggest overall improvement in 2006 among all the indicators of price competitiveness was recorded by the indicator of competitiveness as measured by unit labour costs in the manufacturing sector (3.8%).

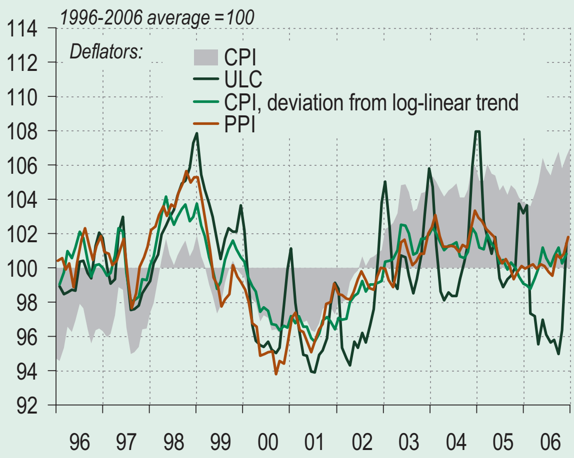
Figure 4.3: Nominal and real effective tolar exchange rate



Source: Eurostat

The indicators of price competitiveness were extremely close to their long-term averages in 2006. The indicators mostly show a neutral or slightly appreciated value compared with the long-term average prior to 2000, then a depreciated value in the period to 2003, and then a moderately appreciated value up to the end of 2005. The index of unit labour costs depreciated in 2006 as labour costs grew slowly than productivity. Only the real effective exchange rate as measured by consumer prices showed an appreciation in 2006 from its average of 1995 to 1999, by 6 percentage points. This appreciation primarily reflects the Balassa-Samuelson effect of catch-up with prices in wealthier economies during the process of real convergence. This real appreciation reflects a real economic equilibrium, and is not harmful to price competitiveness. The indicator of the real effective exchange rate is thus illustrated in Figure 4.4 as a deviation from the long-term (log-linear) trend, which shows similar movement to the indices using producer prices and unit labour costs as deflators.

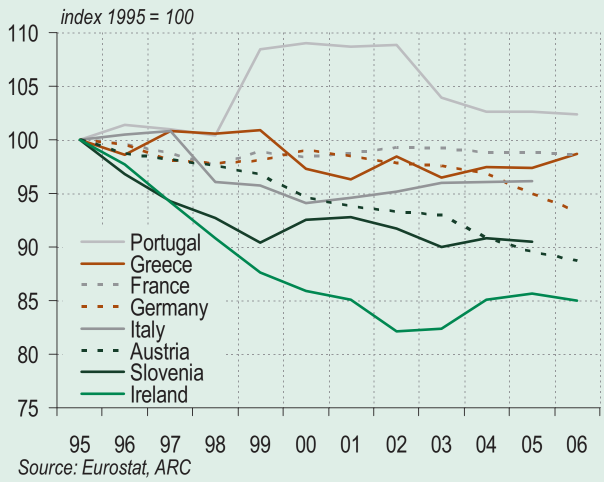
Figure 4.4: Real effective tolar exchange rate



Source: ARC

The indicator of unit labour costs is less dependent on long-term structural trends, and therefore better represents the level of competitiveness in the economy compared with other countries. Of the eurozone countries observed between 1995 and 2005 inclusive, the largest improvement in unit labour costs adjusted with the GDP deflator was recorded by Ireland, at 14 percentage points. Austria and Slovenia were next in terms of improved competitiveness, with competitiveness in Portugal deteriorating by 3% over the period observed. In the majority of the countries observed, competitiveness improved in the period prior to joining the euro (1999, or 2002 in Greece, and 2007 in Slovenia), with the exception of Portugal, where competitiveness as measured by this indicator deteriorated between 1995 and 1999. Labour costs have been relatively stable in these countries in the last three to four years, with the exception of Austria and Germany, where the aforementioned indicator of competitiveness improved by approximately 5 percentage points.

Figure 4.5 : Unit labour costs (total economy) adjusted by GDP deflator



Source: Eurostat, ARC

No significant changes in the price competitiveness of the economy are expected during the projection period. Given the assumed developments in the euro/dollar exchange rate, the real effective exchange rate is merely expected to appreciate slightly, as growth in domestic prices will exceed that in Slovenia's trade partners. Competitiveness as measured by unit labour costs should improve slightly, in the context of the forecast slowdown in labour costs and relatively high economic growth.

5 Financing Conditions

Financial inflows from the rest of the world and financial outflows to the rest of the world remained heavy in 2006, an indication of Slovenia's ever increasing level of involvement in international capital flows. Involvement in international capital flows is increasing after the reduction of risk on the foreign exchange market and interest rate convergence that came as a result of expectations about the upcoming introduction of the euro. The private sector's financial inflows amounted to almost 15% of GDP, and were equal to its financial outflows. Financial inflows from the rest of the world were down from 2005, primarily as a result of lower foreign borrowing by banks, while financial outflows were up, as a result of increased portfolio investments and an increase in lending to the rest of the world. Both the gross external debt and claims against the rest of the world are expected to gradually increase as a result of the increase in financial inflows and outflows. The net external debt, which stood at EUR 1.8 billion at the end of November 2006, is not expected to increase during the projection period.

The introduction of the euro brought an adjustment in the levels and statistical illustration in the most important categories in the financial account, foreign exchange reserves in particular. A change in the statistical classification of foreign exchange reserves means that portfolio investments by banks in euro-denominated first-class securities, which to date have been included in foreign exchange reserves, will now be classed as portfolio investments. Euro deposits held by banks and the Bank of Slovenia in accounts in the rest of the world will be reclassified from foreign exchange reserves to ordinary claims against non-residents in domestic currency.

The decline in foreign borrowing by banks was to a great extent the result of maturing Bank of Slovenia bills. Borrowing in the rest of the world by banks was equivalent to 8.6% of GDP in 2006, down 3.7 percentage points from 2005. Bank of Slovenia bills worth the equivalent of 5.9% of GDP matured in 2006. The release of money from the maturing Bank of Slovenia bills partly compensated for the decline in bank borrowing in the rest

Table 5.1 Financial account

						Projections					
						2007		2008		2009	
% GDP	2002	2003	2004	2005	2006	March	Δ	March	Δ	March	Δ
FDI, net	6,6	-0,6	0,9	-0,2	-1,0	**1,4**	-0,4	**0,1**	0,1	**-0,7**	-
Portfolio investments, net	-0,5	-0,8	-2,0	-3,9	-2,1	**-5,5**	-0,3	**-4,1**	-1,0	**-5,4**	-
Loans, net	2,5	3,7	5,3	8,1	4,5	**4,4**	-3,8	**7,6**	-0,8	**8,2**	-
Gross external debt (EUR millions)	11.524	13.225	15.344	19.614	23.718	**27.262**	-74	**31.975**	187	**36.788**	-
- as % of GDP	51,6	53,5	58,4	71,0	80,5	**86,1**	-3,5	**94,7**	-2,8	**102,5**	-

Vir: Banka Slovenije, ocene ARC.

of the world, thus allowing banks to finance their relatively heavy lending. However, this money was also used to purchase foreign securities. Corporate borrowing in the rest of the world was smaller than bank borrowing at 2.4% of GDP, but recorded an increase on the previous year, particularly in the second half of the year.

Portfolio investments continued to prevail in financial outflows to the rest of the world in 2006, but trade credits and loans to the rest of the world recorded the largest increase from the previous year. With outward portfolio investments having increased rapidly in previous years, in 2006 they remained close to the level in 2005 at 4.3% of GDP. Lending to the rest of the world via trade credits and loans almost doubled last year to more than 4% of GDP. The flow of trade credits in 2006 was 138% more than that in 2005, while loans to the rest of the world increased by 75%. This is partly a case of better inclusion of these flows in the available statistics. Loans to the former Yugoslav republics are prevalent among loans to the rest of the world, accounting for 78% of the total. The regional breakdown of the loans differs with regard to the lender's sector: while the former Yugoslavia prevails among bank loans (79%), EU member-states account for 43% of loans by companies and other financial institutions. Companies also favoured the EU to a great extent in trade credits granted, the EU accounting for 52% of the total.

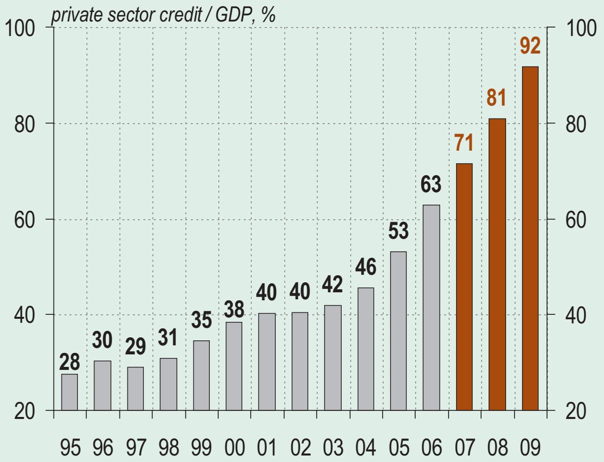
The majority of the factors considered in the projections point to a continuing increase in the total volume of financial transactions with the rest of the world. As in previous years, the largest contributions to the high volume of financial flows will come from bank borrowing in the rest of the world and high outward portfolio investments. In bank borrowing the assumption is that, as in 2006, maturing Bank of Slovenia bills will be equivalent to more than 5% of GDP in 2007, and banks will use this money to partly replace borrowing from the rest of the world. Bank borrowing in the rest of the world in 2007 will remain close to its level in 2006, but will increase in 2008 and 2009. Annual outward portfolio investments including portfolio investments by banks are expected to remain at more than 6% of GDP in the coming years. This also assumes that, as in 2006, the increased liquidity from the maturing Bank of Slovenia bills will be invested in foreign securities in 2007. The total of outward portfolio investments in 2007 is thus projected to be similar to 2006, but slightly smaller in the following years. The projection for outward portfolio investments also takes into consideration the continuing purchase of government securities, which amounted to 1.8% of GDP in 2006, and the maturity of eurobonds in 2009.

In line with past trends, outward FDI, trade credits and loans are likely to increase on the outflow side, while a gradual increase in foreign loans to companies is likely on the inflow side. These trends were in place when the previous projections were drawn up. Should Government plans for the sale of state assets be realised, there will be high inward FDI of more than 3.5% of estimated GDP in 2007, which should return to a lower level in 2008 and 2009.

Bank lending in 2006 and in the early part of 2007 has remained relatively high. Total bank lending increased in 2006 compare to 2005 by 21.6%, within that to the private sector by 26.2% and to the government by just 1.7%. Corporate borrowing in particular continued to gradually increase during the year. Year-on-year growth in lending to companies rose from 24.2% in December 2005 to 28.1% in December 2006, while year-on-year growth in lending to households remained between 25% and 26% during the same period.

The relatively high growth in corporate and household borrowing can to a great extent be attributed to the process of the deepening of financial intermediation, but is also partly cyclical in nature. The high levels of borrowing are in line with the process of real convergence with the wealthier EU member-states. The depth of financial intermediation as measured by private sector credit as a proportion of GDP will increase from 65% in 2006 to more than 90% in 2009, the pace of the deepening remaining unchanged during the projection period. Part of this acceleration is cyclical in nature, and is tied to the relatively low level of interest rates, particularly at the beginning of the year, and to the relatively high economic growth. Another feature of the increase in corporate borrowing is the replacement of foreign sources with domestic sources of finance, particularly in the first half of the year, while household borrowing is being encouraged by housing loans and increased competition on the credit market.

Figure 5.1: Deepening of financial intermediation



Source: ARC

In line with the deepening of financial intermediation, the debt burden on households and companies is also increasing. The ratio of loans to households to total income is gradually increasing, from approximately 5 in 2004 to more than 7 in 2006. The ratio of corporate loans to deposits increased from 2.2 to 2.6 during the same period.

Foreign currency loans again prevailed in the composition of borrowing in 2006. The proportion of the increase in loans for which they account remained at its 2005 level of approximately 90%. Companies recorded nearly all of their net borrowing in foreign currency. Foreign currency borrowing by households also strengthened, with foreign currency accounting for more than three-quarters of household borrowing. This is the expected effect of the introduction of the euro. With the introduction of the euro, the majority of borrowing in foreign currency became borrowing in domestic currency.

The projection for private sector borrowing points to a gradual decline in year-on-year growth in both corporate and household lending. Year-on-year growth in corporate lending and household lending is expected to gradually decline from more than 26% at the end of 2006 to just over 20% in 2009. The forecast for corporate borrowing is slightly higher than in the previous projections as a result of increases in economic activity and investment. Corporate borrowing in the rest of the world is expected to remain at the same level, not exceeding 20% of total corporate borrowing. The current rate of growth in household borrowing will decline more slowly than the current rate of growth in corporate borrowing. The volume of household lending in the coming years will be higher than forecast in previous projections as a result of higher projections for consumer spending, high housing loans and the associated higher growth in 2006.

In 2006 M3[12] rose entirely on account of domestic investments by banks, as the contribution of flows with the rest of the world to M3 growth was negative. Net foreign assets, which show the contribution made by balance of payments flows to growth in M3, fell by EUR 2.5 billion. The decline in net foreign assets is primarily the result of the increase in outward portfolio investments and bank borrowing in the rest of the world, and the simultaneous foreign currency lending for domestic non-banking sectors, but is partly a reflection of the current account deficit. Domestic lending activity is mainly expected to contribute to the creation of broad money in the coming years, as in previous projections.

Foreign currency deposits, tolar term deposits and tolar sight deposits contributed equally to growth in M3 in 2006. The breakdown on M3 in terms of individual types of deposit at the end of 2006 was approximately

[12] M3 is calculated in line with the national definition. Since the introduction of the euro, the Bank of Slovenia has only been publishing and monitoring the harmonised monetary aggregates, the methodology standardised for the whole eurozone

the same as at the end of 2005, with foreign currency deposits accounting for 34%, tolar term deposits for 36% and tolar sight deposits for 26%. One factor in this trend was the continuing convergence of tolar interest rates, with tolar rates being maintained above euro rates throughout. The increase in foreign currency deposits and the decline in tolar term deposits in the final quarter was a logical consequence of the conversion of tolars into euros. As a result of this process, the amount of cash in circulation declined and tolar sight deposits increased at the end of the year. Cash in circulation declined by SIT 60.3 billion in the final quarter, while tolar sight deposits increased by SIT 102.6 billion. The average maturity of deposits will probably lengthen in the future, as the introduction of the euro has reduced uncertainty, and interest rates are also expected to gradually increase.

Box 5.1: Euro cash changeover

On 11 July 2006, the Council of the European Union approved Slovenia's adoption of the euro and inclusion in the euro-zone, on the basis of the convergence reports of the ECB and European Commission. Slovenia introduced the euro as its deposit currency at the same time as introducing euro cash, similarly to Greece at the beginning of 2002.

The preparations for the introduction of euro cash included the Eurosystem supplying the Bank of Slovenia with 94.5 million banknotes, with a total value of EUR 2,175 million. For geographical and logistical reasons the Oesterreichische Nationalbank was responsible for executing the physical supply on behalf of the Eurosystem. The Mint of Finland was selected by public tender to produce 296.3 million euro coins for Slovenia, with a total value of EUR 104 million.

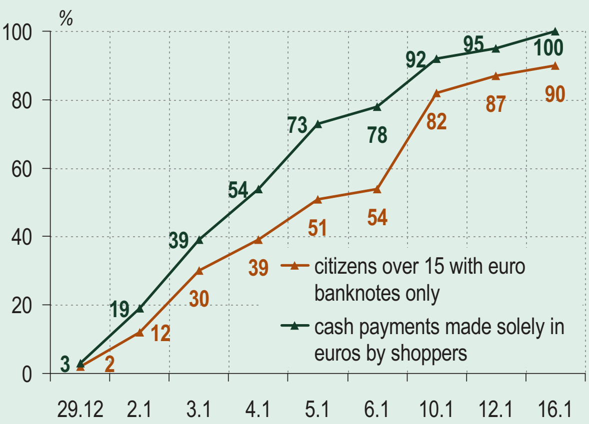
The frontloading of euro coins to banks started on 1 September 2006, while frontloading of euro banknotes started on 11 December 2006. By the end of December 2006, the Bank of Slovenia had frontloaded EUR 771.96 million in euro banknotes, and EUR 83.2 million in euro coins to bank vaults. Banks started supplying traders with euro coins on 1 December 2006, and euro banknotes on 11 December 2006. As part of this sub-frontloading procedure, traders received pre-prepared packages of coins (retail starter kits) with a suitable denomination breakdown for initial cash transactions. The value of each retail starter kit was EUR 201. Before euro adoption, Slovenian businesses were sub-frontloaded from bank and savings bank vaults with EUR 10.1 million in euro banknotes, EUR 8.8 million in coins, and EUR 7.24 million in retail starter kits. The sale of euro coin starter kits to the public started on 15 December 2006, with the value of an individual starter kit being EUR 12.52. By the end of December, 85% of the 450,000 starter kits for the public and the 46,725 starter kits produced by banks themselves had been sold, while 82% of the 100,000 collectors' compendiums had been sold.

Until 9:00 pm on 31 December 2006 ATMs dispensed tolar banknotes, and from a few minutes after 0:00 on 1 January 2007 they started dispensing €10 and €20 banknotes. ATM function was halted for just over three hours, from 9:00 pm on 31 December 2006 to a few minutes after midnight on 1 January 2007. The cash changeover and preparation of ATMs for cash withdrawals was prioritised to cover locations with permanent access. The list of ATMs with a timetable for dispensing euro cash was published in advance, and was available to the public on the Bank Association of Slovenia website.

The dual circulation phase ran from 1 to 14 January 2007, during which it was possible to pay in tolars and euros. Tolar banknotes and coins could be exchanged free-of-charge at the official exchange rate in banks and savings banks until 1 March 2007, inclusive. From 2 March it is still possible to exchange tolar banknotes free-of-charge in perpetuity at the Bank of Slovenia, while coins may be exchanged until 31 December 2016. Until the end of 2007 it is also possible to exchange them free of commission in the branch offices of two commercial banks, which were selected by means of a public tender to perform that service on behalf of the Bank of Slovenia.[1]

Particular attention was paid during the transition process to pricing in euros, with experiences and recommendations from the first euro changeover being closely studied and applied. Additional measures were applied, following on from the price display measures and price monitoring by the Slovenian Consumers' Association. In response to an initiative led by the Chamber of Commerce and Industry and the Chamber of Trade, over 400 companies signed price commitments, stating that they would not use the transition to the euro to make unjustified increases in euro prices. The Slovenian Govern-

Figure: Changeover to the euro



Source: European Commission

Table: Key dates in the changeover

Distribution of starter kits of coins for companies	1.12.2006
Sale of starter kits of coins for the public	15.12.2006
Free exchange at banks	Until 1.3.2007
Final day of tolar notes and coins used as legal tender	14.1.2007
Deadline for exchange of tolar coins at Bank of Slovenia	31.12.2016
Deadline for exchange of tolar notes at Bank of Slovenia	No deadline

ment made a commitment that prices for public administration services would stay the same. In December, as part of its price monitoring campaign, which was jointly funded by the Government and the Bank of Slovenia, the Slovenian Consumers' Association started to publish lists of those goods and service providers on the market that had excessively increased their prices as the euro changeover approached. Due in part to all these measures, the initial assessment of the impact of euro adoption on inflation was that it was minimal.

The introduction of the euro was accompanied by a large-scale publicity campaign, the aim of which was to inform the public of the appearance and security features of euro banknotes and euro coins and about the changeover procedure. In mid-November a joint ECB - Bank of Slovenia publication was issued and distributed to every household, which included descriptions of euro banknote security elements and an overview of changeover procedures. A euro-calculator was supplied along with the publication. In December households received the last round of information before euro adoption, with a joint Government and Bank of Slovenia publication in the two minority languages (Italian and Hungarian) and in Romani, as well as versions for people with visual or hearing impairments. On 29 December a joint press conference was held by the Government and the Bank of Slovenia, at which the governor of the Bank of Slovenia and the finance minister presented their final assessments of preparations for euro adoption. The governor and the minister both issued statements at midnight to mark the adoption of the new currency, and on 1 January press conferences were again held by the Bank of Slovenia and Ministry of Finance, with the governor and the minister providing the first results of the transition to the euro, and the latest news on the changeover.

On 15 January, to mark the end of the dual circulation period, the Government and the Bank of Slovenia organised a special event entitled "Out with the Tolar, in with the Euro" at the Cankarjev Dom Cultural and Exhibition Centre, combined with an exhibition entitled "From Bronze to the Euro: A Brief Monetary History of Slovenia." Every head of government and finance minister from the Eurogroup countries was invited, as well as the central bank governors of all 27 EU member-states, and a number of other esteemed guests. On the same day, the ECB and the Bank of Slovenia organised the international Euro Conference 2007 at Hotel Union, which was attended by the ECB President Mr Trichet, Commissioner Almunie, the president of the Eurogroup Mr Juncker, and the governors of the ESCB national banks.

Two weeks after the introduction of the euro banknotes and euro coins, on 15 January 2007, the cash changeover in Slovenia was completed according to plan, with the euro replacing the tolar as the only legal means of tender. Slovenia's cash changeover to the euro can be assessed as very successful, as confirmed by the ECB and European Commission.[2] All activities took place according to plan and without major problems. Specific disruptions that came to light and that did not substantially affect the changeover were immediately rectified where they occurred. The preparations and frontloading of the euro banknotes and coins were carried out in sufficient time to ensure there was no shortage of euro cash.

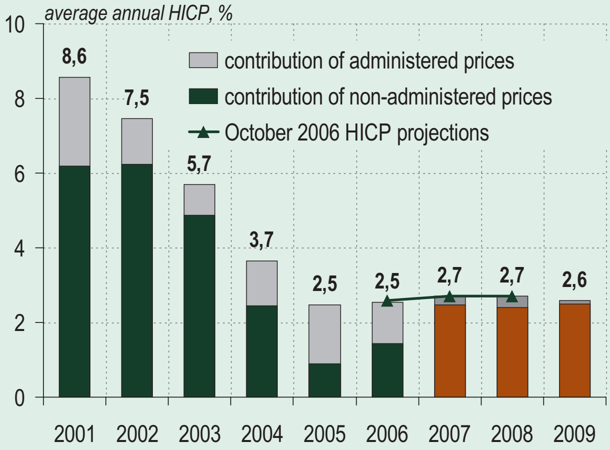
[1] http://www.bsi.si/en/economic-and-monetary-union.asp?MapaId=697

[2] http://www.ecb.int/press/pr/date/2007/html/pr070116.en.html
http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/38&format=HTML&aged=0&language=EN&guiLanguage=en
http://ec.europa.eu/economy_finance/euro/slovenia/main_en.htm
http://ec.europa.eu/economy_finance/euro/slovenia/docs/ebfl20070116en.pdf
http://www.ecb.de/press/key/date/2007/html/sp070115_2.en.html
http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/1903&format=HTML&aged=0&language=EN&guiLanguage=en

6 Inflation Projections

The external assumptions and expected macroeconomic trends being taken into consideration, inflation this year and next year is expected to be only slightly higher than average inflation in the last two years. The projections indicate that this year's average annual inflation as measured by the HICP will be 0.2 percentage points higher than last year's at 2.7%. It should remain at this level for another year, but is expected to decline again slightly in 2009 to 2.6%. The main factor in the rise in prices this year is expected to be faster growth in prices of services and food prices, while energy prices are not expected to change significantly on average during the year. After more than two years of negative growth, prices of other goods are expected to record slightly positive growth of 0.5% this year.

Figure 6.1: Inflation projections



Source: ARC

A comparison with the October projections does not show any major revision to future consumer price movements, as the macroeconomic factors taken into consideration in the projections remain broadly similar. The faster growth in prices this year is mostly a result of a revision for effects already realised, while the slowdown in 2008 is the result of a basis effect. The revisions to administered prices are partly a result of effects al-

Table 6.1 Inflation

						Projections					
						2007		2008		2009	
	2002	2003	2004	2005	2006	**March**	Δ	**March**	Δ	**March**	Δ
	average annual growth, %										
Consumer prices (HICP)	7,5	5,7	3,7	2,5	2,5	**2,7**	0,0	**2,7**	0,0	**2,6**	…
food	8,7	6,1	1,3	0,2	2,7	**3,9**	…	…	…	…	…
energy	4,7	3,4	7,0	11,9	8,5	**0,1**	…	…	…	…	…
other goods	4,9	4,8	1,8	-0,3	-0,9	**0,5**	…	…	…	…	…
services	10,2	7,1	5,8	3,3	3,5	**4,7**	…	…	…	…	…
Non-administered prices	7,6	5,9	3,0	1,1	1,7	**3,1**	0,3	**2,9**	-0,2	**3,0**	…
Administered prices	6,7	4,6	6,9	9,1	6,2	**0,5**	-2,0	**1,7**	0,8	**0,7**	…

Source: ARC

ready realised, and partly a result of different assumptions for the movement of energy prices.

The projections of inflation structure point to inflation in non-administered prices approaching the long-term trend, in line with the process of real convergence. After the relatively low growth in the last two years, average growth in non-administered prices will settle around 3% this year. The gradual increase in the average annual inflation in non-administered prices in 2007 is expected to primarily be the result of the rise already realised in these prices and factors that were already present at the end of last year, when inflation in non-administered prices rose to 2.9% in December 2006. The current rate of growth in non-administered prices is also expected to primarily be under the influence of the continuing strong economic growth and the slightly positive output gap from last year. The projected pressures on prices from the side of aggregate demand are nevertheless expected to be smaller because of the continuing slow pace of final consumption and the gradual rise in interest rates, while the ongoing strength of investment spending should increase production capacity.

The moderate growth in labour costs will remain the main factor in inflation stability. The projections show growth in labour costs remaining behind productivity throughout the projection period. The lag is being additionally underpinned by the observation of the public sector wage agreement, with the adoption of a similar agreement expected in the private sector, and by the gradual abolition of payroll tax.

The projected movements in the international environment also do not provide any indication of an increase in inflationary pressures in the future. Oil prices should stabilise at a level between USD 60 and USD 65 per barrel. Growth in other commodities prices is expected to begin slowing, as should growth in foreign demand. Inflation in the eurozone is expected to fall to 1.9% this year according to the assumptions used, and to remain at this level until the end of the projection period. After relatively high growth in the last two years, growth in prices of manufactured goods in Germany is expected to gradually slow down this and next year.

In contrast to the high growth in non-administered prices, year-on-year growth in administered prices is

Table 6.2: Assumed direct impact on inflation by Government measures in 2007

Measure	expected change	impact on HICP (percentage points)
Changes in administered prices:		
- Planned increase in oil trader margins	rise in fuel prices of 1.2%	0,098
- Change in methdology for setting prices of municipal services	neutral effect	0,000
- Change in prices of railway tickets	rise in prices of 2.3%	0,004
- Change in prices of certain textbooks	rise in prices of 2%	0,005
Changes in excise duties:		
- on tobacco products	rise in cigarette prices of 9.8%	0,324
- on alcohol to 21.5%	rise in prices of alcoholic beverages of approximately 2.7%	0,049
- on electricity	rise in electricity prices of 1.1%	0,025
Other measures:		
- Liberalisation of electricity market	rise in electricity prices of up to 10%	0,229
Overall impact on inflation		**0,735**

Source: Plan for managing regulated prices for 2006 and 2007; Excise Duties Act (Ztro-UPB3); Budget memorandums for 2007 and 2008

expected to continue declining. This is primarily the result of the projected movement of energy prices, which are forecast to remain more or less unchanged on average this year and in the next two years. The assumption for other administered prices is that they will grow at the same pace as non-administered prices, as envisaged in the plan for managing regulated prices in 2006 and 2007, which was adopted by the Slovenian Government last February. Other administered prices and non-administered prices are forecast as having the same rates of growth in 2008 and 2009, with no major deviations from the basic guidelines of the aforementioned plan anticipated.

Overall the Government's envisaged measures are expected to contribute approximately 0.7 percentage points to the inflation this year. The majority of this will result from changes in excise duties and the liberalisation of the electricity market. In addition to the effects of changes to administered prices, this year's renewed increase in excise duties on tobacco products is expected to be higher than originally planned, the Government having decided on early harmonisation with the EU. After a transitional period from May 2004 to January 2007, in line with European legislation Slovenia had to introduce excise duties on electricity, and the liberalisation of the electricity market is also expected. Judging by the budget memorandum for 2007 and 2008, the Government is planning to raise excise duties on alcohol by 21.5% in 2007.

Inflation stability and moderation can make a strong contribution to maintaining inflationary expectations at a low level. The maintenance of the macroeconomic equilibria, which illustrates that price shifts are unnecessary, is also the key to keeping inflationary expectations low. The low inflationary expectations reflect the credibility of macroeconomic policy in maintaining price stability and diminishing the response of inflation to pressure on prices. With no possibility of adjusting the nominal exchange rate, a stable, low inflation rate is of vital importance to maintaining the economy's competitiveness and external equilibria.

7 Possible Deviations from the Projections

The economic projections have been made on the basis of assumptions whose realisation is uncertain. Evaluating the effects of deviations from the assumptions on economic dynamics is essential for taking appropriate economic policy measures. The Bank of Slovenia projections are therefore accompanied by simulations of potential deviations from the assumptions and their impact on the movement of the principal macroeconomic indicators as compared to their their values in the baseline scenario during the period in question. Table 7.1 gives the macroeconomic scenarios should events develop differently from the assumptions used in the baseline scenario. It should be emphasised that here the risks are discussed individually so that potential correlations between devia-

Table 7.1 Model simulations to some macroeconomic shocks

	Simulation	Shock (change)	Qualitative probability estimate
	a) Foreign environment		
1.	Oil price	higher than the forecast price level by 5 USD per barrel	high
2.	Commodity prices	higher than the forecast price level by 10%	moderate
3.	Foreign demand	lower by 1 percentage point than forecast growth	moderate
	b) Domestic environment		
4.	Wage growth	higher by 1 percentage point than forecast growth in wages	moderate
5.	Household spending	higher by 1 percentage point than forecast growth in spending	low
6.	Government spending	higher by 1 percentage point than forecast growth in spending	low
7.	Growth in administered prices	higher by 2 percentage points than forecast growth in free prices	moderate

	Simulation	GDP			Inflation		
		2007	2008	2009	2007	2008	2009
Projections (baseline scenario)		4,6	4,4	4,0	2,7	2,7	2,6
Response of projections to shocks:							
	a) Foreign environment						
1.	Oil price	4,5	4,3	3,9	3,2	2,9	2,7
2.	Commodity prices	4,5	4,4	4,0	2,8	2,9	2,7
3.	Foreign demand	4,5	4,2	3,9	2,7	2,6	2,6
	b) Domestic environment						
4.	Wage growth	4,7	4,6	4,1	2,8	3,1	3,1
5.	Household spending	4,8	4,7	4,4	2,8	3,0	3,0
6.	Government spending	4,7	4,5	4,2	2,7	2,8	2,7
7.	Growth in administered prices	4,5	4,3	4,0	2,8	2,9	2,9

Notes: Year-on-year growth, %. The simulations were made using the model used by the Bank of Slovenia in its forecasts. Simulations 1, 2, 3 and 6 result from changes in exogeneous variables, while simulations 4, 5 and 7 relate to changes that define the simulation in addition to the variables in the baseline scenario. All the other assumptions in the simulations are the same as those in the baseline scenario. The shocks last from the first quarter of 2007 to the final quarter of 2009.
Source: SORS, Bank of Slovenia, ARC calculations

tions from the various assumptions are not taken into account.

The main risks to the projections concern the assumptions for oil prices, and to a lesser extent the assumptions for commodities prices, wage growth and growth in administered prices. These shocks could cause a profound increase in costs, thus directly applying inflationary pressures. On the aggregate demand side there is currently less of a risk of sharp deviations that could threaten the inflation projections. The inflationary pressures brought about by the relatively high level of aggregate demand have already been included in the projections.

Box 7.1: Comparison of the Bank of Slovenia's forecast accuracy with other institutions

The Bank of Slovenia has been producing and publishing projections and forecasts for a set of major macroeconomic indicators since autumn 2001. The Bank of Slovenia projections have been compared with forecasts made by other institutions for the same period (2002 to 2006). The figures indicate comparisons of spring forecasts by various institutions for the current year, while the tables give accuracy indicators for three different time-frames. The brevity of the period means that the indicators do not have the statistic weight to define the most or least accurate forecasts, but the analysis does provide some interesting results nevertheless.

Two features stand out regarding the **economic growth** forecasts of the various institutions. First, the differences between forecasts in the observed period are relatively small and lie within a range of 0.7 percentage points, and just 0.3 percentage points in 2005. Second, errors in forecasts generally have the same sign (negative or positive). Every institution greatly overestimated economic growth in its 2003 forecasts and greatly underestimated growth in 2004. The highest forecast accuracy was for the 2005 forecasts, where the largest error was 0.2 percentage points. The accuracy indicators do not differ significantly between institutions. The most accurate forecast of GDP for the shortest time-frame during the observed period was made by the IMAD (Institute of Macroeconomic Analysis and Development), while the IMAD also produced the least accurate forecast over the longest time-frame, with the IMF being most accurate for that time-frame. The typical mean error (ME), which is generally negative, indicates the tendency to underestimate GDP growth in most forecasts for all the time-frames analysed, which is a reflection of the larger-than-expected downturn in the business cycle in 2004, and the larger-than-expected growth in 2006. The accuracy indicators for Bank of Slovenia forecasts use the average values of all the institutions analysed.

Significant differences between institutions occur in the **inflation** forecasts for individual years. The range of differences between institutions in the spring forecasts was 1.1 percentage points for 2004, but was much closer for 2006, when it was down to 0.3 percentage points. In the past four years, the European Commission has achieved the most accurate fore-

Figure 1: Real GDP growth forecasts

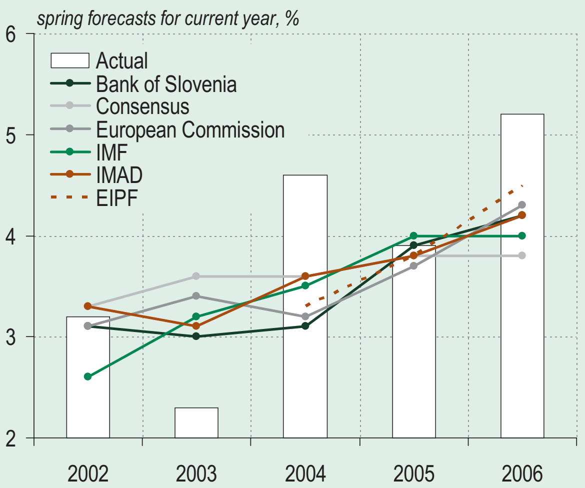
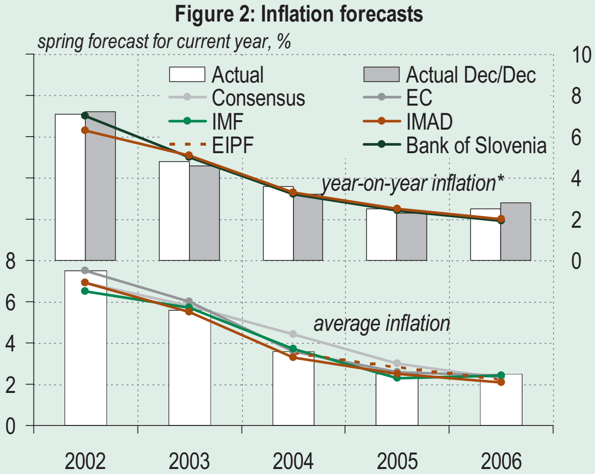


Figure 2: Inflation forecasts

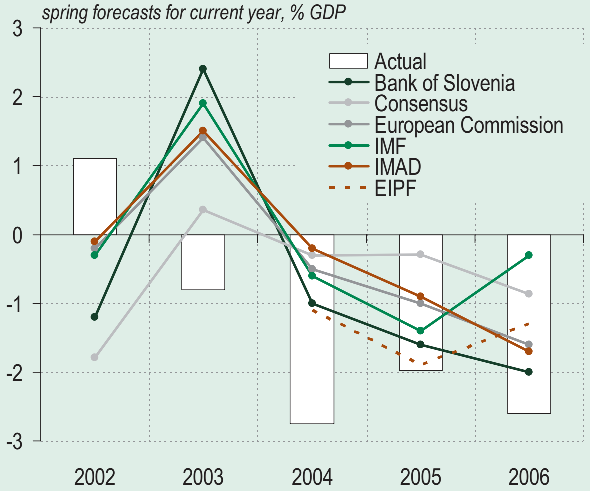


* The Bank of Slovenia forecasts year-on-year inflation for the final quarter, the IMAD for December.

casts of the average growth in prices in the current year for the shortest time-frame, while the IMAD has been most accurate for the longest time-frame. The Bank of Slovenia has been forecasting (publishing) the average inflation figure since 2004, so the year-on-year inflation in the final quarter is given. For the purpose of comparison, the year-on-year forecasts for December published by the IMAD are also given. The Bank of Slovenia's significantly lower RMSE (root mean squared error) is normal, as quarterly inflation is generally less volatile than monthly inflation. Both forecasts are biased towards underestimating inflation in the shorter time-frame, while in the longer time-frame the IMAD forecast on average exceeds the actual value by around half a percentage point; and the Bank of Slovenia forecast was practically unbiased.

Figure 3: Current account forecasts

spring forecasts for current year, % GDP



The largest forecast errors and largest difference between institutions occur in **current account** forecasts. Spring forecasts for the current year differed between institutions in individual years, by as much as 2 GDP percentage points. For longer time-frames (not given in the figure), forecasts sometimes do not even correctly predict the sign (positive or negative) of the current account position. The current account is one of the most difficult variables to predict, in part due to the variability of the phenomenon itself, but largely due to the large changes in past data that arise from frequent statistical revisions. Institutions often respond to the new data with significant corrections to previous forecasts. The most accurate short time-frame forecasts were produced by the European Commission and the IMAD, while the Bank of Slovenia was most accurate for the medium time-frame, and the IMF for the longest time-frame. Figure 3 indicates that the Bank of Slovenia produced the most inaccurate spring forecast for the current year in 2003, but that on average it was the most accurate in the subsequent years.

Table: Estimated forecasting accuracy[1]

	Institution	real GDP growth		current account		inflation			
						average		year-on-year	
		ME	RMSE	ME	RMSE	ME	RMSE	ME	RMSE
Spring forecasts for current year	Bank of Slovenia	-0,38	0,87	-0,14	1,73			**-0,20**	0,34
	Consensus	**-0,22**	0,97	**-0,04**	1,84	0,14	0,52		
	European Commission	-0,30	0,90	0,16	**1,17**	**0,08**	**0,19**		
	IMF	-0,38	0,88	0,40	1,62	-0,22	0,46		
	IMAD	-0,24	**0,73**	0,26	1,18	-0,28	0,35	**-0,20**	0,62
Autumn forecasts for current year	Bank of Slovenia	-0,40	1,04	**0,00**	**1,54**			-0,22	0,63
	Consensus	0,18	1,15	-0,36	2,24	**0,10**	**0,76**		
	European Commission	-0,30	1,04	-0,12	1,77	0,48	1,02		
	IMF	**-0,02**	**0,92**	-0,42	2,15	**-0,10**	1,32		
	IMAD	-0,10	0,96	0,26	1,74	0,12	0,79	**0,08**	0,98
Spring forecasts for next year	Bank of Slovenia	-0,15	1,07	**0,55**	2,22			**-0,05**	0,39
	Consensus	-0,05	1,05	**0,55**	1,64	0,63	0,87		
	European Commission	-0,18	1,14	1,05	1,45	0,95	1,15		
	IMF	-0,13	**0,98**	0,65	**1,34**	0,43	0,87		
	IMAD	**0,00**	1,20	1,40	1,82	**0,13**	**0,51**	0,45	0,74

[1] ME: the mean error in a forecast is the difference between the forecast value and actual value; RMSE: the root mean squared error shows the average size of the forecasting error, irrespective of sign. RMSE gives greater weight to individual large deviations in the forecasts. A comparison of the forecasting accuracy for the EIPF cannot be made because the forecast sample is too short. Analysis will be given in detail in next issue of Prikazi in analize (Surveys and Analyses, avaliable in Slovene only).

Supply-side shocks

The supply-side risks include movements in prices of goods and labour that affect producers' costs, and movements in prices of goods that owing to the inelasticity of demand directly impact on final prices. Certain effects that would result in a permanent structural change in the economy are not considered directly in the projection period. In principle, supply-side effects that modify the economic potential – for example, adjustments in the supply of individuals' labour to changes such as tax reform or increased incentives to invest in knowledge and development or to promote entrepreneurship – are held to be of significance in the long run only.

Oil prices and commodity prices higher than those assumed in the baseline scenario would slow economic growth while simultaneously raising inflation directly. Oil prices have recently been subject to major fluctuations, particularly as a result of geopolitical tensions in the Middle East, the unpredictability of Russian energy and foreign policy, and increasing climatic uncertainties. The oil price assumptions depend to a great extent on the dynamics of the world economy in the context of oil producers' given supply capacity. Higher economic growth, particularly in Asia, would put significant upward pressure on oil prices. The same factor could also act to slow the anticipated decline in commoditiy prices. In particular, metal prices, which in recent years have contributed strongly to high commodity prices, could remain relatively high in the event of current world economic growth continuing. The ARC's model estimates indicate that should oil prices hover at USD 5 per barrel above assumptions, economic growth for each year in the 2007 to 2009 period would be 0.1 percentage points lower. Similarly, an increase in commodity prices of 10% from the baseline scenario would reduce growth by 0.1 percentage points in the first year, and by lesser amounts subsequently. What is particularly unpleasant with this type of shock is the combination of higher inflation and lower economic growth. The aforementioned oil shock would raise inflation by 0.5 percentage points in the first year of the shock, by a further 0.2 percentage points in the second year, and by 0.1 percentage points over the next two years. Similarly, higher commodity prices would raise average inflation by 0.1 to 0.2 percentage points each year.

An additional risk that could arise in the context of higher oil prices is the pass-through of these prices into wages. The Bank of Slovenia's calculations are based on the assumption that oil prices do not feed through into higher wages, but merely have a direct effect on producers' costs. Should demands for proportionate wage increases arise as a result of oil shocks, producers would most probably, at least partly, transfer these additional costs to consumers via higher prices, heightening the risk of a wage-inflation spiral. In this event the impact of oil prices on inflation would be even greater and longer-lasting.

The consolidation of the general government deficit via excise duties would lead to higher growth in administered prices than projected. An additional inflationary shock would arise should excise duties on refined petroleum products be raised while oil prices on world markets remain unchanged. This measure would entail an end to the current policy of smoothing the fluctuations in prices of refined petroleum products.

In addition to prices of refined petroleum products, other administered prices would also be likely to grow more quickly than in the baseline scenario, directly adding to pressures on prices. Worthy of particular note in this area is the uncertainty regarding electricity prices, where a market liberalisation is planned for the second half of 2007. The Ministry of the Economy expects this to raise electricity prices by 10%,[13] which is

[13] *Obrazložitev Načrta uravnavanja reguliranih cen za leti 2006 in 2007* (Explanation of the plan for managing regulated prices in 2006 and 2007), Ljubljana, 23 February 2006
http://193.2.236.95/dato3.nsf/OC/060226164959C/$file/62v6.doc (available only in Slovene)

Box 7.2: Cyclical pitch of the general government deficit and delays in consolidation

Achieving the medium term objective of a cyclically adjusted balance in the government sector is one of the commitments in the Stability and Growth Pact (see Box 7.6), and is based on a sound economic rationale. During periods in which the economic environment is positive, the appropriate fiscal policy is counter-cyclical, which is generally measured by a reduction in the structural general government deficit (the deficit, excluding effects of the business cycle). This is important for two reasons: to smooth the macroeconomic cycle and to create sufficient room for manoeuvre that mitigates the need for subsequent tax rises, that would exert additional inflationary pressures.

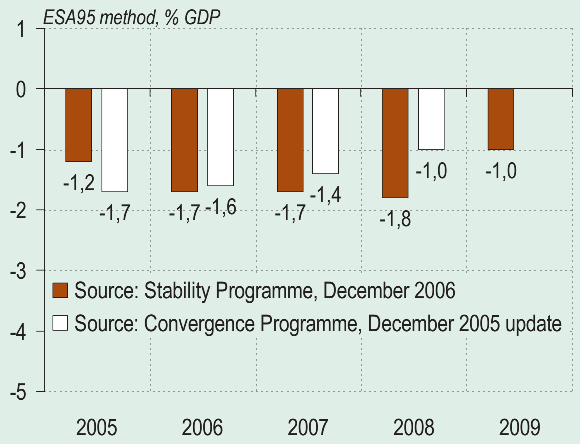
The Slovenian Government's fiscal policy objective for the projection period is to reduce the structural deficit in public finances in 2009 so that the cyclically adjusted deficit be reduced to 1% of GDP. According to most economic trend projections, the business cycle should have slowed by then, in comparison to 2006.

December 2006's Stability Programme envisages a decline in the structural deficit in public finances in 2009. In its assessment of the Stability Programme[1] drawn up by the Slovenian Government, the European Commission stated that the measures to reduce the deficit to 1% of GDP in 2009 should be defined more precisely. In the opinion of the Commission, this applies in particular to the measures on the expenditure side aimed at compensating for the loss of revenue following the tax reform in 2007 and 2008, and the measures that the Government is aiming to take to reduce general government expenditures by 2 percentage points of GDP in 2009, and to meet the medium-term target of a reduction in the general government deficit of 0.25 percentage points of GDP per year between 2006 and 2009. In its assessment of the Programme the European Commission also identified the public finance position in the long term as unsustainable, as Slovenia is classed as high-risk with regard to the aging of the population and the associated public finance consequences. A counter-cyclical and longer-term pitch in fiscal policy, as seen in the conduct of the incomes policy in recent years, is one of the essential factors that could contribute to the maintenance of the macroeconomic equilibria, to the competitiveness of the economy, and thus to price stability in the future.

There are a number of uncertainties relating to the expenditure side of public finances over the Programme period. The Stability Programme bases its government spending forecasts for the period on a policy of reducing public sector employment by 1% a year. At the same time the basic assumption of the projections is for moderate growth in public sector pay, so the total wage bill in the public sector should thus fall by 0.8% of GDP over the period of the Programme. The assessment of problems relating to the relative reduction of the public sector wage burden may have to take on board the experiences of an actual increase in employment of 1.2% in 2006, despite the planned reduction.[2]

Additional risks appear in a number of other specific items. These include obligations arising from the expansion of the Schengen border, the modernisation of the army in relation to NATO obligations, the EU presidency, and the need to co-finance projects related to EU funds. In relation to drawing on EU funds, there is also an uncertainty regarding the actual realisation of the projected volume of funds, which could lead to a reduction or increase in general government expenditure.

Figure: Cyclically adjusted general government position



[1] See *Economic Assessment of the Stability Programme of Slovenia*, European Commission, Brussels, 27/02/2007. http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/si/com_si20062007.pdf
[2] *Nacionalni računi*, 9 March 2007, SORS http://www.stat.si/doc/vsebina/03/BDP_cetrt_SLO_2006Q4.xls

incorporated into the Bank of Slovenia's projections, but a lack of clarity with regard to the actual response to the establishment of a liberalised electricity market in Slovenia is nevertheless making precise inflation projections difficult. Additional uncertainties could also arise in the event of the realisation of a planned increase in certain excise duties, such as those on alcohol, cigarettes and electricity. The projection calculations show that should overall growth in administered prices be 2 percentage points higher than growth in non-administered prices in the baseline scenario in 2007 to 2009, economic growth would be approximately 0.1 percentage points lower each year. Such growth in administered prices would contribute 0.2 percentage points towards inflation one year after the shock, and 0.3 percentage points two years after.

The need to consolidate the general government deficit also points to the risk of raising certain taxes. Given the decline of 2 GDP percentage points in general government revenues in the period to 2009 in connection with the recent tax reform and the gradual abolition of the payroll tax, a rise in VAT rates is also possible during the projection period.[14] In the baseline scenario the Bank of Slovenia has not taken into consideration any change in the VAT. The chance of a rise in both VAT rates in 2008 is small as the Government is not envisaging such a measure, as stated in the Stability Programme.[15] Should a rise nevertheless occur, the Stability Programme estimates that a rise in VAT rates from 20% to 21% and 8.5% to 9% would increase price growth by 0.2 to 0.6 percentage points. An effect similar to the upper limit of this estimate is also suggested by the Bank of Slovenia's simulation.[16] Similar to an increase in administered prices, a rise in the VAT alone has an unfavourable impact, as in addition to the inflationary effect it also has an adverse effect on economic growth, at least during the year of the VAT change. Another risk in the projections, to a lesser extent, is the assessment of the projected effects of the end of the transitional period of a lower VAT rate on the purchase of new real estate in 2008 as opposed to the possibility of extending the transitional period of the lower VAT rate, and the potential introduction of a tax on real estate. In both of these risks no direct impact on inflation is expected.

Labour costs represent the main supply-side risk during the projection period. During periods of a positive output gap, the capacities of the economy and the labour market are increasingly occupied, and the risk concerning wage growth increases. The limited availability of labour means that excessive wage growth, particularly when it covers a large part of the economy, can rapidly feed through into higher prices, and within the single market this would be reflected in reduced competitiveness. The Bank of Slovenia's projections for 2008 and 2009 show slightly lower employment growth than the Stability Programme projections. The ARC's simulations show that wage growth of 1 percentage point more than that in the baseline scenario in each year after the shock would entail inflationary pressure, of about 0.4 and 0.5 percentage points, especially in the second and third years as a result of the delay in the pass-through (the impact on categories linked to wage growth such as pensions and other transfers is not considered). Such a shock would temporarily have a beneficial impact on economic growth owing to increased domestic consumption, but would simultaneously widen the current account deficit owing to reduced competitiveness and would lead to a gradual decline in employment.

The uncertainties about wage growth derive partly from institutional changes in the labour market, particularly owing to the change in negotiations between the social partners. The partial decentralisation of wage

[14] *European Economy, Economic Forecasts Autumn 2006*, European Commission, No 5, 2006
http://ec.europa.eu/economy_finance/publications/european_economy/2006/ee506en.pdf
[15] *Stability Programme*, Republic of Slovenia, Ljubljana, December 2006, p. 9
http://www.gov.si/mf/angl/tekgib/program_stabilnosti_2006.pdf
[16] *Monetary Policy Report*, Bank of Slovenia, October 2006, p. 55
http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=2221

Box 7.3: Institutional changes on the labour market

Some significant institutional changes occurred on the labour market in 2006, largely involving the private sector. The changes are part of the transition to greater autonomy for employers and employees, including the end of compulsory membership of the Chamber of Commerce and Industry of Slovenia (CCIS) for employers.

The Social Agreement for 2006 to 2009 had not yet been signed in 2006. The Social Agreement, which is reached between employers, employee representatives, and government representatives, is a reference document for negotiations on incomes policy.

The main change in the framework for negotiations between the social partners was the cancellation of the General Collective Agreement for the Commercial Sector (SKPgd), which ceased to be in force on 30 June 2006. The Agreement on Private Sector Pay for 2004 and 2005 also came to an end.

These were replaced in 2006 by the first Collective Agreement on Wage Adjustments, Reimbursement of Work-Related Expenses, and Annual Leave Allowances (the KP). This introduced the concept of negotiations at the bilateral level, without government representatives. Another innovation is that the KP is not the successor to the sectoral collective agreements, and that it applies to private sector employers who are not covered by an appropriate sectoral collective agreement. To employers covered by such sectoral collective agreements apply only the elements of the KP relating to institutions of labour law that are not covered by specific sectoral agreements apply. The major features of the KP include the mechanism of the inclusion of an adjusting wage supplement for 2004 and 2005 in the pay system, the harmonisation of the starting or lowest basic wage for 2006 and 2007, annual leave allowances, minimum standard reimbursement of work-related expenses, and bonuses for work in less favourable conditions.[1]

In 2006 the method of adjusting the minimum wage was changed, having previously been regulated by the agreement on private sector pay. The Government now defines the minimum wage directly in the Minimum Wage Act.

[1] See, for example, *Konjunkturna gibanja,* No 3, SKEP GZZ, November 2006, SKEP GZS, p. 19. http://www.gzs.si/slo/storitve/poslovne_informacije/ekonomski_kazalci/31021

negotiations (see Box 7.3) means that growth in labour costs in individual sectors can more directly reflect the productivity of the sector, but in the event of asymmetry in the negotiating power of employers or employees in specific sectors it also increases the risk of growth in labour costs that overall is not appropriate in the context of actual economic conditions. Under the new system the Government no longer participates in the negotiations on the collective agreement, but it retains several other levers for administering incomes policy, namely the setting of public sector wages, the setting of the minimum wage, and the participation in the Social Agreement. The Social Agreement for 2006 to 2009 has not yet been adopted, and in order to maintain low growth it will be important to consider certain items presented by the Government in its precepts for the agreement. Under these precepts, wage growth was to remain at least 1 percentage point behind productivity growth in the period leading up to the introduction of the euro, owing to the risks associated with the introduction of the euro, upon which this gap was to be gradually closed.[17]

Demand-side shocks

All shocks that could threaten the price stability and the stability of economic activity around supply potential are classed as risks to aggregate demand. Given the estimated positive output gap, and the projected positive movement in the business cycle during the projection period, the current risks associated with domestic demand are more on the side of the overheating of the economy and the creation of inflationary pressures. Due to uncertainties in the international environment and

[17] *Socialni sporazum 2006-2009, izhodišča Vlade* (Social Agreement for 2008 to 2009, Government Precepts), Ljubljana, 7 December 2005 http://www.mddsz.gov.si/fileadmin/mddsz.gov.si/pageuploads/dokumenti__pdf/soc_sporazum_7_12_05.pdf (available only in Slovene)

Box 7.4: Competitiveness inside the monetary union – examples from other eurozone member states

An economy's competitiveness depends on the ability of domestic producers to compete on price with foreign producers, given the operating conditions that they face. In the long term, these conditions, particularly the price of domestic production factors, adapt to the structure of the economy, which depends on its productivity. In this light, competitiveness is not in and of itself linked to economic development.

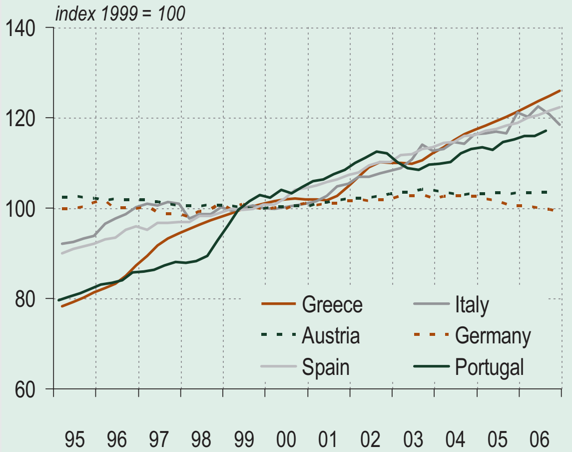
The flexibility of the macroeconomic environment is essential to ensuring the competitiveness of the economy. An uncompetitive economy, in which production is too expensive given the structural capacity, generally adjusts itself by means of reducing nominal prices. Within a monetary union, which eliminates monetary policy independence, price adjustment is linked to changes in the nominal growth of labour costs. The more inflexible that the product market and, in particular, the labour market are, the more the lack of competitiveness is expressed as a higher level of unemployment and a slowdown in economic growth.

A frequent measure of an economy's competitiveness compared to its main trading partners is the real effective exchange rate, which covers the growth of prices in the domestic and foreign economies. Growth in an overall prices index is usually used for this purpose, e.g. the consumer price index or the GDP deflator, or a price index of tradables. In order to take productivity growth into account, however, it is better to observe the development of real unit labour costs (RULC), which measure changes between the growth of labour costs and GDP growth, or the relative labour costs, which compares RULC in the domestic economy with those of trading partners.

The European Commission recently published a large-scale research paper on the dynamics of economic adjustments to life in the monetary union made by the eurozone countries.[1] What is of interest to Slovenia, in terms of competitiveness, is primarily the experience of countries that had a relatively high inflation before adopting the single currency.

In the first years following the introduction of the euro, Italy recorded fairly low growth in its nominal labour costs. However, compared to the eurozone average, its RULC increased somewhat, coinciding with the lower structural growth in productivity, which contributed to a relatively sharp price rise in

Figure 1: Unit labour costs (total economy)



Source: Eurostat

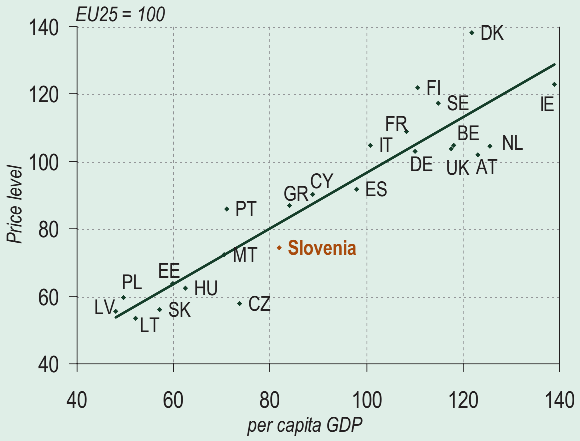
the tradable and non-tradable sectors. Italian exporters lost market share abroad because of their lack of competitiveness. Due to low growth in domestic consumption at the same time, and hence low demand for imports, this was to a small extent reflected in the current account deficit.

Spain experienced a sharp growth in imports, while the relative growth in unit labour costs had been positive since 1999. Inflation remained at a relatively high level, primarily due to adjustments in non-tradable prices. This can be ascribed to the catching-up in prices with more developed countries (the Balassa-Samuelson effect – see Figure 2) and the rigidity of the product market, and is also down to high levels of activity in the non-tradable sector, particularly construction, which is partly an expression of structural adjustments caused by demographic changes and lower interest rates. There is considerable risk attached to these imbalances, however, though it needs to be emphasised that fiscal policy at least was quite restrictive over the entire period. This offers the possibility that the accumulated reserves will be released as domestic consumption falls.

In Greece fiscal policy has been much less restrictive since it joined the eurozone. Labour costs have grown more quickly than the eurozone average, causing a drop in competitive-

[1] Commission of the European Communities, The EU Economy 2006 Review, Adjustment Dynamics in the Euro Area, Experiences and Challenges, Brussels, 22nd November 2006. http://ec.europa.eu/economy_finance/publications/european_economy/2006/ee606_en.pdf

Figure 2: Catching-up in per capita GDP implies catching-up in prices



Source: Eurostat

ness. Despite this, Greece has shown high growth in productivity and GDP in recent years, which is partly due to the long-term economic slowdown in the decade before joining the eurozone.

In contrast to Greece, economic growth and growth in lending were both high in Portugal before it entered the eurozone. The country ran an expansive fiscal policy, and prompted high growth in labour costs, primarily through an inappropriate public sector incomes policy. The loss of competitiveness during the turnaround in the cycle led to a slowdown in exports, and a halt in domestic consumption, while fiscal policy had failed to make the provisions needed to avoid a recession.

The diverse experiences of these countries indicate that a large set of indicators has to be monitored in order to measure competitiveness. The catching-up process with wealthier eurozone countries is expressed in the growth of the ratio of tradable to non-tradable goods, and the somewhat higher rate of inflation. An increase in the current account deficit due to increased imports is not necessarily a key indicator of competitiveness. The macroeconomic danger arises in particular when growth in labour costs damages the competitiveness of exports and leads to a cyclical shift in activities towards the non-tradable sector. By promoting flexibility on the product market and labour market, and through an adequate incomes policy, economic policies can curb price and cost pressures. An appropriately pitched fiscal policy is particularly important when, following strong growth in aggregate debt, economic activity extends beyond the long-term potential.

uncertainties in the economic environment, it is impossible to totally exclude a faster downturn in the cycle and risks on the side of a shrinking demand towards the end of the projection period.

Given the uncertainties in the movement of economic growth in the world economy, the assumption of growth in foreign demand is directly exposed to risks. Uncertainty over the actual economic slowdown in the eurozone and the US, as well as over the continuation of robust growth in developing countries, including those in eastern Europe, could trigger deviations from the projections for Slovenian exports, and consequently from the projections of activity in the Slovenian economy. One significant change from the export projections in the baseline scenario could be a potential deviation from the assumption about additional exports by the car industry during the projection period. The onset of extra production by the car industry in the middle of this year is leading to an increase in export growth of 0.5 percentage points in 2007 and 0.9 percentage points in 2008. In addition, the adjustment of domestic demand in Germany to this year's rise in VAT and the euro's exchange rate against the dollar are also important to the structure of Slovenian exports. The ARC's simulations show that growth in foreign demand that is permanently 1 percentage point less than that assumed in the baseline scenario would reduce economic growth by 0.1 to 0.2 percentage points in 2007 to 2009. In this event inflation would fall slightly.

Shocks in the international environment also affect aggregate demand in the Slovenian economy indirectly via the financial markets. This has been even more the case since Slovenia joined the eurozone, in which further inflationary pressures could arise. These include potential repeated oil shocks, the effects of strong growth in monetary aggregates, and the continuation of the high growth in prices of financial assets and house prices seen in recent years. The risk of stronger growth in prices of manufactured goods could also directly arise, along with pressure to raise wages after several years of decline in employee compensation as a share of GDP, particularly in Germany. Interest rates in Slovenia are now directly dependent on the ECB's response to such phenomena. Given the significant synchronisation of the business cycle, it can be expected that interest rates in the eurozone will move in line with the needs of the Slovenian economy, but their actual effect will depend above all on the responsiveness of domestic demand.

Growth in aggregate demand that is in line with economic potential is the key to price stability. The risk of a mismatch will decrease in the future, insofar as real interest rates will rise more rapidly than assumed. The ARC's simulations show that growth in household spending of 1 percentage point more than that in the baseline scenario would contribute 0.2 percentage points to eco-

Box 7.5: Comparison of 2007 and 2008 forecasts with those of other institutions

Forecasts for Slovenia are compiled by domestic institutions and by international, official and private institutions. It is useful to compare forecasts because they highlight differences in thinking concerning future economic trends, despite the forecasts not being directly comparable as they were not prepared simultaneously and therefore do not take into account the same information. Furthermore, the forecasts rest on different assumptions with regard both to exogenous variables in the international environment and to economic policy actions. This is particularly evident in this comparison, as the earlier preparation of the Price Stability Report means that the reports available from other institutions differ far more in terms of their release dates than was the norm in comparisons made in Monetary Policy Reports in the past.

Economic growth forecasts for 2007 have generally been revised slightly upwards compared with the previous round of forecasts. Despite this, there is a consensus that there will be lower growth in real GDP this year than in 2006, with forecasts ranging from 4.2% to 4.6%. The opinion holds that GDP growth will again exceed 4% in 2008. Forecasts for the current account position in 2007 point to a deficit of between 2.2% and 1.6% of GDP, which represents a reduction in the range of forecasts compared to the previous round, and which is very much the consequence of revisions in the direction of a wider deficit in the forecasts of some foreign institutions. The prevailing opinion among the institutions is that the current account deficit in 2008 will be somewhat lower than in 2007.

Differences between the inflation forecasts are again minor, with estimates of average inflation in 2007 from all institutions ranging between 2.4% and 2.7%. Compared with the previous round of forecasts, most institutions have made minor upward revisions to their average inflation forecast. For 2008 the range of forecasts is somewhat larger, ranging from 2.3% to 3.2%.

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

	Publication of new / previous forecast	GDP annual growth, %				Inflation annual average, %				Current account % of GDP			
		2007		2008		2007		2008		2007		2008	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Mar 07 / Oct 06	**4,6**	0,4	**4,4**	0,5	**2,7**	0,0	**2,7**	0,0	**-1,9**	0,8	**-2,0**	0,4
EIPF	Jan 07 / Sep 06	**4,4**	0,3	**…**	…	**2,5**	0,3	**…**	…	**…**	…	**…**	…
IMAD	Sep 06 / Jan 06	**4,3**	0,3	**…**	…	**2,7**	0,6	**…**	…	**-1,6**	-0,3	**…**	…
Consensus Forecasts	Jan 07 / Sep 06	**4,3**	0,2	**4,1**	…	**2,4**	0,1	**2,3**	…	**-1,8**	-0,8	**-1,4**	…
WIIW	Feb 07 / Jul 06	**4,5**	0,5	**4,4**	…	**2,6**	0,2	**2,3**	…	**-2,2**	-1,2	**-1,5**	…
European Commission	Nov 06 / May 06	**4,2**	0,1	**4,5**	…	**2,5**	0,0	**2,6**	…	**-1,8**	0,0	**-1,4**	…
Standard & Poor's	Mar 07 / May 06	**4,3**	0,3	**4,2**	0,4	**2,7**	0,6	**2,5**	0,4	**-1,8**	-1,6	**-1,6**	-1,7
Raiffeisen Research	Jan 07 / May 06	**4,3**	0,8	**4,3**	…	**2,7**	0,7	**3,2**	…	**-2,1**	-1,3	**-2,2**	…

Source: Bank of Slovenia, EIPF, IMAD, Consensus Economic Forecasts, European Commission, Wiener Institut für Internationale Wirtschaftsvergleiche (WIIW), Standard & Poor's, Raiffeisen Research; ARC calculations.

nomic growth in the first year, gradually increasing to 0.4 percentage points in the third year. This shock would also have a similar effect on inflation. **In particular**, the projections of investment in housing are subject to uncertainty. The anticipated rise in the VAT on the purchase of new housing in 2008 has in all likelihood caused an early surge in the construction of real estate, though it is difficult to estimate the exact effect of this time shift. In the event of unforeseen movements in investment, economic growth would move in a different manner to that in the projections, but no significant deviations in inflation ought to be expected for this reason. In addition, private investment is dependent on other tax changes. It is, however, difficult to predict the effect of the tax reform adopted in 2006, which cut the corporate income tax rate while abolishing some types of relief. Finally, fiscal policy is a direct instrument for preserving a balance between aggregate demand and supply potential.

Box 7.6: Stability and Growth Pact

Like the other eurozone member states, Slovenia is contractually bound to the Stability and Growth Pact. The principal objective of the Stability and Growth Pact is to foster efforts by EU member-states that have joined the monetary union, i.e. after meeting the convergence criteria, to fulfil the agreed conditions for the general government sector. The eurozone members, and European Commission and Council use the Pact to supervise the public finance discipline of individual countries to prevent the irresponsible fiscal policy of an individual member-state threatening the stability of the single currency, the euro.[1]

The key provisions of the Pact relate to avoiding an excessive general government deficit, which is defined as exceeding 3% of GDP, and excessive government debt, defined as 60% of GDP, and to achieving the medium-term objective of public finance consolidation, which requires reducing the cyclically-adjusted public finance deficit in periods of favourable economic conditions.

Close and critical cooperation between all stakeholders (European Commission, EU member-states, European Council) is required for the pact to function in practice, for which reason the Pact is formally divided into three parts:[1]

- *political commitment* by all stakeholders in the Pact to control the public finance budget
- *preventive elements*, which attempt, through frequent controls, to prevent the occurrence of an excessive deficit, i.e. a deficit of over the reference value of 3% of GDP
- *dissuasive elements*, which require member-states to take immediate corrective actions in the case of an excess deficit, and if required, allow for sanctions

In 2005 the Pact was reformed to a certain extent following a decision by the European Council of 22 and 23 March 2005. The basis for the reform was set out in a Council Report with the title “Improving the Implementation of the Stability and Growth Pact.”[2] Given the heterogeneous nature of EU member-states, and the desire for an economically sensible and more effective implementation of the Pact, the changes relate to five areas:

- enhancing the economic rationale of the budgetary rules and improve their credibility and ownership of policy makers
- improving the “ownership” by national policy holders
- making more effective use of periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies
- taking better account of Council recommendations in periods when economies are growing below trend

[1] The main items of the Pact are set out in Council Regulations (EC) 1466/97 and 1467/97 and the amendments to Council Regulations (EC) 1055/2005 and 1056/2005.See, for example, http://ec.europa.eu/economy_finance/about/activities/sgp/sgp_en.htm
[2] *Presidency conclusions*, European Council Brussels 22 and 23 March 2005, Annex II, »Improving the Implementation of the Stability and Growth Pact«, str.21. http://ue.eu.int/ueDocs/cms_Data/docs/pressdata/en/ec/84335.pdf

- giving sufficient attention in the monitoring of budgetary positions to debt and sustainability in public finance trends

The changes to the Pact are reflected particularly in enhancing the role of the preventive elements and providing greater clarity on the requirements for safeguards to prevent the public finance reference values being exceeded. The Pact provides an accurate definition of the medium-term public finance objective for countries within the ERM or the eurozone: a public finance balance between -1% of GDP and balance for countries with low government sector debt and high potential growth, or a balance between balance and surplus for countries with high government sector debt and low potential growth. At the same time, the new arrangements define in greater detail the reference value for the annual reduction in the cyclically adjusted government deficit during economically favourable periods, net of one-off measures, towards the medium term objective of 0.5% of GDP. A favourable period is one in which economic activity exceeds potential. The assumption is that unexpected additional general government revenues are used to reduce the deficit and debt.

The Reformed Pact provides public finances with somewhat greater manoeuvring room for temporary deviation from the medium-term objective in case of fundamental structural reform. These structural reforms primarily involve those that facilitate the long-term sustainability of public finances.[3]

When reviewing the Stability Programme, the European Commission now has a better chance of providing due warning of insufficient consolidation towards the medium-term objectives, and issuing advice for its acceleration as well as to create an appropriate safety margin between the actual balance and the 3% of GDP reference value for the deficit. The European Council issues its opinion on the Stability Programme on an annual basis, based on European Commission proposals. The Council also proposed in its conclusions on the Reformed Pact that member-state governments should also submit Stability Programmes and Council opinions to their national parliaments for possible debate.

[3] See, for example, *Economic Assessment of the Stability Programme of Slovenia*, European Commission, Brussels, 27/02/2007. p 39. http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/si/com_si20062007.pdf

Appendix: Bank of Slovenia projections and Eurosystem projections

The Bank of Slovenia has been participating in the Eurosystem's staff macroeconomic projections since autumn 2006.[1] The projections for Slovenia were included for the first time in the aggregate projections for the eurozone in the ECB Monthly Bulletin in December 2006, for 2007 and beyond.

The projections produced by the Eurosystem are based on close cooperation between ECB and NCB staff.[2] The Monetary Policy Committee[3] is responsible for projections, supported by its Working Group on Forecasting.[4] The first step in producing Eurosystem projections is an agreement on assumptions, which contains sections on interest rates, exchange rate developments, the international environment and fiscal variables. In the next step, the ECB and NCB use the same assumptions to prepare their own projections for individual countries, while the ECB also prepares an aggregate for the eurozone, based on its own projections and NCB projections. After multiple iterations the final projection values are defined for individual countries, and then for the eurozone, which is followed by the preparation of reports for the ECB Board of Governors. A summary of this report is published in the ECB Bulletin.

In the projections set out in the Price Stability Report, the Bank of Slovenia uses its own assumptions. According to the rules that apply to producing Eurosystem projections, these are not identical to those used in Eurosystem projections, and must be taken from other institutions, unless they refer to NCB projections, published within one month of the Eurosystem projections.

The Bank of Slovenia projections[5] published are not identical to Eurosystem projections, and are not produced at the same time. The individual national central banks (NCBs) of eurozone members may publish their own projections outside the regular Eurosystem projections, but their publication has time restrictions. The time difference for the publication of NCB projections is related to the publication of Eurosystem projections, which are in general issued twice a year – at the beginning of June and the beginning of December.[6] If NCB projections are published before Eurosystem projections, the date of publication must preceed that of the Eurosystem by at least two months. If NCB projections are published within one month of a Eurosystem projection, the NCB projection must contain the same assumptions regarding the international environment as the Eurosystem projections.

[1] It is important to emphasise that the projections of Eurosystem staff (ECB and national central banks of eurozone member-states – NCBs) do not reflect the opinions of individual central banks or the ECB Board of Governors. The projections however represent a support material for the assessment of the ECB Board of Governors regarding economic outlook and risks relating to price stability.
[2] For more on Eurosystem projections, see: http://www.ecb.int/pub/pdf/other/staffprojectionsguideen.pdf
[3] The Monetary Policy Committee comprises high ranking officials from the ECB and NCBs.
[4] ECB and NCB experts sit on the Working Group on Forecasting
[5] Projections from the Governing Board of the Bank of Slovenia, which it adopts and approves for publication in the Price Stability Report (previously: Monetary Policy Report)
[6] Since September 2006, interim projections by ECB staff have been published in the ECB Bulletin, which do not include NCB staff involvement. They are issued in September and March