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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
BLEU	Belgium and Luxembourg
BS	Bank of Slovenia
DARS	Motorway Company in the Republic of Slovenia
DJ EUROSTOXX	euro area stock market index (Dow Jones)
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EIPF	Faculty of Law Economic Institute
EMU	Economic and Monetary Union
ERM II	European Exchange Rate Mechanism
ESA95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU27	European Union (of 27 Member States)
EUR	euro
EURIBOR	euro interbank offered rate
GDP	gross domestic product
HICP	harmonised index of consumer prices
IEA	International Energy Agency
IFS	International Financial Statistics, International Monetary Fund database
ILO	International Labour Organisation
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
MoF	Ministry of Finance of the Republic of Slovenia
NCB	national central banks (of euro area Member States)
NKBM	Nova Kreditna banka Maribor
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum-Exporting Countries
p.p.	percentage point
PPI	producer price index
PSR	Price Stability Report
RS	Republic of Slovenia
SBI20	Slovenian Stock Exchange index, which shows the general movement of share prices on the Ljubljana Stock Exchange and is comprised of the ordinary shares of 15 issuers from the regulated and OTC markets
SIT	Slovenian tolar
SLONEP	Slovenian real estate portal
SORS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
USD	US dollar
VAT	value added tax

Summary

Uncertainties regarding future economic trends are unusually high at the current juncture. Assumptions regarding economic trends in the international environment are subject to global uncertainty, for the most part linked to the deepening of the financial turmoil in the US. At the same time, uncertainty in the domestic macroeconomic environment is increasingly present, which could lead to further deviations from macroeconomic equilibria. Risks for inflation projections are concentrated on the upside, while risks regarding projections of economic activity are predominantly on the downside. Amongst external factors, the greatest risk in inflation projections is the continuing rise in prices of oil and other commodities on global markets. A rise in the price of oil by USD 10 per barrel would contribute an additional 0.5 percentage points to inflation this year. Amongst domestic factors, the risk of excessive building of past inflation into compensation of employees is increasingly coming to the fore, including the part of price growth which is linked to supply-side shocks and which, in principle, reduces labour productivity. This risk had, in part, materialised by the beginning of 2008.

Economic activity in Slovenia's most important trading partners has slowed since the middle of 2007 after several years of favourable growth. Available forecasts indicate that growth in the euro area will fluctuate around the long-term average in the future following a slowdown this year. Continued economic growth can be expected in the most important partners from Central and Eastern Europe. Lower growth in foreign demand may be primarily a result of the financial turmoil and high commodity prices. The euro appreciated significantly versus the US dollar last year, particularly in the last quarter when increasingly unfavourable news regarding the US economy was made available. The appreciation of the euro has partially eased pressures stemming from commodity prices. The price of oil has risen significantly, well above USD 100 per barrel. Futures markets expect higher growth than in previous forecasts also in prices of other commodities. Under the influence of high commodity prices, inflation in the euro area and the US rose significantly at the end of last year and the beginning of this year. In the euro area, pressures in the field of labour costs are also gaining importance.

In 2007, GDP growth in Slovenia surpassed 6%, the fastest growth to date. It also exceeded euro area growth by 3.5 percentage points. With continued solid growth in exports, the fastest growing component of domestic expenditure for the second consecutive year was investments, driven primarily by strong growth in construction activities. Following a solid increase in 2006, growth in household and government spending was moderate and lagged well behind GDP growth. Growth in output was based on accelerated employment growth, and not on increased productivity. Thus by the end of 2007, the labour market recorded a significant drop in unemployment. Nevertheless, although until the end of the third quarter of 2007, there was little sign of inflationary pressures arising from labour costs, most indicators point to an increase in nominal labour costs later on. The savings-investment gap has widened since the middle of 2006. Because the economy meets additional and growing financing needs by borrowing abroad, net external debt is rising, while interest payments continue to result in the deterioration of the balance of payments current account. The current account deficit in 2007 amounted to 4.9% of GDP, its highest level since Slovenia's independence. Rapid growth in the deficit indicates a deficit in domestic savings in relation to financing needs. Therefore banks finance the increased credit demand of the domestic private sector by increasingly borrowing abroad.

The average inflation rate rose 1.3 percentage points to 3.8% in 2007, and reached high 6.5% in the first quarter of 2008. The rise in inflation in the past year is partly the result of rapid growth in commodity prices on global markets, but is partly also due to internal factors linked to high domestic economic activity. A key factor, linked to supply-side shocks in the international environment, were the prices of food and energy, whose rise at the end of the year also affected the structure of inflation. Extraordinary high growth in domestic food prices (average growth of 7.1% last year) is, similarly to the euro area, the result of high growth in foods prices on global markets. However, higher inflation in food prices, compared to the euro area, can be attributed to high growth in demand, the density of price adjustments linked to the introduction of the euro and also to an insufficient level of competition in the retail market. The positive output gap in the domestic macroeconomic environment represents a significant difference compared to the euro area where economic growth has been moving in line with potential output recently. Inflation in the euro area did not rise due to supply-side shocks until the end of last year. Average annual inflation in the euro area actually fell from 2.2% in 2006 to 2.1% in 2007 due to certain base effects. The impact of the positive output gap and high aggregate demand on inflation in Slovenia is primarily reflected in indicators of core inflation, which are rising rapidly from the low levels achieved in 2005 and 2006. Average growth in the index of prices excluding food and energy was 1.3% in 2006, 2.7% in 2007, and has been fluctuating around 4% in recent months. Average growth in prices of services was well above 5%, while prices of industrial goods excluding energy are also rising gradually. On the other side, the appreciation of the euro and relatively moderate labour costs, despite their gradual growth in the second half of last year, have acted to slow inflation.

A slowdown in economic growth can be expected in the future, as indicated by low growth in the last quarter of 2007 in Slovenia and in the euro area. Economic growth in Slovenia is expected to reach 4.2% in 2008, 3.9% in 2009 and 4.1% in 2010. Slower growth in gross investments due to less favourable conditions in both the international and domestic environment is expected to contribute to the slowdown in growth. Thus economic activity in Slovenia should become more sustainable and closer to supply potential during the projection period. Current account projections indicate that the deficit will further deteriorate this year to approximately 6% of GDP, and gradually decrease in the next two years. According to assessments, unfavourable terms of trade and increased net outflows of factor income will have the largest impact on the deterioration of the balance of payments current account. Terms of trade, which did not change on average in 2007, are expected deteriorate by approximately 2.2 percentage points in 2008 due to rising prices of energy and other commodities, and become slightly positive afterwards. According to assessments, the increasing interest payments and rising expenditure on dividends and reinvested earnings will be the most important factors behind the expected build up of a negative factor income position during the projection period. Competitiveness indicators also deteriorated in 2007, with the exception of labour costs in the manufacturing sector which were under the influence of strong cyclical growth in productivity. However, this indicator had already reversed by the end of the year and the continuing deterioration of price competitiveness could further contribute to the deepening of external imbalance. Due to tightening financing conditions and expected lower economic activity, the first signs of a slowdown in lending to the private sector have already been seen. This slowdown is expected to continue in the future. On the other hand, a sustained period of negative real interest rates could stimulate growth in domestic demand to the level foreseen in the basic projection, with the risk of further deterioration in the balance of payments current account deficit.

Inflation projections indicate that average inflation in 2008 may reach 5.6%, followed by a gradual drop to 3.5% and 2.6% in 2009 and 2010, respectively. Compared to preliminary estimates, these projections have been revised upwards significantly. The revision is primarily the result of higher recent inflation following the unfolding of certain risks set out in the previous Price Stability Report. It is expected that year-on-year price growth will drop gradually in 2008. This drop is expected to be somewhat faster in the second half of the year due to base effect linked to last year's supply-side shocks. Sustained high energy prices and the increased probability of excessive wage growth, at least in 2008 in the absence of restrictive macroeconomic *policies, may extend the timeframe in which the price stability is re-established again. Inflation is projected to return to a more sustainable and low level only in 2009. More moderate economic activity, consistent with growth in supply potential, and the assumption of growth in unit labour costs without being built into prices into wages should contribute to such development. Estimates indicate that the full indexation of wages on price growth and output per employee could result in inflation remaining at approximately 5% in 2009 and between 4% and 5% in 2010.*

The current disagreements regarding the causes of inflation in Slovenia and the resulting sluggish and overdue response of domestic economic policies to current events expose the economy to risks of excessive demands for wage increases. In areas, not subject to shocks in the external environment, economic policies are responsible for preserving a stable macroeconomic environment and thus give support to the monetary policy of the Eurosystem. By reducing internal pressures it is possible to mitigate risks, posed by adjusting wages to inflation for competitiveness and selling opportunities on foreign markets. With regard to demands to build productivity into wage growth, the recent drop in productivity indicates its predominantly cyclical trend component. Only an appropriate portion of the productivity trend may thus be built into wage growth. The cyclical portion should be left to agreements regarding the profit participation of employees. The law permitting such participation is therefore a welcome institutional change which may be used to regulate wage growth.

Policies still under national jurisdiction must establish frameworks, linked to the Maastricht convergence criteria. The Maastricht price criterion defines price stability for Eurosystem member, that is in line with the ECB's monetary policy. Every deviation from this criterion in Member States is a signal for domestic economic policies to react. This criterion must become the basis for assessing non-inflationary growth in general government expenditure and for sustainable changes in administratively adjusted prices.

At the last discussion on the Stability programme, fiscal policy received a favourable assessment with regard to meeting its medium-term objective. However, several warnings can not be overlooked. In the assessment of the last Stability programme prepared by the European Commission, there are explicit warnings regarding uncertainties linked to the assessment of the output gap during the last three Programmes. The warnings relate to the difference between the assessments of the Commission and submitters of the programme regarding the size of the output gap itself. This implies a risk that the effects of a high economic cycle are also included in current calculations of the structural balance. It is known that due to methodological biases which are difficult to completely eliminate, improvements to the general government position in a period of overheating can be largely attributed to structural improvements, while deteriorations in a period of a slowdown can be attributed primarily to cyclical effects. It is therefore believed that prudence is required when assessing fiscal achievements and progress in meeting the medium-term objective. Given the fiscal results achieved and in light of these warnings, ECOFIN recommendations pointed towards the fiscal policy orientation for 2008 must also be understood.

Domestic macroeconomic instabilities and an uncertain external environment pose new challenges for economic policies under national jurisdiction during the projection period. The deficit in domestic savings and outflows of factor income due to increased cross-border borrowing require balancing the risks that could materialise if these trends continue. The interest rate, which could help stimulate domestic savings, is no longer under national jurisdiction. In this respect, a national economy is dependent on decisions of the ECB and reactions of domestic and foreign banks. Limiting the growing savings-investment gap, which arises due to private sector activities, is the responsibility of fiscal policy. In practice, this means generating fiscal surpluses that ensure sufficient additional domestic savings. This is not an easy task when a drop in economic growth is expected. At a minimum, limitations for the inflationary portion of government revenues, arising from increased price growth, to be used as current government expenditure are expected.

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**April**	Δ	**April**	Δ	**April**	Δ
Activity, employment, wages	*real growth, %*										
Real GDP	2.8	4.4	4.1	5.7	6.1	**4.2**	-0.2	**3.9**	0.0	**4.1**	…
Employment	-0.2	0.4	0.7	1.2	2.7	**0.9**	0.4	**0.6**	0.3	**0.5**	…
Average net wages (nominal)	7.5	4.4	6.2	5.1	7.9	**7.8**	1.2	**6.9**	1.0	**5.5**	…
Disposable income*	1.7	4.2	1.7	5.2	6.6	**3.0**	-0.7	**3.9**	0.7	**3.3**	
Average gross wages (nominal)	7.6	4.6	4.9	4.8	5.9	**7.4**	0.8	**7.0**	1.1	**5.6**	…
Productivity	3.0	4.0	3.4	4.5	3.3	**3.3**	-0.6	**3.3**	-0.3	**3.6**	…
ULC (nominal)	3.6	2.2	-1.4	1.2	2.0	**4.0**	1.4	**3.6**	1.4	**1.9**	
Domestic demand	*real growth, %*										
Domestic demand	4.8	4.9	2.2	5.7	6.9	**4.2**	0.2	**3.5**	0.1	**3.7**	…
Household expenditure	3.5	3.0	2.9	4.0	3.1	**3.2**	-0.8	**3.0**	-0.4	**3.3**	…
Government spending	1.9	3.1	3.2	4.4	1.4	**2.6**	0.7	**1.9**	0.4	**1.8**	…
Gross investment	10.2	10.5	0.4	9.9	17.8	**7.2**	1.7	**5.4**	0.6	**5.6**	…
Balance of payments	*real growth, %*										
Exports of goods and services	3.1	12.5	10.1	12.3	13.0	**9.5**	-2.1	**8.2**	-0.3	**8.3**	…
Imports of goods and services	6.7	13.3	6.7	12.2	14.1	**9.3**	-1.6	**7.7**	-0.3	**7.8**	…
Current account (EUR billion)	-0.2	-0.7	-0.6	-0.9	-1.6	**-2.2**	-1.3	**-2.2**	-1.4	**-2.1**	…
as % of GDP	-0.5	-2.8	-2.0	-2.9	-4.9	**-6.1**	-3.1	**-5.5**	-3.3	**-5.0**	…
Terms of trade**	0.8	-1.0	-2.0	-0.6	0.0	**-2.2**	-2.2	**0.4**	0.1	**0.4**	…
Prices	*average annual growth, %*										
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	**5.6**	2.3	**3.5**	0.6	**2.6**	…
Non-administered prices	5.9	3.0	1.2	1.9	4.1	**5.5**	2.0	**3.6**	0.3	**3.0**	…
Administered prices	4.4	6.1	7.4	4.8	2.1	**5.9**	3.5	**3.2**	2.2	**0.9**	…
International environment	*annual growth, %*										
Foreign demand***	6.0	7.4	4.6	9.0	6.6	**5.5**	-1.7	**6.3**	-0.2	**6.4**	…
Oil (USD per barrel)	28.8	38.3	54.2	64.9	72.7	**100**	27	**98**	25	**97**	…
Non-oil commodities	11.3	16.0	6.0	27.7	17.5	**12.5**	7.5	**5.0**	0.0	**5.0**	…
EMU inflation	2.1	2.1	2.2	2.2	2.1	**2.9**	0.9	**2.1**	0.2	**1.9**	…
PPI Germany	1.7	1.6	4.6	5.5	2.0	**2.3**	0.4	**1.8**	-0.1	**1.8**	…

* Net wages, other earnings from employment and social benefits; HICP deflated

** Based on national accounts deflators.

*** Basket of foreign partners import volumes.

Δ : The difference between April 2008 and October 2007 projections.

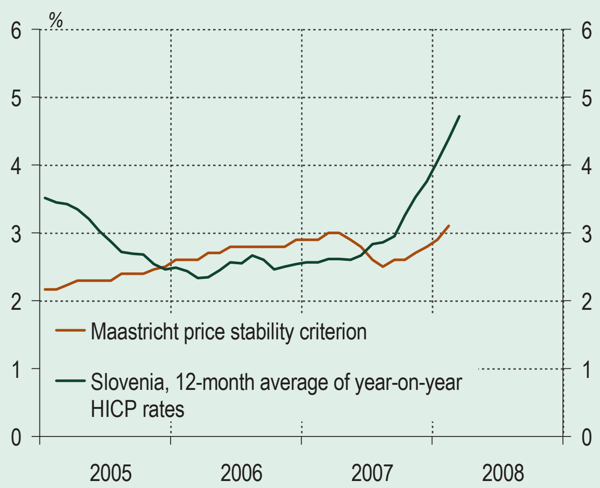
Source: Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook.

1 Recent Price Developments

The average annual rate of inflation in consumer prices as measured by the HICP in 2007 rose to 3.8%, an increase of 1.3 percentage points compared to the 2006 average. Both supply-side and demand factors had an impact on the higher average annual inflation. Supply-side shocks reflect conditions in the global economy which accelerated growth in commodity prices in 2007, particularly food and energy prices. The most notable domestic factors were high economic activity, growth in aggregate demand and favourable real financing terms. At the end of 2007, nominal labour costs, which previously had no inflationary effect, also rose gradually. Inflationary pressures linked to the domestic macroeconomic environment can be seen primarily in the growth in core inflation indicators which rose more sharply than the overall price index on average. Supply-side shocks had a significant effect on the rate of growth of relative prices and the structure of inflation. They also contributed significantly to the growth of the overall price index, particularly in the last quarter of 2007.

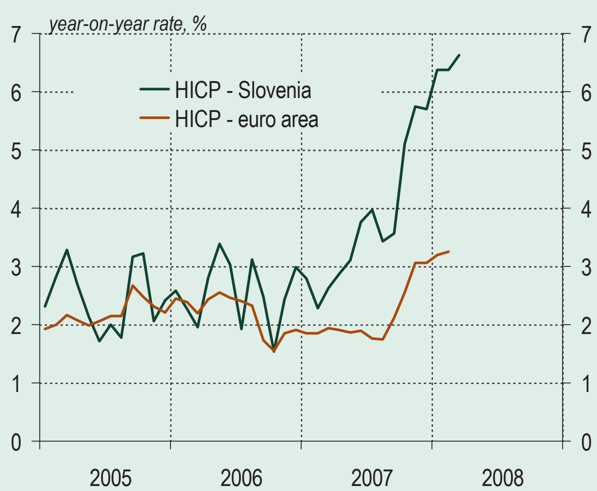
Inflation substantially exceeded the level consistent with sustainable real convergence, and has increasingly deviated from the Maastricht price stability criterion since the summer of last year. In December last year, that criterion stood at 2.8%, or one percentage point lower than the 12-month average HICP growth rate in Slovenia. The process of real convergence results in the catching up of prices with wealthier economies, as seen in the long-term real appreciation of the exchange rate and a higher average inflation rate under conditions of monetary union. Since 1995, the long-term appreciation

Figure 1.1: Maastricht price stability criterion



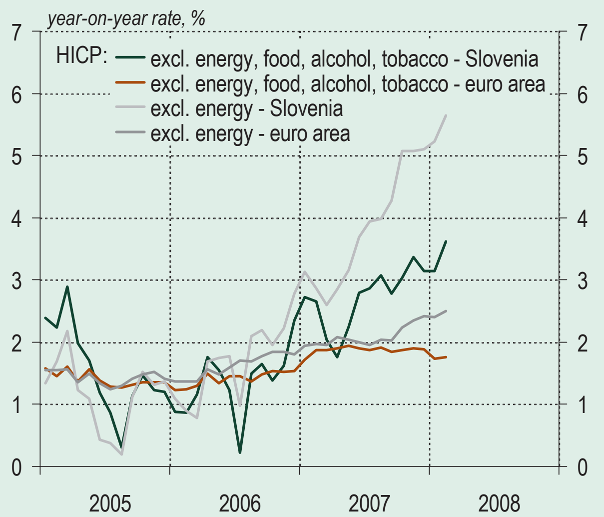
Source: Eurostat.

Figure 1.2: Inflation



Source: Eurostat.

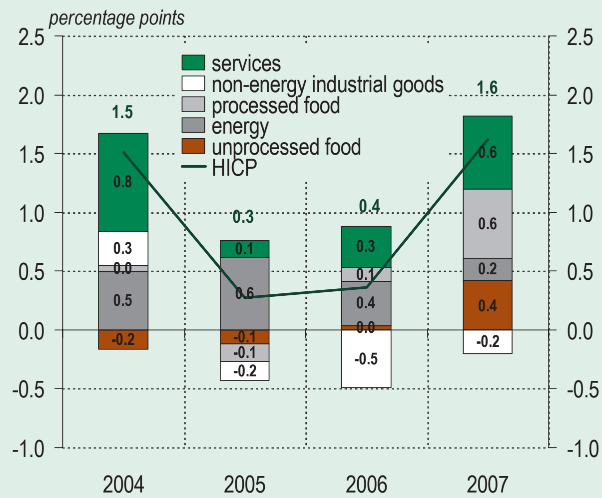
Figure 1.3: Core inflation



Source: Eurostat.

of the real exchange rate versus the euro area has been slightly less than one percentage point per year, which indicates that the process of real convergence in Slovenia is not a restricting factor in achieving price stability.[1] The gap between the average rate of inflation between Slovenia and euro area has risen from 0.3 percentage points in 2006 to 1.7 percentage points, on average, in 2007. At the beginning of 2008, the gap was already more than 3 percentage points. An analysis of macroeconomic indicators shows that the significant difference in comparison with the euro area is linked to the trend of aggregate demand and economic activity in Slovenia, which is significantly higher than supply potential, while the trend of activity in the euro area was at the level of supply potential. Therefore the rise in inflation compared to the euro area is not merely a reflection of a different response of the Slovenian economy to the same factors from the international environment, since inflationary pressures, which do not exist in the euro area, persist in the domestic macroeconomic environment.

Figure 1.4: Difference in contributions to inflation in Slovenia and the euro area



Source: Eurostat, Bank of Slovenia calculations.

Macroeconomic factors and core inflation indicators

Following a reversal in the economic cycle in 2006, the domestic macroeconomic environment is gradually becoming inflationary. Accordingly, core inflation indicators began rising in the second half of 2006. These indicators reached a relatively high level in the second half of 2007, and have continued to rise in the beginning of 2008. The gradual rise in core inflation from the extremely low levels achieved in 2005 was expected, as the low levels reflected not only previously restrictive policies, but also a slowdown in economic activity and unfavourable conditions on the labour market. Entry into the European Union, which was accompanied by the abolition of customs duties, which still existed as some form of goods and services, and an increased level of competitiveness on certain markets, played a role as well. The subsequent reversal in the economic cycle and improved conditions on the labour market were stronger than expected. The insufficient responsiveness of macroeconomic policies to these changes since the second half of 2006 has permitted core inflation to rise to a worrisome level. This increase was significantly sharper than in the euro area. In Slovenia, the price index excluding energy and unprocessed food has risen from 1.5% in 2006 to

[1] The same has been determined by ECB and European Commission convergence reports, which state that these effects are minor in Slovenia due to the high level of real convergence achieved. It should be noted that the Maastricht price stability criteria also includes adjustments for long-term effects on inflation that could result in a sustained process of real convergence.

Table 1.1 Structure of HICP and price movement indicators

		average annual growth, %					year-on-year growth in quarter, %				
	weighting	2003	2004	2005	2006	2007	06Q4	07Q1	07Q2	07Q3	07Q4
HICP	*100.0%*	5.7	3.7	2.5	2.5	3.8	2.3	2.6	3.2	3.7	5.5
Breakdown of HICP:											
Energy	*12.8%*	3.4	7.0	11.9	8.5	3.4	2.3	0.6	3.3	1.1	8.6
Food	*22.1%*	6.1	1.3	0.2	2.7	7.1	3.9	4.0	6.1	7.5	10.7
processed	*14.7%*	7.3	2.7	0.6	2.5	6.3	3.5	3.4	3.9	7.1	10.6
unprocessed	*7.4%*	3.8	-1.4	-0.8	3.1	8.7	4.7	5.2	10.4	8.3	10.8
Other goods	*31.1%*	4.8	1.8	-0.3	-0.9	0.3	-0.4	0.1	0.0	0.4	0.9
Services	*34.0%*	7.1	5.8	3.3	3.5	4.9	3.8	4.6	4.4	5.2	5.3
Core inflation indicators											
HICP excluding energy, seasonal food and tax effects	*83.3%*	6.0	3.0	0.7	1.2	3.2	1.7	2.4	2.4	3.5	4.5
HICP excluding energy and unprocessed food	*79.8%*	6.3	3.7	1.3	1.5	3.4	2.1	2.6	2.6	3.7	4.5
HICP excluding energy, food, alcohol and tobacco	*65.1%*	6.0	3.9	1.5	1.3	2.7	1.8	2.5	2.3	2.9	3.2
Administered and non-administered prices:[1]											
Administered prices	*21.5%*	4.4	6.1	7.4	4.8	2.1	1.1	0.5	2.0	0.7	5.4
Non-administered prices	*78.5%*	5.9	3.0	1.2	1.9	4.1	2.6	3.1	3.5	4.4	5.5
Other price indicators:											
Industrial producer prices on the domestic market		2.6	4.3	2.7	2.4	5.4	2.7	4.4	5.0	5.3	6.4
GDP deflator		5.6	3.3	1.7	2.0	3.9	1.8	4.0	3.5	4.2	3.8
Import prices[2]		2.1	4.1	5.0	3.3	3.3	3.4	3.7	4.6	2.0	3.1
Macroeconomic indicators:											
Output gap (HP trend)		-0.9	-0.6	-1.0	0.1	1.5	0.7	1.3	1.8	1.6	1.1
Unit labour costs[3]		4.2	0.5	0.9	0.3	2.5	0.6	0.6	2.3	2.1	5.0
Labour costs per employee[3]		7.6	4.6	4.9	4.8	5.9	5.1	5.4	5.6	5.8	6.8
Productivity[3]		3.2	4.1	4.0	4.5	3.3	4.4	4.7	3.3	3.6	1.7
Profit indicator[4]		1.3	2.9	0.8	1.7	1.4	1.1	3.4	1.2	2.0	-1.2

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

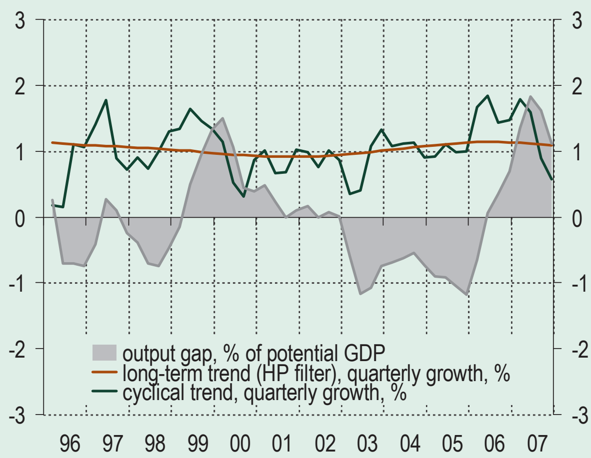
3.4% last year, while the same index rose from 1.5% to 2% in the euro area. In February, the core inflation indicator was already at 4.8%, compared to the euro area average of 2.3%. Since price movements were strongly affected by growth in the prices of processed food at the end of the year, it is interesting to compare overall core inflation indicators excluding food to determine the differences of effects linked to the domestic environment. Last year, the harmonised price index excluding energy, food, alcohol and tobacco rose by 2.7% on average or by 1.4 percentage points more than the previous year and 0.8 percentage points more than in the euro area in 2007. In February 2008, the growth of this indicator had already reached 3.6%, while the same indicator has fallen in the euro area, fluctuating below 2%.

A strongly positive output gap and accelerated deterioration of the balance of payments current account are typically convincing indicators of demand-side inflationary pressures. At 6.1%, growth in economic activity reached a record level last year and exceeded estimated potential growth for the second consecutive year. It should be taken into account that the expenditure breakdown of GDP was more favourable in 2007 in terms of inflationary pressures. In addition to investments, growth in government and household spending was extremely high in 2006. By contrast, according to available data for 2007, domestic demand was driven primarily by investment activity which, at least in part, can contribute to sustained growth in the supply potential of the economy. The structure of investments however was oriented to sectors with a typically lower added value, particularly to the construction sector. The effect on long-term economic potential from this respect is rather limited.

Low or even negative real interest rates had an impact on growth in demand in the second half of 2007. Nominal lending rates for non-financial corporations have risen since the end of 2005, in part due to the tightening of ECB monetary policy. Rising inflation however can also result in increasing inflation expectations which lead to a drop in real interest rates. In contrast to nominal interest rates, real interest rates in Slovenia have been falling since the beginning of last year. As the terms of financing indicators presented in Chapter 5 indicate, real financing terms in Slovenia for non-financial corporations have become more favourable compared to the euro area, while terms for deposit forms of savings have deteriorated. Since nominal interest rates are linked to the ECB's monetary policy and financial conditions in the euro area, a sustained period of low real interest rates could lead to increased investment activity, drive up household spending and further contribute to inflation. From this point of view, it is essential that inflationary expectations fall to a level in line with achieving price stability as soon as possible.

The majority of indicators point to moderate growth in labour costs until the third quarter of 2007, while there was a notable acceleration in their growth in the last quarter. It is not yet clear whether this indicates a more sustained trend. A detailed analysis of labour market trends presented in Chapter 4 indicates that an increase in economic activity is not the result of higher growth in productivity, but was achieved by accelerated employment growth. High employment growth has contributed to a drop in the unemployment rate to a level which is most likely below the natural rate of unemployment. Given the growth in labour costs at the end of the year, high demand for labour together with the desire to maintain purchasing power in a period of rising inflation are considered factors that could contribute to the fluctuation of inflation above the desired level. Last year, growth

Figure 1.5: Output gap trend indicator



Note: Estimate based on most recent quarterly figures.
Source: Bank of Slovenia estimates.

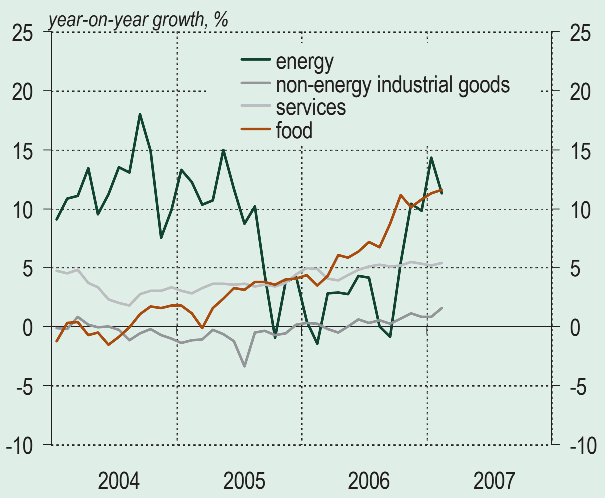
in the average nominal gross wage rose by 1.1 percentage points, reaching 5.9% on average, while year-on-year growth in nominal gross wages in the private sector had already exceeded 8% by year-end. If the fluctuation of productivity at a level between 3% and 4% is taken into account, this means a rise in nominal unit labour costs of between 4% and 5% which is outside the scope of maintaining the inflation rate at a level consistent with price stability criteria.

An important factor limiting inflation has been the appreciation of the nominal effective exchange rate, which partially mitigated inflation shocks from the international environment. The appreciation of the euro has contributed to the reduced roll-over of US dollar commodity prices to the costs of euro area companies. The US dollar depreciation against the euro reached approximately 9% in 2007, while US dollar oil prices rose by approximately 12% and the price of other commodities rose by slightly more than 17%, on average. However the US dollar also depreciated versus most other world currencies, which led to a further increase in US dollar commodity prices. Furthermore, the appreciation of the domestic currency also represents significant pressure on the price competitiveness of the domestic economy. If the real appreciation of major effective exchange rates of the domestic currency (presented in Chapter 5) is taken into account, these factors could, through the deterioration of price competitiveness, act to limit inflation and inflation expectations in the medium term.

Microeconomic factors and the structure of inflation

Factors from the international environment have a considerable effect on rising inflation and the structure of relative prices, particularly the rapid growth in food and commodity prices, and the price of oil since the end of 2007. Among sub-groups of prices, food prices rose at the fastest. Following increases in 2006, their growth rate has accelerated further, exceeding 7% on average annually. At the end of 2007, year-on-year growth in food prices reached 11%, compared to approximately 4% at the end of 2006. Average annual growth was also higher, rising by 4.4 percentage points from the previous year to 7.1%. In the euro area last year, average annual growth in food prices was 2.8%, an increase of 0.4 percentage points from the previous year. In Slovenia, the first food price shock occurred in April in prices of unprocessed food, while new shocks have followed since September in prices of processed food. The result is that the contribution of food prices to inflation has more than doubled, reaching 2.4 percentage points year-on-year in December, compared to 0.8 percentage points in the euro area. The reasons for higher food prices can be attributed to both external and internal factors. The sharp increase in prices is partly linked to the rise in food prices in the international environment, where average year-on-year growth in food prices was 26% in 2007. However, the significantly sharper rise in food prices in Slovenia compared to the euro area is also a reflection of internal factors, including high growth in disposable income and domestic demand. Other possible causes include weak competition in the retail sector and the concentration of price adjustments following the introduction of the euro.[2]

Figure 1.6: Individual price categories

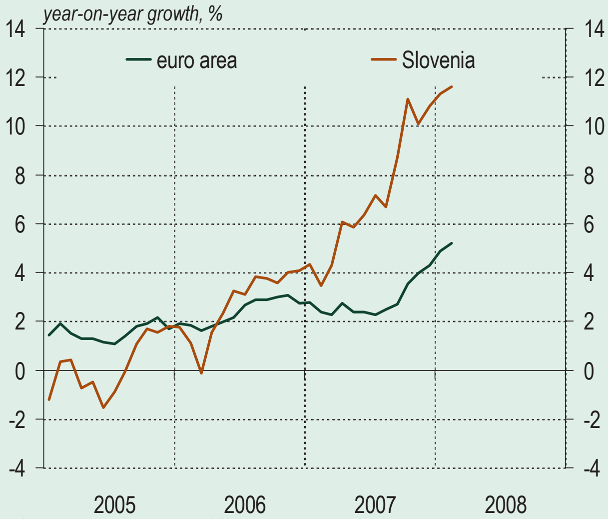


Source: SORS, Bank of Slovenia calculations.

Developments in energy prices were more moderate on average in 2007 compared to a year earlier. However, energy prices rose sharply again in the last two months of 2007. Year-on-year growth in energy prices was quite volatile last year: the contribution of oil prices to the year-on-year inflation rate was actually negative in February and September. Last year, average annual growth in energy prices was 3.4% or 5.2 percentage points lower than the year before. The slower growth in energy prices last year was primarily the result of a drop in prices in the second half of 2006, thus affecting the year-on-year rate of inflation in 2007. Nevertheless, listed prices of all refined petroleum products rose, particularly for diesel fuel and extra light fuel oil. On 11 September 2007, the Government lowered excise duties on petrol and diesel to the lowest level permitted by the EU directive to mitigate the impact of rising energy prices. In the last quarter of 2007, year-on-year growth in oil prices

[2] Slovenia introduced the euro in January 2007. However, previously available assessments regarding the introduction of the euro do not attribute any significant effect on the level of prices. Currently available assessments regarding the effect of the euro's introduction in Slovenia, prepared based on data until February 2007, estimate an effect of approximately 0.3 percentage points (Eurostat) and 0.24 percentage points (IMAD). Furthermore, Eurostat has determined that the effect of the transition to euro prices should also be present primarily in unprocessed food prices which rose sharply in April 2007, but also due to other previously stated factors.

Figure 1.7: Food prices in Slovenia and the euro area



Source: Eurostat, Bank of Slovenia calculations.

again rose significantly (by approximately 60%), while year-on-year growth in energy prices reached 8.6% in Slovenia and 8.1% in the euro area.

In line with macroeconomic and core inflation trends since 2006, the prices of services are also rising, with year-on-year growth exceeding 5% since mid-2007. Average annual growth in the prices of services was up 1.4 percentage points, compared to previous year, to 4.9%. The transitory rise in the prices of services at the beginning of 2007 was likely linked to the concentration of price adjustments during the transition to prices stated in euro. IMAD estimates that the introduction of the euro had the greatest impact on the prices of services, particularly catering services which contributed 0.16 percentage points to inflation in the period from December 2006 to February 2007 (IMAD, March 2007). Growth in the prices of services then slowed again in the first four months of the year, settling at approximately 4% year-on-year. Later, service price inflation began to rise again. As a result, the average contribution of service prices to inflation rose from 1.2 percentage points in 2006 to 1.6 percentage points last year. Within this group, the prices of services for recreation, package holidays and catering services at catering establishments recorded the highest growth. The trend of faster growth in service prices compared to other prices is in part expected and also linked to the process of real convergence, as reflected in the gradual convergence of this price category with euro area prices. Growth in the latter in the euro area rose to 2.5% compared to a year earlier, following a sharp drop in 2006.

Last year, inflation also rose for other non-energy industrial goods from negative inflation rates in 2005 and 2006. The year-on-year growth rate in prices in the first half of the year remained almost flat, while

Figure 1.8: Prices of services in Slovenia and the euro area

Source: Eurostat.

Figure 1.9: Prices of non-energy industrial goods

Source: Eurostat

the 1% growth recorded at the end of the year surpassed the euro area average. Average annual growth in these prices reached 0.3% last year, signalling renewed positive growth following two consecutive years of negative growth, which was primarily the result of falling clothing and footwear prices. The contribution made to total inflation by prices of industrial goods also rose, from -0.3 in 2006 to 0.1 percentage points last year. After two years of negative growth, clothing and footwear prices recorded the highest growth in 2007, followed by the prices of furniture and equipment and household maintenance products. Besides macroeconomic factors, the rise in prices in this group was likely the result of base effects due to negative growth in 2006. Since 2005, growth in these prices in the euro area was slightly positive and therefore even higher than in Slovenia. Growth stabilised at around 1% in 2007.

Administered prices

In line with its plan for managing regulated prices, the Slovenian Government consistently implemented its administered price policy last year. Administered prices excluding energy rose by 0.7% on average last year, contributing 0.3 percentage points to inflation. However, dynamics of administered prices excluding energy accelerated somewhat at the end of the year. The Ministry of the Economy estimates[3] that administered prices rose by 1.5% in the first eleven months of 2007, excluding the effect of growth in prices of liquid fuels for transport and heating.[4] Prices of liquid fuels for transport and heating rose by 12.9% in the same period. Of particular note among administered prices were refined petroleum products prices, which were determined last year based on the methodology defined in the Decree on the Setting of Prices of Refined Petroleum Products.[5] Growth in prices of the latter in the first eleven months of 2007 contributed approximately 0.9 percentage points to inflation. In addition to the aforementioned prices, prices of passenger railway services within Slovenia and prices of municipal services also rose, both by approximately 2.3%. Last year, a new plan was adopted for adjusting administered prices in 2008 and 2009 which maintains the basic guidelines that administered prices will not rise faster than market determined prices.

In accordance with EU directives and the Excise Duties Act, the Slovenian government continued raising excise duties on tobacco products last year. On 1 July 2007, an amendment to the Decree Fixing the Amount of Specific and the Rate of Proportional Excise Duty on Cigarettes was adopted, thus fulfilling the final legal obligation regarding the adjustment of excise duty on tobacco products to the minimum level defined by EU directives. The increase in excise duty resulted in an increase in tobacco prices, which rose 8.6% year-on-year in 2007 or 2.3 percentage points more than a year earlier. This had an inflationary effect of approximately 0.3 percentage points, an increase of 0.1 percentage points compared to the previous year.

Producer prices

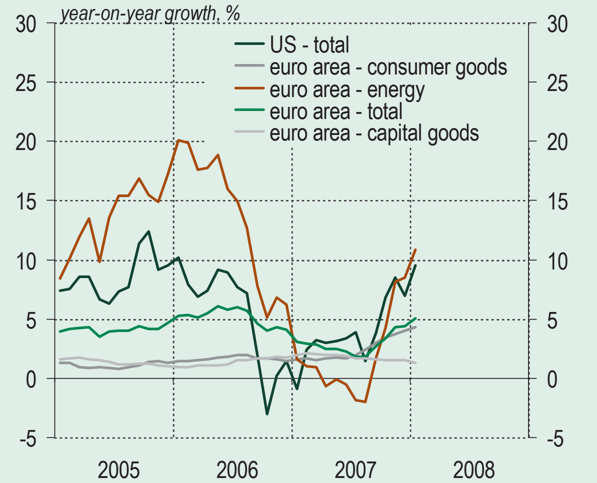
Producer prices on the domestic market rose by an average of 5.4% last year, or nearly 3 percentage points more than the previous year, while their growth in the euro area fell by 2.2 percentage points in the same period. Prices of intermediate goods recorded the highest growth (8.1%), as the result of high growth in prices of commodities and energy. Despite slower growth than a year earlier, metal prices, including high growth in the prices of lead, nickel and tin which exceeded 50% year-on-year, also contributed to growth in commodity prices. A drop in year-on-year growth rates of metal prices was partly the result of the high basis from

[3] See the plan for managing regulated prices in 2008 and 2009.
http://193.2.236.95/dato3.nsf/OC/080103210540A/$file/152v1_11.doc
[4] The calculation also includes the price of electricity, which rose by 4.9% in April 2007 in accordance with the Slovenian Government's decision. Since 1 July, the price of electricity is formed freely.
[5] See Official Gazette of the Republic of Slovenia, Nos. 101/06 and 91/07.

Figure 1.10: Producer prices of manufactured goods on the domestic market

Source: SORS, Bank of Slovenia calculations.

Figure 1.11: Producer prices of manufactured goods on the domestic market for the euro area and US



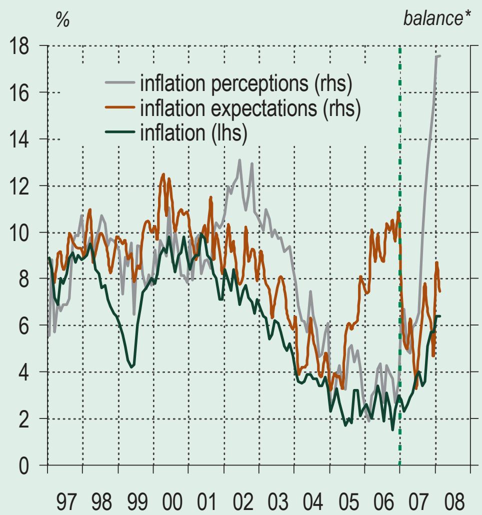
Source: Eurostat, Federal Reserve Bank of St. Louis, Bank of Slovenia calculations

the previous year and partly due to a slowdown in the economic growth of major world economies. Average growth in the prices of capital goods also rose from 0.2% in 2006 to 1.3% in 2007, as did the growth in prices of consumer goods, from 1.5% in 2006 to 2.9% in 2007. Lower growth in producer prices in the euro area compared to a year earlier was mostly the result of lower average growth in energy prices compared to the previous year. In contrast to energy prices, average capital good and consumer good prices rose compared to the previous year. Similar to the euro area, growth in producer prices in the US fell by 1.7 percentage points compared to 2006 to 3.8% last year.

Box 1.1: Surveyed assessment of perceived inflation and inflationary expectations

Assessments based on a recent survey indicate that the perceived inflation rate has risen to its highest level since this indicator has been measured. The notably sharp rise is likely the result of the actual increase of the overall level of prices and the prices of products which consumers purchase most frequently (particularly food and energy), which to a great extent influence the perceived trend of inflation. Assessments of inflationary expectations have also risen, but significantly less than assessments of perceived inflation. Given that the HICP has actually risen, the fluctuation of both assessments could indicate that the current rise in inflation is only transitional in nature for consumers.

Figure: Inflation, perceptions and expectations



Source: SORS, European Commission

**The European Commission verifies consumer perceptions of inflation with regular monthly surveys. Indicators reflect consumer perceptions of inflation in the past and over the next 12 months. The indicator of perceived inflation is calculated as the difference between the weighted average percent of questions for which the answers were that consumer prices "rose a lot" or "rose moderately" in the past 12 months and the weighted average percent of questions for which the answers were that prices "fell" or "stayed about the same" in the same period. More moderate answers receive half the weight of more extreme answers. This means that equilibrium statistics only indicate how prices have changed in the last 12 months according to the opinion of consumers. They also do not provide any information as to how high the inflation rate experienced by consumers actually is. The same methodology is valid for the expected inflation indicator. This must be taken into account for the explanation of data presented in the figure.*

2 International Environment and Projection Assumptions[6]

The relatively strong economic growth of the global economy in the last medium-term period began to slow at the end of 2007. The rate of growth is particularly worrying in the US, while the slowdown in the euro area was more moderate. Growth is more sustained in Slovenia's other major trading partners. A significant slowdown in economic growth in the second half of the year followed growth which exceeded expectations at the beginning of the year in the euro area. Although growth in household spending slowed in the first quarter due to the VAT increase in Germany in January 2007, the slowdown was less than expected. Investments in the euro area also rose faster in the first half of the year than expected owing partly to the mild winter. The slowdown at the end of the year was primarily due to weak household spending, most likely driven by a decrease in real income related to high inflation and wealth effects linked to developments on world financial markets and increased uncertainty after August 2007. The end of the year was also characterised by a decrease in investments in housing construction which was partly the result of tightened borrowing terms, higher financing costs, an expected drop in real estate prices and increased uncertainty on financial markets. Economic growth in the US was also lower last year than in 2006. This was particularly evident at the end of the year with an obvious slow-

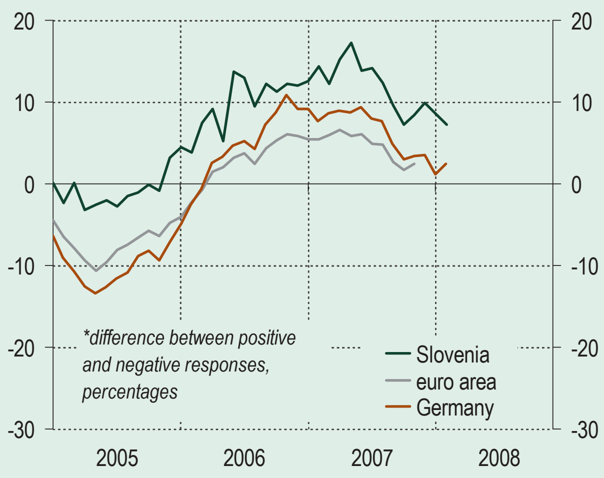
Table 2.1 Assumptions regarding factors from the international environment

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	April	Δ	April	Δ	April	Δ
			annual growth, %								
Foreign demand*	6.0	7.4	4.6	9.0	6.6	**5.5**	-1.7	**6.3**	-0.2	**6.4**	…
Oil (USD per barrel)	28.8	38.3	54.2	64.9	72.7	**100**	27	**98**	25	**97**	…
Non-oil commodities	11.3	16.0	6.0	27.7	17.5	**12.5**	7.5	**5.0**	0.0	**5.0**	…
EMU inflation	2.1	2.1	2.2	2.2	2.1	**2.9**	0.9	**2.1**	0.2	**1.9**	…
PPI Germany	1.7	1.6	4.6	5.5	2.0	**2.3**	0.4	**1.8**	-0.1	**1.8**	…

** Volume of imports of basket of foreign partners*
Δ: The difference between current projections and projections in the Price Stability Report, October 2007.
Source: Bank of Slovenia, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook

[6] The forecasts were made on the basis of data available and the statistical methodology applicable on 10 March 2008. The projections of macroeconomic factors in the Price Stability Report are based on assumptions regarding the movement of variables in the international environment and certain domestic factors conditioned by economic policy decisions. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumed volumes used in the projections are not the same as those used in its projections by the ESCB.

Figure 2.1: Business confidence in Slovenia and abroad

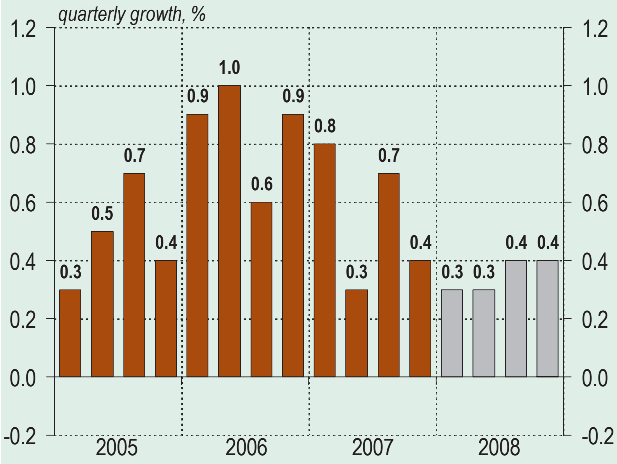


Source: Eurostat.

down, accompanied by the increasing risk that the economy could slide into a recession. A slowdown in household spending, and even more so in housing construction, were characteristic last year, particularly at the end of the year, while government spending and investment rose sharply, primarily in the second half of the year. The economic growth of Slovenia's other important trade partners, such as Croatia, Russia, Serbia and Poland, continued to rise somewhat and remained at high levels.

Lower economic growth is expected for the most important trade partners this year compared to 2007. An additional downward deviation is possible, primarily due to shocks in financial markets and higher commodity prices. Given the forecasted slowdown in the decline of the unemployment rate and increased wage growth in the euro area in line with expectations, a drop in consumer and retail sector confidence will have almost no effect on household spending. Confidence indicators in the manufacturing, construction and services sectors deteriorated in the second half of the year, and in particular at the end of 2007 and the beginning of 2008. They remain however at high levels. Decreased business confidence is partly the result of spreading uncertainty in financial markets. It could also be an indication that the investment cycle has reached its peak. Lower forecasts regarding economic growth in the US, the appreciation of the euro against the dollar last year and increased competition from emerging markets have also led to expectations of a slowdown in the growth of euro area exports. Due to the simultaneous slowdown in components of domestic spending, which determine import developments, the contribution made by foreign trade to euro area economic growth will be virtually unchanged compared to last year. Recently, international institutions have revised their euro area economic growth forecasts downwards. Thus the Consensus forecast for euro area economic growth for this year was revised downwards to 1.7% in February 2008 from 2.4% in August, where it stood prior to the notable tightening of conditions on financial markets. The IMF has also made a downward revision of 0.5 percentage points for 2008 compared to its previous forecast, as have the European Commission (by 0.4 percentage points) and the ECB (by 0.3 percentage points) with regard to the average spread. The downward revision of forecasts is primarily the result of volatility in financial markets, a decline in growth on the real estate market and high prices on commodity markets. Even more notable is the downward revision of forecasted US economic growth for 2008, from 2.7% in August 2007 to 1.7% in February this year (Consensus).

Figure 2.2: Euro area economic growth and European Commission projections

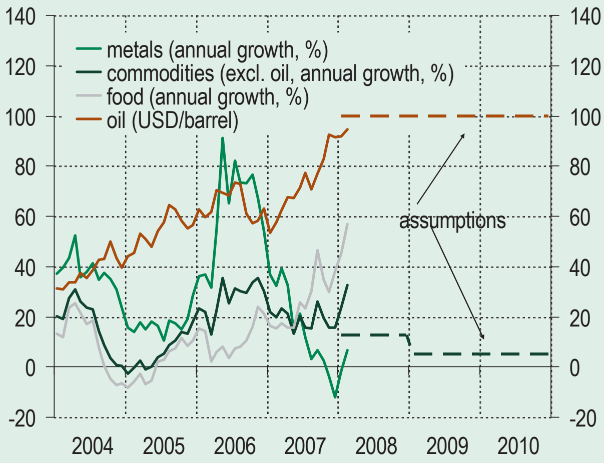


Source: European Commission forecasts, February 2008; projections for all quarters of 2008.

Available forecasts of economic trends in the international environment indicate a decline in the growth of foreign demand for Slovenian exports with regard to previous projections. Although revisions to economic growth as measured by GDP are not significant, these revisions relate primarily to components of domestic spending that are important in determining the imports of trade partners or foreign demand. Most risks, which were not taken into account in assumptions regarding developments in the international environment, have been realised in the last six months. These risks include continuing uncertainty in financial markets and its spread to Europe, a slowdown in growth in the US, the appreciation of the euro and high commodity prices. This has led to a deterioration in the bases for forecasts of economic growth in the euro area and the US. Estimates of economic growth have also been revised downwards for Slovenia's other trading partners. The possible worsening of geopolitical tensions could also result in lower demand from some south-eastern European countries. The assumption regarding growth in total foreign demand for this year is lower than estimates from 2007. An easing of conditions in financial and commodities markets is expected next year, leading to a renewed increase in demand of the most important trade partners. Deepening of unfavourable economic developments in the US and uncertainty regarding their spread to other markets, particularly emerging markets and the continued rise in commodity prices represent the greatest risk at the moment which, taking into account assumptions, could result in lower foreign demand this year and in 2009. Nevertheless, foreign demand is expected to remain at the level of the long-term average.

Oil prices rose gradually in 2007, reaching nearly USD 100 per barrel by the end of the year. They reached record highs in the first days of March 2008, while financial markets expect high prices to persist in the future. The only exception during the sustained rise in oil prices last year was the period from mid-July to the end of August (i.e. the period when uncertainty on

Figure 2.3: Prices on world commodity markets



Source: The Economist, Bloomberg, Bank of Slovenia assumptions.

financial markets began to grow), when the price of oil fell from nearly USD 80 per barrel to just below USD 70. The average price of a barrel of oil was USD 74 in 2007. Dollar oil prices rose by more than 12% during the year, while prices expressed in euros rose by just 3% due to the appreciation of the euro. The main factor in rising oil prices remains the gap between high demand and relatively slow growth in supply, which in addition to insufficient investments in the infrastructure, was driven by geopolitical tensions in oil-rich regions. In 2007, OPEC raised it official output quota just once. This however did not stop continued growth in prices. Rising oil prices were also the result of low oil inventories in the US and the depreciation of the US dollar against other currencies. According to IEA (International Energy Agency) estimates, demand for oil last year remained at an unchanged high level due to solid demand from emerging markets, despite somewhat slower global economic growth. The reasons for the upward revision of oil price assumptions are high oil prices at the beginning of the year and the fact that oil producing quotas remain unchanged even after OPEC's March meeting. In line with a downturn in the economic growth and increased oil inventories, the IEA expects a slight drop in demand which, according to estimates, will not result in a drop in prices, but will rather prevent their continued sharp growth. Nevertheless, assuming a price of USD 100 per barrel, oil prices are expected to rise by nearly one quarter in 2008, or by approximately 26% measured in euros compared to the average price in 2007. At the same time, this assumption means that the price of oil measured in euros would be 37% higher compared to the assumption used for 2008 in previous projections.

Taking into account current developments and expectations on commodity markets, the previous assumption regarding commodity prices was also revised upward. While notably more moderate growth in metal prices was recorded in the second half of 2007, food prices, particularly wheat, soy and milk prices, have risen sharply since the middle of last year. Although metal prices were subdue in the second half of 2007, a new agreement on iron ore prices, which are 50% higher than last year, indicate that metal prices could experience renewed growth this year. The sharp growth in food prices is primarily due to increasing demand from emerging markets, the use of grains and agricultural land in the production of bio-fuels, unfavourable weather conditions in some large producer countries, and due to agriculture policies aimed at reducing agricultural surpluses. At the beginning of 2008, the price of wheat rose to a level exceeding 100% year-on-year, while the price of corn rose by 40% in the first two months of the year.

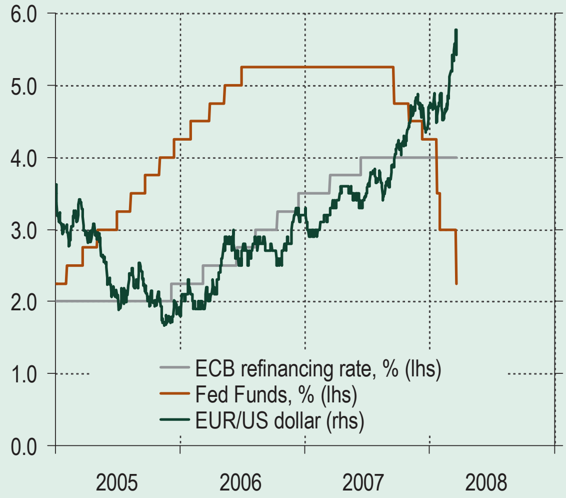
Inflation in the euro area and US rose sharply at the end of 2007 and the beginning of this year. According to the assessments of analysts however this increase is merely transitional and is the result of a sharp rise in commodity prices in world markets. Until the end of the summer, growth in prices in the euro area was rather subdued, while year-on-year inflation remained at approximately 1.9%. Since September, inflation has risen sharply, reaching 3.2% in the first two months of 2008. The growth of inflation since September was primarily due to sharp growth in energy prices since that time in 2007 and the low basis from the end of 2006. Besides energy prices, the prices of processed food (average growth of 5.5% in the first two months of 2008, compared to just 2.8% in 2007) have also had an impact on growth in the HICP. Last year, core inflation, i.e. inflation excluding the prices of energy and unprocessed food, also rose compared to 2006, driven by a rise in processed food prices and an increase in the VAT rate in Germany at the beginning of the year. Core inflation was 1.5% on average in 2006, 2.0% on average in 2007 and 2.3% on average in the fist two months of 2008. Growth rates of euro area producer prices of manufactured goods gradually fell in the first half of 2007 driven by lower growth in energy sector prices. In the second half of the year, growth rates rose sharply due to higher energy and unprocessed food prices. At the beginning of this year, the year-on-year growth rate in producer prices was approximately two percentage points higher that the average growth recorded last year. A similar trend in producer prices was characteristic for Germany. Price developments in the US last year and in the beginning of this year were similar to those of the euro area, except that price growth fluctuated a great deal more and was higher throughout the period. The rise in inflation at the beginning of 2008 was also sharper, as prices grew 4.0% and 4.3% year-on-year in January and February respectively (despite a decline in domestic demand), following average growth of 2.9% in 2007. While core inflation, defined as the price index excluding energy and food, was approximately 2.1% at the beginning of the second half of the 2007, it had risen to 2.4% on average in the first two months of this year in the US. This trend in core inflation indicates the transfer of high energy and food prices to other prices, which should fall in the future given an expected slowdown in demand.

Assumptions regarding growth in prices in the euro area and US were revised upward primarily due to inflationary factors in the international environment and in the euro area also due to some indications of the risk of higher growth in labour costs. The increase of assumed euro area inflation to 2.9% for 2008 is primarily the result of higher energy prices and sustained growth in food prices on the world market. While high commodity prices and indirect taxes resulted in inflationary pressures in 2007, more pressure on prices can be expected this year and in 2009 from labour costs. Risks regarding higher labour costs are particularly notable in light of demands from unions for compensation of a portion of lost purchasing power in relation to high food prices and for employee participation in favourable economic results from past years. The rise in assumption regarding the inflation rate in the US is not as high as in the euro area. This primarily reflects the expectation of a more notable slowdown in economic growth. This year, the higher assumption regarding inflation in the US is primarily the result of higher assumptions relating to trends in the prices of energy and commodities, particularly food prices. Expectations of more moderate growth in prices in the US in the next several years are also consistent with moderate growth in prices on commodity markets, while the same is true for euro area inflation. The assumption regarding growth in German producer prices is also higher due to commodity prices which are higher than assumptions in previous projections. In the absence of shocks in commodity markets, growth in German producer prices will slow in the next two years compared to 2008.

The ECB did not change interest rates in the last projection period, while the Federal Reserve has lowered its rates sharply several times following the rise of financial uncertainty, which has already carried over into financial turmoil. Last year, the ECB raised its key interest rate in March and June, both times by 25 basis points, and has left it unchanged since that time. The key refinancing interest rate remained unchanged at 4% until March this year. Last year, the Federal Reserve kept its key Federal Funds interest rate unchanged until September when it lowered it by 50 basis points to 4.75%. By March this year, it had lowered the key interest rate four more times by 175 basis points to 3%. The largest single reduction of the interest rate (by 75 basis points to 2.25%) was carried out in mid-March. The key reversal that contributed to a change in interest rates by several central banks was increased uncertainty in financial markets. The standard assumption in the projections is that interest rates in the euro area will be aligned with expectations of financial markets. Expectations from the beginning of March 2008 were taken into account.

The euro appreciated significantly versus the US dollar last year, particularly in the last quarter following the deepening of uncertainty in financial markets and the publication of increasingly bad news regarding US economic indicators. Exchange rate assumptions remain unchanged at March 2008 levels for the projection period. The euro appreciated approximately 9% versus the US dollar last year, while year-on-year appreciation was just above 12% in the last quarter. For the projection period, the technical assumption that the euro-dollar exchange rate is equal to the average for the month prior to the preparation of projections is taken into account.

Figure 2.4: EUR/US dollar exchange rate and central bank interest rates



Source: ECB, Federal Reserve.

3 Economic Trends and the Labour Market

Slovenia's real GDP rose by 6.1% in 2007, exceeding euro area growth by 3.5 percentage points. Despite the slowdown in the last quarter, average growth in Slovenian economic activity last year exceeded estimated growth in supply potential. Last year, economic growth reached its highest level since Slovenia's independence. Growth in the euro area was 2.6% in 2007. In the last quarter of 2007, both current and year-on-year economic growth in Slovenia had already slowed considerably. Year-on-year growth was 4.7%, while estimated current growth fell from 1.4% in the third quarter to just 0.4% in the last quarter. In the last quarter of 2007, there was a notable closing of the output gap and convergence to the long-term potential.

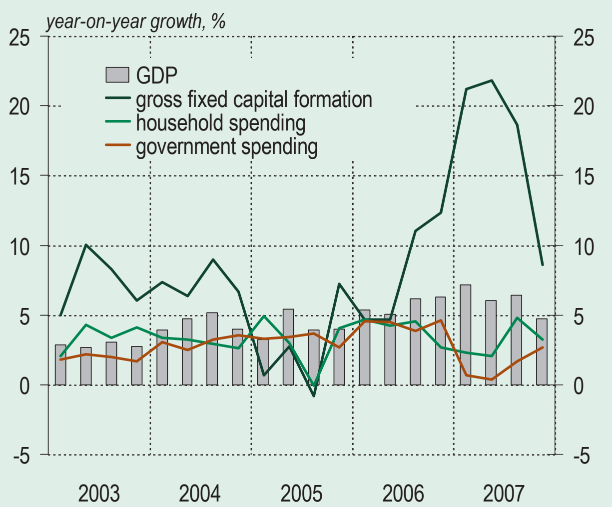
According to the output structure of GDP, the most obvious difference in growth of added value between Slovenia and the euro area can be seen in construction, financial intermediation and the manufacturing sector. As in 2006, the highest growth in added value was achieved in construction (18.7%), financial intermediation (12.1%) and in the retail sector (7.6%). Driven by rapid growth in industrial production, manufacturing also achieved a record high year-on-year growth in added value (8.5%). Growth in industrial production in Slovenia in 2007 deviated significantly from the euro area, as year-on-year growth was twice as high at 6.9%. By the end of the year however, both year-on-year and current growth had slowed. Current growth rate indicators point to a considerable slowdown in industrial production in the last quarter, when growth rates were actually negative. The structure of economic growth in Slovenia for last year still points to a favourable, yet likely unsustainable, economic cycle. In this respect, economic growth, which exceeds estimated growth in the economy's supply capacity, fuels

Table 3.1 Activity, employment and wages

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**April**	Δ	**April**	Δ	**April**	Δ
	real growth, %										
Real GDP	2.8	4.4	4.1	5.7	6.1	**4.2**	-0.2	**3.9**	0.0	**4.1**	…
Employment	-0.2	0.4	0.7	1.2	2.7	**0.9**	0.4	**0.6**	0.3	**0.5**	…
Average net wages (nominal)	7.5	4.4	6.2	5.1	7.9	**7.8**	1.2	**6.9**	1.0	**5.5**	…
Disposable income*	1.7	4.2	1.7	5.2	6.6	**3.0**	-0.7	**3.9**	0.7	**3.3**	…
Average gross wages (nominal)	7.6	4.6	4.9	4.8	5.9	**7.4**	0.8	**7.0**	1.1	**5.6**	…
Productivity	3.0	4.0	3.4	4.5	3.3	**3.3**	-0.6	**3.3**	-0.3	**3.6**	…
ULC (nominal)	3.6	2.2	-1.4	1.2	2.0	**4.0**	1.4	**3.6**	1.4	**1.9**	…

Δ: The difference between current projections and projections in the Price Stability Report, October 2007.
** Net wages, other earnings from employment and social benefits; HICP deflated*
Source: SORS, Bank of Slovenia calculations

Figure 3.1: Domestic demand and GDP

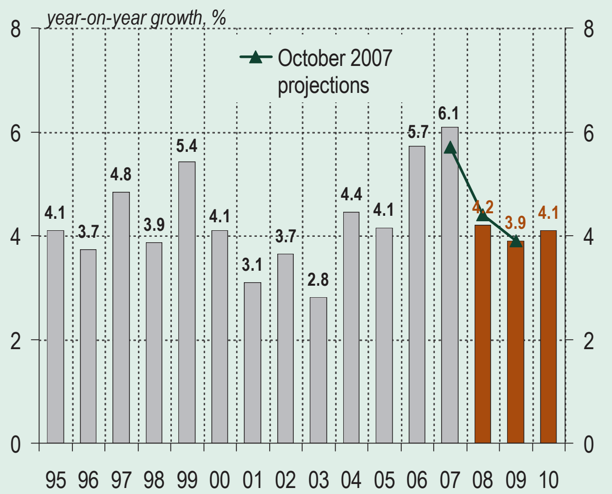


Source: SORS; Bank of Slovenia calculations.

pressures from aggregate demand, thus resulting in a shift to macroeconomic imbalances. These, among others, are indicated in increased growth in core inflation and a large balance of payments deficit.

The slowdown in economic growth in the last quarter of 2007, both in Slovenia and the euro area, indicates a gradual slowdown in economic activity in the projection period. Slovenia's economic growth reached a record level in 2007. In the last quarter however, year-on-year and, to a greater extent, current growth slowed significantly, affecting projections for the entire period. Downward revisions of projections regarding economic growth were for the most part the result of a slowdown in economic activity in Slovenia and the euro area. As indicators of expectations regarding economic activity in Slovenia's more important trade partners show, analysts assume more moderate growth in foreign demand, resulting in lower growth in exports compared to previous forecasts. Despite less favourable factors from the external environment, high inflation and an increasing lack of confidence among consumers, domestic spending is expected to remain at a relatively high level under favourable terms of financing.

Figure 3.2: GDP growth projections

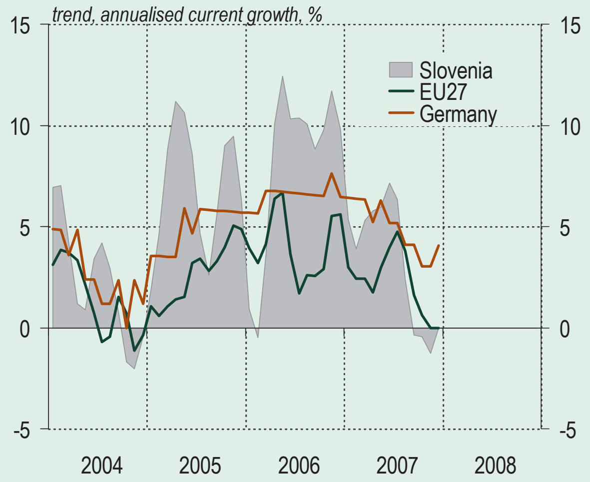


Source: SORS, Bank of Slovenia projections.

Slovenia's economic activity in the projection period will be more in line with supply potential. Projections of economic growth for Slovenia indicate that GDP growth will slow in the coming years and become more sustained in the medium-term, in line with previous projections. Expected growth, of approximately 4% in the coming years, will lag somewhat behind estimates of potential growth, or its long-term trend, which will close the output gap. This means that aggregate demand and economic activity will gradually converge with supply potential during the projection period, resulting in the easing of inflationary pressures which have caused excess aggregate demand recently. Despite a slowdown, this growth will facilitate, on more sustained bases, the process of real convergence to wealthier euro area countries, as GDP growth in Slovenia will continue to exceed euro area growth by approximately two percentage points.

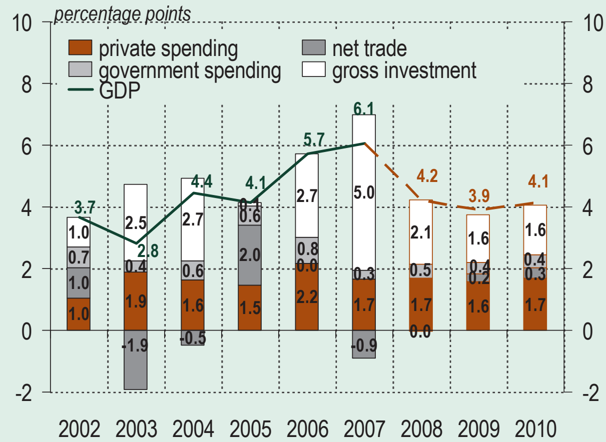
Domestic demand is expected to remain the main factor in the economic cycle throughout the projection period, primarily due to sharp growth in investments. Relatively rapid growth in gross investments will continue to be the driving factor in growth in domestic demand in 2008, following the 17.8% year-on-year growth recorded in 2007. Persistent relatively high investments growth, together with moderate growth in employ-

Figure 3.3: Total industrial production - excluding construction



Source: Eurostat

Figure 3.4: Contributions to GDP growth by components of spending



Source: SORS, Banka of Slovenia projections.
Note: The sum of components may vary from aggregate values due to the use of chain indices and rounding.

ment, will also contribute to growth in the economy's supply capacity. In line with expectations, the contribution of foreign trade to economic growth was negative in 2007, while its average contribution throughout the projection period is expected to be slightly positive. With a slowdown in the growth of domestic demand, exports are expected to surpass growth in imports.

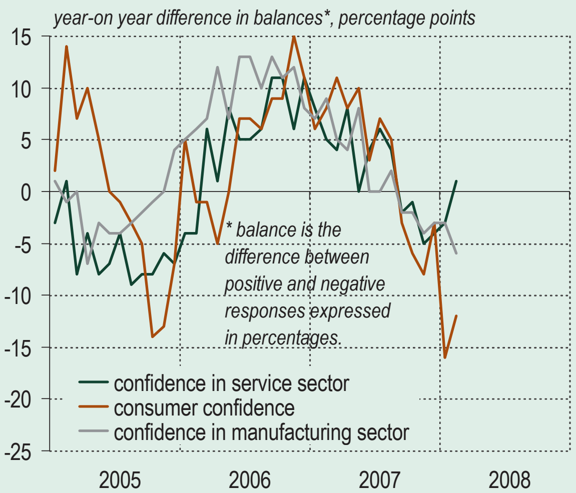
The contribution made to aggregate demand by domestic demand will decline slightly by the end of the projection period in line with lower growth in investment spending. Despite this slowdown in growth, domestic demand will continue to account for the majority of aggregate demand during the period from 2008 to 2010, while the average contribution made by foreign trade will be positive. The decreasing contribution of domestic consumption will primarily be the result of a gradual cooling in investment spending and also due to a high basis following a sharp increase in total investments in 2007. Among components of domestic spending, gross investment in housing and non-residential construction rose at an average rate of approximately 20% in 2007. Rapid growth in housing construction was partly the result of a low basis from 2006, favourable weather conditions in the first quarter of 2007, favourable financing terms and a significant imbalance between supply and demand for housing units in some parts of the country. In addition to the aforementioned factors, a high level of investment activity at state-owned companies contributed to rapid

Table 3.2 Components of domestic demand

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	April	Δ	April	Δ	April	Δ
	real growth, %										
Domestic demand	4.8	4.9	2.2	5.7	6.9	**4.2**	0.2	**3.5**	0.1	**3.7**	…
Private spending	3.5	3.0	2.9	4.0	3.1	**3.2**	-0.8	**3.0**	-0.4	**3.3**	…
Government spending	1.9	3.1	3.2	4.4	1.4	**2.6**	0.7	**1.9**	0.4	**1.8**	…
Gross investment	10.2	10.5	0.4	9.9	17.8	**7.2**	1.7	**5.4**	0.6	**5.6**	…

Δ: The difference between current projections and projections in the Price Stability Report, October 2007.
Source: Bank of Slovenia.

Figure 3.5: Seasonally adjusted confidence indicators



Source: SORS, Bank of Slovenia calculations.

growth in non-residential construction, particularly with regard to investments in the infrastructure. This growth is expected to slow considerably in 2008, when growth of investments in the infrastructure will be halved according to assumptions. Current and year-on-year growth in non-residential construction slowed significantly in the last quarter of 2007, indicating the slowdown in high growth from last year is likely to carry over into 2008. In line with favourable foreign demand and a high domestic economic cycle, investments in plant and equipment also rose sharply, primarily in the first part of 2007. These investments made the most significant contribution to the increase in the economy's supply potential. There were however signs of a drop in the growth rate at the end of the year. A slowdown in growth in the latter is thus expected in 2008, for the most part due to uncertain and deteriorating conditions in the international environment.

Following high growth in 2006, household spending slowed in 2007, settling at approximately 3%. According to the latest data from SORS, growth in household spending fell from 4.0% in 2006 to 3.1% in 2007, when growth in the second half of the year nearly doubled the growth recorded at the beginning of the year. Household consumption's contribution to economic growth fell by 0.5 percentage points compared to the previous year, amounting to 1.6 percentage points. In this regard, actual growth in household spending in 2007 was 0.7 percentage points lower than previous forecasts. The majority of this difference can be explained by the methodological revision of data for 2006 and the resulting change to the basis for year-on-year comparisons in national accounts for the third quarter of 2007.

In the future, growth in household spending similar to 2007 is expected, i.e. approximately 3% annually, while the contribution of household consumption to economic activity will remain virtually unchanged during the projection period. These expectations are based on assumptions regarding favourable financing terms in conditions of low real interest rates and continued favourable conditions in the labour market. In addition to reasonably favourable financing terms, low interest rates could realistically make savings less attractive and keep spending at a high level that would be in line with developments in disposable income and uncertainty linked to economic developments. In uncertain economic conditions, the number of appropriate forms of alternative investments also decreases, leading to the increased probability of a rise in spending in such conditions. On the other hand, there are factors such as higher inflation, a decrease in real income and the pessimistic expecta-

Figure 3.6: Household spending and disposable income

* Deflated by the HICP
Source: SORS; Bank of Slovenia calculations.

tions of consumers which, according to assessments, will prevent household spending from growing faster than current assumptions. Consumer confidence indicators reached their highest level in recent years during the first half of 2007, while they fell sharply in the second half of the year and fluctuated more than 10 percentage points below last year's average in the first months of 2008. In this regard, a significant risk factor of current projections is the extent of rising wages in the private sector. The institutional changes already introduced in the area of pension insurance will continue to stimulate households to use longer-term forms of savings.

Household spending in the last year has lagged behind the relatively rapid growth in disposable income, which will fall slightly this year compared to previous projections. The level of disposable income rose in 2007 due to growth in average earnings and rapid employment growth. Although changes in tax legislation in 2007 led to a notable increase in net wages, which represent the majority of disposable income, certain other components of disposable income have recorded rather subdued growth. Since net wages have risen the most in higher income brackets with a generally lower marginal propensity to spend, this increase has not had any considerable impact on household spending. The number of income earners in households rose last year mainly due to rapid employment growth. The number of pension recipients rose by 1.3% in 2007, while the number of unemployment benefit recipients fell sharply. Since a large portion of the rise in employment in 2007 is the result of additional employment of the foreign labour force, which is typically less inclined to spending, the increase in disposable income is not reflected to a great extent in household spending. Real disposable income per employee rose by 6.6% in 2007, compared to the 5.2% growth recorded in 2006. Higher inflation reduces growth in real disposable income, which nevertheless rises due to favourable employment growth.

Over the next medium-term period, household spending will be sustainable, thus will continue to lag behind GDP growth and will not give rise to any inflationary pressures. The main risk factors affecting household spending are conditions on financial markets, terms of financing and uncertainty regarding private sector wage adjustments given the previously realised and substantial growth in prices. Since pension increases have been tied to gross wages since the middle of 2005, disposable income from pensions is also a risk to the forecast for household spending due to the uncertainty of rising private sector wages.

The contribution of government spending to economic growth fell considerably last year. Given budget estimates, a slight rise in government spending is expected in 2008, followed by a drop in the next two years to a level below 2%. The decrease in government spending last year was slightly higher than expected. Expenditure for employees and social transfers in kind recorded the most significant decline. Slightly higher real growth in government spending is expected this year, driven by higher growth in expenditure for goods and services. The difference compared to the government spending assumption for 2008 from previous projections is 0.7 percentage points. The assumption regarding government spending in 2009 has been revised upwards by 0.4 percentage points. Growth in government spending should settle just below 2% in the next two years, which still indicates moderate real government spending. In this regard however the assumption of nominal growth in government spending for 2008 was revised upwards due to estimated high deflators, as the result of expected higher growth in average public sector wages and a higher rate of inflation. The government's gross fixed capital formation in 2007 rose 5.9% in real terms and represented 3.7% of GDP.

According to assessments from the Stability Programme update, Slovenia met its medium-term public finance objective which, in accordance with the Stability and Growth Pact, is defined as a structural deficit amounting to 1% of GDP. The objective was met earlier than planned. The government sector deficit was estimated at 0.6% of GDP in the Stability Programme 2007 update, significantly lower than the planned 1.5% of GDP in the Stability Programme from December 2006. The Ministry of Finance revised its estimate of the deficit in February 2008, and foresees a surplus of 0.1% of GDP, while the structured deficit for 2007 is expected to be 0.2% of GDP.[7] Estimates of the structural public finance deficit for 2008, as well as those from the Stability Programme update (December 2007) and the European Commission's estimate, indicate a deterioration of the structural position.[8] At the same time, warnings regarding the fluctuation of the output gap from the estimate in the Stability Programme of December 2007, prepared by the Commission, should not be overlooked. These warnings imply a risk that the effects of a high economic cycle are also included in current calculations of the structural balance. It is recognised that one of the important methodological issues when calculating potential output is the method used to exclude cyclical effects. The methodology used by the Commission explicitly points out the significance of this issue.[9] The structural balance is, according to its content, a balance that should reflect the state of public finances in an environment of a stable growth trend without the effects of overheating or cooling. A comparison with the previous Stability Programme indicates the estimate of potential output, used in the current Stability Programme, fluctuates sharply and that significant differences exist between the estimates of the Commission and the submitters of the Programme regarding the output gap. It is also known that, due to methodological biases which cannot be eliminated, improvements to the public finance position in a period of overheating can be largely attributed to structural improvements, while deteriorations in a period of cooling can be attributed primarily to cyclical effects. This therefore reinforces the need for caution when assessing shifts in the structural balance of public finances. This is also reflected by ECOFIN recommendations regarding Slovenian public finance policy which, despite favourable results, indicate the need for additional measures relating to inflation.

When assessing the effect of fiscal policy on aggregate demand and inflation, the activities of government-controlled companies outside the government sector are important. In this regard, the recent investment activities of DARS represent a significant factor. Since 2002, DARS has increased net borrowing to implement its investment programme, thus contributing considerably to aggregate demand. In 2007, DARS's net borrowing represented 1.47% of GDP, a significant increase compared to previous years when DARS's net borrowing represented 0.45% of GDP in 2001 and 0.8% and 0.85% of GDP in 2005 and 2006, respectively.[10] By increasing its investment activity, DARS has contributed significantly to accelerated economic activity. Government guarantees have been issued on loans raised to support this activity. Growth in government guarantees by approximately 4% of GDP in the last four years has contributed significantly to shaping the rate of growth of DARS investments, and thus to the rapid growth of total investments. In the overall balance of guarantees at the end of 2007, guarantees of the road traffic sector represented approximately two-thirds of all guarantees issued, while newly approved guarantees for DARS represented 1.62% of GDP in 2007.

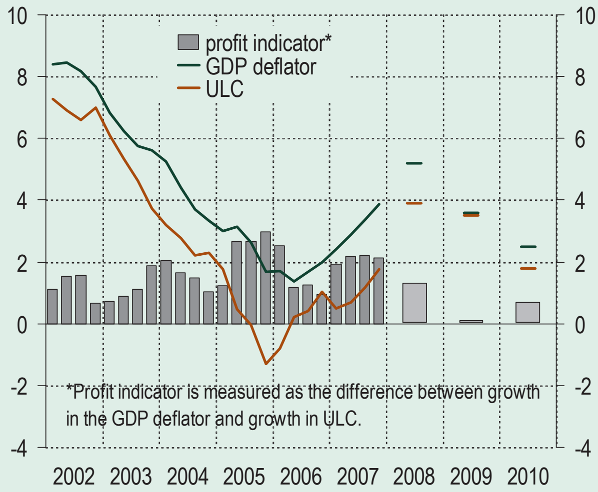
Gross fixed capital formation in 2007 rose 17.2% primarily due to high growth in investments in construction and facilities. The high growth rate of gross investments from the second half of 2006 continued in the first three quarters last year. By the end of 2007, current and year-on-year investment growth had slowed. In 2007, the acceleration of investment spending was strongest in the

[7] Resolving the issue of high inflation and the preparation of measures to counter inflation, presented by the Ministry of Finance at the irregular session of the National Assembly, February 2008.
[8] Stability and Growth Programme, December 2007 (http://www.mf.gov.si/slov/tekgib/program_stabilnosti_2007.pdf) and the assessment of the European Commission's Stability Programme, February 2008 (http://ec.europa.eu/economy_finance/publications/publication11925_en.pdf).
[9] Calculating potential growth rates and output gaps; A revised production function approach; Economic papers, Number 247, March 2006.
[10] Resolving the issue of high inflation and the preparation of measures to counter inflation, presented by the Ministry of Finance at the extraordinary session of the National Assembly, February 2008.

construction sector, where investments in housing and non-residential construction were most notable, while investments in transportation equipment also rose sharply. High growth in investment in non-residential construction at the beginning of the year was partly the result of favourable weather conditions which sped up motorway construction already planned for this year. Investments in this area also rose rapidly due to the construction of facilities intended for retail activities and the construction and renovation of facilities in the scope of preparations for the expansion of the Schengen border and facilities related to Slovenia's EU presidency in the first half of 2008. Housing construction is probably also in part due to expectations that the transitional period of low VAT for housing construction and renovation would expire at the end of 2007. Investments in plant and equipment, with a growth rate of 13.3%, also rose rapidly in 2007. In this regard, investments in transportation equipment grew fastest, reaching 24.7% year-on-year. This growth was driven in part by certain one-off transactions, primarily the purchase of aircraft in the second quarter.

Projections indicate continued high growth in investment spending, which will nevertheless slow from the record growth rates witnessed last year. Given favourable financing terms, a high volume of investments is also expected for the coming period. However, year-on-year growth will slow somewhat due a high basis from 2007 and less favourable conditions in the international and domestic environments. A slight slowdown in housing construction is expected, in part due to lower growth in the number of building permits issued; an increase of 6.5% year-on-year in 2007 compared to growth of 11.6% in 2006. Non-residential construction is also expected to slow, as DARS's plans for 2008 indicate an 11.5% year-on-year increase in the construction and repair of motorways.[11] Construction and repair of motorways represent a significant proportion of non-residential construction which rose by approximately 20% last year. Growth in investments in plant and equipment is expected to slow

Figure 3.7: Profit indicator



Source: SORS, Bank of Slovenia calculations.

slightly due to lower domestic and primarily foreign demand, and due to increased uncertainty in the macroeconomic environment. According to assessments, decreasing corporate profits will contribute further to a slowdown in investments in plant and equipment. In line with expectations during the projection period, these investments will contract due to increased costs arising from high commodity prices on international markets. They will also be curbed by increased domestic costs, primarily due to higher wages. The forecast of growth in gross investments for 2008 and 2009 was revised upwards slightly compared to previous projections, primarily due to currently known plans in the area of housing and non-residential construction, due to higher investment expenditure items in the revised budget for 2008 and due to the higher realisation of investments in 2007 than previously expected.

The projections are that the fastest-growing component in gross fixed capital formation will be investments in non-residential facilities. With slightly slower growth in investments in plant and equipment and persistently high growth in housing construction, the highest growth rates in 2008 will be recorded by investments in non-residential facilities, taking into account the fore-

[11] Source: http://www.ukom.gov.si/slo/seje-vlade/sporocila/id/index.html?&i1=UVI&i2=slo&i3=1&i4=sjv&i5=ter_lst_021&i10=artic&i12=4E58375AB89ED882C1257404004F4BB5.

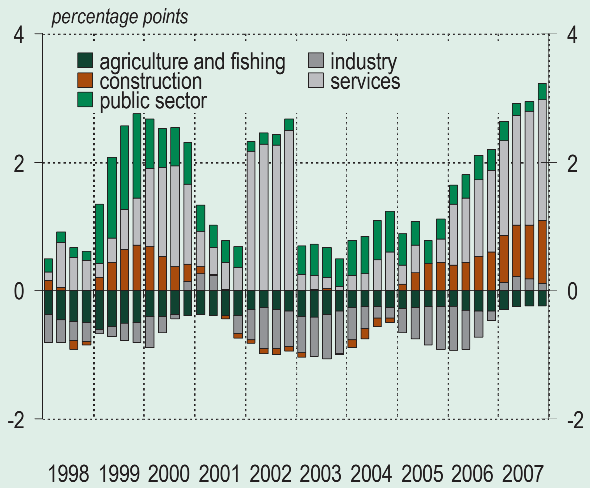
casted increase in DARS's investment spending for construction of the motorway infrastructure. However according to expectations, growth in investments in construction and facilities will be somewhat slower than in 2007, as indicated by the results from surveys of business trends in construction since the middle of last year. Growth in government investments and investments of government-controlled companies will gradually slow after 2008 in line with expectations, while these investments will remain at high levels during 2008. A slowdown in the economic outlook, higher costs and the resulting lower profits will have a less favourable impact on public sector investments in the future, while continuing favourable financing terms will have a positive effect, despite growing uncertainty in financial markets.

A number of labour market indicators in the second half of 2007 point to a growing imbalance between supply and demand, linked to economic activity exceeding the supply potential. In 2007, the survey unemployment rate was more than one percentage point lower than what had previously been the lowest value since Slovenia's independence and stood at 4.9%; the labour force came closest to the level reached in 1991; and a large number of companies reported a labour shortage, a fact corroborated by the high number of job vacancies relative to the number of the unemployed. Nevertheless, the fall in real unit labour costs in 2007 was below the long-term average. However, both trends in the movement of labour costs at the end of the year and the as yet unsuccessful negotiations between employers and unions regarding private sector wage growth point to an increased risk that inflationary pressures from labour costs will be realised in the future.

Last year, the construction sector recorded the fastest growth in employment; employment also increased in the manufacturing sector. In 2007, year-on-year employment growth in the construction sector was 10.8%, in line with high growth in added-value in this sector, while employment growth in the service sector was 4.9%. In addition to the construction sector, employment grew rapidly in the transport sector (6.4%) and in the real estate sector (6.3%). Since the first quarter of 2007, employment in industry has also risen, in contrast to the previous period when it tended to fall, particularly in labour-intensive sectors. Despite preparations for the EU presidency and the introduction of the Schengen border controls, employment growth in the government sector was also very slow last year, at 0.3%.

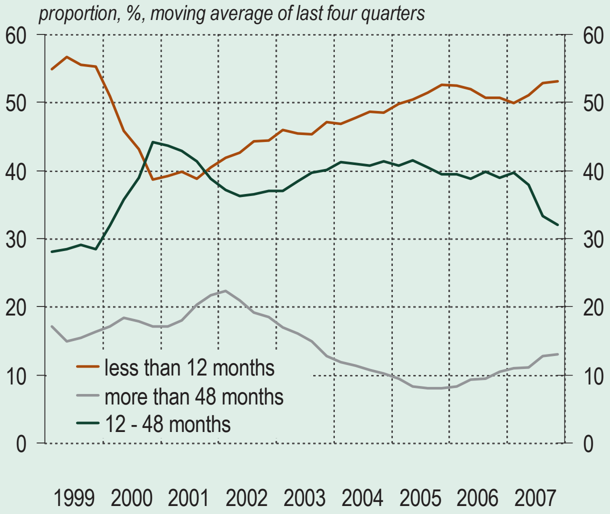
In line with high economic growth and rising employment, the trend of falling unemployment continued in 2007. The unemployment rate measured by the Labour Force Survey and the registered unemployment rate fell significantly in 2007, to 4.9% and 7.7%, respectively. However, the trend of falling unemployment slowed slightly in the second half of 2007. The survey unemployment rate is also low by international standards, as it was more than two percentage points below the EU15 (EU27) average of 7% (7.1%) at the end of the 2007. The structure of unemployment by unemployment duration has also changed as the unemployment rate has decreased. The trend of an increase in the proportion of long-term unemployed (those unemployed for more than 48 months) from 2005 has continued. The fact that their actual number remains relatively constant indicates the presence of objective, structural barriers which could pre-

Figure 3.8: Contributions to employment growth by sector



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

Figure 3.9: Structure of unemployment by duration



Source: Eurostat - Labour force survey, BS calculations

clude further decreases in unemployment. In recent quarters the proportion of the short-term unemployed (those unemployed for less than 12 months) has also risen. This is primarily the result of the smaller drop in the absolute number of short-term unemployed compared to those who have been unemployed for between 12 and 48 months.

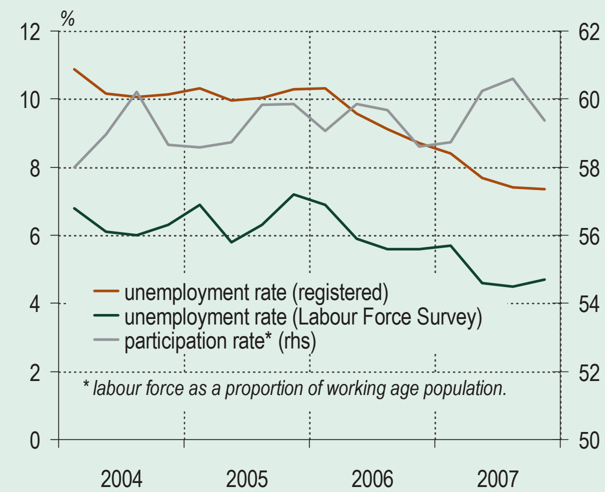
Indicators regarding the worker flows and data on the number of job vacancies also indicate an increase in the imbalance between supply and demand in the labour market. The high level of economic activity accelerated worker accessions (flows into employment from other jobs, from unemployment or from inactivity) in 2006 and 2007. Worker separations (flows out of employment to other jobs, to unemployment or to inactivity) stood at approximately 6.3%. The number of vacant jobs relative to employment has risen by 0.5 percentage points since the beginning of 2006 to 1.3% in the third quarter of 2007, partly due to a higher number of vacant jobs and partly due to the falling number of unemployed.

The sharp drop in unemployment since the end of 2005 and the high growth in the number of job vacancies have not been reflected significantly in a higher participation rate. If the participation rate responds to labour market conditions with a lag, a higher participation rate could be expected in the short term, particularly given the possible realisation of wage pressures. The reason for the unresponsiveness of the participation rate to the unemployment rate could also be of a structural nature and will only change slowly with an improved educational structure of the population, an increase in the retirement age and a decrease in the labour tax burden. The participation rate in Slovenia is relatively high in the 25 to 49 age group, for both men and women. However, there is still significant room to raise the participation rate

Figure 3.10: Worker flows and number of vacant jobs relative to the number of the unemployed

Source: SORS, Eurostat, Employment Service of Slovenia; BS calculations.

Figure 3.11: Unemployment and participation rates



Source: SORS, Labour Force Survey.

in the 50 to 64 age group, where Slovenia lags behind the EU average by approximately 10 percentage points, with a participation rate of 32%.

In line with the slowdown in the economic cycle, employment growth is expected to become more moderate during the projection period. The greatest slowdown is expected in sectors where employment rose most under the influence of the economic cycle. It is worth highlighting the construction sector and to some extent the transport and real estate sectors. The fall in employment is expected to be the largest among employees with fixed-term contracts. These represent the "flexible" segment of the labour market — the segment of the labour market which is most dependent on changing labour market conditions. Following the introduction of the new Law on Labour Relations in 2003, the proportion of these employees in the overall structure of employment has risen by more than one-third, reaching 19.3% in the third quarter of 2007.

Although growth in labour costs remained moderate until the end of June 2007 despite the strong labour demand, current developments indicate an increased risk that these costs will rise in the future. Growth in average gross wages in the private sector, which best reflects cyclical developments in the labour market, was 8% in nominal terms in the last quarter of 2007, while growth in the manufacturing sector was 8.4%. Gross wages per unit of output, which achieved growth of 5% in the fourth quarter, are also rising, reaching 2.5% on average in 2007, while growth from 2004 to 2006 was less than 1%. The gradual phasing-out of payroll taxes enabled growth in labour costs to lag behind the accelerated growth rate of gross wages. At the same time, the labour cost indicator is somewhat misleading when ana-

Table 3.3 Labour cost indicators

	2002	2003	2004	2005	2006	2007	Q107	Q207	Q307	Q407
	nominal year-on-year growth, %									
Gross wages	9.8	7.6	4.6	4.9	4.8	5.9	5.4	5.6	5.8	6.8
Gross wages in the private sector	9.5	7.8	5.3	5.4	5.4	6.8	6.4	6.3	6.7	8.0
Gross wages in the public sector	11.6	6.7	2.7	3.3	3.4	4.1	3.5	4.6	4.4	3.8
Gross wages in the manufacturing sector	9.8	7.6	6.6	5.9	5.5	6.8	5.9	6.0	6.8	8.4
Labour costs per employee[1]	9.3	7.3	6.6	2.7	5.0	4.5	3.6	4.9	5.0	4.6
Other employment earnings per employee	6.2	4.3	14.3	-7.0	10.1	2.9	-0.8	6.0	5.9	0.5
Gross wages per unit of output	7.5	4.2	0.5	0.9	0.3	2.5	0.6	2.3	2.1	5.0
Gross wages per unit of output (trend)[3]	6.4	4.2	1.2	1.5	1.4	2.5	2.0	2.2	2.4	3.4
Gross wages per unit of output in the manufacturing sector	9.4	4.4	1.0	0.7	-2.4	-0.2	-2.8	-1.1	0.5	2.8
Gross wages per unit of output in the manufacturing sector (trend)[3]	5.1	2.9	1.9	1.2	0.8	2.1	1.2	1.3	2.1	3.7
Unit labour costs[1]	7.1	4.0	2.4	-1.2	0.5	1.2	-1.0	1.6	1.3	2.9
Unit labour costs (trend)[1,3]	5.9	3.9	3.2	-0.7	1.6	1.1	0.2	1.5	1.6	1.2
Compensation of employees per unit of output[2]	6.5	5.2	3.7	1.6	1.2					
Output per employee	2.1	3.2	4.1	4.0	4.5	3.3	4.7	3.3	3.6	1.7
Output per employee - manufacturing sector	0.4	3.1	5.6	5.3	8.1	7.0	9.0	7.2	6.2	5.4
HICP	7.5	5.7	3.7	2.5	2.5	3.7	2.6	3.2	3.7	5.5
GDP deflator	7.7	5.6	3.3	1.7	2.0	3.9	4.0	3.5	4.2	3.8

[1] Labour costs include gross wages (SORS), other employment earnings (AJPES), employers' social security contributions and payroll taxes (MoF).
[2] National accounts
[3] Output per employee - average of the last 10 years: 3.4% Output per employee in the manufacturing sector - average of the last 10 years: 4.7%
Source: SORS, AJPES, Ministry of Finance; Bank of Slovenia calculations

lysing trends due to the high volatility of other employment income. In the last quarter of 2007, year-on-year growth in other employment income was just 0.5%, while average annual growth fluctuated at a level of 3%. In January, growth exceeded 10%. A slowdown in productivity in the last quarter also contributed to higher unit labour costs.

The lagging of unit labour costs compared to the GDP deflator indicates that labour costs were not a factor in rising inflation. In this regard, the sharp growth in gross wages in the last quarter of 2007 should not be overlooked. However, if nominal unit labour costs exceed price growth in conditions of price stability, this could hinder a drop in inflation in the future. A comparison of growth in nominal labour costs and growth in average long-term (ten-year) productivity in Table 3.3 is shown for the purpose of stripping out the effects of the economic cycle on the productivity estimate and the effects of fluctuations in deflators. This indicator points to an inflationary effect on labour costs if the economic cycle were balanced. Due to the volatility of other employment income and the decrease in the payroll tax, this indicator remained favourable last year at the level of the overall economy. Taking into account the growth rate of gross wages indicates a significant deterioration in this indicator at the level of the overall economy and a more serious deterioration at the manufacturing sector level. At the moment it is not clear to what extent this is a one-off or more sustained trend. If the current growth rates of wages and productivity continue in the future, labour costs could contribute significantly to a deviation in price growth from price stability.

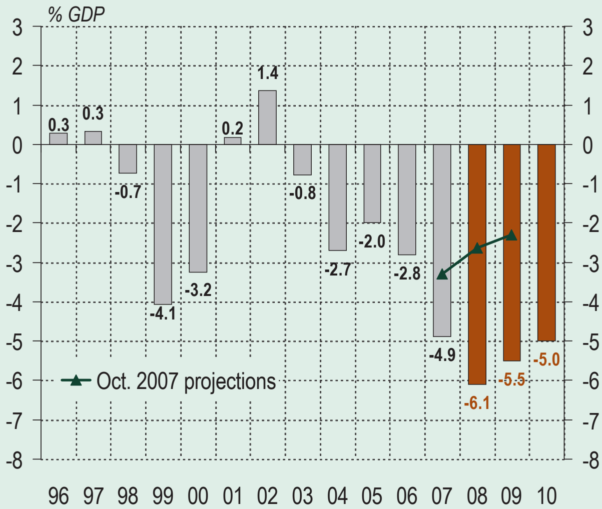
In contrast to recent years, public sector wage growth will exceed private sector wage growth by 1.5 percentage points on average. The assumption in the projections is for public sector wage growth of 8.8%, 7.5% and 7.4% in 2008, 2009 and 2010, respectively. In January 2008, the government and representative public sector unions agreed on public sector wage adjustments for this year. The general wage adjustment in January 2008 (due to higher inflation than forecasted last year) was 3.4%. The parties also agreed that the changeover to the new wage system will take place in May 2008 (and not in January as originally planned), regardless of the actual completion of negotiations regarding sector collective agreements. The assumption regarding growth in the average nominal gross wage in the public sector for 2009 and 2010 takes into account further regular wage adjustments and the elimination of wage discrepancies within the foreseen deadlines.

The private sector social partners have not yet agreed on a wage adjustment related to the high inflation in 2007, or on wage growth in the coming years. There is an increased risk that wages will grow faster than expected due to tight labour market conditions. According to the latest information, the unions are demanding an adjustment of base wages in the amount of annual inflation and at least 20% of productivity. The baseline scenario includes an assumption regarding public sector wage growth in 2008 that takes into account economic and productivity trends and a partial adjustment for price growth. Private sector wages are expected to rise by just over 7% in 2008. This takes into account the assumption that the dissipation of supply-side shocks in commodity markets will give companies somewhat more flexibility in the next two years until the end of the projection period for employee expenditures, which are expected to rise by close to 7% in 2009 and settle at a level just above 5% in 2010. Due to the high level of uncertainty arising from imbalance between supply and demand on the labour market and the as yet unsuccessful negotiations of the public sector social partners, current wage projections are further exposed to high risks.

4 External Balance and Competitiveness

Slovenia's balance of payments current account deficit rose sharply in 2007 compared to the previous year, reaching 4.9% of GDP. Projections indicate that the deficit could rise further this year. The current account deficit is expected to rise from EUR 1.6 billion in 2007 to EUR 2.2 billion this year and remain at this level for the next two years. Thus the deficit is expected to rise from 4.9% of GDP in 2007 to 6.1% of estimated GDP in 2008 and gradually fall over the next two years. In the context of forecasted GDP growth, the current account deficit is expected to fall to approximately 5% of estimated GDP in 2010. The increase in the deficit compared to last year and previous projections is expected to be accompanied by lower growth in exports and imports in terms of volume, unfavourable terms of trade and continuing negative trends on the factor income and transfer account. According to assessments, trends for trade in goods will have the greatest impact on deterioration in the current account. The growth rate in export and import volumes from 2008 to 2010 has been revised downwards compared to previous projections. The most significant

Figure 4.1: Current account projections



Source: Bank of Slovenia.

Table 4.1 Balance of payments current account

	2003	2004	2005	2006	2007	Projections 2008 April	Δ	2009 April	Δ	2010 April	Δ
	real growth, %										
Exports of goods and services	3.1	12.5	10.1	12.3	13.0	**9.5**	-2.1	**8.2**	-0.3	**8.3**	...
Imports of goods and services	6.7	13.3	6.7	12.2	14.1	**9.3**	-1.6	**7.7**	-0.3	**7.8**	...
Current account (EUR billion)	-0.2	-0.7	-0.6	-0.9	-1.6	**-2.2**	-1.3	**-2.2**	-1.4	**-2.1**	...
as % of GDP	-0.5	-2.8	-2.0	-2.9	-4.9	**-6.1**	-3.1	**-5.5**	-3.3	**-5.0**	...
Terms of trade*	0.8	-1.0	-2.0	-0.6	0.0	**-2.2**	-2.2	**0.4**	0.1	**0.4**	...

Δ: The difference between current projections and projections in the Price Stability Report, October 2007.
** Based on national accounts deflators.*
Source: Bank of Slovenia.

Box 4.1: "Rotterdam-Antwerp" effect

Since entry to the EU, the so-called "Rotterdam" or "Rotterdam-Antwerp" effect[1] has likely had impact on the aggregate growth in Slovenian foreign trade as well. This is primarily represented by the effects on a change in the level and growth rate in trade in goods, where these effects were already present to a lesser degree immediately following Slovenia's entry to the EU, but according to assessments, were most notable in 2007 in terms of value and most notable in terms of growth in 2006. The effects on growth in exports and imports will also be seen in the coming years. The "Rotterdam" effect occurs when goods, which are imported from countries outside the EU, are custom cleared in an EU Member State, and thus released into free circulation within the EU and then transported to other EU Member States. This type of transaction is recorded in the Member State's statistics as an extrastat import, i.e. as an import from non-EU countries and then as the export of an EU Member State to another EU Member State where the goods are intended for final use. During our analysis, we focus solely on the trade in goods which is a subject of Slovenia's national balance of payments and on data collected in the territory of the Republic of Slovenia (residents and non-residents with a centre of economic interest in Slovenia). We do not consider these types of transaction by non-residents in the geographical territory of the Republic of Slovenia or those by Slovenian residents in the geographical territory of other EU Member States. Therefore the following analysis also focused on a specific group of products from foreign trade. The subject of such trade may be any type of goods, but it is assumed that in the case of Slovenia most transactions of this type, in terms of quantity and value, are linked to the Port of Koper and the import and distribution of passenger cars. In 2007, the import of passenger cars to Slovenia rose 60% year-on-year, reaching EUR 1.46 billion. Imports from the Republic of Korea recorded the highest growth, rising by a factor of 5.5 to EUR 0.44 billion. At the same time, the export of passenger cars rose 45% year-on-year to EUR 2.2 billion. In this regard, the exports of Slovenia's manufacturer of passenger cars reached 21% year-on-year or EUR 1.1 billion. The difference between total exports of passenger cars and the export of the domestic manufacturer was EUR 1.1 billion, and rose 82% year-on-year, representing the year-on-year increase in exports of passenger vehicles not produced in Slovenia. The difference between total imports of passenger cars in the amount of EUR 1.46 billion and the export of passenger cars not produced in Slovenia (EUR 1.1 billion) was EUR 0.36 billion in 2007 and represents imports of passenger cars for sale and use on the domestic market. The question is how the "Rotterdam" effect impacts Slovenia's balance of payments current account. Assuming that the value of the export of goods is equal to the value of the import of goods, the effects on net foreign trade are neutral. In terms of the balance of payments current account, these types of transactions have a positive effect, as services income, such as external trade intermediation, warehousing, transport and the insurance of goods, increases when these transactions are carried out. On the other side however, the effect of these transactions on the assessed situation and growth in the source economy can also be misleading by taking them into account in macroeconomic analyses. If the effects of these transactions are stripped out of 2006 and 2007 data and new growth rates for exports and imports of goods are calculated, the growth rates are nominally lower by approximately 0.3 percentage points on average than actual rates in 2007 and by more than 2.2 percentage points higher than actual rates in 2006. Taking into account actual import and export prices, real growth rates in trade in goods also change accordingly.

[1] Global Britain Briefing Note, No 22, 20th September 2002, http://www.globalbritain.org.

Table: Assessment of the effects of the re-export of passenger cars on nominal growth in exports and imports

	Export of passenger cars			Import of passenger cars		Trade in goods					
	Total	Produced in Slovenia	Produced abroad	Total	For the domestic market*	Value		Growth		Growth**	
						Exports	Imports	Exports	Imports	Exports	Imports
					EUR millions						
2004	1,041	778	263	803	539	12,783	14,143				
2005	1,552	1,074	478	791	313	14,397	15,805	12.6	11.7	11.0	10.2
2006	1,535	930	605	917	312	16,757	18,339	16.4	16.0	18.8	18.2
2007	2,227	1,125	1,102	1,462	360	19,385	21,487	15.7	17.2	15.4	17.0

Source: SORS, Bank of Slovenia calculations
** Estimated as the difference between total imports and other automobile exports*
***Growth adjusted for the assumed symmetrical effect of the re-export of passenger cars to growth in exports and imports.*

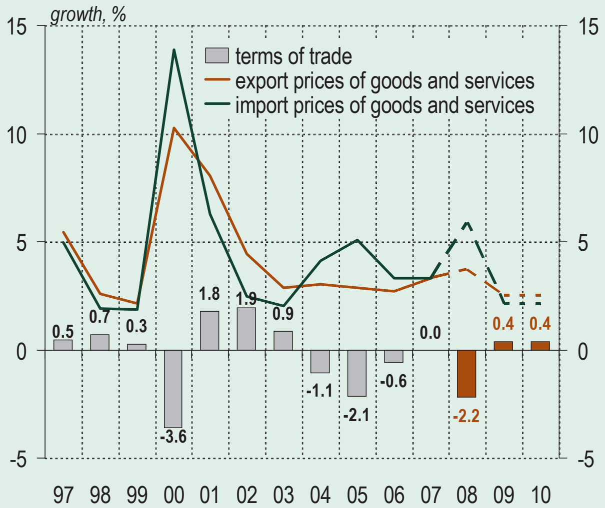
revisions with regard to the last projection in October 2007, and according to estimates for 2008, will be downward revisions of 2 and 1.6 percentage points in exports and imports, respectively. Changes for the coming years are expected to be relatively small (between 0.1 and 0.2 percentage points). Price factors are expected to have a greater impact on the deficit in trade in goods and the balance of payments current account than the decrease in the volume of trade in goods with the rest of the world. Due to rising energy, commodity and food prices, terms of trade which, according to initial assessment were neutral in 2007, are expected to deteriorate by 2.2 percentage points in 2008 compared to last year, and become positive in the next two years at a level of approximately 0.4 percentage points annually. Given the uncertainty in world markets, this assessment of trends for terms of trade is exposed to a high level of risk, as is the assessment that the net outflow of factor income will remain at a level of approximately -2% of GDP on average over the next three years. With regard to the latter assessment, the assumption regarding the future movement of interest rates and the assumption regarding a slowdown in the growth of the debt ratio in the coming years play a significant role.

Despite a slightly lower growth rate from estimates in previous projections, the rate of growth in exports is expected to exceed that of imports this year and in future years. This will facilitate the gradual improvement of external balance. Although the relatively strong domestic demand will stimulate growth in imports, the persistence of a good climate in the rest of the world will also ensure that growth in exports remains at a favourable level. In 2007, growth in trade in goods was sharply lower than growth in trade in services. The favourable outlook in Europe, particularly in new EU Member States, has led to higher demand for the export of Slovenian goods and services. This was to be expected given the estimate of foreign demand used in previous projections. The above-average increase in the volume of trade with EU Member States following Slovenia's entry into the EU can be attributed in part to the favourable effects of higher integration of the Slovenian economy with other EU and euro area Member States. These favourable effects can primarily be seen in a decrease in operating costs related to trade in goods arising from the elimination of customs duties on the European internal market and other costs linked to trade in goods within the single economic area. However, other factors, which are not directly linked to the Slovenian economy, could contribute to high growth in Slovenia's trade in goods with the rest of the world. Given the continuation of current trends, the projection of trade in goods for this year takes into account the fact that the so-called "Rotterdam" effect, measured only as the effect in automobile trade, will contribute an additional percentage point to growth in exports and imports. In the following years, this effect on growth in trade in goods is expected to gradually dissipate.

Another factor that will contribute to high growth in exports this year will be increased production and exports by the domestic automobile industry which, like the majority of exports, is closely linked to imports of equipment and material, and will thus also contribute to maintaining high growth in imports. According to assessments, additional exports from the automobile industry are expected to contribute 0.9 percentage points to growth in total exports of goods and services in 2008. Increased imports of intermediate goods resulting from additional exports by the automobile industry will contribute 0.6 percentage points to growth in total imports of goods and services in 2008. By achieving planned utilisation of production capacity and exports, these effects on the rate of growth of trade in goods are expected to be negligible. A possible aggravation of geopolitical tensions, which could lead to the deterioration of economic relations with certain countries in south-eastern Europe, could have negative consequences this year and in the next several years, not only on the volume of trade in goods, but also on the position and further development of investments of the Slovenian economy in this region. Since Slovenia achieves a balance of payments current account surplus with most of these countries, a further deterioration in the balance of payments current account is possible.

A further increase in the deficit in trade in goods, compared to 2007, is expected this year and in 2009, followed by a gradual reduction. The deficit in trade in goods is expected to rise to EUR 2.4 billion in 2008, or 6.4% of GDP. This deterioration will primarily be the result of negative terms of trade, as the export of goods grows faster than the import of goods in real terms. In the coming years, growth in trade in goods will gradually fall with regard to the average of the last several years, and will fluctuate in line with growth in foreign demand on the export side. Both lower growth in the export of goods, driven by high import dependence of production for exports, and the projected slowdown in domestic spending, particularly investment spending (the most dynamic domestic component of GDP growth in 2007), will have a significant impact on slower growth in the import of goods. The estimated higher growth in exports than imports itself is not enough to improve the current account with the rest of the world. Negative terms of trade, which are for the most part a reflection of high growth in oil and other commodity prices on world markets, are expected to have the most significant impact on the estimated high balance of payments current account deficit in 2008 (EUR 2.2 billion). Euro oil prices are expected to rise by 25% in 2008 compared to last year. Together with growth in the commodities index and euro area inflation, import prices are expected to rise faster than export prices by 2 percentage points. The estimated negative effect of terms of trade in goods and services in 2008 is EUR 0.6 billion, which practically explains the entire increase in the balance of payments current account deficit compared to the 2007 deficit. Although the nominal balance of payments current account deficit will remain at a level of approximately EUR 2.2 billion in 2009 and 2010, terms of trade are expected to improve in these two years and contribute approximately EUR 100 million to reducing the current account deficit. Average growth in the export and

Figure 4.2: Terms of trade



Source: SORS National accounts; Bank of Slovenia calculations.

import of goods in the next two years will be between 7.5% and 8.5%.

According to estimates, the surplus in trade in services with the rest of the world will be the most important factor in reducing the balance of payments current account deficit in the future. Similar factors influence growth in the export and import of services and trade in goods. During the projection period, a reduction in economic activity and lower foreign demand will have the greatest indirect impact on services which are closely linked to trade in goods. For the most part, these include transport service and business and technical services. The most noteworthy of the latter services are foreign trade intermediation, services linked to the handling of goods (receipt, shipping and warehousing) and other services associated with the promotion of goods. Due to a significant slowdown of growth in construction investments, particularly in civil engineering work, income and, above all, expenditure from investment work in Slovenia will fall slightly in the coming years. The expected drop in economic activity in Slovenia's most important trade partners will likely result in decreased revenues from tourism. Higher growth in the export prices of services compared to import prices will also have a significant effect on export-import trends. Taking into account all of the aforementioned factors, the rate of growth in the export and import of services is expected to outstrip the rate of growth in trade in goods. However the size of this gap will gradually narrow in the future. Compared to the latest projections, the growth rate of trade in services is expected to be slightly more than one percentage point lower on both the export and import sides. The import of services in 2009 and 2010 is expected to be approximately 0.3 percentage points slower than exports due to a lower growth rate of imported goods and more moderate growth in domestic investment. The surplus in services as a proportion of GDP was 3.1% in 2007 and is expected to rise to 3.6% of estimated GDP by 2010.

The deficit in net factor income has risen sharply in recent years. In 2007, it rose by 80% year-on-year to EUR 726 million, or 2.2% of GDP. According to estimates, it is expected to remain at this level during the projection period. With an increased number of foreign workers in Slovenia, net inflows of labour income have been falling for a number of years, and were more than halved last year compared to the previous year, reaching only EUR 55 million. Due to faster growth in expenditure than income, the deficit in capital income rose by EUR 265 million compared to 2006 to EUR 780 million. Interest payments to the rest of the world rose the most on the expenditure side. With an increase in gross external debt in the past four years by approximately EUR 4 billion annually and the rise in interest rates on world financial markets, interest payments on foreign loans rose by 61% year-on-year in 2007. The transfer of profits to parent corporations abroad has risen since 2005. Last year, foreign-owned companies reinvested just EUR 52 million of the EUR 478 million in profit generated by companies, while transferring the remainder abroad. Among capital income, only income from investments in securities recorded a net inflow, increasing by more than EUR 40 million year-on-year to EUR 220 million in 2007. On the income side, the largest increase was recorded by banks' income from investments in foreign bonds and notes.

Given the lower labour income surplus, the net deficit in capital income and interest payments will, according to estimates, contribute most to the negative factor income position during the projection period. The main factors in the widening of the deficit in capital income, which is expected to amount to slightly more than 2% of GDP during the projection period, are increasing interest payments and rising expenditure on dividends and reinvested earnings. The rise in interest payments is expected due to the increasing accumulation of debt in the form of loans from the rest of the world in comparison with accumulated loans to the rest of the world, where this assessment is subject to considerable risk due to uncertainty regarding the future movement of interest rates on world financial markets. High and rising expenditure on dividends and reinvested earnings are partly, in terms of volume, a reflection of foreign direct investment realised in the past in Slovenia, and also, in terms of dynamics, a reflection of projected foreign direct investment in the future.[12] According to assessments, labour income, together with expenditure from investments in foreign debt securities which, despite the expected cut in interest rates on world financial markets, will significantly outstrip expenditures from foreign investments in domestic debt securities, will contribute to a decline in the factor income deficit in the future.

The deficit of EUR 297 million in current transfers in 2007 rose by more than two-thirds compared to the previous year, and remains a major factor in the deterioration in the balance of payments current account. Last year, private transfers fell by EUR 12 million year-on-year to EUR 79 million. The greatest drop was recorded by official transfers, as the deficit in official transfers doubled to EUR 218 million year-on-year. The major-

[12] The privatisation of the Government's 49% stake in Telekom through the sale to a foreign partner was foreseen in previous projections of foreign investments in Slovenia. Since the privatisation of Telekom is currently on hold, the estimated value of this investment was not taken into account in the calculation of expenditure from equity in these projections.

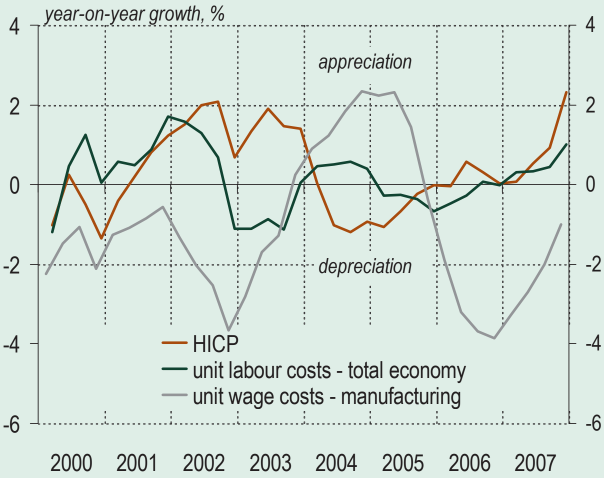
ity of official transfers relate to payments of taxes and contributions to the rest of the world, insurance premiums and other transfers. Receipts from the EU budget amounted to 59.8% of the planned value, while expenditure was 112.2% of the planned value. An above-average increase in liabilities from traditional funds (customs duties) and expenditure arising from VAT was recorded on the expenditure side in 2007. The net position of the Slovenia's budget against the EU budget was nearly balanced in 2007 at a level of EUR 7 million. Given previous trends, an increase in the volume of transfers is also expected in the future, particularly in official transfers. However following growth in 2008 to 0.8% of GDP, the negative transfers balance is expected to fall slightly next year and remain at this level until the end of the projection period. While planning the net position with the EU budget, data from the budget memorandum[13] for 2007 and 2008 were taken into account. These data forecasted receipts of 1.56% of GDP and expenditure of 1.13% of GDP. Given these figures and estimated GDP, the result is an annual surplus of approximately EUR 150 million. This surplus, given the previous realisation, particularly on the receipt side, was sufficiently reduced so that, according to estimates, the balance of receipts and expenditure linked to the EU budget will be nearly balanced in the next two years. The proportion of the deficit in transfers is expected to fall by 0.1 percentage points compared to last year to 0.8% of GDP in 2008, and reach a level of approximately 0.7% of GDP over the next two years.

Given the assumptions made for import and export prices, changes in exchange rates and trends in commodity and energy prices, terms of trade are expected to deteriorate significantly this year and represent the most significant factor in the deterioration of the balance of payments current account balance. Terms of trade were neutral in 2007. Annual growth in both exports and imports was 3.3%. This trend in import and export prices was significantly more favourable than in 2006, when terms of trade deteriorated by 0.6 percentage points. Terms of trade in 2008 will deteriorate by 2.2 percentage points with regard to last year due to high oil prices and persistently high prices of other commodities. A gradual improvement in terms of trade is expected over the next two years. On the export side, expected growth in exports of products with higher added-value will have a positive effect on terms of trade. On the import side, slower growth in the prices of commodities and the expected stagnation of oil prices on world markets will contribute to improved terms of trade. Initial estimates indicate that terms of trade for services were positive in 2007, as export and import prices of services rose by 4% and 1.7%, respectively, year-on-year. A positive contribution by terms of trade to trade in services is expected, as export prices are forecasted to grow from 0.5 to 1.0 percentage points faster than import prices during the projection period. Under the aforementioned assumptions, the contribution of terms of trade to the current account balance would be negative in 2008 in the amount of 1.5% of estimated GDP. According to estimates, terms of trade will reduce the current account deficit by 0.3 percentage points annually over the next two years.

The real effective exchange rate based on consumer prices and total labour costs appreciated significantly last year which could indicate a decrease in price and cost competitiveness. In contrast, the real effective exchange rate based on labour costs in the manufacturing sector depreciated until the last quarter under the influence of fluctuating productivity. This holds true for the real effective exchange rate calculated versus both the euro area and EU27 Member States. The difference between these two indicators is in the weights of individual countries and in the movement of the nominal effective exchange rate, which since Slovenia's entry to ERM II has no impact on measuring competitiveness versus euro area Member States. The real effective exchange rate measured by the HICP appreciated by an average of 1% in 2007 against the EU27, with

[13] Budget Memorandum for 2007 and 2008, Slovenian Government.

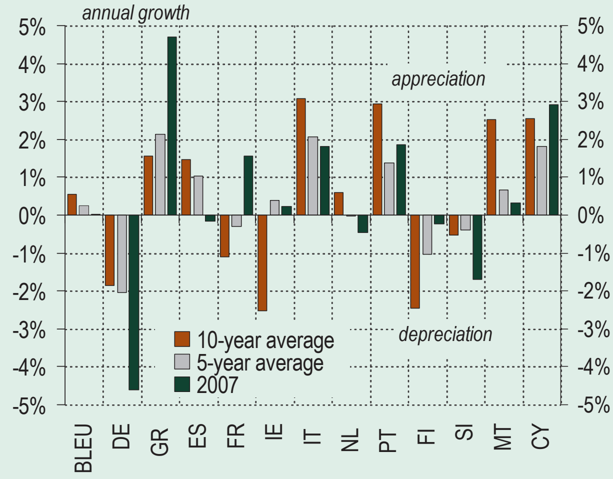
Figure 4.3 : Real effective exchange rates*



* against EU27

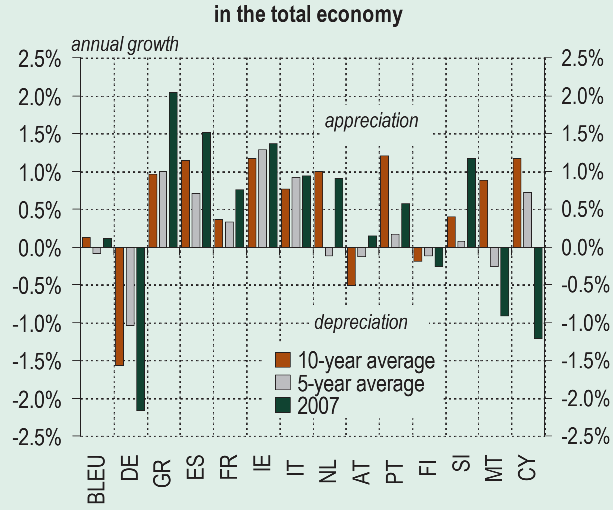
Source: European Commission

Figure 4.4: Competitiveness indicator - unit wage costs in manufacturing



Source: European Commission; Bank of Slovenia calculations.

Figure 4.5: Competitiveness indicator - unit labour costs in the total economy

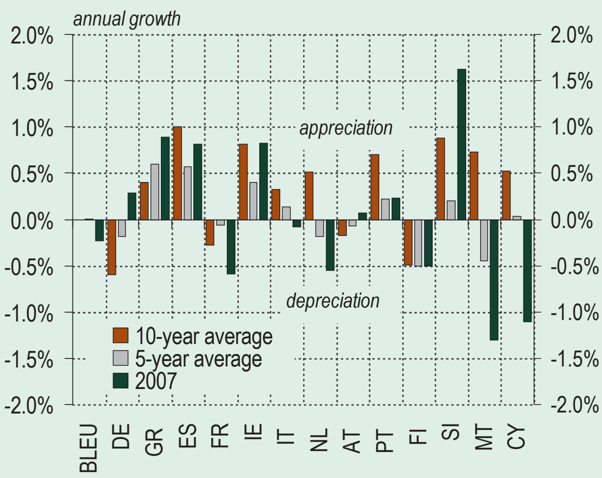


Source: European Commission; Bank of Slovenia calculations.

the appreciation being 1.3% in the second half of the year. The real effective exchange rate as measured by unit labour costs of the entire economy appreciated by an average of 1% over the entire year, while the appreciation was increasing in the second half of the year. By contrast, the real effective exchange rate as measured by unit labour costs of the manufacturing sector depreciated by 1% on average over the entire year, while the depreciation slowed down in the second half of the year. The real effective exchange rate as measured by gross unit labour costs in the manufacturing sector is thus the only indicator that, on average, points to an improved competitive position of the Slovenian economy and manufacturing sector over the entire year. High growth in production and productivity in the last two years have more than offset growth in labour costs in the manufacturing sector. Nevertheless, the latest data indicate that growth in production and productivity has halted and became negative.

Following the depreciation of the effective euro exchange rate in the euro area against the basket of currencies of EU27 Member States in recent years, this trend somehow reversed in the past year, while the annual appreciation of the euro in the euro area against the basket of currencies of 41 countries exceeded 3%. In the middle of the last year, the trend of the depreciation of the nominal effective euro exchange rate in the euro area against the basket of domestic currencies of EU27 Member States also reversed. The nominal effective euro exchange rate against EU27 Member States outside the euro area depreciated approximately 4% in the last four years until the second quarter of 2007 inclusive, while appreciation of 3% was recorded in the second half of last year. Taking into account trade with countries outside the EU27, the nominal effective euro exchange rate in the euro area against the basket of cur-

Figure 4.6: Competitiveness indicator - HICP



Source: European Commission; Bank of Slovenia calculations

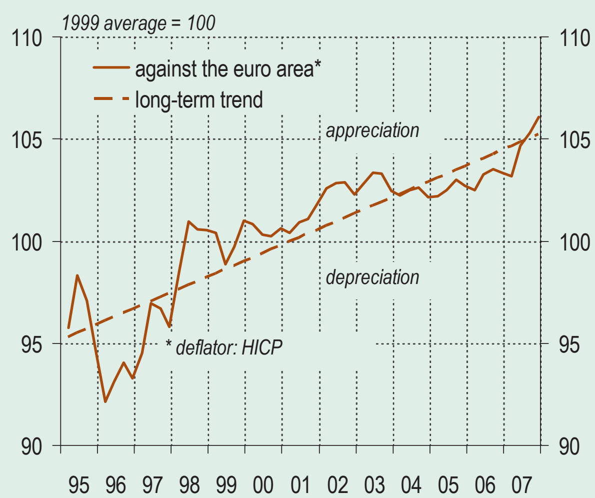
rencies of 41 countries appreciated by an average of 3.2% year-on-year in 2007. Last year, the euro rose the most in terms of value against the US dollar (10.3%) and the pound sterling (7.1%). By the end of February 2008, the euro had surpassed USD 1.5 and was approaching USD 1.6. The euro has risen more than 40% against the US dollar in the last five years. Since the movement of the US dollar is linked to several currencies of industrially developing competitor countries from Asia, the appreciation of the euro against the US dollar represents significant pressures on the competitiveness of the euro area and Slovenian economies. The weakness of certain currencies versus the euro also reflects the difficulties in the economies of these countries, particularly in light of current uncertainty on financial markets.

A comparison of the trend of competitiveness indicators in Slovenia with other euro area Member States for 2007 indicates that the rate of appreciation in Slovenia is higher for the price competitiveness indicator measured by the HICP and the cost competitiveness indicator in the economy as a whole, while Slovenia's position in terms of labour costs in the manufacturing sector is more favourable than the euro area average due to the depreciation of the corresponding real effective exchange rate. Both cost competitiveness indicators are fluctuating around the average values in the euro area. Due to the high level of inflation in Slovenia in the last year, the price competitiveness indicator is appreciating sharply, placing Slovenia on the tail of all Member States in terms of price competitiveness. The high inflation set out in projections for 2008 will result in a further deterioration of the current situation.

The cost competitiveness indicator in the manufacturing sector indicates that only Germany was more competitive than Slovenia in 2007. However the indicator's trend shows that this is only cyclical in nature and does not indicate lasting improvement. Due to the cyclical nature of industrial production, the situation had already reversed in the last quarter of 2007, as depreciation in Slovenia slowed considerably.

The competitiveness indicator regarding unit labour costs in the economy as a whole is less favourable for Slovenia. Although this indicator has been relatively stable over the last year, its rate of appreciation was exceeded by just three countries. All other countries are more competitive than the Slovenian economy with regard to this indicator. In particular, in should be noted that there is a considerable difference between the average rate of appreciation in the last five years and the average rate of appreciation in 2007, which indicates a deteriora-

Figure 4.7: Real effective exchange rate



Source: European Commission

tion in Slovenia's competitiveness last year compared with its long-term average. Germany, Cyprus and Malta are noteworthy with regard to favourable competitiveness based on total labour costs.

With regard to price competitiveness, where Slovenia's position was worst compared to other euro area Member States in 2007, countries are quite evenly matched. Last year, Malta, Cyprus, Ireland and the Netherlands held the most favourable positions in terms of price competitiveness. The reason for the deterioration in this indicator is the rise of inflation in Slovenia compared to the euro area. Given inflation projections for 2008, appreciation will remain at a high level in the coming years, indicating the deterioration of Slovenia's price competitiveness in the future.

Indicators of price competitiveness through the real exchange rate based on the price index must be treated with caution, as the appreciation of these indicators could reflect the effect of real convergence, but not a reduction in competitiveness. Since 1995 the effect of long-term real convergence, taking into account the long-term trend of appreciation of the real effective interest rate, has been quite moderate. The sharp appreciation of the real interest rate against the euro area in 2007 cannot be explained solely by the process of long-term real convergence which is an additional indicator of the likely deterioration in price competitiveness with regard to the euro area (Figure 4.7). Against the euro area, where the majority of more economically developed EU27 Member States are located, the Slovenian currency has appreciated by an average of just less than 1 percentage point annually. If the long-term trend is linked to the process of real convergence, which typically does not influence the price competitiveness of the economy, the movement of price competitiveness can be explained as a deviation from the long-term trend. Price competitiveness indicators show that price competitiveness with regard to the euro area in recent years was favourable, but has gradually deteriorated, approaching the euro area average. In the second half of 2007, it reached the level of a real appreciated currency, which can indicate decreased price competitiveness.

5 Terms of Financing

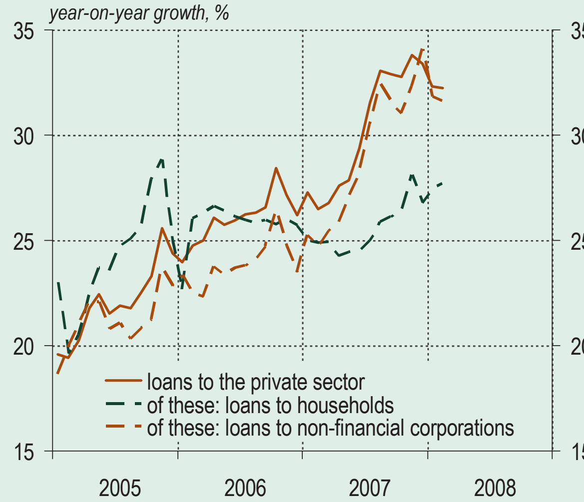
Last year, the growing financial needs of the domestic private sector were primarily linked to high economic and investment activity. At the same time, the process of financial deepening continued, in which the development of the domestic financial sector is catching up with the level of more developed economies. The result of the negative savings-investment gap is increased borrowing abroad and rising net external debt.

Lending activity and terms of financing

The significant financial needs of the domestic private sector can be seen in the sharp growth in bank credits to the private sector[14], which achieved year-on-year growth of approximately 35%. Growth in credits has risen by nearly 10 percentage points over a period of one year. Figure 5.1 clearly shows that lending to non-financial corporations began to rise noticeably in the second quarter of 2007. The first signs of a slowdown in lending to non-financial corporations were seen at the end of 2007 and the beginning of 2008. Lending to households also increased in the second quarter (growth remains just above 25%), but significantly less than lending to non-financial corporations.

The accelerated increase in borrowing by non-financial corporations is partly cyclical in nature and is linked to rapid economic growth, particularly investments.[15] The strong borrowing by non-financial corporations, mostly in the second and third quarter of 2007, is linked primarily to rapid growth in investments. Real growth in investments slowed in the last quarter, coinciding with a slowdown in borrowing by non-financial corporations. Financing needs for takeover activities, for consolidating and deepening positions on foreign markets, particularly in the western Balkans and for relatively high financial investments further contributed to the relatively high level of borrowing by non-financial corporations.

Figure 5.1: Lending to the domestic private sector

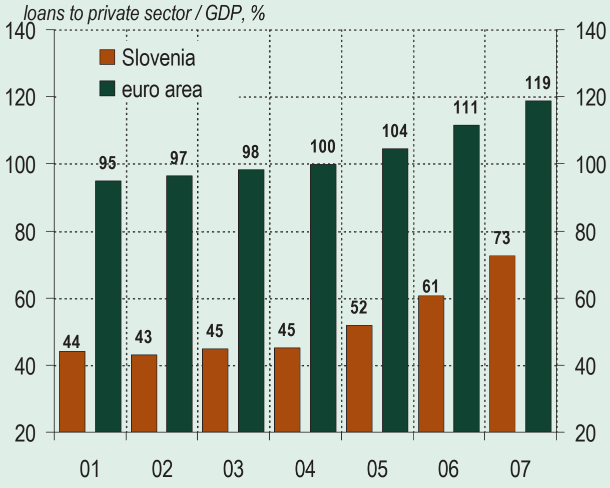


Source: Bank of Slovenia.

[14] The domestic private sector includes non-financial corporations, households and non-monetary financial institutions. Data are taken from Table 1.2 in the Bank of Slovenia Bulletin.

[15] Growth in lending to non-financial corporations in the euro area is the highest in the last 25 years, amounting to just under 15% year-on-year. The ECB attributes the relatively strong lending to non-financial corporations in the euro area to rapid economic growth and the expectation of tighter terms of financing (ECB, Monthly Bulletin, November 2007, ECB, Monthly Bulletin, February 2008).

Figure 5.2: Depth of financial intermediation



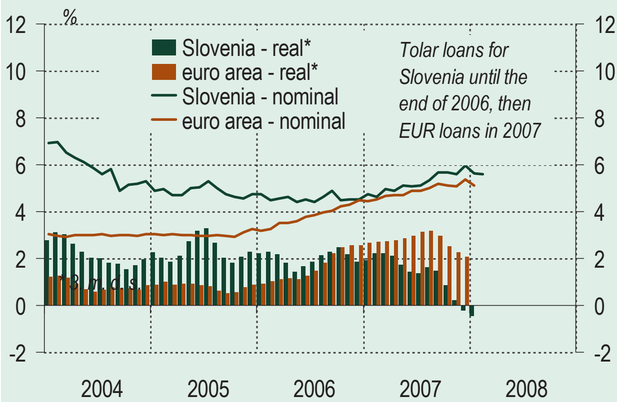
Source: ECB, Bank of Slovenia.

Nevertheless, the relatively high long-term trend of growth in borrowing by domestic private sector entities established in Slovenia at banks can to some degree be attributed to the process of financial intermediation deepening. As Figure 5.2 clearly shows, this process has become more evident since 2004. The depth of financial intermediation, measured by private sector loans as a share of GDP, has risen at a rate of more than 10% of GDP annually in recent years in Slovenia, with the balance already exceeding 70% of GDP. Measured as such, the difference of financial deepening between the euro area and Slovenia has fallen by approximately 55% of GDP in 2004 to around 45% of GDP in 2007.

Despite the gradual rise in nominal interest rates since the end of 2006, financing terms for non-financial corporations are still favourable. As evident from Figure 5.3, nominal interest rates for non-financial corporations began to rise in the euro area at the end of 2005 as the result of tightened ECB monetary policy, following the low levels experienced in 2004 and 2005. Since the end of 2006, the trend and level of nominal interest rates for loans to non-financial corporations are comparable to those in the euro area, indicating a high level of integration of Slovenia's financial system with the euro area. Until the middle of 2006, real interest rates in Slovenia were above those of the euro area. During this period, the process of interest rate convergence to the euro area's monetary conditions was completed. Following entry to the euro area, real interest rates have fallen, despite rising ECB interest rates. Inflation, which was higher in Slovenia than in the euro area, was a contributing factor in this regard. Real financing terms for non-financial corporations are therefore actually more favourable in Slovenia than in the euro area.

The expected continued slowdown in economic activity and investments indicates a gradual decrease in the year-on-year rate of growth in credits to non-financial corporations. Projections of economic trends indicate a gradual slowdown in economic growth to approximately 4%, accompanied by a continued slowdown in investments. A gradual decrease in year-on-year growth in lending to non-financial corporations from the current level of more than 30% to below 20% until the end of the projection period can therefore be expected. In this way, a component of growth in lending, linked to the economic cycle, would gradually disappear. Growth in loans will continue to exceed euro area levels due to the process of real convergence which can be seen in financial deepening.

Figure 5.3: Interest rates on loans of more than EUR 1 million to non-financial corporations



** In terms of methodology, the real interest rate is calculated taking into account expected inflation. Due to the unavailability of expected inflation indicators, we calculate the real interest rate taking into account current inflation. 3-month moving average.*
Source: ECB, Bank of Slovenia.

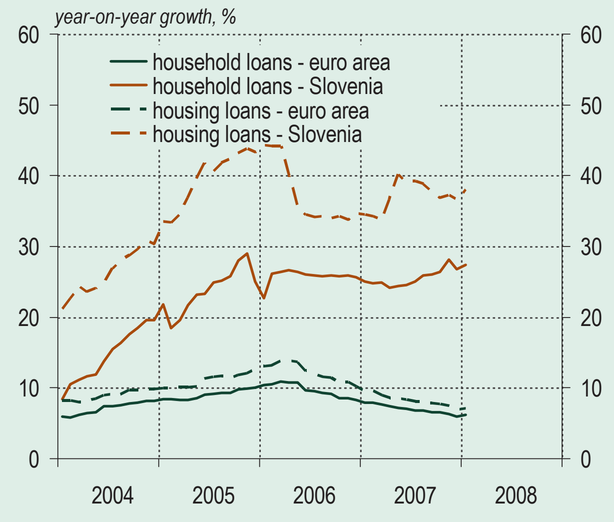
The somewhat higher lending to households is primarily the result of a high level of housing loans.[16] It is evident from the structure of household lending that growth in housing loans to households rose until the end of 2005. Since that time, it has gradually slowed, but still achieves year-on-year growth of nearly 40%. Growth in housing loans has always exceeded total growth in loans to households, taking into account the fact that high growth in housing loans is also the result of a relatively low basis. Housing loans, as a proportion of all loans to households, have risen from approximately 25% at the beginning of 2005 to more than 40% at the beginning of 2008. Since the middle of 2007, year-on-year growth in consumer loans has risen, increasing from approximately 15% at the beginning of 2008 to more than 20% year-on-year. This is in line with the trend of domestic consumption which rose from 2.2% in the first half of the year to 4.0% in the second half of 2007.

A portion of increased housing loans is also the result of higher real estate prices. In the last two years, real estate prices have risen by approximately 15% annually (source: SLONEP). The latest available data indicate that growth in real estate prices has slowed since the second half of 2007.

Since the middle of 2006, terms of financing for household spending are more favourable in Slovenia than in the euro area. Figure 5.5 clearly shows that since the beginning of 2006 nominal, and to a greater extent, real interest rates for consumer loans are lower in Slovenia than in the euro area. Low real interest rates, particularly in the second half of 2007, are probably only one reason for the renewed gradual increase in consumer loans. Nominal interest rates for housing loans are still significantly higher in Slovenia than in the euro area.

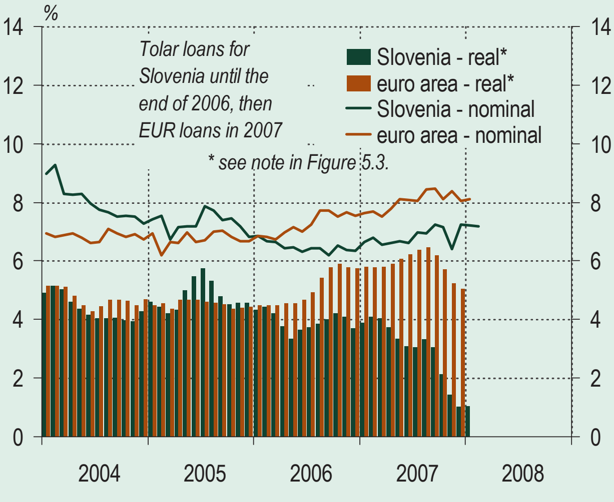
With regard to household borrowing, a gradual decrease in growth in lending is expected due to forecasted more moderate growth in real income and the continued slowdown in housing loans. With a continuing trend of falling real estate prices and the associated decrease in housing loans, the slowing trend in housing loans is expected to continue despite still favourable terms of financing. With a decrease in real growth in consumption from more than 4% in the second half of 2007 to approximately 3% during the projection period, lending to households is expected to slow gradually.

Figure 5.4: Breakdown of lending to households



Source: ECB, Bank of Slovenia.

Figure 5.5: Interest rates on consumer loans to households



Source: ECB, Bank of Slovenia.

[16] Lending to households in the euro area has slowed since the middle of 2006. The ECB attributes the gradual decline in lending to households in the euro area primarily to a drop in real estate prices and a gradual rise in lending interest rates (ECB, Monthly Bulletin, February 2008).

Box 5.1: Opportunities and the effectiveness of measures for reducing the lending activities of banks

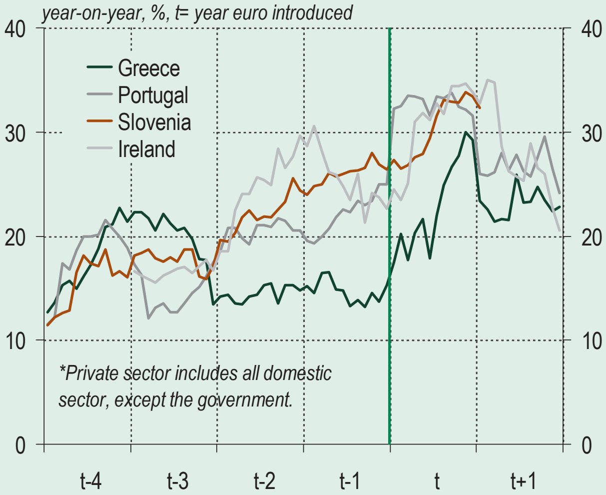
Increased lending activity in Slovenia in recent years is primarily linked to the process of financial deepening and rapid economic growth. The effect of the convergence of interest rates prior to entry to the euro area on these processes was rather neutral. Real interest rates did not fall significantly before Slovenia joined the euro area. Other less developed countries, where growth in credits was quite high in the first year following entry to the euro area[1], faced similar processes when entering the euro area. It should be noted that current growth in credits in the euro area is also relatively high, exceeding 10%.

Strong lending can bring about macroeconomic and/or microeconomic risks. At the macroeconomic level, strong lending stimulates economic growth primarily through investments and consumption. This, in conditions of excessive economic growth with regard to potential growth, results in inflationary pressures and/or external imbalance. Currently, Slovenia is also faced with such effects. Here it should be noted that high growth in the prices of foods and energy on world markets and the resulting deterioration in terms of trade contribute significantly to rising inflation and external imbalance. The main consequences of higher inflation and external imbalance could be a loss of competitiveness and rising external debt, which could lead to a decrease in economic activity and higher unemployment in the long-term. At the microeconomic level, excessive lending activity could jeopardise the liquidity and solvency of individual banks and the security of their operations. It should be emphasised that the dangers arising from macroeconomic and microeconomic factors of high lending are linked to a great extent.

With its entry to the Eurosystem, Slovenia lost the ability to limit credit activity via traditional monetary policy instruments, such as interest rates. The conditions and financing instruments of banks via the central bank (ECB) are the same for banks in Slovenia and throughout the euro area. Thus the central bank's interest rate, as a traditional instrument of monetary policy, is also the same in Slovenia as in other euro area Member States. The ECB interest rate is adjusted to conditions in the euro area as a whole, and not to conditions in individual euro area Member States. Given somewhat higher inflation in Slovenia and some, primarily less developed euro area Member States, real terms of financing of banks at the ECB are more favourable than in more developed euro area Member States, reflecting the processes of real convergence. These processes are macro-economically sustainable as long as they are maintained within the Maastricht criteria. Deviations from these criteria require the response of economic policy, where they lead to the deepening of macroeconomic balances.

The purpose of limiting the lending activity of banks through credit ratings and other instruments is to maintain financial stability and not to maintain macroeconomic stability. Under conditions of the free mobility of capital, possible interventions in the supply of loans due to a decrease in credit risks would decrease domestic lending by banks. However given the absence of similar measures in other environments, the domestic non-financial sector would borrow from financial intermediaries or abroad. This would result in aggregate demand and, consequently inflation and external balance, remaining unchanged. The aforementioned instruments[2] thus ensure the financial stability, liquidity and solvency of banks and the security of their operations. Furthermore, there is increasingly less room in European arrangements for national particularities in the regulation of risks in banking and financial intermediation. The need for additional capital due to the implementa-

Figure: Growth in lending to the private sector and the introduction of the euro*



Source: IFS.

tion of the provisions of the new banking directive could have a further impact on reducing lending activity. In December 2007, the Bank of Slovenia warned banks in writing regarding the importance of and obligation to adequately inform borrowers about the risks to which they are exposed, particularly when raising loans in foreign currencies. At the same time, the Bank of Slovenia expressed its expectations that banks begin taking a more conservative approach to approving loans in foreign currencies. Furthermore, the Bank of Slovenia increased the weighting of necessary capital for banks which are exposed to loans of companies established for the purpose of acquiring target companies, and recommended that banks increase their profit reserves.

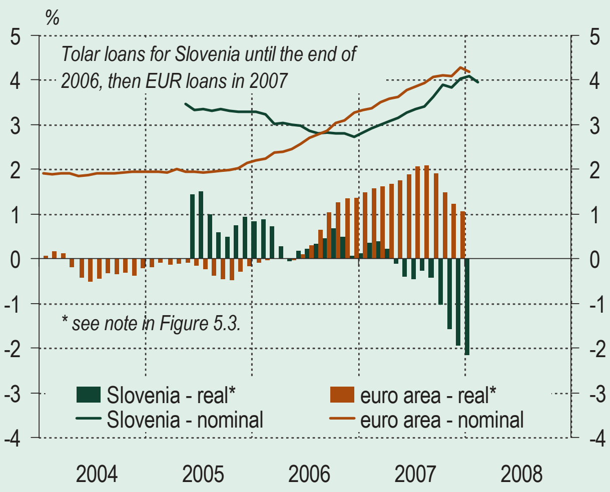
The market itself represents an increasing limit to growth in lending activities. Foreign sources are becoming more expensive for domestic banks due to persistent uncertainty in financial markets. The price of foreign sources has risen by approximately 40 basis points recently. The acquisition of capital, which acts as leverage for lending growth, is becoming more difficult. Available sources are directed to the recapitalisation of several stronger market players, such as domestic banks, due to losses resulting from global financial turbulence. Several signs of a slowdown in lending activity were seen at the end of 2007 and the beginning of 2008 (see Figure 5.1).

[1] For additional details in this regard see the Price Stability Report, October 2007, p 46, Box 5.1: Increased lending activity following entry to the euro area.

[2] Croatia stands out in recent years regarding the use of different, traditional monetary policy instruments, and other, such as credit ratings and administrative instruments to limit lending growth. Using these instruments, the Croatian National Bank has limited growth in lending, resulting in a sharp increase in borrowing abroad, particularly at foreign banks with branches in Croatia. This is further evidence that these types of measures improve financial stability. They cannot however ensure macroeconomic stability under conditions of the free mobility of capital.

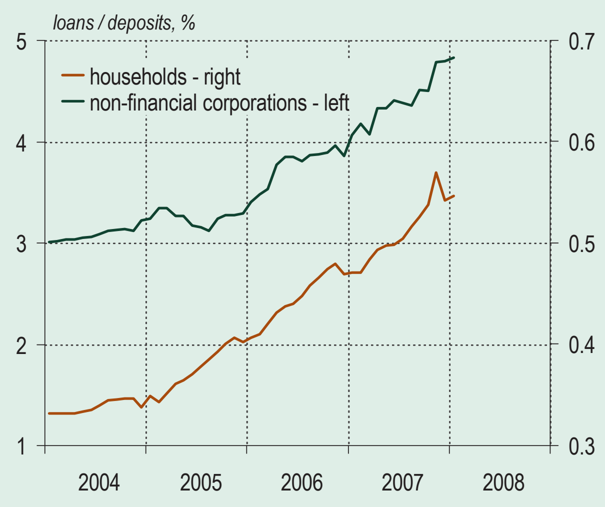
Real interest rates for household deposits in Slovenia have fallen gradually in the last two years. This is partly the result of convergence of nominal interest rates, while a rise in inflation and inflation expectations have recently acted to reduce real interest rates. Since the end of 2006, the movement of nominal interest rates for household deposits indicates a high level of integration with the euro area, where nominal, and to a greater extent, real interest rates for household deposits of up to one year are lower in Slovenia than in the euro area, and were even negative during 2007. Falling real interest rates for household deposits in Slovenia lowers yields, result in a drop in the growth in deposits and a shift to other forms of investments, primarily to mu-

Figure 5.6: Interest rates on household deposits up to one year



Source: ECB, Bank of Slovenia.

Figure 5.7: Net indebtedness at banks



Source: ECB, Bank of Slovenia.

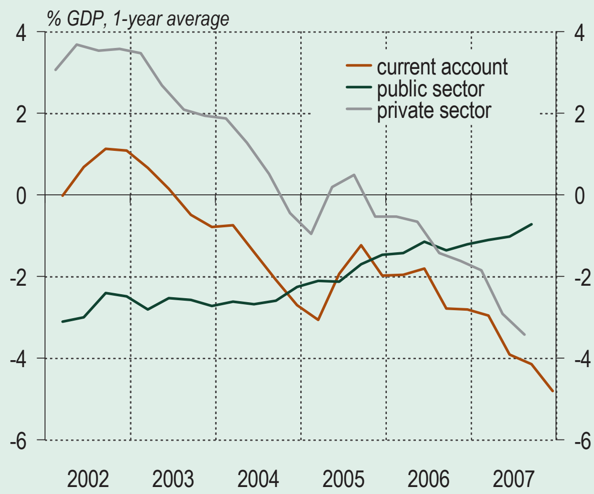
tual funds, real estate and abroad. While a shift from bank deposits to higher risk investments increases the vulnerability of households to possible fluctuations, it stimulates domestic consumption, and may thus be a source of inflationary pressures. Banks are compensating for falling growth in deposits primarily by increasing borrowing abroad. With more difficult and expensive access to foreign sources of financing, primarily due to turbulence on financial markets, it is expected that nominal deposit interest rates in Slovenia will gradually be aligned with those in the euro area.

The net indebtedness of non-financial corporations and households at banks is rising, while a sustained period of low real interest rates could act to accelerate this process. The net indebtedness of non-financial corporations and households, defined as the ratio of lending stock to the deposits of a specific sector, began to increase significantly in 2005. Until that that time, the ratio for non-financial corporations was slightly more than 3 and just above 0.35 for households. By the beginning of 2008, that ratio had risen to more than 4.5 for non-financial corporations and to approximately 0.55 for households.

Financial flows with rest of world and external debt

The savings-investment gap of the private sector has continued to widen since the middle of 2006. Since net savings of the domestic sector are insufficient, the deficit in domestic savings is compensated for by financial assets from the rest of the world. National savings has risen gradually from 25.3% of GDP in 2005 to 25.6% of GDP in 2006 to 26.6% of GDP in 2007. Gross investments have risen even faster, from 27.3% of GDP in 2005 to 28.4% of GDP in 2006 to 31.3% of GDP in 2007. Therefore the savings-investment gap, or the difference between domestic savings and investments, has risen from 2% of GDP in 2005 to 4.8% of GDP in 2007. As evident from Figure 5.8, the public sector sav-

Figure 5.8: Savings-investment gap*



Source: Bank of Slovenia, SORS, own calculations.

** The public sector savings-investment gap is deifned as a deficit of general government according to the ESA95 methodology. The private sector savings-investment gap is the difference between public sector savings-investment gap and the balance of payments current account.*

ings-investment gap has been less than 1% of GDP over the last year. The private sector savings-investment gap has been rising gradually since the beginning of 2003, and following a temporary reversal has continued to rise since the middle of 2005. At the end of 2007, the private sector savings-investment gap had already reached nearly 5% of GDP.

Given the deficit in domestic sources, banks finance the increased credit demand of the domestic private sector by increasing borrowing abroad. The flow of loans from the rest of the world to banks and the flow of non-resident deposits in 2006 was EUR 2.4 billion in 2006 and EUR 4.5 billion in 2007, while the flow of credits to domestic sectors was EUR 4.2 billion in 2006 and EUR 6.8 billion in 2007. This means that in 2006 banks financed more than half of the flow of credits to the domestic private sector by borrowing abroad, and approximately two-thirds in 2007. That proportion exceeded 90% in the second half of 2007.

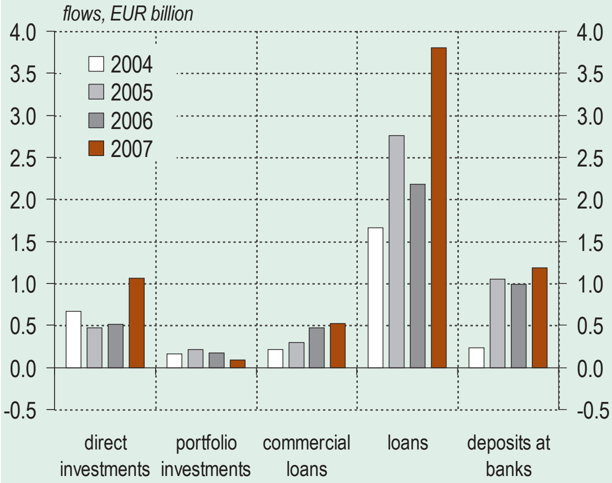
The widening savings-investment gap indicates an increase in net financial inflows in the balance of pay-

ments. The net financial inflow rose from EUR 1.0 billion in 2006 to EUR 1.7 billion in 2007, with EUR 0.8 billion of this amount in the last quarter of 2007 alone.[17] The net financial inflow to the private sector recorded the highest increase.

In 2007, financial outflows and, to a greater extent, financial inflows to the private sector continued to rise. Slovenia's involvement in international financial flows has increased with the introduction of the euro and the resulting elimination of exchange rate risk and the decreased risk of foreign financing. The private sector's financial inflows exceeded 15% of GDP in 2006, and were approximately equal to its financial outflows. In 2007, financial inflows to the private sector rose to more than 20% of GDP, while financial outflows from the private sector remained just above 15% of GDP. For the most part, financial inflows to the private sector rose during 2007, representing 40% of the total flow in the last quarter, where foreign borrowing by banks rose most significantly.

The main increases among financial inflows of the private sector have been recorded by loans to banks from the rest of the world and bank deposits by non-residents. Of the total financial inflow to the private sector in 2007 of EUR 6.8 billion, loans to banks from the rest of the world represented EUR 3.4 billion, while bank deposits of non-residents accounted for EUR 1.2 billion. Loans to banks from the rest of the world nearly doubled compared to the previous year. Despite uncertainty on financial markets and the associated higher costs of borrowing abroad, financial inflows via loans from the rest of the world and non-residents' deposits strengthened towards the end of the year (see Box 5.2). In the last quarter of 2007, loans from the rest of world represented more than one-third of the total flow, while the deposits of non-residents represented more than one half.

Figure 5.9: Financial inflows from the rest of the world



Source: Bank of Slovenia.

Among other financial inflows of the private sector, foreign direct investments are gradually rising, while corporate borrowing abroad has fallen considerably. Foreign direct investments rose from EUR 0.5 billion in 2006 to EUR 1.1 billion in 2007, while corporate borrowing abroad fell from EUR 0.7 billion to EUR 0.5 billion which, to a great extent, is the result of a shift from foreign sources of financing to domestic sources. Corporate borrowing abroad as a proportion of total borrowing fell from almost 20% in 2006 to less than 10% in 2007. Inflows from portfolio investments remained negligible in 2007.

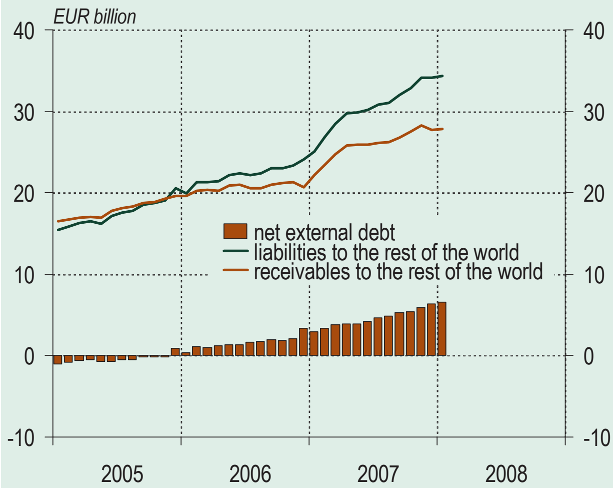
The main increases among financial outflows in 2007 were recorded by loans and deposits abroad. Lending to the rest of the world via loans totalled EUR 1.8 billion in 2007, almost three times more than the previous year, with bank lending prevalent. Bank deposits in the rest of the world increased by EUR 0.9 billion in 2007, while there were almost no such outflows in 2006. Portfolio investments, which totalled EUR 3.5 billion in the first half of 2007 and were the result of the repayment of Bank of

[17] The disclosure of an increased financial inflow to the Bank of Slovenia and the outflow of portfolio investment of the private sector is the accounting effect of the repayment of Bank of Slovenia bills until the end of April 2007. The repayment of these bills resulted in an outflow of portfolio investments and the investment of these funds by domestic banks in foreign securities. For a detailed explanation of this process, see the Price Stability Report of October 2007, p 48, Box 5.2: Adjustment of certain balance of payments categories following the introduction of the euro.
http://www.bsi.si/en/publications.asp?MapaId=786

Slovenia bills, slowed in line with expectations, and amounted to just EUR 0.2 billion in the second half of the year due to falling yields and increased instability in markets. Foreign direct investments totalled EUR 1.1 billion and were equal to direct investments in Slovenia by non-residents.

In line with past and current trends, the increase in financial inflows from the rest of the world and financial outflows to the rest of the world will continue, resulting in an increase in gross external debt and claims against the rest of the world. Inflows from loans from the rest of the world are expected to rise and, together with domestic lending, finance somewhat slower economic growth. The trend of rising direct investments is also expected to continue. This is largely dependent on the realisation of the government's plan to sell off state assets. On the outflow side, loans and direct investments are expected to continue increasing at their current rate. Inflows and outflows via portfolio investments are expected to remain negligible. Slovenia's gross external debt rose from EUR 24.0 billion at the end of 2006 to EUR 34.1 billion at the end of last year. In the same period, Slovenia's claims against the rest of the world rose from EUR 20.7 billion to EUR 27.7 billion.

Figure 5.10: External debt



Source: Bank of Slovenia.

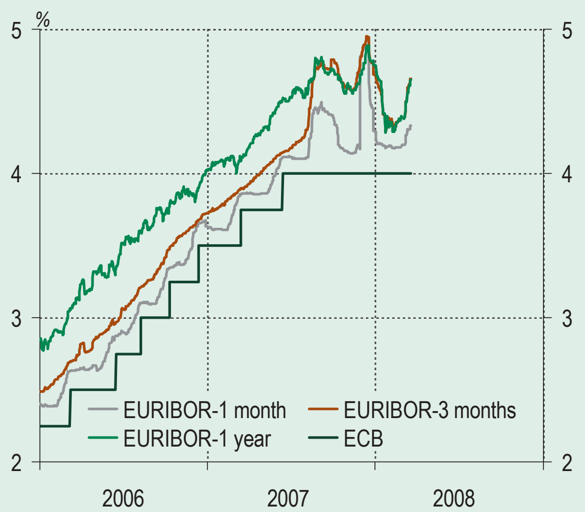
Due to the prevailing net financing from the rest of the world via debt instruments, net external debt is also rising, leading to a further deterioration in the balance of payments current account. Net external debt rose by EUR 1.8 billion, EUR 2.4 billion and EUR 3.1 billion in 2005, 2006 and 2007, respectively. Net external debt thus amounted to EUR 6.4 billion at the end of last year. The net debt of the government sector represented 40% of total net external debt. An increase in the burden of financing, which adds to the deterioration of the

Box 5.2: The impact of volatility on financial markets on economic and financial developments

Volatility on financial markets resulting from the turmoil on the US sub-prime mortgage loans market in the second half of 2007 have not yet had a significant effect on economic trends in the euro area. It has however led to a considerable increase in uncertainty regarding future economic and financial trends. Since volatility on financial markets persists and has grown to a financial turmoil in the US, a final assessment of its impact on economic trends will not be possible for some time. Economic activity was high in 2007, although it slowed during the year, while the unemployment rate fell to its lowest level in the last 25 years. In addition to other factors, such as a slowdown in the real estate market, developments on financial markets have resulted in the deterioration of both consumer and business confidence indicators since the middle of 2007. To date, volatility on financial markets has not yet affected economic trends in the euro area as a whole or in Slovenia.

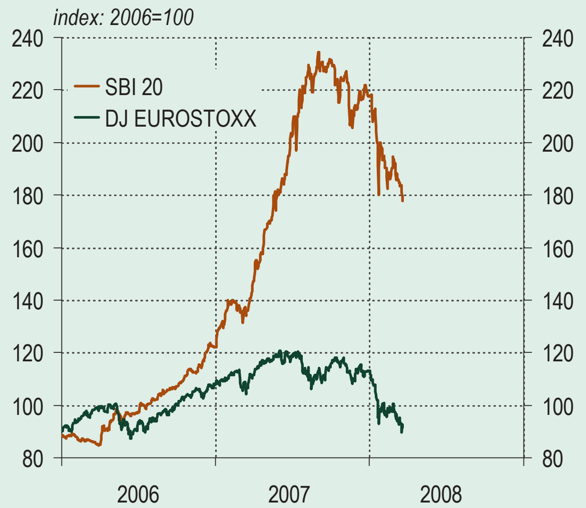
Despite growing uncertainty, the trends of the main monetary and credit aggregates in the euro area have remained unchanged recently. Increased uncertainty in financial markets has not yet resulted in a shift from less secure investments to bank deposits, as the growth in the M3 monetary aggregate has not changed significantly since the middle of the year. A possible increase in transactions due to the restructuring of portfolios could be reflected in a rising M1 monetary aggregate (including mostly transaction money). Growth of this aggregate has actually slowed since the middle of 2007 due to a rise in ECB interest rates. Falling securities prices and

Figure: Money market and ECB interest rates



Source : ECB.

Figure: Stock markets in Slovenia and the euro area



Source: Ljubljana Stock Exchange, Reuters.

general uncertainty could result in a drop in lending. Growth in loans to the private sector however remained unchanged during the year at just over 10%. The slowdown in lending to households is not linked to financial turbulence, as the slowdown began already in the middle of 2006 and is primarily the result of a slowdown on real estate markets and the gradual rise in ECB interest rates since the middle of 2007.

The consequences of financial turbulence are seen in the euro area as an increase in mark-ups for risk and thus an increase in money market interest rates, a drop in securities prices and in the structure of monetary and credit aggregates. Euro interbank interest rates have risen since the middle of the year in line with the ECB's refinancing rate. These rates rose sharply at the outbreak of financial turbulence, while they began to fluctuate considerably in the months following, indicating general uncertainty and a lack of confidence. Nevertheless, rising interbank interest rates were not carried over to an increase in lending interest rates. Securities prices on capital markets in the euro area fell by approximately 10% immediately following the outbreak of turbulence, while fluctuations in securities prices have also increased. Growth in lending to non-monetary financial institutions by banks rose by approximately 10 percentage points in the euro area in the second half of 2007, reaching year-on-year growth of nearly 25%. This is largely the result of the restructuring of financing of certain financial institutions, from issuing securities to borrowing from banks. Specific shifts have also been seen in certain items of the broad monetary aggregate, primarily in the restructuring of liabilities from units/shares of money market funds to debt securities. These types of shifts indicate that turbulence on financial markets has a certain impact on the monetary sector despite the currently favourable aggregate outlook.

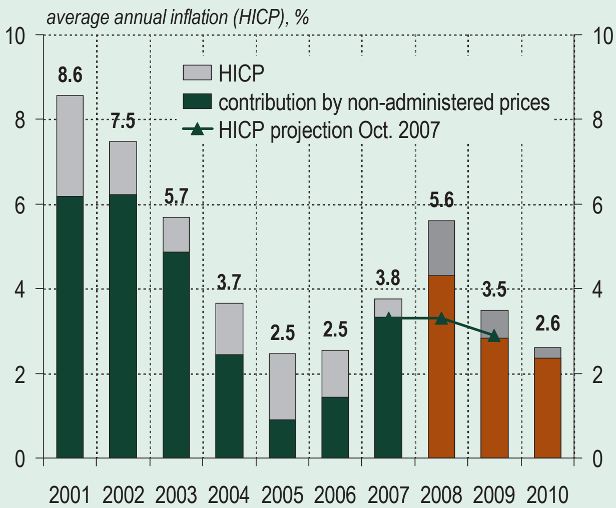
To date, there has been no evidence of a significant impact of turbulence in financial markets on the main monetary and credit aggregates in Slovenia; in addition to other factors this turbulence has had resulted in a drop in prices on capital markets. Growth in deposits in Slovenia rose in the middle of the year, but this was more the result of rapidly growing lending and economic activity than shocks in financial markets. Despite more difficult access to and higher prices of foreign sources, borrowing by banks abroad actually increased following the financial shocks. Bank deposits of non-residents, comprised primarily of the deposits of foreign parent banks in banks in Slovenia, also rose. High and more expensive borrowing by banks abroad and/or their possible redirection to less developed markets for financing result in certain risks for the banking system, including a reduction in profitability and increased currency risk. Similar to the euro area, securities prices have fallen in Slovenia since August as the result of financial turbulence, high growth in securities prices in the past, uncertainty regarding the state-owned share in Telekom Slovenije and the collection of funds for participation in the privatisation of NKBM.

balance of payments current account, accompanies rising net external debt. Net capital expenditure also rose from EUR 0.5 billion in 2006 to EUR 0.8 billion in 2007, representing more than 2% of GDP. Due to the relatively high balance of payments current account deficit during the projection period and the continued financing via debt instruments, the current trend of rising net external debt can be expected to continue. The costs of financing net external debt are also dependent on the uncertain assumption regarding the future movement of interest rates.

6 Price Projections and Risks

The inflation projection has been revised upwards due to current inflation trends and sharply depreciated and uncertain assumptions. Inflation is not expected to return to a level in line with price stability until the end of the projection horizon. Projections indicate that this year's average annual inflation as measured by the HICP will be 1.8 percentage points higher than last year's, amounting to 5.6%. This means an upwards revision of inflation by 2.3 percentage points in 2008 and 0.6 percentage points in 2009. New assumptions, which are the basis for new estimates, indicate the partial realisation of certain risks, outlined by the Bank of Slovenia in the previous Price Stability Report, linked to high economic activity, increasing labour costs and rising oil prices. Furthermore, growth in the prices of processed

Figure 6.1: Inflation projections



Source: SORS, Bank of Slovenia projections.

Table 6.1 Inflation

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	April	Δ	April	Δ	April	Δ
			average annual growth, %								
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	**5.6**	2.3	**3.5**	0.6	**2.6**	…
food	6.1	1.3	0.2	2.7	7.1	**9.6**	4.2	**5.5**	…	…	…
energy	3.4	7.0	11.9	8.5	3.4	**8.1**	6.3	**2.8**	…	…	…
non-energy industrial goods	4.8	1.8	-0.3	-0.9	0.3	**1.5**	1.0	**1.5**	…	…	…
services	7.1	5.8	3.3	3.5	4.9	**5.4**	0.5	**4.2**	…	…	…
Core inflation indicators (HICP)											
excluding energy prices	6.0	3.2	1.2	1.7	3.8	**5.2**	…	**3.6**	…	**2.0**	…
excluding energy and unprocessed food prices	6.3	3.7	1.3	1.5	3.4	**5.3**	…	**3.7**	…	…	…
excluding energy, food, alcohol and tobacco prices	6.0	3.9	1.5	1.3	2.7	**3.6**	…	**3.0**	…	…	…
Non-administered prices	5.9	3.0	1.2	1.9	4.1	**5.5**	2.0	**3.6**	0.3	**3.0**	…
Administered prices	4.4	6.1	7.4	4.8	2.1	**5.9**	3.5	**3.2**	2.2	**0.9**	…

Δ: The difference between current projections and projections in the Price Stability Report, October 2007.
Source: Bank of Slovenia

food at the end of the year was unexpectedly high. All these factors, together with the sluggish and insufficient responsiveness of macroeconomic policies, extend the timeframe for re-establishing price stability. Assumptions foresee inflationary factors becoming more moderate during the projection horizon. In the absence of additional external or domestic shocks, inflation could return to a more sustainable long term level over the next two years. Inflation is expected to be 3.5% and 2.6% in 2009 and 2010, respectively.

A gradual decrease in inflation should facilitate expected more moderate economic activity and sustained growth in labour costs. High economic activity and aggregate demand growth accelerate core inflation and growth in free prices. The key to lowering inflation in the future will be the closer alignment of economic activity with potential output growth, or as indicated by projections, somewhat slower economic activity. Growth in free prices is expected to rise to 5.5% this year and gradually decline to approximately 3% over the next two years. A gradual decrease in unit labour costs, despite a temporary rise in growth to approximately 4% this year, should further limit inflationary pressures. Although this growth rate exceeds the level consistent with price stability, this still only represents a partial adjustment to inflation trends, as indicated by a comparison of the trends of real labour costs and productivity, or the lagging of nominal unit labour costs behind the inflation trend. Nevertheless, the persistence of high growth in labour costs in the future could pose additional inflationary pressure, as indicated by the scenario in the chapter on risks, and hinder the achievement of price stability. Estimates of inflation in the baseline scenario are based on the premise that social partners remain responsible and maintain wage growth and other earnings within sustainable limits in line with productivity growth.

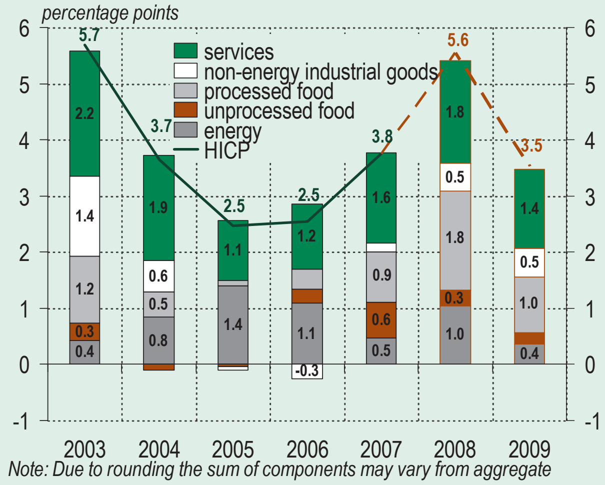
In line with trends in the domestic macroeconomic environment, core inflation is also expected to fall. Core inflation indicators show that core inflation should again fall to between 2.5% and 3%, a level that facilitates the achievement of sustained price stability and also reflects a sustained process of real convergence. The HICP excluding energy, food, alcohol and tobacco is expected to rise further this year, reaching average annual growth of 3.6%. With the cooling of the economy, core inflation index is expected to fall again next year. In the absence of new shocks in food prices, growth in the other two indices is expected to drop below 3.5% by the end of next year, following a rise this year to approximately 5.5%.

Table 6.2 Assumed direct inflationary effects of government measures in 2008 and 2009

Measure	expected changes	expected effect on HICP (percentage points)
Planned changes to administered prices in 2008:		
- Changes in prices of certain textbooks	average price increase of 2.8%	0.007
- Change in prices of tickets for rail transport of passengers	3.5% price increase	0.007
- Planned increase in the contribution for obligatory reserves of refined petroleum products	10% contribution increase	0.000
- Changes to network charge and supplements to the network charge for the transmission of electricity	1.4% increase in final electricity price	0.032
Total effect on inflation in 2008		**0.046**
Planned changes to administered prices in 2009:		
- Changes in prices of certain textbooks	average price increase of 2.6%	0.007
- Change in prices of tickets for rail transport of passengers	2.8% price increase	0.007
- Planned increase in the contribution for obligatory reserves of refined petroleum products	10% contribution increase	0.000
Total effect on inflation in 2009		**0.014**

Source: Plan for managing regulated prices in 2008 and 2009

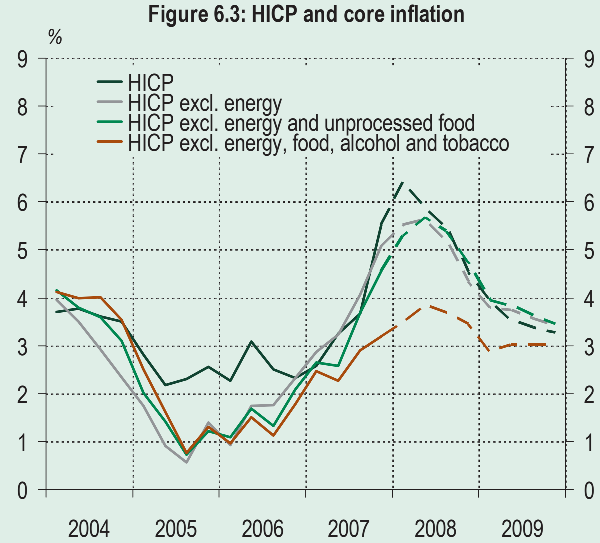
Figure 6.2: Contributions of components to inflation



Note: Due to rounding the sum of components may vary from aggregate values.

Source: SORS, Bank of Slovenia projections.

Figure 6.3: HICP and core inflation



Source: Eurostat, Bank of Slovenia projections.

Expected trends in the international environment during the projection horizon pose no indication of additional inflationary pressures. Oil prices should stabilise at a level of approximately USD 100 per barrel. Growth in prices of other commodities, particularly unprocessed food prices, is also expected to begin slowing gradually. In line with the last year's shocks passing-through, inflation in the euro area is expected to rise this year, while it is projected to be in line with a renewed slowdown over the next two years, settling at a level just above 2%. Growth in producer prices in Germany is also expected to fall just below this level during the projection horizon, following significantly higher growth in recent years. The external environment's impact on inflation is also expected to be limited due to slower foreign demand.

Estimates of year-on-year inflation rates have been revised upwards in all price aggregates compared to previous projections. The upwards revision of headline inflation for this year is to a large extent the result of previous inflation developments, primarily due to shocks in foods prices in the last quarter of 2007 and low assumptions regarding growth in energy prices. The estimate of growth in food prices was revised upwards by 4.2 percentage points to an average of 9.6% this year. The estimate of growth in energy prices was also revised upwards by 6.3 percentage points and is expected to reach an average of around 8.1% this year. Although the economic cycle is expected to reverse this year and growth in economic activity should be slower than previously expected, projections of growth in the prices of non-energy industrial goods was revised upwards by 1 percentage point compared to previous projections. Higher projected year-on-year growth is, to a large extent, due to the higher level of these prices at the beginning of 2008, while the current growth rate is result of an expected slowdown in economic activity. Growth in the prices of services has also been revised upwards by 0.5 percentage points to 5.4%. Higher growth for this year is primarily the result of stronger current growth in these prices from 2007, when they were heavily influenced by the domestic macroeconomic environment. This was particularly notable at the end of the year when, due to high current growth in these prices, the year-on-year inflation rate in services prices did not fall, although the effects of the high base from the period around the introduction of the euro acted to reduce inflation.

Despite the growth in prices of non-energy industrial goods which, according to expectations is expected to be higher than the euro area average, this growth should not have a negative impact on the competi-

tiveness of the economy. In recent years, growth in the prices of non-energy industrial goods in Slovenia has been considerably slower than growth in the euro area. Therefore growth slightly above the long-term average was expected, particularly in light of the adjustment in relative prices during the currency changeover. However, the growth rate which accompanies this process exceeds expectation and is, to a large extent, the result of high domestic economic activity. Nevertheless, the moderate pressure on growth in prices of non-energy industrial goods from the previous period is expected to fall further given the projected slowdown in economic activity in 2008 and in the coming years. For the most part, this price group is concerned with products from the tradable sector, which are typically under the influence of competition from the rest of the world. Thus, given more moderate economic trends as indicated by projections, no major upward deviations are expected in this price aggregate in the coming period.

Following relatively rapid growth in administered prices this year, growth is expected to fall below growth in free prices over the next two years. Accelerated growth in administered prices this year will be affected primarily by the sharp growth in energy prices from the end of 2007 and the beginning of this year. The projection of growth in energy prices is in line with assumptions regarding the trend of oil prices on world markets and the dollar/euro exchange rate, which do not change significantly with regard to initial values during the projection horizon. Therefore, current growth in energy prices during the projection horizon remains low and, as a result, lowers year-on-year growth in energy and administered prices. Growth in other administered prices is assumed to be in line with growth in free prices as foreseen in the plan for managing administered prices in 2008 and 2009.[18] According to the plan, the direct effects of changes in government-controlled prices on inflation are expected to be considerably less in 2008 compared to previous years. This year, the effect is expected to be approximately 0.05 percentage points and just one-fifth of this year's effect is expected for next year. The majority of necessary adjustments and reconciliation of excise duties with European directives have already been carried out. This year, the effect of last year's increase in excise duties on tobacco will be a decrease in year-on-year inflation by 0.3 percentage points.

Risks

Projections of inflation and economic trends are exposed to a number of uncertainties, which are unusually high. On the side of external factors, uncertainty stems primarily from the instability on world financial markets and the resulting increase in overall uncertainty with regard to global activity and commodity prices on world markets. These uncertainties have increased with regard to previous projections. Trends in commodity prices, primarily recent increases in food prices, indicate that there are factors of more structural nature affecting global demand which typically have a lasting effect on price movements. There is also considerable uncertainty with regard to domestic factors, including uncertainty linked to wage developments. Discussions regarding wage setting in the private sector have come to a halt due to disagreements, while risks of second-round effects or the pass-trough of currently high inflation to wage growth are increased. This year, considerable uncertainty is also represented by projections of investment which rose sharply last year. At the end of the year there were already indications of a reversal to lower growth. According to expectations, less favourable economic growth in the rest of the world, difficult access to sources of financing and a contraction in corporate earnings will contribute to lower growth in investments, although expected continued high investments in the infrastructure and low real interest rates could stimulate investments.

[18] Source: Plan for managing regulated prices in 2008 and 2009: [http://193.2.236.95/dato3.nsf/OC/080103210540A/$file/152v1_11.doc].

In addition to the baseline scenario, there are alternative scenarios of projections and simulations due to uncertainties linked to the realisation of assumptions. These alternatives indicate possible deviations from the baseline scenario. Assumptions from the international environment and assumptions regarding fiscal and income policy actions are taken into account in the baseline scenario of projections. Alternative scenarios of projections are based on revised assumptions, primarily with regard to those variables which are most exposed to risks. From a comparison of scenarios, it is possible to assess the impact of deviations on projections (Table 6.3).

Risks for economic growth have turned to the downside, while inflation risks remain on the upside. In conditions of unusually high uncertainty, this combination of risks is present despite the fact that the forecast of economic growth was revised slightly downwards, while the forecast of inflation was revised upwards, as most external risks from the October Price Stability Report materialised. Risks relating to a slowdown in economic growth stem primarily from the international environment. Vital in this respect is how the effect of financial turmoil and a slowdown in economic growth in the US will be transferred to demand from Slovenia's trade partners and how commodity prices and terms of financing will effect aggregate demand in Slovenia and the rest of the world.

Tabela 6.3 Model simulations of certain macroeconomic shocks

	Simulation	Shock (change)	Estimated probability
	a) Foreign environment		
1	Oil price	USD 10 per barrel higher than forecasts	high
2	Commodities prices	10% higher than forecasts	high
3	Foreign demand	1 percentage point lower than forecasts	high
	b) Domestic environment		
4	Wage growth	1 percentage point higher than forecasts	high
5	Household spending	growth 1 percentage point higher than forecasts	moderate
6	Government spending	growth 1 percentage point higher than forecasts	moderate
7	Growth in administered prices	2 percentage point higher than forecast growth	high

	Simulation	GDP			Inflation		
		2008	2009	2010	2008	2009	2010
	Projections (baseline scenario)	4.2	3.9	4.1	5.6	3.5	2.6
	Response of projections to shocks:						
	a) Foreign environment						
1	Oil	4.2	3.8	4.0	6.0	3.8	2.7
2	Commodities	4.2	3.9	4.1	5.9	3.7	2.7
3	Foreign demand	4.0	3.6	4.0	5.5	3.3	2.6
	b) Domestic environment						
4	Wages	4.3	4.1	4.2	5.8	3.9	3.1
5	Household spending	4.5	4.3	4.5	5.8	3.8	3.0
6	Government spending	4.4	4.1	4.3	5.7	3.7	2.8
7	Administered prices	4.3	3.8	4.1	5.8	3.8	3.0

Notes: Year-on-year growth, %. The simulations were made using the model used by the Bank of Slovenia for its forecasts.
Simulations 1, 2, 3 and 6 have changes in exogenous variables, while simulations 4, 5, and 7 have the change that defines the simulation in addition to the variables in the baseline scenario. All other assumptions in the simulations are the same as those in the baseline scenario.
The shocks last from the first quarter 2008 to the final quarter of 2010.
Source: SORS, Bank of Slovenia, Bank of Slovenia calculations.

Lower risks regarding the development of economic growth are expected to have the opposite effect of the risk that wage growth will be higher than expected and a sharper drop in real interest rates (due to higher inflation) which would have a stimulating effect on domestic spending and investment. Key inflation risks are on the upside. These risks arise from both external and domestic factors, such as the risk that the rise in commodity prices will be sharper than forecasted and that wage growth will be above expectations, which would accelerate inflation over the medium term. On the other side, downside risks regarding inflationary trends are largely the result of weaker than expected economic growth in Slovenia and the rest of the world.

Uncertainty on world financial markets and a slowdown in economic activity in the international environment represent the main downside risk for economic growth. If the slowdown in global activity spreads, it could result in lower exports and domestic demand compared to baseline scenario projections. The baseline scenario assumes that instability in financial markets and lower economic growth in the US will have a limited effect on the demand of other trade partners; despite a slight slowdown in the growth of foreign demand in 2008, the baseline scenario assumes that an easing of conditions on financial and commodity markets will once again stimulate the demand of foreign partners. Given model forecasts of the elasticity of macroeconomic factors on foreign demand presented in Table 6.3, it is possible to evaluate the effect of a slowdown in foreign demand on the Slovenian economy. If in 2008 foreign demand falls to 2001 levels (when growth in foreign demand fell by approximately 5 percentage points), economic growth and inflation in 2009 would drop by approximately 1.5 percentage points and 1.0 percentage points, respectively.

Tightening financing conditions for domestic companies and households or even the rationing of credit could further slow economic growth. The baseline scenario assumes slightly lower short-term interest rates, in line with market expectations. However, there are risks that costs of financing for domestic companies could rise, particularly in the event of continuing financial turbulence on world markets and the resulting increase in risk premiums or a rise in key interest rates in a response to persistently high inflation. At the same time, there could be a significant decrease in the amount of lending from the expected level or even a restriction of lending in terms of volume. Tighter financing conditions would decrease spending and limit investing. However, a higher level of inflation than in the euro area could stimulate continued borrowing and household spending, as the real costs of borrowing would drop together with returns on savings.

Among external factors, the greatest risk to inflation is posed by oil and other commodity prices, particularly food prices. Due to the rapid growth in commodity prices, the baseline scenario takes into account commodity prices that are notably higher than in previous projections. The prices of oil and other commodities, primarily food prices, have risen sharply on world markets. This has also had an impact on the prices of food and oil in Slovenia. This confirms the risks from the previous Price Stability Report regarding inflationary factors from the international environment. These risks continue to rise. In addition to supply-side shocks, this is primarily the result of increased global demand which is partly structural (income growth and the resulting changes to the nutritional habits of the population in developing economies and the production of bio-fuels). Risks are also substantiated by speculative reasons. In addition to prices on world markets, the trend of the euro exchange rate also affects domestic prices of imported commodities. The recent appreciation of the euro has helped to ease inflationary pressures in euro area markets which arise from growth in commodity prices on world markets. Although very few indicators point to this possibility, inflationary pressure could rise further if current exchange rate trends reversed.

In addition, inflationary risks are linked to the prices of imported goods, in particular for those products which have significantly contributed to lowering infla-

tion in past years. In the period following entry to the EU, imports from countries with cheap labour and imports of used cars from EU Member States have increased sharply. In addition to a direct effect, the import of cheaper goods also had an indirect effect on lowering inflation due to the revised structure of the consumer basket (a shift to cheaper imported goods) and increased competition on the domestic market. It is possible that the favourable effect of global competition and imports from countries with cheap labour would become limited over time. However, the time-frame and extent of this effect is still quite uncertain.

Among domestic factors, wage growth represents the greatest risk for inflation during the projection period. This risk has risen with regard to the October Price Stability Report, as union demands have risen, while disputes brought wage agreements to a halt in March. At the same time, current inflation and indicators of inflationary expectations and perceived inflation have risen. These typically have a considerable impact when setting wage demands. In current conditions, a high level of production capacity utilisation and tightened conditions on the labour market have increased the risks of second-round effects or the pass-trough of high price growth to wage growth. Furthermore, the risks of wage growth have risen due to the recently reached agreement on public sector wage growth and a possible demonstration effect. Higher growth in wages from the baseline scenario could cause a rise in inflation, as it increases the costs of companies on one side and increases pressures on the demand side. Likewise, in conditions of high economic growth it is more likely that companies will transfer higher wages by increasing prices to maintain (or even increase) their mark-up on prices (profit). This is particularly true for sectors which are less exposed to competition such as the services sector. Since this sector typically demonstrates a lower level of productivity which could absorb higher costs in the form of wages, the risk of inflationary pressures arising due to growth in wages is greater in this sector.

Risks brought about by uncertainty regarding future wage trends are assumed in the alternative scenario of complete indexation of wages in price growth which, according to assessments, would result in spiralling growth in prices and labour costs. This scenario is presented in Table 6.4. The alternative scenario assumes that growth in public sector wages throughout the projection period will be fully in line with growth in output per employee and price growth. This would result in growth in wages in the period 2008 to 2010 between 1 and 1.5 percentage points higher than in the baseline scenario, amounting to between 7% and 8.5%. If this scenario were realised, inflation in the projection period would rise significantly above the inflation projection in

Table 6.4 Alternative scenario of projections: higher nominal wage growth

	scenario of full indexation			deviations from the baseline scenario		
	2008	2009	2010	2008	2009	2010
	year-on-year growth, %			in percentage points		
Gross wages (nominal)	**8.6**	**8.4**	**7.1**	1.2	1.4	1.5
Consumer prices (HICP)	**5.7**	**5.0**	**4.4**	0.1	1.5	1.8
Real GDP	**4.2**	**4.0**	**4.2**	0.0	0.1	0.1
Domestic demand	**4.4**	**3.9**	**3.9**	0.2	0.4	0.2
Exports of goods and services	**9.5**	**8.1**	**8.3**	0.0	-0.1	0.0
Imports of goods and services	**9.4**	**7.9**	**8.0**	0.1	0.2	0.2

Note: This scenario assumes that wage growth throughout the projection period will be fully in line with growth in the productivity of the economy and growth in prices.
Source: Bank of Slovenia.

the baseline scenario and could reach 5%, compared to 3.5% in the baseline scenario in 2009 and 4.5% compared to 2.6% in 2010. At the same time, economic activity would increase only slightly and temporarily due to real growth in disposable income and aggregate demand. This scenario points out the danger of a wage-inflation spiral occurring if one-off supply-side price pressures are built into growth in wages, such as growth in energy and food price - these do not increase labour productivity - and the part of inflation linked to cyclically-accelerated economic activity. The baseline scenario suggests that public sector wage policy will not change significantly given the period of moderate growth in labour costs over the last several years. If there are deviations from this policy, the possibility of not achieving price stability also increases.

Orientation of macroeconomic policy

The Treaty establishing the European Community defines the single market and economic and monetary union as a tool to achieve the European Community's economic and social objectives, oriented to the congruent development of the entire community. Stimulating sustained and non-inflationary economic growth is one of these objectives. As an EU Member State, Slovenia is, in accordance with the European Community Treaty, obliged to orient economic policies

Box 6.1: Comparison of 2008 and 2009 forecasts with those of other institutions

Forecasts for Slovenia are compiled by domestic and international 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 cover different periods and therefore do not take into account the same information. Furthermore, the forecasts are based on different assumptions with regard to both exogenous variables in the international environment and economic policy actions.

Economic growth forecasts for 2008 have generally been revised slightly downwards compared with the previous round of forecasts. Nevertheless, institutions unanimously agree that growth of 4% will be achieved. Most institutions forecast a further slowdown in economic activity for 2009. A significant increase in the forecasted current account deficit for 2008 is characteristic of projections of those institutions that prepared forecasts this year. The prevailing opinion among the institutions is that the current account deficit in 2009 will be somewhat lower than in 2008.

Significant revisions to inflation forecasts for this year are characteristic in this comparison, with all institutions revising inflation forecasts upward by at least one percentage point compared to the previous round. Nevertheless, forecasts differ more than in previous rounds. This year's assessments indicate that inflation will reach levels around 5% in 2008. All institutions agree that inflation will be lower in 2009 than this year.

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

	Publication of new/previous forecast	GDP annual growth %				Inflation annual average in %				Current account as % of GDP			
		2008		2009		2008		2009		2008		2009	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Apr. 08 / Oct. 07	**4.2**	-0.2	**3.9**	0.0	**5.6**	2.3	**3.5**	0.6	**-6.1**	-3.1	**-5.5**	-3.3
EIPF	Mar. 08 / Sep. 07	**4.5**	-0.5	**4.5**	…	**5.1**	2.8	**2.2**	…	**-4.7**	-5.8	**-3.0**	…
IMAD	Apr. 08 / Sep. 07	**4.4**	-0.2	**4.1**	0.0	**5.2**	1.8	**3.2**	0.4	**-4.6**	-1.5	**-2.8**	-0.8
Consensus Forecasts	Mar. 08 / Sep. 07	**4.7**	0.0	**4.4**	…	**4.5**	1.8	**3.3**	…	**-3.0**	-2.2	**-2.6**	…
European Commission	Nov. 07 / May 07	**4.6**	0.6	**4.0**	…	**3.7**	1.0	**2.9**	…	**-2.6**	-0.3	**-1.8**	…

Δ: The difference between new and previous projections.
Source: Bank of Slovenia, EIPF, IMAD, Consensus Economic Forecasts, European Commission; Bank of Slovenia calculations.

that would contribute to the realisation of the Community's objectives. The positive convergence report published in 2006 is confirmation that Slovenia duly meets this obligation. This allowed the introduction of the euro in 2007. In this regard, the convergence report placed special attention on the importance of maintaining the sustained economic convergence achieved, in line with the Community's objectives. Thus the Maastricht criteria remain a permanent guide and orientation for economic policies in Slovenia. These policies are established such that they require the active supplementation of Community's monetary policy with nationally administered economic policies. For the implementation of a common monetary policy, permitted deviations from the defined average price growth of the three best performing European Union Member States reflect other acceptable differences which can be the result of asynchronous economic cycles and various levels of development in individual Member States. The control of these differences is at the discretion of nationally administered economic policies. Deviation from the Maastricht inflation criterion therefore represents a strong signal for the response of these policies to developments.

Fiscal policy, with its medium-term orientation, plays a central role in controlling inflationary pressures on the domestic demand side. This contributes to maintaining medium-term inflationary expectations at a level of price stability. Loose internal macroeconomic stability and an uncertain external environment provide new challenges for fiscal policy. A deficit in domestic savings and the outflow of factor income as the result of rising cross-border debt require the balancing of these risks. The interest rate, which could help stimulate domestic savings, is no longer under national jurisdiction. We are dependent on the decisions of the ECB and responses of domestic and foreign banks thereto. Halting the growing savings-investment gap which, in the given circumstances, arises due to activities in the private sector and is reflected in a high balance of payments current account deficit, is the responsibility of fiscal policy. In practice, this means generating surpluses that ensure sufficient additional domestic savings. This is not an easy task when a drop in economic growth is expected. At a minimum, we can reasonably expect the possibility of the inflationary portion of public finance revenues, arising from increased price growth, spilling into current public finance expenditure to be limited. Therefore it is necessary to create a criterion of non-inflationary growth in expenditure linked to the Maastricht price stability criterion in guidelines of public finance policy.

Structural policies are important for achieving sustainable economic growth in the medium and long-term period, consistent with maintaining price stability. In particular, structural policies include measures for increasing the flexibility of the labour market, improving the competitiveness of markets for products and reforms of social programmes. In the monetary union, the labour market bears the greatest burden in the short-term during the adaptation of the economy in unfavourable conditions. Therefore the flexibility of the labour market is vital. It is important that the labour market does not face discord which could lead to unjustifiably high wage demands. The risk for inflation brought about by high wage growth increases the indexation of certain incomes of the population, particularly pensions and social transfers linked to wage growth. Previously adopted structural measures taken by the government for increasing market flexibility and stimulating competition are appropriately oriented.

When forming wage agreements it is important to distinguish between cyclical and long-term trend component in productivity developments. The longer-term trend should direct wage policy. Productivity growth of a cyclical nature should be reflected in agreements regarding the profit participation of employees. Recently adopted legislation makes this distinction possible. The realisation of this distinction could contribute significantly to maintaining cost competitiveness, compared to the most successful countries in the Eurosystem. In recent years, the trend of overall labour costs has contributed considerably to achieving low rates of inflation. Longer-lasting deviations of inflation trends in Slovenia from euro area trends, the slow response of nationally administered policies to these deviations and the accelerated deviation from the Maastricht price stability criterion resulted in an inflation driven compensation in increased wages at the beginning of the year. This adjustment has resulted in a slowdown in wage growth towards the end of the projection period in the baseline scenario. Some views of unions regarding future wage growth indicate an understanding of the factors important for maintaining competitiveness and jobs in an uncertain external environment. These views also require support in the functioning of available internal economic policies. The implementation of a public sector wage policy has an important impact in other parts of the economy, which has a significant signalling effect on private sector wages. The latest agreements dictate public sector wage growth which does not restrict inflation, particularly in 2008.[19] What effects this type of agreement will have on public sector wages depends largely on the agreement of social partners.

The Governing Board of the Bank of Slovenia adopted measures to limit the continuing increase in lending activities by banks. With the high level of economic growth and the continuing privatisation process, growth rates of loans to the non-banking had reached 35% by the end of the year. Demand for loans and easier access to foreign sources following the introduction of the euro significantly increased foreign sources for financing of bank loans. It is necessary to take into account that the supply of loans for domestic economic entities is formed in both the European and Slovenian economic areas. In addition to adopted measures, the tightening of terms of financing of banks on international financial markets will also have an impact on the supply of loans in the domestic area. Another significant limiting factor for further credit expansion will be represented by the need for additional capital for banks due to the implementation of the provisions of the new banking directive (Basel II). With the implementation of the latter, the operating conditions of banks in the euro area, as defined by national credit risk regulations, will be equalised to a great extent.

The administered prices policy must be oriented to controlling costs in sectors with administered prices, while at the same time preventing a distortion between relative prices. Forecasts assume that administered prices will move in line with the administered prices plan from December 2007, while no changes are foreseen with regard to taxes. Although the risk of deviation from this assumption is relatively low, the greatest uncertainty (with the exception of refined petroleum product prices) is represented by the trend of electricity prices following the opening of the market last year. The programme of administered prices and the limiting of tax effects on prices cannot represent the core of policies for ensuring prices stability: the short-term effects on inflation from such policies could result in a distortion of relative prices, which has an adverse effect on economic efficiency in the long-term. These types of policies are typically unsustainable and gradually lead to sharp inflation shocks from administered prices. With regard to administered prices, it is particularly important to prevent the formation of inflationary factors due to insufficient cost control in sectors in which prices are administered.

[19] The agreement on the adjustment of public sector wages includes a "safety catch" by which wage growth in 2009 and 2010 may not exceed productivity growth by more than 0.5 percentage points.

Annex: Bank of Slovenia projections and Eurosystem projections

The Bank of Slovenia has been participating in the Eurosystem's macroeconomic projections since autumn 2006.[1] The projections for Slovenia were included for the first time in the aggregate projections for the euro area 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 national central bank (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 of assumptions, which contains sections on interest rates, exchange rate developments, the international environment and fiscal variables. In the next step, the ECB and NCBs use the same assumptions to prepare their own projections for individual countries, while the ECB also prepares an aggregate for the euro area, based on its own projections and NCB projections. After multiple iterations the final projection values are defined for individual countries, and then for the euro area, which is followed by the preparation of reports for the ECB Governing Council. A summary of this report is published in the ECB Bulletin.

The Bank of Slovenia uses its own assumptions in the projections set out in the Price Stability Report. 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.

The Bank of Slovenia projections[5] published are not identical to Eurosystem projections, and are not issued at the same time. The individual NCBs of euro area Member States 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 generally issued twice a year – at the beginning of June and the beginning of December.[6] If NCB projections are published before Eurosystem projections, the publication date must be at least two months earlier than Eurosystem projection. 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] The projections of Eurosystem staff (the ECB and NCBs of euro area Member States) relating to the euro area which are published in the ECB Monthly Bulletin do not reflect the opinions of individual central banks or the ECB Governing Council. The projections represent support material for the assessment of the ECB Governing Council regarding economic events and risks relating to price stability.
[2] For more on Eurosystem projections, see: http://www.ecb.int/pub/pdf/other/staffprojectionsguideen.pdf
[3] The committee is comprised of high ranking officials from the ECB and NCBs.
[4] ECB and NCB staff comprises the working group.
[5] Projections approved by the Board of the Bank of Slovenia 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.