BANKA SLOVENIJE

THE MEDIUM-TERM MONETARY POLICY FRAMEWORK

1. INTRODUCTION

The enlargement of the European Union is coming into the phase when – at the conclusion of the negotiations for accession itself – the preparation for the adoption of the Euro is also becoming important. The present candidate countries for membership in the European Union have no choice regarding this. The adoption of the Euro is the final and inevitable objective of their accession to the European Union. Therefore, their time horizon for the adoption of the Euro is different from that of the Member States, which in 1999, on the introduction of the Euro, had the option to postpone the transition to the single currency for an indefinite period. The concept of the process of preparations for the adoption of the Euro is also broader. In meeting the Maastricht criteria with the nominal convergence, the real convergence is also vital for the present candidate countries – structural compliance and catching up with the economic development of the existing Member States of the European Union.

Thus, the candidate countries for membership have a hard task to ensure for themselves, in a relatively short period of time pending accession to the European Union, relatively equal long-term and sustainable starting conditions for participation in the Single European Market, such as are in force for the existing Member States. In the opposite case, their accession to the European Union may result in imbalances, the final consequences of which would be equalised only by the increase of unemployment alongside low economic growth. To this end, the main task of the candidate countries is to bring the rates of price growth in line with the level of the Maastricht criterion before their accession to the European Union.

The monetary policy is one of the key factors in decreasing the price growth. With accession to the European Union, the free character of its formation will still be retained until the adoption of the Euro, however with reduced flexibility. The exchange rate of the domestic currency will become a matter of common interest to all the Member States of the European Union already upon accession. Therefore, it is important to make full use of it until accession to the European Union. The present materials aim to set up the frameworks for the conduct of the monetary policy during the period of time remaining before accession to the European Union. Nevertheless, they also represent the outlook on reaching the adoption of the Euro as a new domestic currency of the Republic of Slovenia. The purpose of these materials is to present the formal environment, to which the monetary policy must adjust itself before the adoption of the Euro, the mode of the action of the monetary policy to fix the exchange rate of the Tolar within the European exchange rate mechanism, and the economic environment in which the monetary policy will be exercising its function in the next two years. The result must be the decrease of price growth to a comparable European level before accession to the European Union and the formation of a long-term and sustainable exchange rate of the Tolar against the Euro.

The second chapter describes the time-stages and formal procedures provided for by the European legislation after the adoption of the Euro. Within this scope, it also defines the time limits for the full integration of Slovenia into the European Monetary Union. The third chapter describes the targets of the operations of the monetary policy in the period until integration into the EMU, its transmission mechanisms, bases for the conduct of the monetary policy and structural elements requiring adjustments for attaining the appropriate efficiency of the monetary policy. Further on, the chapter describes the tools which the monetary policy will have at its disposal on exercising its function. The fourth chapter describes the economic environment in which the monetary policy should be operating in the next two years and the effects which, together with a certain economic growth element structure, will establish the conditions for its functioning. The fifth chapter determines the indicators which the monetary policy will follow in its operations, their limit values and mutual compliance.

The materials represent a guide for the assessment of operation consistency of the monetary policy and the circumstances in which the monetary policy will react to immediate events. The Bank of Slovenia will also check these circumstances during the year and, if necessary, amend the guidelines of its operations on their basis.

2. A GUIDELINE: ACCESSION TO THE EMU

2.1. Accession phases

The time until the introduction of the Euro in the countries of the Central and Eastern Europe (CEE) can be divided into three periods:

The first period represents the period before accession to the EU, in which all the mentioned countries have free choice to make their own selection of the exchange rate regime, and thus an independent monetary policy. However, according to the "acquis" they have to ensure the independence of the central bank, the prohibition of financing the state by the central bank, and the liberalisation of international capital flows. In September 1999, new foreign exchange legislation was adopted, in June 2000, a schedule of the liberalisation of international capital flows was accepted, and soon a new Law on the Bank of Slovenia will be enacted. By all these measures, Slovenia will, to a great extent, comply with the above mentioned criteria.

The second period starts with accession to the EU and ends with accession to the EMU. During this period, the CEE countries will accede to the so-called ERM2 mechanism. This mechanism requires that the rate of the national currency be set against the Euro, the allowed fluctuation of the market rate being ±15% around the central rate.

The third period starts with accession to the EMU and the ECB system; which means with the introduction of the Euro and the abolition of the national currency. Thereby, the CEE countries will have the same rights and obligations in the conduct of the monetary policy as do other states of the Euro area. Before the introduction of the Euro, the states must fulfil the so-called **nominal convergence criteria** based on the Maastricht criteria, to which the conditions regarding exchange rate arrangements are added:

- The achievement of a high level of **price stability** reflected in the rate of inflation, which must not exceed the average rate of inflation of three Member States of the ERM with the lowest inflation by more than 1.5 percentage points. In September 2001, the lowest rate of inflation was recorded by France (1.6%), Belgium (1.9%) and Luxembourg (1.9%), which means the convergence criterion 1.8% + 1.5% = 3.3%.
- The sustainability of convergence: **long-term interest rates** must not exceed the average rate of inflation of three Member States by more than 2 percentage points. Taking into account the data of September, these are France (4.94%), Belgium (5.14%) and Luxembourg (4.67%), and the convergence criterion amounts to 6.92%.
- **General government deficit** must not exceed 3% of GDP, and should be on the incessant decrease and should approach the reference value or be exceptionally above this value.

Public debt must not exceed 60% of the GDP, except if this ratio tends to decrease and approaches the reference value at a satisfactory pace.

- Observing the normal fluctuation limits provided for in the **ERM2** mechanism for at least two years.

Table 1: The fulfilment of the Maastricht criteria

THE EMU STATES	*Inflation (in %) Sept 01/Sept 00*	*Long-term interest rates (in %) Sept. 01*	*Deficit (in % of GDP) 2000*	*Public debt (in % of GDP) 2000*
Belgium	1.9	5.14	0.0	110.9
Germany	2.1	4.81	1.3	60.2
Greece	4.0	5.31	-0.9	103.9
Spain	3.4	5.14	-0.3	60.6
France	1.6	4.94	-1.3	58.0
Ireland	3.8	5.01	4.5	39.1
Italy	2.6	5.20	-0.3	110.2
Luxembourg	1.9	4.67	5.3	5.3
Netherlands	5.4	4.38	2.0	56.3
Austria	2.5	5.07	-1.1	62.8
Portugal	4.1	5.16	-1.4	53.8
Finland	2.6	5.06	6.7	44.0
EURO area 12	2.5	4.99	-0.7	69.6
Convergence criterion	3.3	6.92	-3.0	60.0
Slovenia	7.9*	13.36**	-2.3***	25.1****

Notes:
* The non-harmonised CPI index.
** The RS12 bond is taken as an approximation for the calculation of the long-term interest rate of Slovenia.
*** According to the methodology of ESA95.
**** The debt of the Republic of Slovenia.
Sources: The Bulletin of the ECB, SORS, EUROSTAT, calculations by ARD.

Lately, the so-called **real convergence** is being mentioned, relating mainly to the approximation process of the CEE countries to align with the countries of the Euro area in their GDP per capita, price levels and structural reforms. Referring to real convergence will probably enable the states of the Euro area to hold back the CEE countries outside the Euro area, if need be.

2.2. Systemic framework for functioning of the ERM2

The basic elements of **exchange rate arrangement** between the states of the Euro area and other EU Member States have been defined by two legal Acts:

- The Resolution on the Establishment of an Exchange Rate Mechanism in the Third Stage of the Economic and Monetary Union (16 June 1997)

- The Agreement between the European Central Bank and the National Central Banks of the Member States outside the Euro Area Laying down the Operating Procedures for an Exchange Rate Mechanism in Stage Three of the Economic and Monetary Union (1 September 1998).

From 1 January 1999, according to the above mentioned agreements, the system of foreign exchange-rates between the states of the Euro area and the EU Member States outside the Euro area is as follows:

- **The ERM2** replaces the previous European monetary system.

- The EU Member States outside the Euro area must conduct the **exchange-rate policy** as a matter of common interest. They decide on participation in the ERM2 on a voluntary basis. Nevertheless, the country with derogation regarding the introduction of the Euro is expected to join the ERM2.

- The ERM2 should not endanger the **primary objective** (price stability) of the ECB and the central banks of the EU states outside the Euro area.

- The **central rate** of the national currency against the Euro is to be defined. Such a decision is accepted by a mutual agreement between the ministers of the states of the Euro area, the ECB and the ministers and governors of the central banks of the Member States outside the Euro area participating in the ERM2. The procedure also involves the European Commission and the Economic and Financial Committee.[1] The ministers and governors of the central banks of the Member States not participating in the exchange-rate mechanism will take part, but will not have the right to vote in the procedure. All parties to the mutual agreement will have the right to initiate a procedure aimed at reconsidering and redefining central rates.

- The standard **fluctuation band** is plus or minus 15% around the central rate. At the request of a non-Euro area Member State seeking to join the ERM2, a formally agreed fluctuation band narrower than the standard one and backed up in principle by automatic intervention and financing may be set. All parties mentioned in the previous paragraph will participate in this decision-making procedure.

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[1] The Economic and Financial Committee is a consultative body monitoring the economic and financial situation of the EU Member States, the exchange rate of the Euro, relations with third countries and international institutions. The EU Member States, the European Commission and the ECB nominate two members of the Committee at the most.

- **Exchange rate intervention** in case of reaching the upper or lower margin is automatic and unlimited, with very short-term financing available (up to 3 months). Intervention includes only spot sales and purchases of foreign currencies. The ECB and the central banks participating in the ERM2 could suspend intervention only if this were to endanger their primary objective of price stability. All other relevant factors have to be taken into account, mainly those which have an influence on the credible functioning of the ERM2. Co-operation in the protection of the conversion rate of a certain currency may be carried out before reaching the lower or upper margin of the band. The Member State of the ERM2 and the ECB must notify each other of all exchange rate interventions regarding currencies of areas both within and outside the EU.

2.3. Slovenia and the EMU

The Bank of Slovenia is oriented towards the preparation of the conditions which will enable Slovenia to gain **access to the EMU** as soon as possible. The implementation of this guideline can be divided into three parts:

- first, *accession to the EU as soon as possible*,
- second, *accession to the ERM2 as soon as possible* - upon accession to the EU and
- third, *the shortest possible participation in ERM2* and transition to the EMU.

Accession to the EU does not legally and formally represent any new substantial limitation or obligation for the Bank of Slovenia itself:

1. free movement of capital should be fully liberalised by then,
2. the Law on the Bank of Slovenia will already be in compliance with the requirements of the EU.

The BS will have to conduct the exchange rate policy as a matter of common interest. The European Commission explains the notion of »considering the foreign exchange rate policy as a matter of common interest« as the prohibition of the use of the exchange rate policy for attaining competition advantages in commercial trade. The Internal EU Market should not be endangered by excessive fluctuations between the Euro and other EU currencies which would disrupt trade flows between the Member States.

More than accession to the EU itself, accession to the **ERM2** and then accession to the EMU are important for the implementation of the monetary policy. The intention of accession to the ERM2 is probably expected also in the pre-accession economic programmes of the candidate

countries.[2] To this end, of course, only a candidate country is obliged, while the EU is not bound to start the negotiations on accession to the ERM2 until the time of accession to the EU. Actually, it is on the basis of such a statement that the European Commission starts the informal "monitoring". The standpoint of the European Commission is that the membership of the ERM2 is not possible before the membership in the EU. Hence, it follows that informal discussions on joining the ERM2 may start before accession to the EU, while formally such an agreement can be effected only after accession to the EU.

Accession to the ERM2 means that the Bank of Slovenia will accept a fixed exchange rate arrangement against the Euro. The ERM2 is a bilateral agreement on the SIT/EUR central rate and also on maintaining the exchange rate within the permissible fluctuation band of ± 15% around the central rate (in case of the standard fluctuation band). The procedure of defining the central rate (and possible narrower fluctuation band) is in principle a matter of negotiation between the ECB, the ministers and governors of the EU Member States, the European Commission, the Economic and Financial Committee, and Slovenia. In case of disagreement about the central rate:

1. accession to the ERM2 (and therefore accession to the EMU as well) may be greatly delayed even after accession to the EU,
2. the Bank of Slovenia gains access to the ERM2 with the central exchange rate, which does not reflect the real value of domestic property and can therefore represent greater national economic expenses.

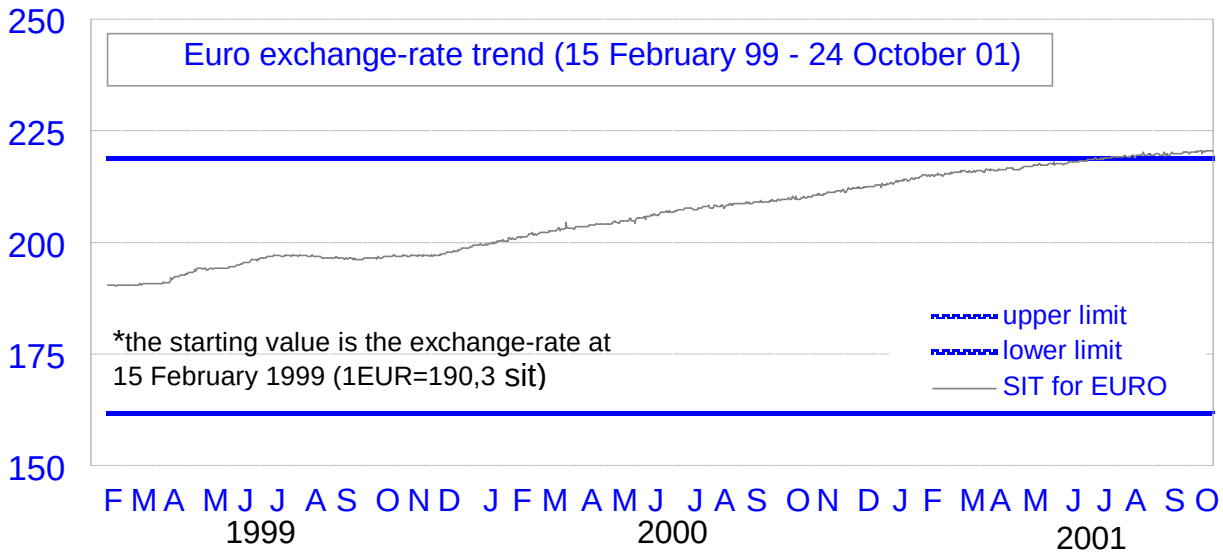
In the ERM2, the Bank of Slovenia must treat its exchange rate policy as a matter of common interest. The costs of remaining within the agreed margins will be shared by the Bank of Slovenia, other ERM2 Member States and the ECB.

It is not quite clear whether Slovenia has to comply with the convergence criteria for accession to the EMU in the whole period of its participation in the ERM2 or only before accession to the EMU by showing signs of meeting them in a "sound and sustainable" way. Although low inflation is not a pre-requisite for participation in the ERM2 (under nominal criteria), inflation exceeding that of the EMU area upon accession to the ERM2 would mean a great problem for Slovenia, i.e. the monetary policy has a narrower manoeuvre area for its operations because of a fixed exchange rate. Revaluation, however, is possible but only after the consent of the ECB and the ERM2 Member States. The exchange rate history of the Tolar against the Euro in the last two years was within the fluctuation band (See Picture). If we joined the ERM2 now with the central rate corresponding to the present exchange rate, and supposing that the future exchange rate fluctuations were similar to those in the last months, we would reach the upper margin of the

[2] The most explicit pre-accession programme regarding accession to the ERM2 is that of Hungary.

ERM2 fluctuation band in approximately three years. However, such participation in the system of the ERM2 is not recognised by the ECB and EU as meeting the nominal criteria.

Picture 1: The exchange rate of the Tolar and ERM2[3]



Fulfilling the nominal criteria means fixing an exchange rate and its trend near the central rate. Since inflation, considerably higher than that of the EU states, alongside a fixed rate could endanger macro-economic stability, it seems to us that the lowering of inflation to the level of the Maastricht criteria as early as upon accession to the ERM2 is one of the priorities of economic policy.

2.4. A possible timescale for accession to the ERM2 and EMU

Under an optimistic scenario, Slovenia would be integrated into the EU in 2004 and, at the same time, join the ERM2 system, and adopt the Euro in 2006.

Thereby, the monetary policy is given a formal long-term inflation target, i.e. an annual inflation from 3% to 4% until the end of 2005 (the second monetary target, i.e. a long-term interest rate is closely connected with inflation), in which we must be aware that present inflation in the Euro area is quite high. Since, according to this scenario, Slovenia would join the ERM2 as early as in 2004, it should come very close to the mentioned target inflation by then.

[3] The average annual rate of nominal depreciation of the Tolar against the Euro in the last two years amounted to 5.8%.

According to less optimistic scenarios, when accession to the ERM2 is more distant in terms of time, the Bank of Slovenia has more time to lower the inflation to the target level of 3% to 4% at an annual level.

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Deriving already from the above-mentioned facts, the monetary policy has already been given a **long-term inflation target**. The question is what is the desired process of disinflation – whether with gradual or fast jumps. Until accession to the ERM2, the monetary policy has entirely free hands to choose the exchange rate regime which also has an influence on the choice of the short-term and operative goals of the monetary policy.

3. WAYS AND DYNAMICS OF TRANSITION TO THE EMU

3.1. The impact of transition on the conduct of the monetary policy

In the period prior to Slovenia's accession to the EMU, the conduct of the monetary policy will depend on the changed economic circumstances in which the Bank of Slovenia will operate and also on the need to create the conditions to reduce disparities between the economic development levels of Slovenia and EU Member States on the one hand, and on the other hand on the requirements to meet the nominal convergence criteria for accession to the EMU and taking into account the institutional arrangement for the implementation of the common monetary policy in the ECB. While accession to the EMU is conditioned by fulfilment of the nominal criteria (a rate of inflation, general government deficit, public debt, relative interest rates), a prior achievement of economic integration of the Slovenia's economy is a sufficient implicit condition (not formally defined).

The correlation between the dynamics of reducing disparities in the economic development levels or real convergence based on relatively stronger growth of the Slovenia's economy induced by the stronger growth of productivity, particularly in the tradable sector, and the fulfilment of nominal convergence criteria defined by the Maastricht agreement, has a direct impact on real exchange rate trends. The long-term dynamics of real effective exchange rate is the result of the fundamental structural changes in the economy, leading to the permanent changes in relative ratios between individual economic variables. The new relative ratios can be established only when accompanied by stronger or weaker inflationary pressures. Accelerated real convergence induced by higher growth of productivity (than that of the EU Member States) is therefore in contradiction with the fast reducing of the disparities between the inflation rate of the Slovenia's economy and that of the EU Member States. Real appreciation of the Tolar is an inevitable consequence of the reduction of disparities in economic development levels. However, real appreciation of the Tolar is acceptable only to the extent resulting from the relatively stronger growth of the productivity of the Slovenia's economy and not to the extent resulting from economically unsound borrowings abroad or the utilisation of the mentioned factors of production.

In the above context, the need to define two goals, reflecting the tendency to establish the balance between the real EU convergence and the movements of nominal variables, can be observed:

1. approximation to a long-term sustainable (balanced) nominal foreign exchange rate which, on adoption of the ERM2 system will represent the central rate of the Tolar.

2. attaining price stability or attaining an inflation rate comparable to the European one.

3.2. The transmission mechanism of the monetary policy and foreign exchange rate policy

Pursuant to a new Law on the Bank of Slovenia, the final objective of the monetary policy is to attain price stability. Attaining medium-term price stability is consistent with the purpose of the monetary policy to establish, together with other economic policies, the conditions for stable economic growth and general welfare.

Decision-taking regarding the conduct of the monetary policy directly depends on the course of the monetary transmission mechanism or the role of an individual transmission channel for attaining the final objective. In the conduct of the monetary policy, the Bank of Slovenia makes use of various transmission channel levers, which is reflected in the choice of economic variables by means of which it controls price stability. By changing the interest rates of the monetary policy instruments[4] and the interest rates of the bills, it controls the growth rate of the monetary aggregates, particularly the M1 aggregate in a narrow sense, and to a negligible extent the growth of the broad M3 aggregate. The growth rates of the narrow monetary aggregates are relatively closely connected with the growth of nominal volume of transactions in the economy as an indicator of economic activity.

Due to the great openness of the Slovenia's economy, the impact of a foreign-exchange transmission channel on the behaviour of the real sector is evident. By changing the intervention foreign exchange rates (or by foreign-exchange intervention buying / selling), the Bank of Slovenia controls the dynamics of foreign exchange market rate growth. Through the import price trends, this has a direct influence on the growth of the consumer price index and, through the borrowings of companies and banks abroad, an indirect influence on the growth of total credit offer financing domestic demand. Besides defining the described influences on the changes in price levels, the foreign exchange rate also defines the relative price ratios of domestic and foreign goods and services (the rate of purchasing power), which has an impact on establishing an external economic balance.

The significance of an interest rate transmission channel is relatively negligible. The widespread use of the indexation of the lending and deposit interest rates of banks as well as other financial instruments, and until the end of 1999 the presence of interbank recommendation on setting deposit interest rates, have an influence on the slow reaction of banks to the changes in costs of refinancing by the central bank and to setting the bank's interest rates. This is furthermore induced by a surplus structural position in the money market which enables banks to manage

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[4] By setting quotas for operations on the open market (the 7-day and 60-day repos of the foreign exchange bills), the Bank of Slovenia directly controls the highest possible growth of the base money offer by these operations.

liquidity independently (as is seen in the high volume of the investments in the short-term Tolar bills).

Due to the complexity, interference and instability of monetary transmission channels, which change further because of the institutional changes in a transitional period, it is impossible to define the strategy of the monetary policy in a »monolithic« form (e.g. the strategy of monetary aggregate targeting, the strategy of exchange rate targeting or the strategy of inflation rate targeting). Therefore, when stating the reference value for a short-term objective of the monetary policy, the Bank of Slovenia defines the range of the growth rate of the monetary aggregate (from 1997 onwards, this is the M3 aggregate), however, this is not the only criteria value for taking decisions on the conduct of the monetary policy, as there are other economic variables, particularly the foreign exchange rate, which have a suspended effect on a price rise. The developments of the M3 aggregate, which by definition also comprises foreign exchange household and corporate deposits, are relatively independent of the changes in the volume of the base money offer, and its growth is influenced also by foreign exchange flows. The problem of the limited controllability of the M3 aggregate becomes even greater with the increased variability of international capital flows.

The operative implementation of the monetary policy of the Bank of Slovenia is based, similarly to the conduct of the monetary policy of the ECB, on two pillars:

The first pillar represents the volume of money in circulation, or all indicators which as far as possible directly reflect the development of the M3 monetary aggregate, as one of the key criteria values for the conduct of the monetary policy. Besides monitoring the reference value for a broad monetary aggregate, the Bank of Slovenia will monitor the individual components of the M3 aggregate as well. Special attention will be paid to the developments of M1 transaction money, mainly because of its connection with trends in economic activity and inflation, and because of its close connection with the base money. The first group of indicators in explaining the developments of the M3 aggregate consists of:

- The liquidity of the banking system, where the aggregate of surplus reserves reflecting free credit potential of banks is of special importance. Within the short-term liquidity of banks, it is necessary to take into account the portion of the Tolar bills in the total structure of the securities with a maturity of less than one year because of the extremely short maturity of these papers. What this matter is concerned with is that part of the secondary liquidity of banks which can be changed into the primary liquidity within the period of forming obligatory reserves.

- The short-term interest rate trend is a result of the changes in the commercial banks' interest rates, although the short-term interest rates influence the establishing of the

maturity structure of the commercial banks' interest rates at the same time, which has a direct effect on the changes in the structure of saving with banks, and the maturity structure of bank loans.

- The structure of the monetary aggregates is a result of the ratio between the transaction money, which directly defines demand in the economy, and those aggregate components which can be transformed into the transaction money in short or long time.

- The credit activity of commercial banks towards an individual national economic sector is important because of monitoring the ratio between final consumption and investment expenditure in the economy.

The second pillar. Adopting the monetary policy measures is not based on a mechanistical perception of the deviations of the M3 growth from the reference value which would result from movements in the above mentioned indicators, but on a reasonable consideration of a broad set of information offered by the second pillar indicators. The decisions regarding the conduct of the monetary policy are based also on other indicators significantly supplementing information on the economic situation and on the rate of expansive or restrictive aspects of the monetary policy. At the same time, these variables also explain the reasons for deviations in the developments of the M3 monetary aggregate and nominal GDP, and the need for taking them into account in further implementation of the monetary policy, either to a larger or smaller extent. The major indicators having an influence on price stability and the sustainability of the monetary policy are as follows:

- the balance of payments,
- the foreign interest rates and the interest rate difference,
- the foreign exchange rate is an indicator of the second pillar of the implementation of the monetary policy of the Bank of Slovenia, particularly in the periods without interventions in the foreign exchange market. In the periods of interventions, by determining the dynamics of the foreign exchange rate growth (or by the purchases of foreign exchange from commercial banks, by determining the margin on the foreign exchange market), the variable of foreign exchange rate functions in the role of the main instrumental variable.
- the wages in the economic and public sector,
- the price rises under the control of the Government of the RS.

The wages represent an important cost element and potential source of demand, both of which can have a significant influence on inflation and external balance. Due to the smallness and openness of Slovenia, the monitoring and analyses of the balance of payments are even more important than in other economies. The external balance is the basis of sustainable economic growth. Greater financial inflows and outflows can be a significant threat to the stability of the

economic environment. By analysing and influencing the difference between the foreign and domestic interest rates, we can avoid these dangers to a great extent. Therefore, these indicators represent the second pillar of the monetary policy on which the decisions of the central bank are based.

As in most small open economies, the foreign exchange rate has a special role. The foreign exchange rate directly and indirectly affects inflation through import prices, and represents an important element of competitiveness. The Bank of Slovenia considers the foreign exchange rate an instrument and agent which enables the control of the volume of money in circulation. On account of this special role of the foreign exchange rate and the high efficiency of the foreign exchange rate as a transmission mechanism channel in the economy, the Bank of Slovenia tries to influence its dynamics and, in co-ordination with the commercial banks, temporarily intervenes in the foreign exchange markets.

The information collected from both the financial and the real sector, and from international financial and trade flows, forms the basis for taking decisions in the monetary policy, which leads to a decrease of the inflation rate during a medium-term period, while simultaneously taking into account the real developments reflected in the real foreign exchange rate.

3.3. The restrictions in the conduct of the monetary policy in the transitional period

Due to the above-stated facts, the Bank of Slovenia will conduct the monetary policy which will allow »a soft transition« to a new real stability – the economic integration with the EU economy. The appreciation of the real exchange rate of the Tolar may be understood as an inevitable stability-oriented result of the transformation process. For a soft economic transition, it is, however, necessary to retain adequate nominal flexibility of the economic variables, in particular the nominal foreign exchange rate.

The policy of a soft transition requires the Bank of Slovenia to carry out a co-ordinated activity and monitoring of the processes in the following areas which represent the restrictions in the conduct of the monetary policy in a transitional period.

1. By the entry into force of a **new Foreign Exchange Act in 1999**, credit operations have been completely liberalised, however, the restrictions regarding short-term capital flows have been retained. By the Decision of the Governing Board of the Bank of Slovenia of 8 June 2000, the following timescale for the liberalisation of the remaining restrictions on international capital flows was set:

- the liberalisation of the restrictions on physical transfers of financial means of residents from or into the Republic of Slovenia (until the end of 2001).

- the liberalisation of the restrictions on the opening of current and deposit accounts for individuals abroad (until accession to the EU).

- the term after which a non-resident need not pay a premium for the purchase of foreign exchange with the BS will eventually be shortened (at present, this term is limited to six months).

- the elimination of the obligatory payment of a premium for the purchase of the rights to buy foreign exchange with the BS in the amount of the balance at a safe custody account (the end of 2002).

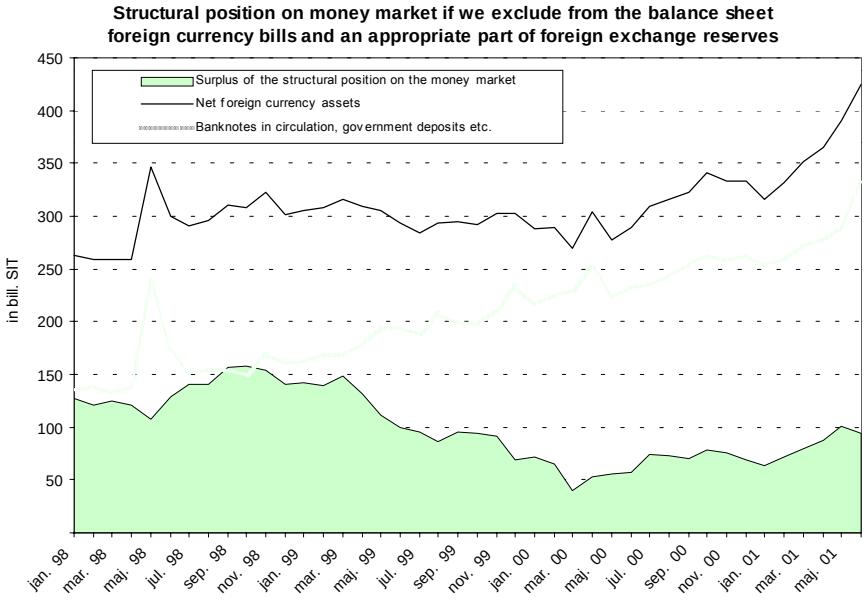
On 13 November 2001, the Governing Board of the Bank of Slovenia decided to speed up the liberalisation of capital flows and eliminated all the restrictions on cash transactions and all the restrictions on operations in securities. The mentioned decisions shall take effect on 1 January 2002.

The restrictions directly or indirectly affected concluding operations with securities, opening of current and deposit accounts abroad, and transfers of domestic and foreign exchange cash and securities. The dynamics of capital flows will be furthered also by the privatisation of state assets in the banking sector and in the telecommunications sector. The elimination of capital restrictions together with the expected greater variability of international capital flows requires systemic regulation and supervision of the foreign-exchange and liquidity risk management with which the banking system is faced. The regulations governing the systemic impacts of foreign-exchange and liquidity risks (i.e. liquidity rating, methodology of capital adequacy assessment) will ensure the stability of a banking system during the transition. Besides that, the elimination of the remaining capital restrictions will further reduce the possibility of control over the movements of the M3 monetary aggregate.

2. **Changing of the monetary transmission mechanism** will be a consequence of setting interest rates depending on the desired dynamics in the foreign exchange rate and the volume of the base money offer. Setting interest rates will be in the function of the relative price of the Tolar liquidity. The desired dynamics in the foreign exchange rate, which will be manifested also through forward purchases of foreign exchange by the Bank of Slovenia from the co-operating banks, will mean a gradual approximation to the central foreign exchange rate which the Slovenia's economy will face following a bilateral agreement on adoption of the ERM2 system.

3. **The promotion of interest rate monetary transmission** through setting interest rates for refinancing with the BS on the basis of the pledged foreign exchange property requires a developed (foreign-exchange and Tolar) money market. It is particularly important to establish institutional conditions for effective secondary trading on the money market (organised, standardised trading in financial forms, ensuring liquidity of the money market with market maintainers, transparent information on a price and interest rates on the money market in real time for major and most important participants, etc.). This is the only possible way to expect a more effective transfer of information from the instruments of the BS to a real sector. Within a wider sphere of establishing conditions for strengthening the interest rate channel of transmission, there is also the process of the abolition of the indexation of financial ratios which would be possible only with effective functioning of the money market.

4. The efficiency of employing the interest rate transmission channel of the monetary policy is, besides other stated factors, influenced by **a structural position in the money market**, which the central bank has to deal with. The Bank of Slovenia conducts the monetary policy in circumstances of a surplus structural position in the money market. Actually, it is the surplus structural position that prevents a faster development of operations on the open market to offer the base money by which the Bank of Slovenia could signalise the situation of the monetary policy and influence the setting of short-term interest rates. The surplus structural position in the Slovene money market, which has ranged between 24.5% and 1.2% of the monthly balance sheet of the central bank since 1996, required a net withdrawal of liquidity from circulation or more intensive use of instruments, which made it possible to change the structural position (the sale of the BS securities). In such circumstances, the conduct of the monetary policy, in the sense of its influence on the formation of short-term interest rates, is relatively more difficult than under the conditions of a deficit structural position when a central bank takes the role of a net bidder of liquidity in the banking system. The occurrence of a structural position in the money market is, however, closely connected with the volume of foreign exchange inflows and the wish of the Bank of Slovenia to have an active influence on the movements of a foreign exchange rate.



5. **The need for the development of the money market** because of the promotion of the interest rate monetary transmission is also connected with reducing the financial load of commercial banks in the form of obligatory reserves and the foreign exchange minimum. By means of increasing the part of non-banking financial intermediaries and opening of the banking system to direct foreign competitors, the institutional regulations which, besides other factors, influence the costs of the financial intermediary of the Slovenian banks, should be aligned with the ECB regulations. This includes mainly the alignment of the system of obligatory reserves. In general, this means:

   a) lowering the rates of obligatory reserves from values presently in force (12% for sight deposits, 6% for fixed-term deposits from 31 to 90 days, 2% for fixed-term deposits from 91 to 180 days, 1% for fixed-term deposits from 181 days to one year, 0% for fixed-term deposits tied for more than one year) to 2% or 0% depending on the type of obligation and its maturity.

   b) the adjustment of the basis for the computation of the obligatory reserves according to maturity and equal treatment of the Tolar and foreign exchange obligations. In Slovenia, the regulation on the obligatory reserves governed only the subject of the Tolar deposits but not the foreign exchange deposits which were regulated by the regulation on the foreign exchange minimum.

   c) the increase of the interest rates on the obligatory reserve from the present 1% to a market level.

The adjustment of the parameters of the obligatory reserve system will bring about the release of the liquid funds of commercial banks and thus influence the rise of the monetary multiplier through a greater credit activity. The costs of managing the base money offer will rise. The listed reasons speak in favour of the gradual adjustments of the rates of the obligatory reserves, which, however, is not a restriction to the relatively faster process of methodological alignment with the ECB regulations governing the way of data collection for calculating the obligatory reserves. On the other hand, the changes of the obligatory reserve system – particularly a decrease in the effective rate of obligatory reserves from 5.16% (in August 2001) without taking into account the effective rate of the foreign exchange minimum at a level of approximately 2% – have an influence on decreasing the interest rate margin.

3.4. Tools for the implementation of the transition

The tools for the implementation of the monetary policy and foreign-exchange rate policy, which will be used by the BS, can be divided into two groups in terms of contents:

a) the group of instruments which trigger the desired processes in the transmission mechanism through their influence on the key variables of the monetary policy and foreign-exchange rate policy (foreign exchange rate, interest rate, volume of the base money) and which function using the principle of engaging market levers in the behaviour of commercial banks.

b) the group of measures, which govern the systemic risks to which the banking system is exposed in the process of approximation to the EU. These measures define the limits of prudential and safe operating of the banks within which they implement their business policy.

Foreign exchange rate:

The possibility of direct impact on the dynamics of foreign exchange movements makes it possible for the Bank of Slovenia to actively take care of maintaining external balance (deficit in the current account of the balance of payments). Giving signals through the dynamics of the foreign-exchange rate growth within the existing Contract has an influence on international financial flows which are responsive to the changes of relative profitability. Since not all international financial flows are in the short-term highly flexible in terms of a price regarding the expected depreciation of the Tolar exchange rate (e.g. the inflow of equity capital), and since the expected depreciation does not even regulate the exchange rate transformation of the foreign exchange inflows realised with the BS, it is necessary to influence the volume of the issued base money by *the active formation of interest rates on a temporary sale or purchase of the foreign exchange from the BS*.

The Contract ensures the Bank of Slovenia the possibility to influence the dynamics in the foreign-exchange rate growth, which must be in accordance with the changes in relative ratios resulting from the relatively faster growth of the Slovenia's economy (particularly in the tradable sector) in comparison with the economy of the EU. This means that by maintaining the nominal flexibility of the foreign exchange rate the Bank of Slovenia can more easily balance between the »negative« consequences of the Balassa-Samuelson effect on the nominal categories – »catch up inflation« – and the indispensable real effects for reducing relative differences in the development level of economies. Regarding this, only those pressures on the real appreciation of the exchange rate of the Tolar, which result from the relatively faster growth of productivity and not from the increased borrowings abroad, the sales of assets to non-residents or the utilisation of the mentioned development factors, have to be taken into account.

According to the above explanation, the instrument of a final forward purchase (sale) of foreign exchange from co-operating banks is also used to give signals of dynamics in the foreign exchange rate being consistent with the long-term trend of the real appreciation of the exchange rate of the Tolar in a period of diminishing disparities in the level of economic development on the basis of the faster growth of productivity.

Interest rates:

By an active formation of interest rates on temporary sales or purchases of foreign exchange, the BS exerts influence on the volume of the monetisation of foreign exchange and acquires greater control over the volume of the issued base money. Setting interest rates on temporary sales of foreign exchange depends on the need to issue the base money, therefore the price affects the relative profitability ratios of the foreign exchange holdings and Tolar holdings of commercial banks allowing them refinancing with the BS. Thus, the interest rate transmission mechanism, which requires a developed money market for attaining higher efficiency, gains significance. The Bank of Slovenia will ensure further development of the money market, particularly that of the secondary market, with financial instruments which the BS will be ready to adopt for refinancing commercial banks. The meaning of an effective money market will even increase with the changing of the foreign-exchange rate regime, as the Slovenian financial system will be directly exposed to the fluctuation of interest rates on the European financial markets and to the difference in inflation rates.

Setting interest rates on a temporary purchase of foreign exchange is only one element in calculating the relative profitability of foreign-exchange and Tolar holdings. Therefore, in setting interest rates, the Bank of Slovenia will have to take into account the (expected) movement of the foreign exchange rate and the level of nominal interest rates on comparable Tolar holdings. The flexibility of setting interest rates will have to be greater than the flexibility of setting interest rates for the Tolar instruments of the monetary policy.

Foreign-exchange rate risk management:

Foreign-exchange rate risk management on the level of a banking system is fully governed by a decision on the capital adequacy of banks and savings banks. The methodology of calculating capital adequacy is harmonised by the *aggregate gross method* for individual foreign currencies, taking into account a foreign exchange clause as an »individual currency«. In this way, the greatest possible control is exerted to avoid the exposure of the banking system to foreign exchange risks occuring in circumstances when the assets of banks in foreign currencies represent 34% of the total balance sheet assets and when the major part of these assets owned by residents, is relatively sensitive to the exchange rate changes and to the changes in the relative profitability of savings in domestic and foreign currency.

Liquidity risk management:

The systemic regulation of liquidity risk management is connected with the fact that the banking systems in transitional economies are much more sensitive to the changes in the economy and in the international financial environment than are the developed financial systems, and that the Slovenian banking system is also characterised by a relatively high volume of foreign exchange savings of residents. In spite of well regulated guarantees for bank deposits in foreign currency, there is a much greater possibility of a rush on banks to withdraw foreign currency than domestic money (the central bank issues final money only in its own currency). Therefore, it is reasonable that banks hold liquid assets in foreign currency for short-term deposits in foreign currency and do not use liquidity in domestic currency for paying out foreign currency deposits. The changes in the foreign exchange rate, which would be induced in case of extensive and fast converting of the banks' Tolar liquid assets into foreign currency assets required for the withdrawals from foreign currency deposits, would have great national economic consequences.

Banks are obliged to establish adequate maturity and a foreign exchange structure of assets in accordance with collected resources. The decision on a minimum volume of liquidity requires banks to form Tolar as well as foreign currency liquidity scales with separated time-bands: from 0 to 30, and from 0 to 180 days. Banks have to fulfil the prescribed rate of assets covering the liabilities within all four categories. The ratios between assets and liabilities may change in dependence of their impact on the volume and costs of financial intermediary of banks within the frames of acceptable systemic risks. If the BS takes on the liquidity risks of the co-operating commercial banks, it is not reasonable to separate the requirement to establish assets in adequate currency for foreign currency and Tolar savings with these banks. A single liquidity scale with two time-bands of matching assets with the liabilities from 0 to 30 days and from 0 to 180 days is to be set.

4. TWO-YEAR ECONOMIC TREND FORECASTS

Projections are based on the data available up to 7 November.

4.1. International environment

In the international environment, we can still observe uncertainty regarding the further decrease in economic growth, which was lower than expected in the first half of the year, and the emergence of guesses as to when a new drive to economic activity will occur again. After the September events in the USA, it became obvious, in fact, that the world economy will need a lot more time than usual to gain a fresh impetus.

Since international forecasts on economic growth switched downwards, we lowered our assumptions regarding the growth of foreign demand, the most uncertain of which are the estimations regarding the demand from the ex-Yugoslavian and ex-Soviet Union countries, the portion of which in total export should increase at least in the following year.

Although the forecasts at the beginning of the year talked about lowering inflationary pressures, the international levels of a price rise over the whole year even increased on account of still high prices of oil, and, in the EU, also because of higher prices of food and weakening of the value of Euro. On the basis of the expected slowdown of oil prices (these should – assuming a slower world economic growth – move in the lower half of the OPEC target band between 22 and 28 USD per barrel), of the relatively unchanged level of commodities' prices and gradual strengthening of the Euro, a lower price rise in the EU is expected in 2002 and 2003.

The reactions of foreign central banks to modest economic growth and inflationary pressures were very different. Until the end of 2001, international interest rates are supposed to decrease slightly, while, according to the forecasts of foreign institutions, we presume them to remain unchanged for the following two years.

In spite of an assumed increase of the value of the Euro in comparison to the American Dollar in 2001, which we included in our previous forecasts, the Euro was still losing value in the first half of the year and a slight increase of its value followed only in the second half of the year. The expectations of the international institutions are lately inclined to a slower pace of changing the EUR/USD ratio in favour of the Euro than were shown in the forecasts at the beginning of the year. Therefore, in our forecast for 2001 and 2002, we included the EUR/USD ratio by approximately 10% lower than in the assumptions used in the forecasts in April.

Table: The basic indicators from the international environment

in %	Realisation			Forecast		
	1998	1999	2000	2001	2002	2003
Foreign demand	10.2	6.9	10.5	3.8	4.2	5.6
USD/EUR	1.122	1.067	0.924	0.897	0.921	0.926
Oil USD/barrel	12.8	17.9	28.5	25.4	24.3	22.0
Commodities	-18.0	-9.5	3.2	-2.6	-0.8	0.2
Inflation in the EU	1.1	1.1	2.3	2.7	1.4	1.4
PPI Germany	-0.3	-0.3	3.3	1.6	1.7	1.0
LIBOR EUR 3m	4.0	3.0	4.4	4.2	3.2	3.2

Source: ARC

4.2. Activity, employment and wages

The forecasts for domestic economic activity are influenced mainly by the lower growth rates and uncertainty regarding the future international developments, and the expectations of gradual recovery of the individual components of domestic consumption. Thus, in this year and the following one, economic growth will be considerably lower than in the previous years, while growth, which will be somewhat closer to a long-term average – will, according to our projections, be reached only in 2003.

We estimate that GDP will increase by approximately 3% this year and in 2002, whereby this year's growth rate will be slightly higher, while in 2002, it will be lower owing to low foreign conjuncture and a slow pace of domestic demand growth. Higher growth, similar to a long-term average, is expected only in 2003 when economic activity should increase by approximately 4%.

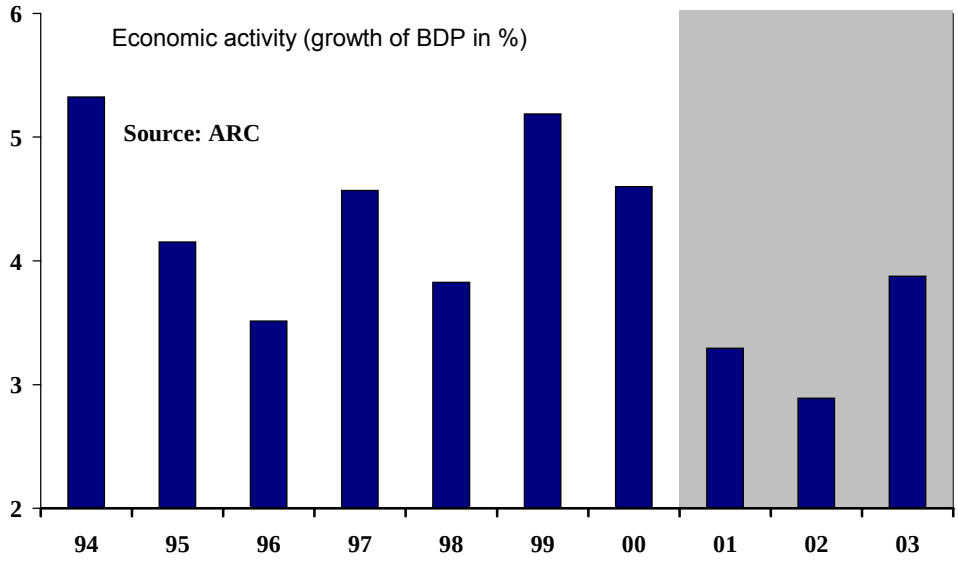
				Forecast		
	1998	1999	2000	2001	2002	2003
	real annual growth rates in %					
Activity, employment, wages						
Real GDP	3.8	5.2	4.6	3.2	2.9	3.9
GDP per capita (in USD	9,782	10,044	9,062	9,386	10,225	10,899
Employment	0.0	1.2	1.1	0.9	0.5	0.5
Net wages (real)	1.6	3.2	1.4	3.1	1.7	2.1
Productivity	3.8	4.0	3.5	2.3	2.3	3.4

Source: ARC

In the following years, a slightly slower employment growth is expected due to a somewhat worse outlook regarding economic growth. So, in 2002 and 2003, employment is expected to increase by 0.5% annually, mainly due to greater employment in services which will be a result of the recovery of domestic demand and anticipated employment in public administration.

The relatively fast growth of wages in 2001 will gradually slow down in the following two years, although the social partners have not yet concluded an agreement on the wage policy, and in spite of the fact that certain wage rises in 2002 have already been agreed for the public sector. We estimate that wages in 2002 will rise by 2.0% in real terms and in 2003 by 2.1%.

Thus, given the assumed developments of activities, wages and employment – except in 2001 when wage growth in real terms is expected to be faster than the growth of productivity – the wage growth will be lagging behind the productivity growth. With the expected recovery of economic activity, the difference between the wage growth and the productivity growth within the assessed period should even increase.



4.3. The components of the Expenditure of GDP

Similarly to last year, the greatest contribution to economic growth in 2001 will be that of international trade. In the second half of the year, we expect additional strengthening of all the components of domestic demand, in spite of which it will only modestly contribute to economic growth, much the same as in 2000. We estimate that in the following two years the domestic demand will add to the growth of GDP a great deal more than will international trade.

This year the direct impact of international events on the domestic economy will, in spite of the high growth of export to the countries of the former Yugoslavia and the SU, be reflected in a decreased export demand, and an indirect impact only through a gradual recovery of the individual components of domestic demand.

				Forecast		
	1998	1999	2000	2001	2002	2003
	real annual growth rates in %					
Domestic demand						
Domestic demand	6.0	9.1	1.1	1.2	2.8	4.7
Private consumption	3.3	6.0	0.8	2.3	2.5	4.3
Government consumption	5.8	4.6	3.1	2.5	2.9	3.9
Gross capital formation	12.4	18.9	0.5	-1.9	3.5	6.2

Source: ARC

Private consumption will gradually recover and, after a considerable slowdown in 2000 and 2001, will regain the annual growth rates of between 3% and 4%. We expect household consumption to strengthen mainly due to relatively high rises in wages and low rates of indebtedness. In spite of its strengthening, the portion of household consumption in GDP will stagnate in the following years, and will not be the main source of economic growth.

Decisions on investments are closely connected with a general economic activity and depend particularly on expectations. This holds true especially for private sector investments which – with better prospects for economic growth after a decline in 2001 and more favourable conditions for domestic and foreign financing in the following two years – are estimated to become again one of the basic factors of economic growth. A higher growth rate of investments in the private sector will be partially limited by an expected increase of corporate investments in the countries of ex-Yugoslavia. Therefore, we assume that the total capital formation will, in spite of the anticipated – and forecast in the budget memorandum – increase in the volume of government investments, have an annual growth of between 4% and 5%, which is a considerably lower rate than the several years' average before 2000 when annual growth rates exceeded 10%.

Government consumption will be slightly lower in the following two years than the several-years' average due to the forecasts of relatively slow economic growth, intended greater investments and the tendency to lower public financial deficit, so that the annual growth will amount to around 3% in 2002 and 4% in 2003.

Taking into account the relatively slow growth of the individual components of domestic consumption and the expected improvement in the balance of international trade in goods and

services, we estimate that domestic savings in the following years will increase and should reach a level of 26% of GDP in 2003.

4.4. External balance and the conditions of financing

The two factors that contributed most to a distinctive improvement of deficit in the international trade of goods and services in the first nine months of 2001, which dropped to the level of 0.4% of GDP, were strong foreign and low domestic demands.

The export in the first half of the year, when exporters managed to compensate gradual weakening of demand from the EU with sales to the countries of the former Yugoslavia and the SU, were above expectations, while the growth of absolutely all the components of domestic demand was very moderate at the same time.

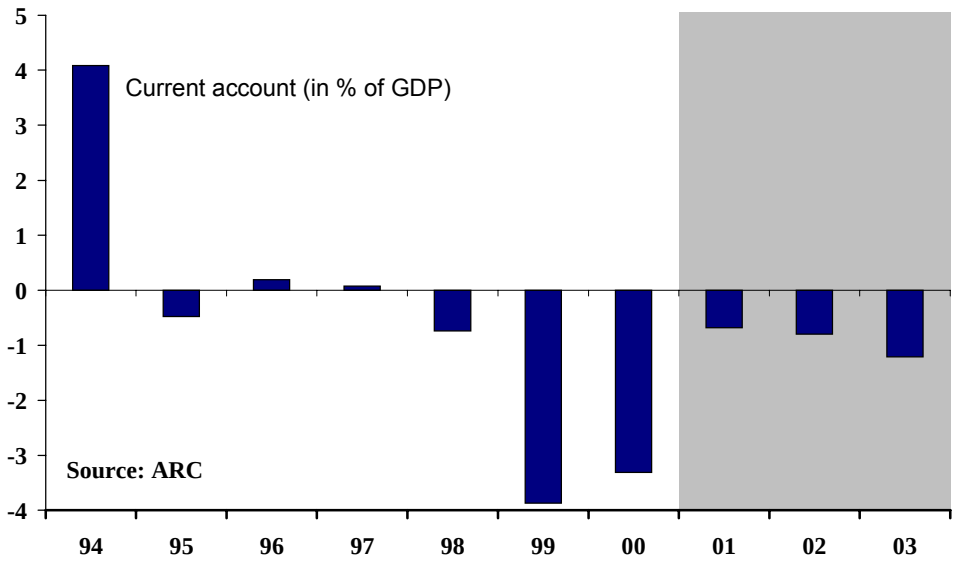
In the second half of 2001, we expect only minor improvements in trade balance in comparison to the first half of the year. Foreign demand will slow down. The import of consumer goods, and particularly the import of investment goods, which were, in the first half of the year, by more than a tenth lower than in the same period last year, will eventually strengthen on account of the gradual recovery of domestic demand. Due to the slight consequential invigoration of economic activity at the end of the year, the import of reproduction materials will also increase. In the structure of the import of goods in the following two years, the most significant will be the increase of the import of investment goods, while with the import of consumer goods only a gradual increase is anticipated.

				Forecast		
	1998	1999	2000	2001	2002	2003
		real annual growth		rates in %		
Current account						
Exports of goods and services	8.3	3.9	11.3	6.0	3.8	5.0
Imports of goods and services	10.9	9.2	3.6	2.7	3.5	6.2
Current account: in mil USD	-147	-783	-594	-132	-161	-250
in % GDP	-0.7	-3.9	-3.3	-0.7	-0.8	-1.1
Terms of Trade	2.5	-0.4	-5.2	0.6	0.8	0.8

Source: ARC

We estimate that, in the following two years, the external imbalance will still remain at a sustainable level with current deficit inclining towards a level of 1% of GDP. Maintaining a sustainable balance will – besides anticipated gradual strengthening of foreign demand – also be underpinned by improving trade conditions.

The forecasts of a relatively favourable development of exports include also the anticipated rise in the volume of trade with the countries of the former Yugoslavia. The increased trade flows with the countries of that area will, on the other hand, induce greater financial outflows through granting trade credits and loans abroad. The opening of these markets will also mean greater outflows through direct investments by the Slovenian companies abroad.



This year, the contribution of terms of trade to the balance of the current account will be positive, mainly due to low oil prices at the end of the year and the expected strengthening of the Euro against the American Dollar. We estimate that terms of trade will further improve in the following two years.

The balance of investment income will be further decreasing but much more slowly than projected in our forecasts in April. External debt will remain greater than the foreign exchange reserves, however, in a relative sense – due to high inflows from foreign direct investments which do not increase external debt – it should grow at a slightly slower pace.

* * *

The expectations regarding the developments in the real sector of the economy and assessments of a deficit in the current account of the balance of payments, and a series of uncertainties connected with this, will be reflected also in the ways and conditions of financing economic entities.

In the following years, the current account deficit will be entirely covered by capital inflows. In the whole year of 2001 and in the following two years, we expect, mainly due to the privatisation of state assets and borrowings by the private sector abroad, high financial inflows from abroad

which will jointly reach a level slightly above 6% of GDP in 2002 and slightly above 4% in 2003. Regarding this, the net foreign direct investments in Slovenia will amount to around 4% of GDP in 2002 and around 2.5% of GDP in 2003.

				Forecast		
	1998	1999	2000	2001	2002	2003
Capital flows						
Net financial inflows (% of GDP)	1.8	3.2	5.8	5.8	6.5	4.3
of which: foreign direct investments	1.3	1.1	1.3	2.6	4.0	2.5
			stock	year-end		
Foreign-exchange reserves (in mil USD)	4,781	4,115	4,376	5,162	6,423	7,056
- as % in GDP	24.6	20.6	24.3	27.5	31.4	32.4
External debt (in mil USD)	4,915	5,400	6,217	6,879	8,077	8,908
- as % in GDP	25.2	27.0	34.5	36.6	39.5	40.9

Source: ARC

The borrowings of companies from domestic and foreign banks will increase. The main reason for this assumption is the gradual recovery of investment activity. Since we estimate that domestic banks will not be able to satisfy the total demand of companies for loans, we expect that the share of the borrowings of companies abroad, which totalled slightly less than a half last year, will not decrease but will continue to remain at this level in the future. This will be supported by the formal opportunity of opening accounts abroad which will facilitate credit taking abroad. Faster increasing of the share of financing of companies in favour of foreign loans will be prevented mainly by Slovenia's approaching to the EU and by the opening up of the Slovenian financial system which will increase the competitive position of banks, and thereby the possibilities of domestic crediting. By the expected extension of the maturity of deposits, banks will also be given the possibility of increasing long-term crediting.

The basic reason for weak retail crediting this year is low private consumption. The purchase of durables was done before the introduction of the VAT, while at the same time individuals began to save on the long-term, also on the basis of the housing saving scheme and partly because of the pension scheme reforms. Since we expect growth in household consumption, we also anticipate that the same will be supported by retail crediting.

We estimate that the trend of increasing indebtedness of the state with domestic banks will continue to the end of 2001, and afterwards will slow down. The government sector deficit will also be partly financed by indebtedness on the domestic financial market this year, whereby loans will prevail. In the following two years, when the Government does not plan new issues of Euro-bonds but only minor additional issues of the existing ones, the need for its financing will be greatly reduced, in spite of the projected higher public finance deficit in 2002 on account of a

lesser volume of the liabilities falling due and expected inflows from privatisation. Therefore, in the following years, we do not expect greater pressures from the State on monetary aggregates, to increase interest rates, and through this to crowd out the private sector.

Since we expect high inflows from privatisation, regarding the volume of state property the Government is planning to privatise (banks, Telekom, etc.), and according to the presently known terms for privatisation, we expect a reduction of the public debt.

				Forecast		
	1998	1999	2000	2001	2002	2003
			annual growth	rates in % (year-end)		
Banking system						
M1	21.6	21.3	7.0	8.9	12.5	13.5
M3	21.0	16.0	16.5	20.3	15.3	12.3
Domestic credits	22.8	20.7	17.8	20.5	16.4	15.0

Source: ARC

In spite of the reduced current account deficit and of the expected inflows in financial account of the balance of payments, both from the equity investments and from the debt instruments, we estimate that the increased demand of households and companies to raise loans, will be reflected in a smaller part of net foreign assets and slightly greater part of domestic crediting during the emergence of a broad monetary aggregate. The projected recovery of economic growth on the basis of domestic consumption which will also induce greater demand for loans and higher balance of payments inflows – part of which will be transferred to foreign exchange reserves – will cause the growth rate of a broad monetary aggregate to decrease at a slightly slower pace than we forecast in April.

4.5. Inflation

The price rise at the end of the year will to a great extent exceed our expectations from the beginning of the year as the values of all variables which we had assessed as unstable, actually deviated in the direction of increasing inflation.

First of all, the positive effect of the reduction of price pressures from abroad was delayed quite unexpectedly. The government policy, from the point of lowering prices, was rather tolerant in the area of administered prices and its closely connected financing of the budget through excise duties. The exchange rate policy allowed for relatively fast depreciation of domestic currency in the early months of the year and, doing so, through import prices influenced the setting of consumer prices and inflationary expectations.

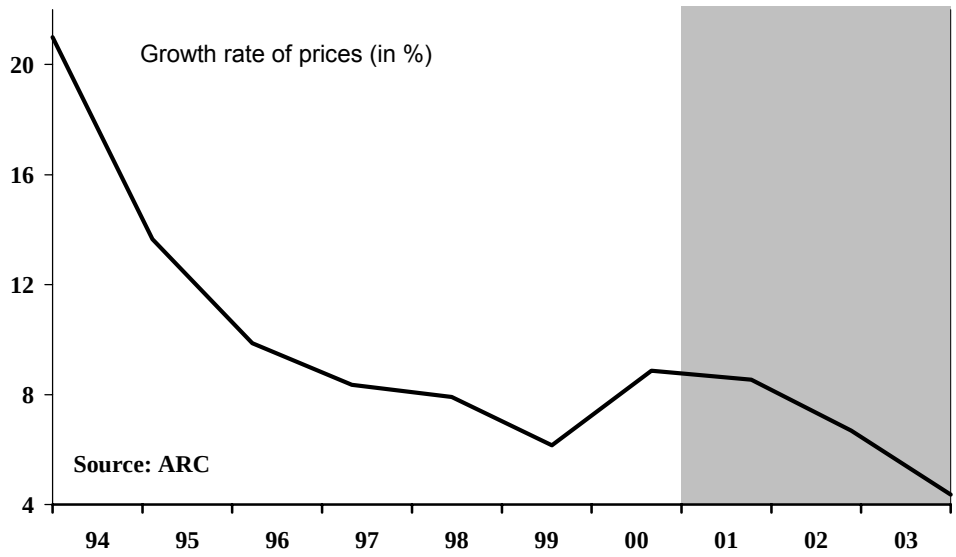
At the end of 2001, the inflation will amount to approximately 7.5% if, by the end of the year, the policy of administered prices is more moderate than in the first half of the year and if increasing excise duties for oil derivatives do not extremely slow down the transfer of lower world prices of raw materials to the domestic energy prices.

				Forecast		
	1998	1999	2000	2001	2002	2003
		annual growth		rates in % (year-end)		
Prices						
Consumer prices	6.5	8.0	9.2	7.5	5.8	4.1
Free prices	6.0	7.1	6.8	7.4	5.3	3.9
Administered prices	9.2	12.0	21.7	8.2	8.0	5.2

Source: ARC

The forecast for the level of a price rise until the end of 2001 and for the following two years is, in fact, based on the assumption that inflationary pressures from the international environment will finally slow down. The price of oil has for quite some time ranged around a level of about 20 USD per barrel, while we expect it to range in the lower part of the OPEC target band in the following two years. The Euro stopped losing value in comparison to the Dollar, and we expect a slight increase in its value in future. Mainly the development of these two variables can substantially contribute to a slow-down of external pressures on domestic prices.

The forecasts for inflation in the long-term are even more optimistic, as they project a gradual decrease of the level of a price rise to approximately 4.1% at the end of 2003. Consequently, we assumed that the administered prices will again overtake the growth of the average price index in 2002 and 2003, but by less than two percentage points per year.



THE SELECTION OF THE MAIN INDICATORS AND THE COMPARISON OF FORECAST RESULTS

	The for the year							
	2001			2002			2003	
	Forecast from			Forecast from			Forecast from	
real growth rates in % except where otherwise stated	Mar 01	Sep 01	Nov 01	Mar 01	Sep 01	Nov 01	Sep 01	Nov 01
Exogenous variables								
Foreign demand	5.0	5.0	3.8	5.0	6.9	4.2	6.9	5.6
USD/EUR	0,975	0.892	0.897	1.008	0.919	0.921	0.926	0.926
Oil/barrel	25.2	26.6	25.4	25.0	25.8	24.3	25.0	22.0
Commodities	-0.9	-3,0	-2.6	0.0	0.0	-0.8	0.0	0.2
Inflation in EU	2.1	2.5	2.7	1.3	1.6	1.4	1.6	1.4
PPI Germany	...	3.3	1.6	...	1.7	1.7	1.7	1.0
LIBOR EUR 3m	4.2	4.3	4.2	4.0	3.5	3.2	3.5	3.2
Activity, employment, wages								
Real GDP	3.4	3.5	3.2	3.3	3.5	2.9	4.3	3.9
GDP per capita (in USD)	10,247	9,409	9,386	11,034	10,326	10,225	11,091	10,899
Employment	1.0	0.9	0.9	0.5	0.5	0.5	0.5	0.5
Net wages (real)	2.8	3.4	3.1	1.9	2.8	1.7	2.2	2.1
Productivity	2.4	2.6	2.3	2.7	3.0	2.3	3.8	3.4
Domestic demand								
Domestic demand	3.5	1.1	1.2	3.8	3.5	2.8	4.4	4.7
Private consumption	3.2	1.6	2.3	4.2	3.1	2.5	4.0	4.3
Government consumption	5.1	2.7	2.5	3.0	3.1	2.9	3.5	3.9
Gross capital formation	2.9	-0.9	-1.9	3.4	4.7	3.5	5.9	6.2
Balance of payments								
Exports of goods and services	4.9	6.8	8.0	4.5	6.3	3.8	6.3	5.0
Imports of goods and services	4.9	2.1	2.7	5.2	6.1	3.5	6.5	6.2
Current account: in mil USD	-543	-320	-132	-675	-350	-161	-395	-250
in % GDP	-2.6	-1.7	-0.7	-3.1	-1.7	-0.8	-1.8	-1.1
Terms of Trade	1.7	-0.6	0.6	0.7	0.8	0.8	0.5	0.8
Net financial inflows (%GDP)	3.9	4.8	5.8	5.6	5.3	6.5	4.1	4.3
of which: foreign direct investments	1.4	1.5	2.6	1.6	2.9	4	1.6	2.5
Foreign exchange reserves (in mil USD)	4,928	4,780	5,162	5,492	5,729	6,423	6,212	7,056
- as % in GDP	24.1	25.5	27.5	24.9	27.9	31.4	28.3	32.4
External debt (in mil USD)	7,642	6,878	6,879	8,912	8,130	8,077	9,069	8,908
-as % in GDP	37.3	36.7	36.6	40.4	39.6	39.5	41.1	40.9
Banking system *(growth rates at year-end)*								
M1	19.5	14.6	8.9	14.0	18.3	12.5	14.9	13.5
M3	15.5	18.7	20.3	12.0	14.9	15.3	12.4	12.3
Domestic credits	16.8	19.4	20.5	14.7	16.0	16.4	14.7	15.0
Prices *(growth rates at year-end)*								
Consumer prices	6	7.7	7.5	4.5	5.7	5.8	4.2	4.1
Free prices	6.3	7.6	7.4	4.9	5.2	5.3	4.0	3.9
Administered prices	6.4	8.3	8.2	4.2	8.1	8.0	5.4	5.2

Source: ARC

5. THE FUNDAMENTAL GUIDELINES OF THE MONETARY POLICY OF THE BANK OF SLOVENIA

5.1. The objective of the monetary policy

The objective of the Bank of Slovenia is accession to the EMU as soon as possible. Thereby, the monetary policy is given a formal long-term inflation target, i.e. the European level of inflation by accession to the EMU at the latest. The Bank of Slovenia will endeavour to reach price stability by means of the monetary policy and will concentrate on lowering **inflation** to the level of 4% by the end of 2003. The decrease of inflation to 4% in the following two years is a demanding task, since, in spite of the expected favourable impacts on prices from abroad and a projected consistency of the monetary policy, it requires commitment to the goal and to the co-ordination of all the key economic policies.

5.2. The indicators of the monetary policy

The Bank of Slovenia monitors the **indicators of the first and the second pillars** with the implementation of the monetary policy. As an aid in the conduct of the monetary policy it has set the reference values for these indicators:

- **The first pillar represents money and its structure.** To the central bank, money is an important indicator, since, in the long run, inflation is principally a monetary phenomenon. By controlling the volume of money in circulation, the Bank of Slovenia will create stable conditions for financing and saving which will not be the source of inflationary pressures. The growth of the **broad monetary aggregate** which enables the decrease of inflation will gradually be reduced and will amount to between 12% and 18% in 2002, and between 9% and 15% in 2003 and will also reflect the increased saving. The creation of the broad monetary aggregate will, beside domestic credits, be still significantly influenced by financial inflows through the capital account of the balance of payments.
- The increase of the narrow monetary aggregate **M1**, due to the extremely low base from 2001 and expected lowering of inflation, will be strengthened and will catch up with the growth of broad money towards the end of 2002. The Bank of Slovenia will, as until now, devote special attention to the changes in the structure of the monetary aggregates and allow for the faster growth of the M3 monetary aggregate only if this reflects greater saving.

The **second** pillar of the monetary policy of the Bank of Slovenia comprises all other indicators which have a substantial influence on price stability and sustainability of the monetary policy. The fundamental elements and the values of the second pillar of the monetary policy are based on "The forecasts" prepared by the Bank of Slovenia:

- A reduced economic activity due to the worsening of foreign demand, particularly from the EU, and a gradual recovery of domestic consumption. **The roughly estimated economic growth is about 2.9% in 2002 and 3.9% in 2003.**
- The moderate growth of wages in real terms both in the public and in the private sectors which will not, through extensive consumption and costs, induce additional inflationary pressures and endanger the external balance. It is projected that the growth of wages in real terms will gradually slow down and the rise in 2003 will be under 2.5%. **The growth of wages in the public sector should not significantly overtake the wage growth in the private sector.**
- **The moderate deficit in the current account of the balance of payments** which should amount to around 1% of GDP. Thereby, it is assumed that the prices of commodities and oil on the world markets will slow down and that the exchange rate of EUR against USD will gradually increase.
- **The policy of administered prices,** which should not exceed the growth of common consumer price index by more than 2 percentage points.
- **The gradual reduction of the government sector deficit,** which should amount to 0.7% of GDP in 2003. The part of public finance expenditure in GDP should amount to around 44.5% of GDP.

Eventual greater or longer lasting deviations from the projected reference values of the indicators will continue to be a basis for the measures of the monetary policy in future. The Bank of Slovenia will regularly monitor the fulfilment of the stated projections and take decisions on its actions accordingly.

5.3. The monetary policy instruments

- The instruments of the Bank of Slovenia are adapted to the characteristics of the transmission mechanism which functions mainly through the channel of the **foreign exchange rate**. The Bank of Slovenia will support the growth of the foreign exchange rate which facilitates a gradual decrease of inflation and partial closure of the interest rates gap between the domestic and foreign interest rates. Deviations from the projected interest rate growth are possible in case of significant imbalances in the balance of payments of international trade, particularly the one regarding privatisation.

- The Bank of Slovenia will encourage functioning of the **interest rate transmission** of the monetary policy and more effective transfer of information from its instruments to a real sector. Within a wider sphere of establishing interest rate transmission, there is also the process of the abolition of the indexation of financial ratios, encouraging effective

functioning of the money market and reducing the financial burden of commercial banks. The Bank of Slovenia is aware that an obstacle to the functioning of this transmission mechanism is also the surplus structural position in the money market which is the result of strong inflows of foreign exchange.

- The movements of the **base money** will be similar to those of the M1 narrow monetary aggregate; its growth rate will therefore be gradually increased. This assumption is based on the relatively stable present ratio between the base money and the M1 (multiplier).

The Bank of Slovenia expects that, by means of this guideline, the monetary policy will contribute to the further maintenance of the stable macro-economic environment necessary for the normal functioning of both companies and individuals.

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