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EUROSYSTEM

ECONOMIC AND FINANCIAL DEVELOPMENTS WITH PROJECTIONS

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Executive Summary

As a result of revisions to the national accounts and stronger realisation in the first half of this year, the Bank of Slovenia's projections of economic developments have been revised upwards. GDP is forecast to increase by more than 2.5% this year, with growth averaging in excess of 2% over the next two years. The slowdown in growth compared with this year will primarily be a result of the dynamics in government investment. With the recovery in private consumption, the structure of economic growth is becoming better balanced. This is creating the conditions for solid growth in activity despite a decline in government investment, while at the same time stimulating growth in general government revenues, which is easing the fiscal consolidation process. This will continue to hold down growth in total final consumption. With the anticipated solid growth in exports, supported by improved cost competitiveness in the export sector, and with stronger performance on the domestic market, investment in machinery and equipment will gradually increase, which will contribute to the renewal of the technological capacity of the economy. The financing for this investment will primarily come from corporate financial surpluses, while domestic bank financing will not yet be a decisive factor. Inflation will rise only gradually over the projection period, and will not exceed 1.5%.

* * *

Of the components of domestic demand, a notable feature in these projections is the rise in estimated growth in private consumption. This was attributable to the revision to the national accounts for 2014, and faster-than-expected growth in employment and consumption in the first half of this year. The developments are now more in line with an increase in survey-based consumer confidence. Growth in private consumption will reach approximately 2% towards the end of the projection period, but will remain constrained by the breakdown of new hires, where uncertain, poorer-paid forms of work are prevalent. Stronger private consumption will promote employment in service activities. Because growth in labour productivity in private-sector services is rather low in general, a considerable decline in aggregate growth in productivity is also expected. Real consumer purchasing power will strengthen slightly faster, albeit largely as a result of growth in employment. Wage growth will depend primarily on the negotiations in the public sector and adjustments for inflation.

A major factor in developments in investment this year and in 2016 will be the end of disbursement of EU funds from the "old" financial perspective, and the beginning of disbursement from the "new" perspective. The significant decline in government infrastructure investment in 2016 and 2017 will gradually be compensated for by the private sector investment into machinery and equipment, which will improve the structure of investment. Taking the government plans partly into account, aggregate gross fixed capital formation will increase by just under 3% this year, and is expected to decline in 2016, as growth in private investment will not yet be high enough. Private investment will gradually increase throughout the projection period, as further improvements are expected in corporate results, and with utilisation of production capacity already high. The technological capacity of the economy will thus be gradually renewed, thereby increasing growth potential.

Although domestic demand will strengthen slightly faster, the export sector will remain the key factor in economic growth. Export growth in the first half of the year was higher than expected, as a result of which the estimate for annual growth is also higher, and is indicative of a further increase in the market shares of Slovenian exporters, having outpaced growth in foreign demand. Growth in industrial production will remain at a level of around 5%, in line with export growth, while stronger demand on the domestic market means that exposure to fluctuations in foreign demand will be slightly smaller *than in previous years. At the same time growth in the export sector is having a positive impact on numerous domestic suppliers of goods and services, which is additionally encouraging economic growth. As a result of the faster recovery in domestic demand, a gradual decline is expected in the contribution made to GDP growth by net exports, although the projected pace of import growth will not close the current account surplus.*

Economic growth will take place in an environment of low inflation. The inflation projection for 2015 is down 0.5 percentage points on the previous projection, as a result of a fall in core inflation and a fall in energy prices. Inflation is expected to gradually increase over the next two years, as commodity prices rise gradually and private consumption strengthens, but will remain below the monetary policy target level until the end of the projection period.

The risks to the realisation of these projections are relatively balanced. The largest uncertainty in the domestic environment is the amount of government investment, but the international environment entails the greater risk. This relates to the situations in Russia, China, Brazil and Turkey. The Volkswagen scandal could also have an adverse impact on export growth, as could any closure of borders because of the refugee crisis. By contrast, the ECB's quantitative easing programme could have stronger positive effects. The latter could also have a larger impact on inflation, where the uncertainties are related to oil price developments and, in the domestic environment, to wage growth.

* * *

Slovenia continued to outperform the euro area as a whole in terms of growth in the first half of this year. GDP growth stood at 2.7%, to which the export sector made the principal contribution. This year the export sector is again demonstrating its flexibility in the context of volatile foreign demand, having compensated for the decline in exports to Russia by exporting to non-traditional markets. On these markets, exporters' price competitiveness has been boosted by the ECB monetary policy. Tourism is also a major factor in export growth, the number of foreign visitors having increased sharply. The current account surplus remained around 7% of GDP. Household final consumption is gradually strengthening as employment rises and consumer confidence increases, which is encouraging growth in numerous private-sector services. The sole exception among the major sectors is construction, where activity has declined sharply this year in line with the decline in investment in buildings and infrastructure. However, an improvement in the structure of aggregate investment is already taking place, corporate investment in machinery and equipment having strengthened slightly in the first half of the year. At the same time the provisional figures suggest that economic growth has remained solid in the third quarter of this year.

Growth in employment in the first half of the year was stronger than expected, although structural weaknesses remain on the labour market. Employment was up 1.6%, the largest rise since 2008. Uncertain forms of employment remain prevalent, and the proportion of jobs that they account for is increasing. At the same time the number of self-employed is rising; their share of total employment is significantly higher than in the most developed European countries. Unemployment is continuing to fall, but there was a deterioration in this fall in terms of structure. The number of deregistrations for reason of employment is falling, which is also attributable to a decline in employment subsidies. At the same time the proportion of those registering as unemployed because their temporary employment has ended is increasing. Wage growth has slowed sharply this year as a result of its adjustment to deflation, but also as a result of the change in the breakdown of employment. This year's recovery in purchasing power is thus primarily occurring via an increase in employment.

Evidence that firms are not yet sufficiently confident that current economic growth will be sustained comes from Slovenia's 12-month financial surplus against the rest of the world. In the first quarter, surplus in national saving over investment stood at 6.5% of GDP. It is striking that corporate saving is already at the pre-crisis level, but investment is only just over half of the pre-crisis level, which is indicative of the autonomous investment potential of the corporate sector. With the exception of the general government sector, the domestic institutional sectors have recorded financial surpluses over *the last two years. The corporate sector primarily directed its surplus into paying down debt, while households directed their surplus into bank deposits, despite the sharp fall in interest rates. The restoration of confidence in the banks has improved their funding structure, thereby reducing systemic risks. Interest rates on corporate loans have fallen, but the banks remain cautious about investment, and their credit terms remain a strong limiting factor on the supply side.*

The improved economic situation is easing the fiscal consolidation process, although there remain considerable risks to the attainment of the fiscal plans. This year the key target in the fiscal realm is permanently eliminating the excessive general government deficit, i.e. reducing it to below 3% of GDP. In the wake of the positive developments on the labour market and growth in private consumption, general government revenues are strengthening. At the same time growth in general government expenditure remains low, but is still highly influenced by a large burden of interest payments on the public debt. These are estimated at 3.1% of GDP this year, although the burden will fall in the coming years as a result of the more favourable terms of government financing on international markets. The risks in the fiscal realm include those in relation to macroeconomic developments being less favourable than those expected when the fiscal plans were drawn up, to the upward pressure on expenditure from various interest groups and to the potential impact of expenditures of a one-off nature.

* * *

The Bank of Slovenia estimates that, in the absence of major shocks from the international environment, growth in the Slovenian economy will remain solid, and will be more sustainable than before the crisis because of the smaller role played by debt financing. Despite significant progress, numerous obstacles are still preventing growth from becoming more robust.

The corporate restructuring process is not yet complete. The Bank of Slovenia has been proactively involved in this process since the very start, and has been recently advocating a stronger focus on SMEs, which play a predominant role in the Slovenian economy. The successful completion of the restructuring of over-leveraged firms would release additional potential for investment and employment, which would improve the conditions for faster economic growth.

For firms to genuinely embark on more significant investment, confidence in sustained economic growth must first be established across society. This is largely dependent on the situation in the external environment, although the domestic business environment also has an important impact. Here the role of the government is key, as with zero tolerance to payment indiscipline and corruption, a flexible, professional and responsive public administration, and an efficient legal system it can ensure that the domestic business environment is stable and predictable. The vital fiscal adjustment must also remain gradual, without sudden measures that might interrupt the projected growth in private consumption.

								Projections					
								2015		2016		2017	
	2008	2009	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	3.3	-7.8	1.2	0.6	-2.7	-1.1	3.0	**2.6**	0.4	**1.9**	0.1	**2.2**	0.2
Employment	2.6	-1.8	-2.1	-1.7	-0.9	-1.4	0.6	**1.4**	0.8	**1.1**	0.7	**1.3**	0.9
Compensation per employee	7.2	1.8	4.0	1.5	-1.0	0.6	1.1	**0.7**	-0.4	**1.9**	0.6	**2.2**	0.8
Productivity	0.7	-6.1	3.4	2.4	-1.8	0.3	2.5	**1.1**	-0.5	**0.8**	-0.5	**0.9**	-0.7
ULC (nominal)	6.4	8.5	0.6	-0.8	0.8	0.2	-1.3	**-0.4**	0.1	**1.1**	1.1	**1.3**	1.5
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	4.0	-5.7	-2.7	-1.2	-3.7	-2.3	1.0	**1.2**	0.5	**0.7**	0.0	**1.7**	0.5
Net exports	0.2	1.9	2.0	1.3	3.0	1.1	1.6	**1.1**	0.0	**1.0**	0.0	**0.6**	-0.1
Changes in inventories	-0.9	-4.0	1.9	0.6	-2.0	0.2	0.5	**0.2**	-0.2	**0.1**	0.1	**0.0**	0.0
Domestic demand	*real growth rates, %*												
Domestic consumption	3.1	-9.5	-0.8	-0.7	-5.8	-2.2	1.6	**1.6**	0.4	**0.9**	0.1	**1.8**	0.4
Private consumption	2.4	0.9	1.3	0.0	-2.5	-4.1	0.7	**1.1**	0.6	**1.8**	0.6	**2.0**	0.7
Government spending	4.9	2.4	-0.5	-0.7	-2.3	-1.5	-0.1	**0.3**	-0.1	**0.4**	-0.1	**0.5**	0.0
Gross fixed capital formation	7.0	-22.0	-13.3	-4.9	-8.8	1.7	3.2	**2.9**	1.0	**-1.7**	-1.6	**3.2**	0.9
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	4.2	-16.6	10.2	6.9	0.6	3.1	5.8	**5.0**	0.3	**4.7**	-0.2	**5.0**	-0.1
Imports of merchandise and services	3.8	-18.8	6.8	5.0	-3.7	1.7	4.0	**4.0**	0.4	**3.9**	-0.2	**4.8**	0.1
Current account: EUR billion	-2.0	-0.2	0.0	0.1	0.9	2.0	2.6	**2.6**	0.4	**2.8**	0.5	**2.7**	0.2
as % GDP	-5.3	-0.6	-0.1	0.2	2.6	5.6	7.0	**6.7**	0.9	**7.0**	1.1	**6.6**	0.4
Terms of trade*	-1.3	3.5	-4.0	-1.4	-1.1	0.8	1.0	**1.3**	0.9	**-0.1**	0.6	**-0.8**	-0.1
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	1.9	0.4	**-0.6**	-0.5	**1.0**	-0.1	**1.5**	0.1
HICP excluding energy	4.9	1.7	0.3	1.0	1.8	1.9	0.7	**0.5**	-0.4	**1.2**	0.0	**1.6**	0.1
HICP energy	9.4	-4.5	13.9	8.8	9.0	1.8	-1.4	**-7.3**	-1.3	**-0.2**	-1.2	**0.9**	0.1
International environment	*growth rates, % (if not specified otherwise)*							Assumptions					
Foreign demand**	3.0	-13.7	10.0	6.8	0.7	1.8	2.2	**2.1**	-0.3	**2.7**	-0.5	**3.4**	0.0
Oil (USD per barrel)	98	62	80	111	112	109	99	**53**	-9	**54**	-14	**60**	-12
Non-oil commodities	10.3	-23.2	36.9	22.2	-14.3	-6.1	-8.6	**-19.7**	-8.7	**-4.6**	-7.2	**4.4**	-0.4
EMU inflation	3.3	0.3	1.6	2.7	2.5	1.4	0.4	**0.1**	-0.2	**1.1**	0.0	**1.7**	0.0
PPI Germany	5.3	-3.9	1.5	5.1	1.7	0.0	-1.0	**-0.8**	-0.3	**1.3**	-0.2	**1.5**	-0.3

* Based on national accounts deflators.

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

Δ : Difference between current projections and projections in Macroeconomic Developments and Projections, April 2015.

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

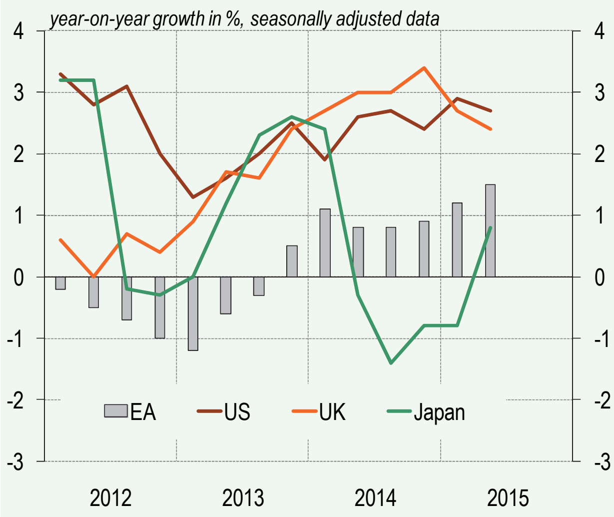
1 International Environment

The main features of the global economy this year have been slightly faster growth in advanced economies, a slowdown in developing countries and a sharp fall in oil prices. The euro area continued to record moderate economic growth in the second quarter and unemployment fell slightly, while the economic sentiment remained above its long-term average. At the same time the recession deepened in Russia and Brazil, while growth also slowed in China. Monetary policy in the majority of advanced economies remained expansionary. In addition to oil, prices of other commodities have fallen sharply this year.

Economic developments

The contribution made to global economic growth by advanced economies increased in the first half of this year. In the context of expansionary monetary policy, the depreciation of the euro and a fall in oil prices, euro area GDP in the second quarter of this year was up 0.4% in quarterly terms and 1.5% in year-on-year terms. This growth was driven primarily by net exports and domestic private consumption, which was solid despite the high unemployment rate. The rate fell slightly in the second quarter, but remained close to 11%. GDP growth in the US averaged 2.8% in the first half of the year, which was largely attributable to high growth in the second quarter under the influence of net exports and strong private consumption. The latter has strengthened as a result of the fall in the unemployment rate, which had reached 5.1% by August, the lowest rate since the first half of 2008. The

Figure 1.1: GDP in the major global economies



Source: Eurostat, BEA, Tradingeconomics.

Figure 1.2: Unemployment rate

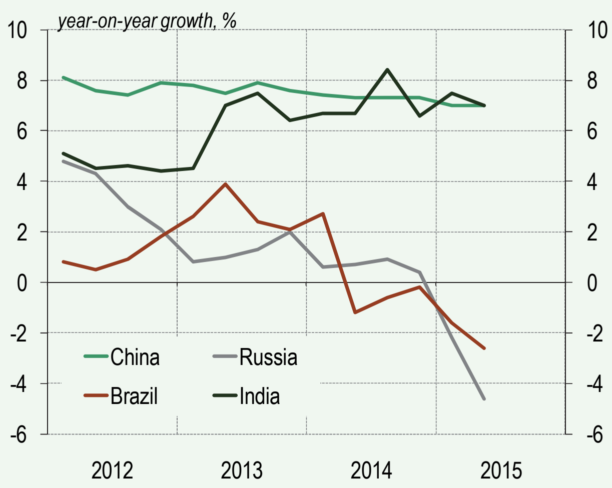
Source: Eurostat, FRED.

proportion of the population that is economically inactive remains high in the US, in the context of low unemployment. Economic activity in Japan has strengthened slightly this year, having contracted sharply in the second half of last year. GDP in the second quarter was up 0.8% in year-on-year terms. Of the other large advanced economies that are Slovenia's major export markets, growth in the UK remained solid at 2.5% over the first half of this year.

The contribution made to global economic growth by the BRIC countries has declined this year. Under the influence of international sanctions, the sharp fall in oil prices and the fall in the domestic currency, GDP in Russia in the second quarter was down 4.6% in year-on-year terms, the largest decline since 2009. The recession also deepened in Brazil, as a result of the decline in foreign demand and the global fall in prices of the commodities that are its key export products. It is also beset by political tensions. Growth in China has been gradually slowing for several years now. Owing to the structure of economic growth, which was primarily based on exports and very high growth in investment, economic growth in China has declined further this year, while the domestic stock markets have been shaken. Economic growth stood at just 7.0% in the first half of this year. This was also the rate recorded in India in the second quarter, down 0.5 percentage points on the first quarter. The slowdown was attributable to a decline in investment, a decline in government consumption, and lower export growth.

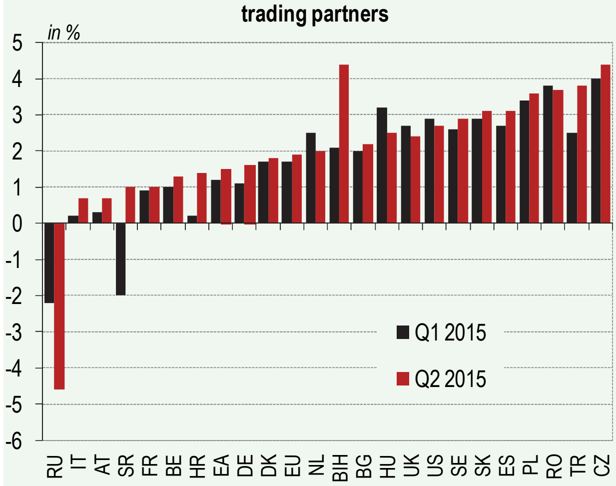
Economic developments were relatively favourable in the majority of Slovenia's main trading partners in the first half of this year. GDP in Germany in the second quarter was up 0.4% in quarterly terms, 0.1 percentage points more than the rate in the first quarter, and was up 1.6% in year-on-year terms. The main factor in the increase in economic growth was net exports, in the wake of the favourable impact of the fall in the euro. Economic growth slowed in the second quarter in Austria and Italy, and was unchanged in France. Other major EU partners recorded stronger economic activity in the second quarter, most notably Poland, where growth in the first half of the year remained around 3.5%. While there was a positive contribution from net exports, the high growth in Poland was also attributable to strong private consumption and gross investment. The latter has continued to record robust growth as a result of the utilisation of EU funds. Croatia, which emerged from a long recession this year, recorded solid year-on-year economic growth of 1.4% in the second quarter. The increase in GDP was the result of net exports, whose positive contribution was partly attributable to a very good holiday season. Private consumption also increased as unemployment fell. After declining sharply last year in the wake of heavy floods, economic activity in Serbia has strengthened this year. GDP in the second quarter was up 1.0% in year-on-year terms, primarily as a result of increases in investment and exports.

Figure 1.3: GDP growth in BRIC countries



Source: Tradingeconomics, National Bureau of Statistics of the People's Republic of China.

Figure 1.4: Y-o-y GDP growth in Slovenia's important trading partners



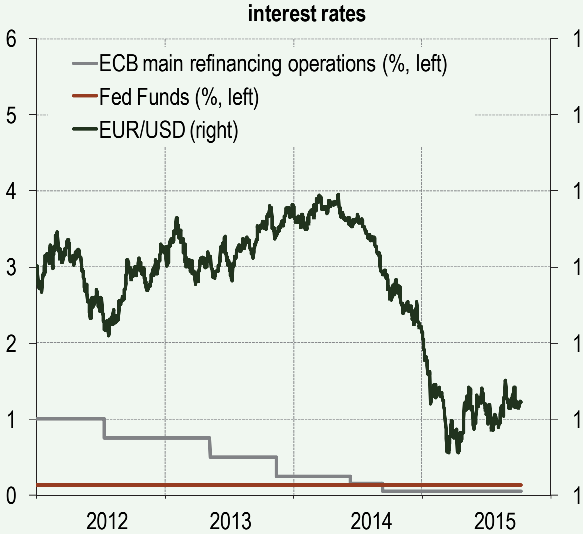
Note: Countries with at least 1% share in Slovenia's total goods exports in the last 12 months with available data.
Source: Eurostat, Tradingeconomics.

Financial markets and commodity prices

Monetary policy at the major central banks of the advanced economies remained expansionary early in the second half of 2015. The ECB has been highly active in the implementation of non-standard measures,[1] and has been taking additional non-standard measures since March in the form of monthly securities purchases in the amount of EUR 60 billion. The ECB maintained the programme of securities purchases at the same level in September, while raising the proportion of public-sector securities purchased in an individual issue from the original 25% to 33%. Mario Draghi signalled the Eurosystem's readiness to respond with additional non-standard measures if inflation remains significantly below the monetary policy target rate. In light of the strengthening economic activity and the fall in unemployment, in the summer the Fed announced the possibility of the first rises in key interest rates, but this did not happen at its most recent meeting. Monetary policy in the US thus remains expansionary, the key interest rate remaining in the interval between zero and 0.25%. The Bank of England's key interest rate has remained unchanged at 0.5% since March 2009, while the volume of securities purchases has also remained unchanged. The two measures remained in effect in August as inflation stood low, despite the strong economic activity. The Bank of Japan also left its key interest rate and securities purchases unchanged at its most recent meeting, despite signs that economic activity is again slowing.

After falling rapidly in the second half of last year and the early part of this year, the euro exchange rate against other major currencies stabilised. The key factor in the fall in the euro was the increased intensity of the ECB's expansionary monetary policy. The exchange rate was also affected by the more favourable macroeconomic developments in the US, while the volatility in recent months was primarily attributable to the temporary rise in tensions with regard to the resolution of the debt crisis in Greece. The average euro exchange rate against the US dollar in September was down 13.0% in year-on-year terms, and down 3.4% on January of this year. It was down 4.6% on January against the pound sterling, and 1.9% against the Japanese yen. It has again risen sharply against the Russian ruble in recent months. As a result of an intervention by the Russian central bank and the simultaneous stabilisation of oil prices, the ruble strengthened in April and May, but has since begun falling again. There were 75 rubles to the euro in September, compared with an exchange rate of 56 rubles to the euro in May. The euro was up 52% against the ruble in September in year-on-year terms. In light of weak exports, the Chinese central bank intervened on the foreign exchange market in August, the euro rising against the yuan by 3.8% in monthly terms. The yuan remained stable in September.

Figure 1.5: EUR/USD exchange rate and central banks' interest rates



Source: ECB, Federal Reserve.

Figure 1.6: Exchange rates

Source: ECB, Bank of Slovenia calculations.

[1] https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html

Box 1.1: Macroeconomic profile of Greece

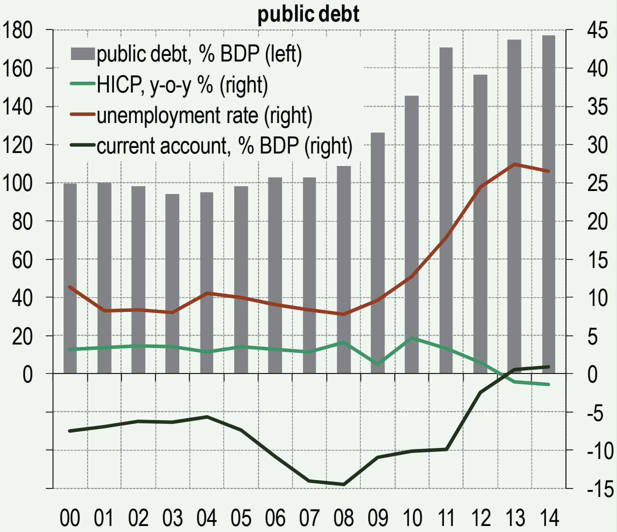
Between joining the euro area in 2002 and the outbreak of the crisis in 2008, Greece recorded positive economic growth, stable albeit slightly high inflation, a significant current account deficit and an unemployment rate of around 9%. Shortly after it joined the euro additional imbalances began to accumulate, which were reflected most notably in the widening of the general government deficit, which during the height of the crisis in 2008 and 2009 exceeded 15% of GDP, while the public debt increased to 130% of GDP. The current account deficit exceeded 14% of GDP in 2008. After 2010 there was a sharp rise in unemployment and the proportion of the population at risk of poverty increased by just under a quarter, while the government debt had reached 177% of GDP by the end of 2014.

After a large contraction in economic activity, which declined by just over a quarter between 2010 and 2013, the situation stabilised in 2014, when GDP increased by 0.8%, its first increase after six years of decline. In the wake of increased merchandise imports and exports and a small increase in gross investment, the main factor in the renewed growth was an increase in household consumption. This was also attributable to an easing of the unemployment rate, which actually fell slightly at the beginning of this year, but nevertheless remains high at around 25%.

At the end of the first half of this year, uncertainty increased again as a result of financial and political upheaval, and the forecasts were lowered. In August Consensus forecast that Greece's GDP would decline by 1.7% in 2015 and 1.0% in 2016. The fiscal indicators stabilised last year, but the outlook remains unfavourable. According to the most recent IMF forecasts, Greece's public debt will reach 200% of GDP in 2015 or 2016, and will not return to a level of 170% of GDP until 2022.

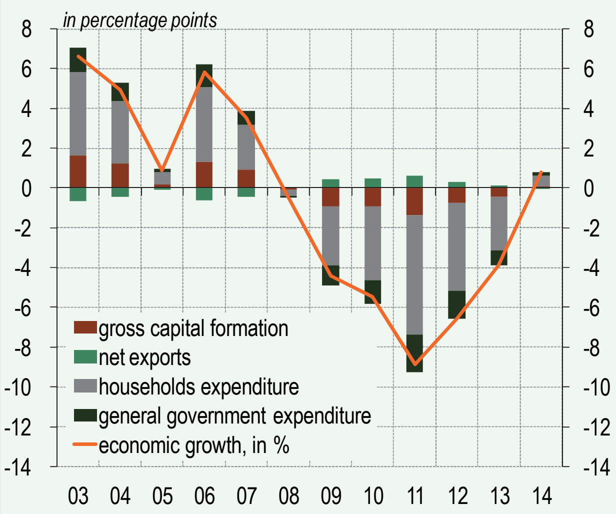
There have been significant structural changes since Greece joined the euro. The weights of industry and agriculture have declined sharply in relative terms. Value-added in industry stood at just 13% of GDP last year, having stood at a relatively high 22% as recently as 2003. The figure for agriculture declined by just under 2 percentage points to 4%. By contrast, the figure for services has undergone a sustained increase, reaching 83% of GDP in 2014. Transport and travel services are prominent in the service sector, and account for

Figure 1: Inflation, unemployment, current account and public debt



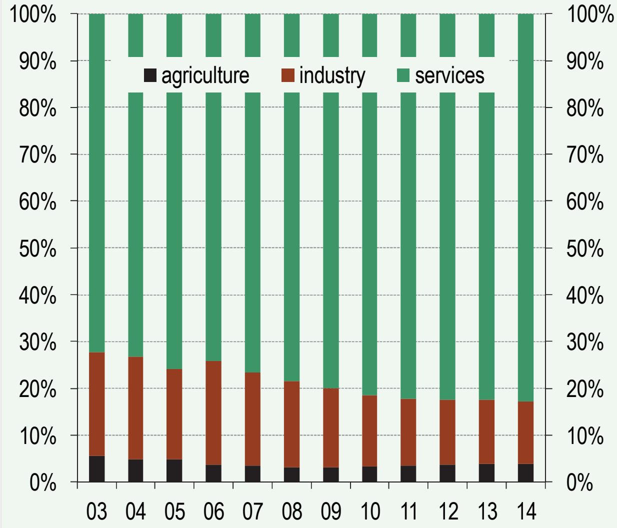
Source: International Monetary Fund, 2015.

Figure 2: GDP growth structure, expenditure method



Source: Hellenic Statistical Authority, 2015.

Figure 3: GDP structure by value added



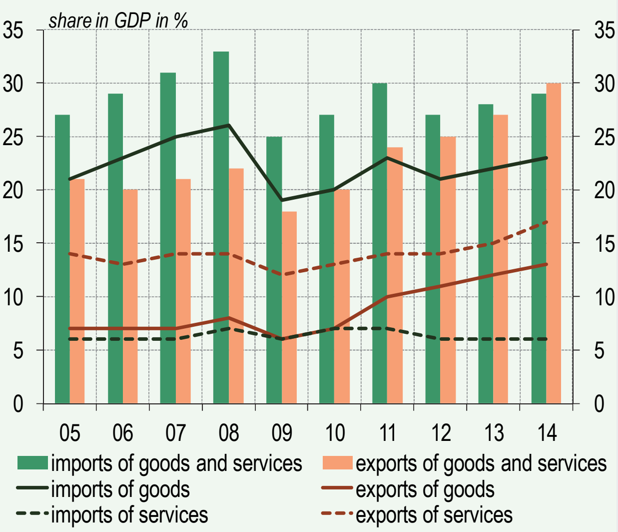
Source: World Bank, 2015.

85% of total exports of services. They have been relatively stable since Greece joined the euro, although the proportion of exports accounted for by tourism has increased slightly at the expense of the proportion accounted for by transport.

Exports of merchandise and services amounted to just 33% of GDP last year, a record figure, of which just under half comprised exports of services. Regions outside the euro area account for two-thirds of Greece's exports of merchandise and services and around 60% of its imports. Exports of services declined during the crisis, but rose significantly in 2014, when the surplus of trade in services stood at approximately 9% of GDP. The imbalances that accumulated in the past were primarily in merchandise trade. Merchandise trade is of relatively modest importance to Greece; merchandise imports rose rapidly before the crisis to stand at almost 30% of GDP in 2008, which in the context of a significantly lower share of exports resulted in a trade deficit of almost 20%. Merchandise imports declined during the crisis, while exports increased significantly, albeit primarily as a result of exports of refined petroleum, while exports of other merchandise actually declined. The trade deficit still amounted to around 12% of GDP in 2014. The current account moved into a small surplus overall in 2013 and 2014, for the first time in 15 years.

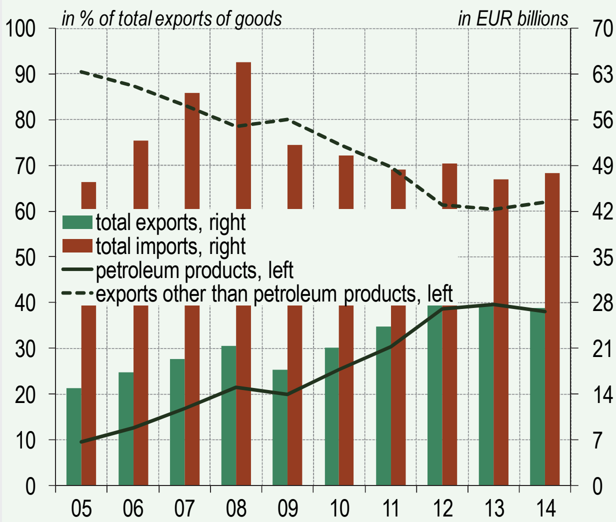
The fiscal deficit had declined to just 3.5% of GDP by last year, the lowest figure of the last ten years. The primary position in 2013 and 2014 was a small surplus, for the first time in a decade and for the first time since Greece joined the euro. The structural position also moved into the positive zone at this time.

Figure 4: Exports and imports of goods and services



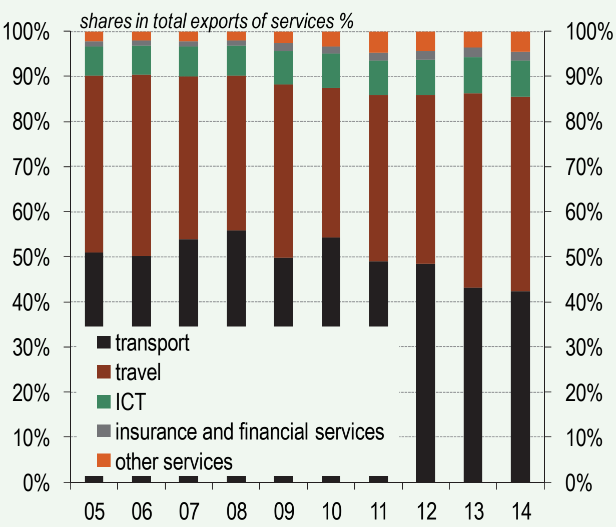
Source: World Bank.

Figure 6: International trade in goods



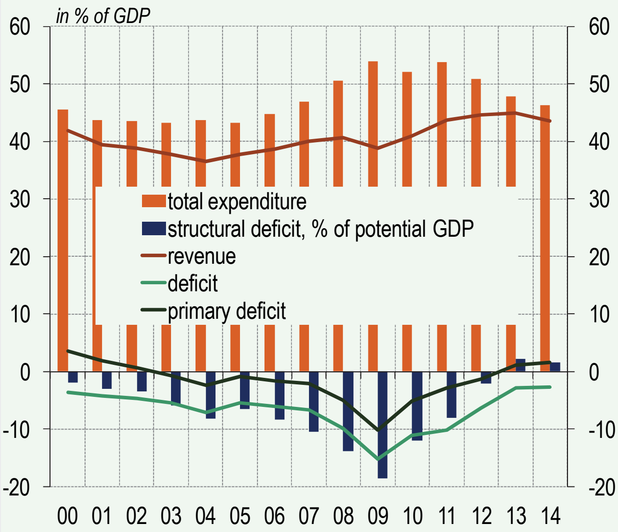
Source: Eurostat, 2015.

Figure 5: Structure of exports of services



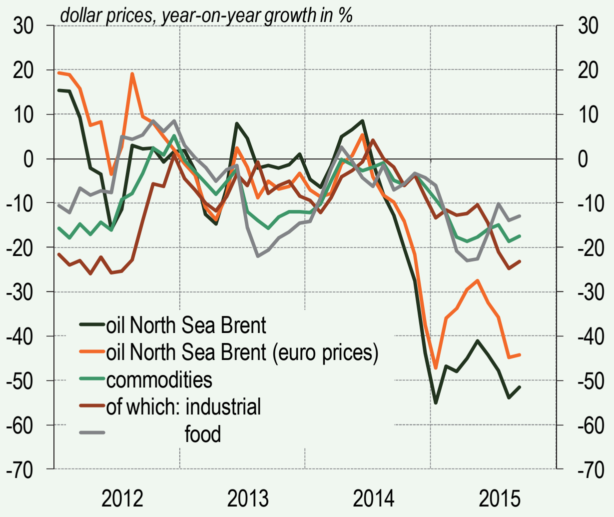
Source: World Bank, 2015.

Figure 7: Public finance



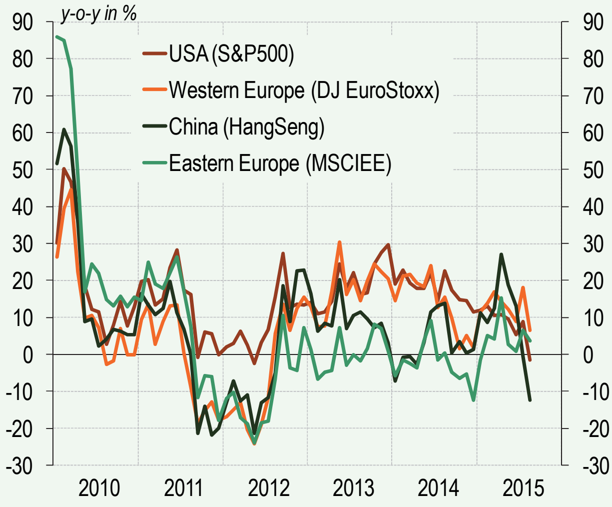
Source: International Monetary Fund, 2015.

Figure 1.7: Commodities



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

Figure 1.8: Foreign stock exchange indices



Source: Bloomberg.

Oil prices have fallen sharply this year, while prices of other commodities have also fallen. The price of a barrel of Brent crude averaged less than USD 48 in September, down 51.5% in year-on-year terms. The main factors in the movement in oil prices are surplus production and increases in stocks, but in recent months forecasts of a slowdown in global economic activity have also had an impact. A significant factor is the slowdown in economic growth in China, the world's largest oil importer. Prices of other commodities have also fallen sharply, and were down 19.8% in year-on-year terms in September. Most notably, metals prices were down 25%. The fall in other commodity prices was primarily attributable to the slowdown in economic growth in major developing countries.

International capital markets

The most notable developments on international capital markets over the summer months were the resolution of the situation in Greece, the cooling of the Chinese economy, and the expectation of the first rise in US interest rates. Share indices fell in the context of increased volatility.

After numerous negotiations between the Greek government and international lenders with regard to the approval of a third programme of financial assistance for Greece in the amount of EUR 85 billion, an agreement was reached in the second half of August. The agreement also set out budget targets for the years ahead (a primary deficit of 0.25% of GDP this year, and primary surpluses of 0.5%, 1.75% and 3.5% of GDP respectively in 2016, 2017 and 2018).

Chinese share indices fell in July and August, after rising sharply in the first half of the year. The large wave of share selling was the result of tighter conditions being imposed on margin lending for share purchases, and the cooling of the Chinese economy. The curbs on margin lending triggered greater pressure to sell, particularly from local investors. The Shanghai composite index, which tracks daily changes in prices of shares on the A and B markets, fell 37.9% between its peak in June and the end of August, while Hong Kong's Hang Seng lost 23.8% from its peak in May. Another factor in the wave of selling was concerns over the cooling of the Chinese economy, and consequently lower corporate profits.

A number of major stock market indices fell significantly in August. The DJ Euro Stoxx, a composite index that tracks the movements of stock markets in western Europe, fell by 8.3% in monthly terms in August, after increased volatility in June and July. There were similar developments in the S&P 500 in the US, which fell by 6.3% in August. The year-on-year changes in the two indices in August were +6.5% and -1.6% respectively. The mood of international investors was also affected by speculation as to whether the Fed would raise interest rates at its September meeting. Despite the growth in the US economy, there were increasing signs that the anticipated first rise in interest rates would be postponed to the final quarter of this year, and this was indeed how the Federal Open Market Committee voted at its September meeting.

2 Economic Trends and the Labour Market

The revision of the national accounts[2] indicated that economic growth was faster and more balanced than suggested by previous estimates. Growth remains based on the performance of the export sector, despite the strengthening of household consumption and the service sector at the same time. Households significantly increased their consumption particularly in the second quarter of this year when, in contrast to the previous quarters, they also spent more on non-durables. Confidence in sustained economic growth nevertheless remains weak, as indicated by the absence of major private-sector investment in production capacities, although the conditions for investing are improving. According to the provisional figures, economic developments remained favourable in the third quarter. Corporate confidence and household confidence remained relatively high, while the majority of private-sector activities continued to record solid growth. Of the major sectors, the main exception was construction, where activity has been declining sharply in the absence of government investment.

The labour market saw strong growth in employment and a further fall in unemployment in the first half of the year, albeit with certain structural weaknesses. The rise in total employment was largely attributable to employment activities, wholesale and retail trade, and manufacturing. Uncertain forms of employment remain prevalent, and the proportion of jobs that they account for is actually increasing. The structure of reduction in unemployment is deteriorating. The number of people newly registering as unemployed is falling, but the number of deregistrations for reason of employment is also falling, which is attributable to a decline in employment subsidies. At the same time the proportion of those registering as unemployed because their temporary employment has ended is increasing. Wage growth has slowed sharply this year according to the monthly figures, partly as a result of deflation, but also as a result of the change in the structure of employment.

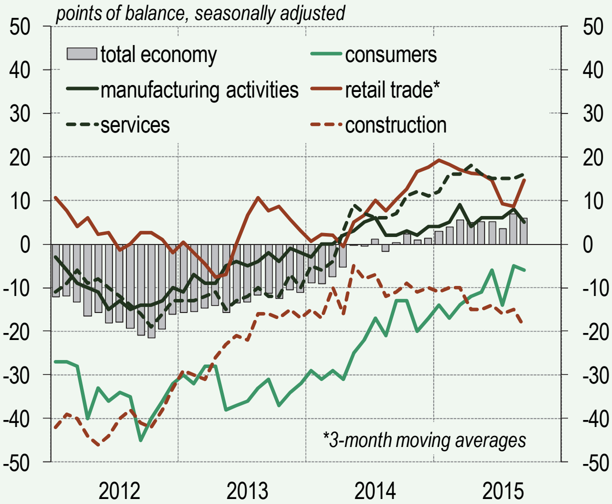
[2] When releasing the national accounts figures for the second quarter of 2015, the SORS also revised the figures for 2014. The fundamental reason for the upward revision could be found in the release of firms' closing accounts for 2014. GDP growth was revised upwards by 0.4 percentage points to 3%. The largest change on the output side was the contribution made to GDP growth by private-sector services, which was increased by 0.3 percentage points to 1.4 percentage points. On the expenditure side, the largest change compared with the previous forecast was in the contribution made by inventories, which was revised from -0.2 percentage points to +0.5 percentage points. The forecast for the contribution made by final consumption was also raised, from 0.1 percentage points to 0.4 percentage points, with comparable positive revisions in relation to households and the government sector. The contribution made by gross fixed capital formation (investment minus inventories) was reduced from 0.9 percentage points to 0.6 percentage points. The contribution made by net trade was also reduced by the same amount, as a result of a lower forecast for export growth.

Confidence indicators and limiting factors

The economic sentiment remained high in the third quarter, with the exception of construction. Manufacturing confidence has remained solid since the beginning of the year. The minor decline in September was the result of an increase in estimated inventories, although estimated export demand and overall demand for the remainder of the year remained high. Confidence also remains high in the retail sector and in other private-sector services, with positive indicators of current and expected demand, which is indicative for further growth in private consumption. Additional evidence of the latter comes from rising household confidence with households anticipating an improvement in their financial position, while there was also a significant improvement in their assessment of the timing of major purchases. The exception was construction, where confidence fell sharply in September in particular. Construction firms remain relatively optimistic with regard to future orders, but assess the current situation as very poor. The current level of orders is extremely low, while the number of months for which construction firms have guaranteed work is at its lowest level of the last two years.

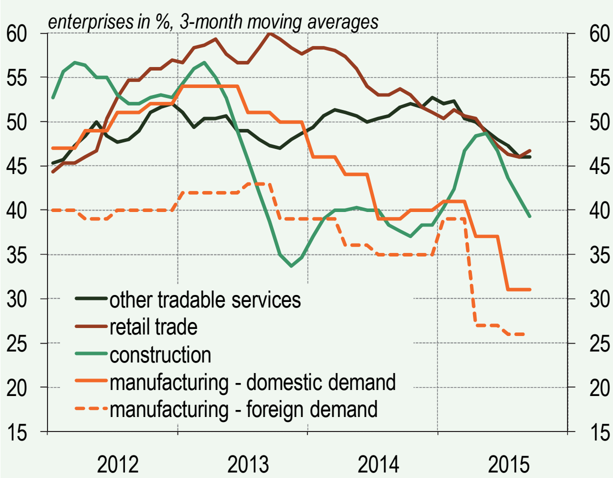
According to SORS survey figures, firms' difficulties with insufficient demand and financing are diminishing. The proportion of firms in the manufacturing sector facing insufficient demand is significantly lower this year than last year. They have fewer difficulties on foreign markets, while the proportion of firms reporting difficulties as a result of weak domestic demand also declined. The proportion of firms in the retail and service sectors facing difficulties as a result of weak demand is also declining, but nevertheless remains above 45%, in line with the low level of domestic final consumption. After a sharp increase in the early part of the year, the proportion of construction firms facing difficulties as a result of low demand began to fall rapidly, which for the moment is still in contradiction with the indicators of investment and construction activity. Difficulties with financing are diminishing in the majority of sectors. The exception are services other than retail, where the proportion of firms facing such difficulties has remained unchanged this year. These devel-

Figure 2.1: Confidence indicators



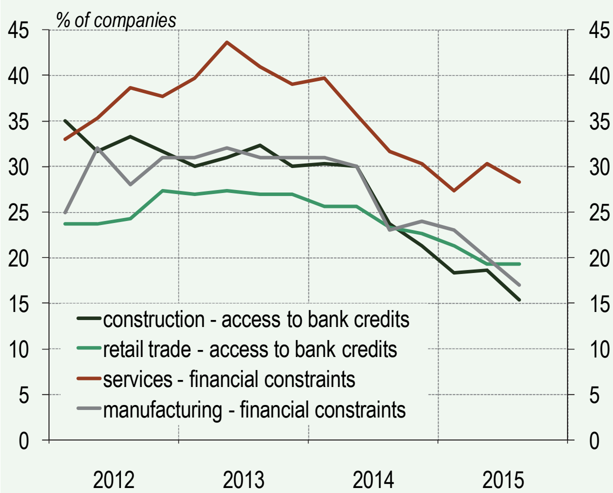
Source: SORS, Bank of Slovenia calculations.

Figure 2.2: Limiting factor – insufficient demand



Source: SORS, Bank of Slovenia calculations.
Note: Quarterly data for manufacturing.

Figure 2.3: Limiting factor – financing



Source: SORS.

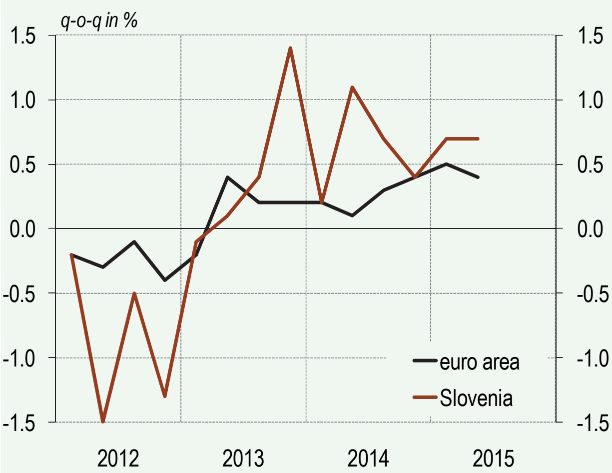
opments are still unrelated to the domestic banking system having the stock of corporate loans declined again over the first seven months of the year. Bankruptcies are also a factor in the fall in the proportion of firms facing difficulties.

GDP

Slovenia continued to outperform the euro area as a whole in terms of growth in the second quarter of this year with manufacturing making a larger contribution to GDP growth this year than services. Quarterly growth was again slightly higher than forecast on the basis of the monthly indicators of activity, reaching 0.7% for the second consecutive quarter. GDP in the first half of the year was up 2.7% in year-on-year terms, 1.2 percentage points more than the growth recorded across the euro area. Manufacturing continued to record favourable developments as the effect of weaker output in the euro area in the second quarter was less than anticipated. It contributed 1.3 percentage points to GDP growth in the first half of the year. After declining at the end of last year the quarterly growth in private-sector services again strengthened slightly this year, although it was concentrated in a smaller number of segments. The overall contribution made to GDP growth by services in the first half of the year was 1 percentage point, less than the average of 1.4 percentage points recorded last year. After recording weak growth last year value-added in public services was unchanged in the first half of the year, despite slightly faster growth in employment. The situation in the construction sector deteriorated in the second quarter as the decline in value-added reduced GDP growth by 0.3 percentage points. The contribution made by net taxes on products increased at the same time as a result of increased consumption of goods carrying the higher VAT rate. Despite its relatively rapid growth, GDP is still down 6% on its pre-crisis peak.

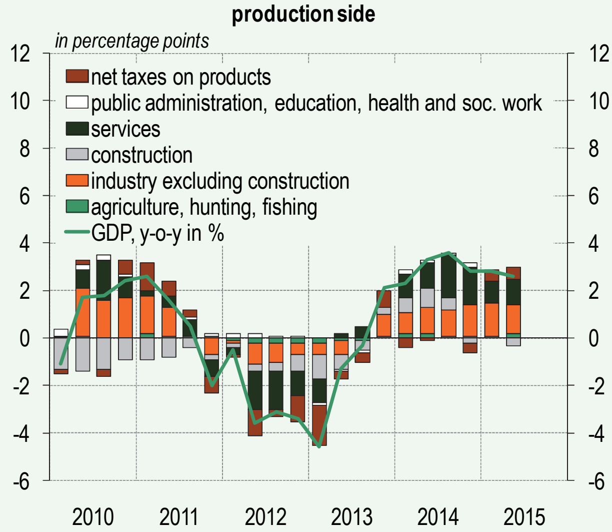
Although its quarterly rates of growth are slowing, manufacturing was the main engine of economic growth in the first half of the year. Quarterly growth in value-added peaked in the second quarter of last year at 1.9%, but had slowed to 1.1% in the second quarter of

Figure 2.4: GDP growth in Slovenia and the euro area



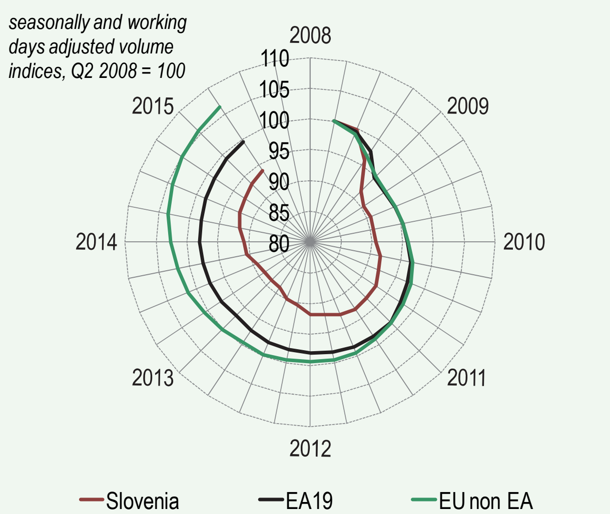
Source: Eurostat – national accounts; seasonally and working days adjusted data.

Figure 2.5: Contributions to y-o-y GDP growth, production side



Source: SORS.

Figure 2.6: Recovery clock – GDP

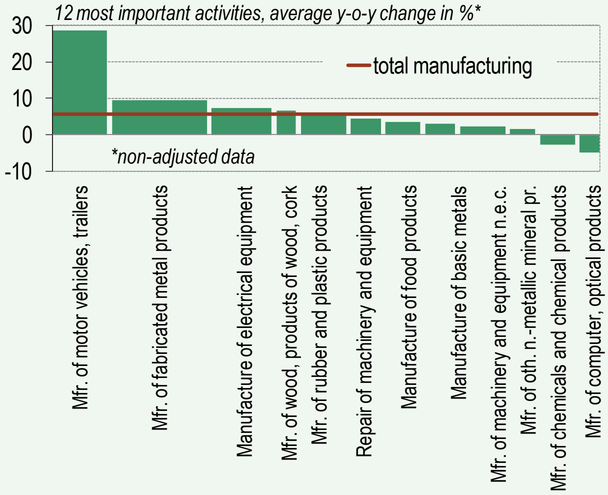


Source: Eurostat, Bank of Slovenia estimates and calculations.

this year. Year-on-year growth in the second quarter nevertheless stood at 5.7%, the highest figure of all the major sectors of the economy. Last year's acceleration coincided with the beginning of the production of new models in the automotive industry, which contribution to growth has declined this year. After difficulties caused by the situation in the Russian economy, the pharmaceutical industry's output strengthened again in the second quarter, based on export figures. Of the other major segments, growth in the manufacture of electrical appliances and the wood industry increased, while there was also a surge in activity in the repair and assembly of machinery and equipment. Growth declined in the manufacture of fabricated metal products, which remains the most important segment of the manufacturing sector in terms of total value-added, but remained above the long-term average for the manufacturing sector. The contribution made to overall growth in industrial production by the energy industry has been negative this year, as a result of the refitting of the nuclear power station and a base effect owing to last year's record electricity production at hydro power stations. Industry accounts for just over 24% of GDP, almost 6 percentage points more than the euro area average. Despite growth, value-added is still down almost 4% on its pre-crisis peak.

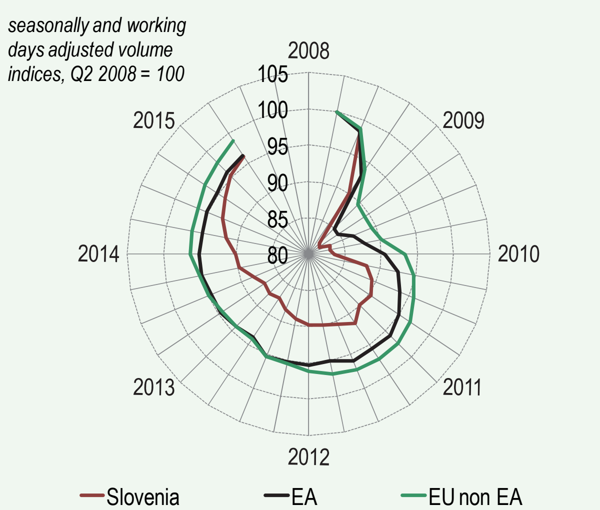
The largest contribution to growth in turnover in industry in the first half of the year came from sales on euro area markets, while sales on the domestic market were also up on the previous year. Year-on-year growth in sales on euro area markets had increased to almost 8% by the second quarter, thereby continuing the positive trend seen over the last two years. The growth in turnover has a broad basis: it is evident in all the main categories of products of Slovenian industry. At the same time there was a sharp decline in sales on non-euro area markets, primarily as a result of the difficulties facing the Russian economy. After increasing by almost 5% in 2014, turnover in industry on these markets in the first half of the year was up just under 1%. The slowdown in growth was mostly attributable to a decline in sales of consumer goods, the category to which pharmaceutical products belong. Year-on-year growth in sales on the domestic market strengthened sharply in the final quarter of last

Figure 2.8: Manufacturing production: Jan. - Jun. 2015



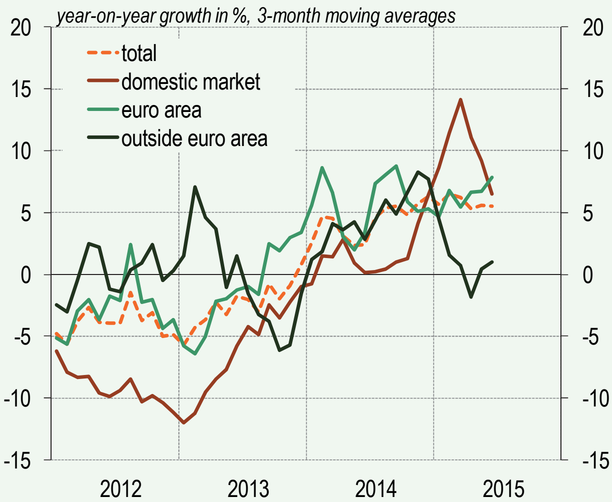
Source: SORS, Bank of Slovenia calculations. Notes: Width of each column represents a share of activity in total value added in manufacturing in 2014. Pharmaceuticals not included due to data confidentiality.

Figure 2.7: Recovery clock - Industry



Source: Eurostat, Bank of Slovenia estimates and calculations.

Figure 2.9: Volume turnover in industry



Source: SORS, Bank of Slovenia calculations.

year and the first quarter of this year. Growth in sales of capital goods was particularly notable, although there was a significant negative correction in the second quarter of this year. This reduced year-on-year growth in turnover on the domestic market from just over 14% in the first quarter to 6.5% in the second quarter. Sales on the domestic market nevertheless remained approximately a quarter down on the pre-crisis level.

Box 2.1: Structural weaknesses in Slovenian exports

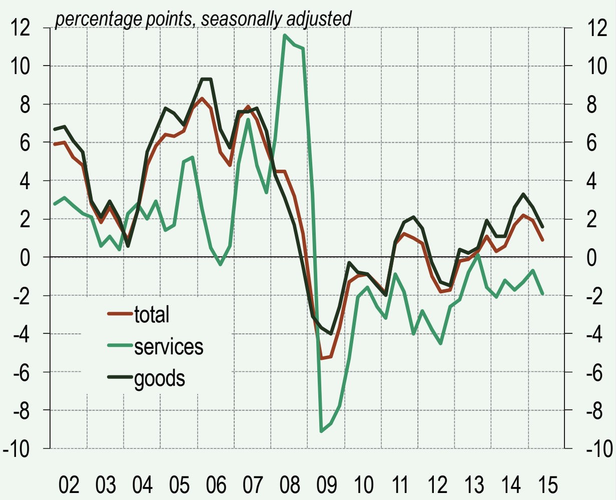
The new cycle of economic growth that began in late 2013 has been mostly driven by exports. The first year of the cycle also saw an increase in government infrastructure investment, and consequently activity in construction, but this was temporary. The share in total value-added accounted for by construction was 5.7% last year, which was still above the euro area average, but in a situation with very tight credit this sector cannot contribute more significantly to aggregate growth. The recovery in private consumption is not yet having a more noticed impact on import growth.

We tend to demonstrate high export efficiency with the large current account surpluses of the period following the end of 2012. The current account surplus recently reached around 7% of GDP, while the trade surplus was almost 9%. But this was mostly a product of contracting imports, first at the outbreak of the crisis in 2009, and then again after the adoption of the ZUJF legislation and the sharp decline in final consumption in 2012. Between 2011, when the current account was still roughly balanced, and the 12-month period ending in June 2015, exports of goods and services increased by EUR 3.4 billion or 13%, while imports increased by just EUR 0.6 billion or 2%.

Export growth in the current cycle has been driven by the recovery in European economic growth since the end of 2013, after which there was a further leap in exports in the second half of 2014. Growth stalled in the first quarter of this year, and recovered in only a modest extent in the second quarter. The actual strength of the export cycle that is driving current economic growth can be estimated by comparing year-on-year rates of export growth in Slovenia with average export growth rates in the euro area. This comparison reveals that Slovenia's current out-performance of average euro area export dynamics is still well behind Slovenia's relative export efficiency before the crisis. The large external surplus is mostly generated by weak imports, while export growth is in reality moderate at best.

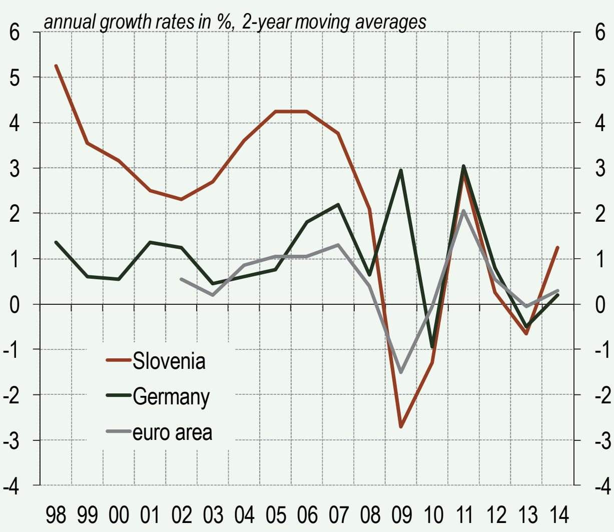
Contributing to this is the relatively weak growth in exports of services. In spite of the two quite strong exporting activities, travel and transport, services account for just 19% of Slovenian total exports of goods and services, compared with an average of 25% across the euro area (18% in Italy, 29% in Austria and Spain, and around 50% in Greece and Croatia). Growth in exports of services has been outpaced by growth in merchandise exports for almost all of the recent past, which is normal given the limited potential for technological advance in services, but since 2008 it has also been outpaced by the average euro area growth in exports of services. In contrast to merchandise trade, the surplus of trade in services has

Figure 1: Differences in real annual growth rates of exports: Slovenia – euro area



Source: Eurostat, Banka of Slovenia calculations.

Figure 2: Labour productivity



Source: Eurostat, Bank of Slovenia calculations.

been stagnating since mid-2013, with just a minor upward turn in the last year. Slovenia's exports are driven by merchandise exports and by manufacturing.

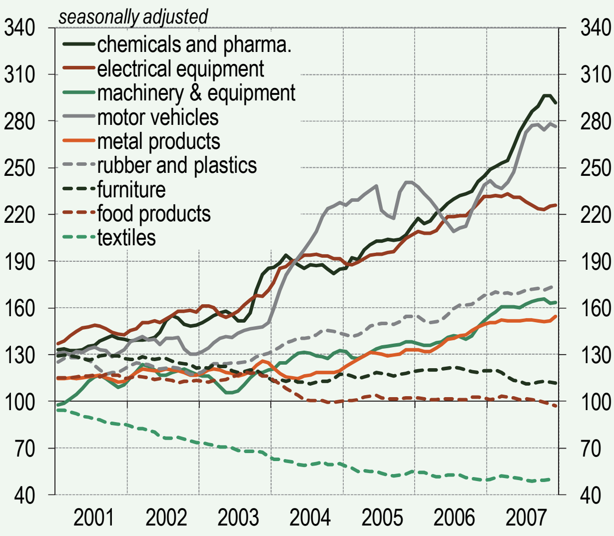
The relatively weak recovery of export growth since the outbreak of the crisis has parallels in other indicators of economic efficiency. Aggregate growth in labour productivity averaged around 4% annually over the 15 years before the crisis, but was only just over 2% last year and just over 1% in the first half of this year. Annual growth in labour productivity in manufacturing was relatively stable before the crisis at around 7%, but has dropped to merely 3.5% last year.[1] Annual growth in aggregate productivity was outperforming the euro area average by 3 to 4 percentage points before the crisis, and by less than 2 percentage points last year.[2]

Selected data on changes in the structure of manufacturing output, which is a significant factor of export efficiency, are shown below. Figure 3 illustrates the structure and dynamics of manufacturing output in the period before the crisis, in which the transition-linked opening of the economy, on both the import and export sides, was already producing increasing sectoral restructuring. The figure shows an already full-blown decline of the textile industry, and the emerging stagnation of the food and furniture industries, the food industry undergoing a contraction of 15% when Slovenia joined the EU. There were also significant differences in the rates of growth in other major sectors. In this period the slower sectors grew at an average annual rate of around 5%, while the two fastest-growing sectors, the motor vehicles and the chemical industry, which also included pharmaceuticals in the statistics of that time, recorded annual rates of above 10%.

These trends were exacerbated in the period after the crisis. The crisis virtually dealt a death blow to Slovenia's textile and furniture industries. In the remainder of manufacturing, growth has picked up slightly in many sectors this year, but in the medium term perspective growth after 2008 has practically stalled in most sectors, in which output was still at least 10% down on its pre-crisis level even in the improved climate of mid-2015. Only three sectors have so far exceeded their pre-crisis levels: the electrical industry, motor vehicles and, most probably, the pharmaceuticals industry, for which statistics are now no longer provided for reasons of individual data protection. Slovenia's export base has become quite narrow.

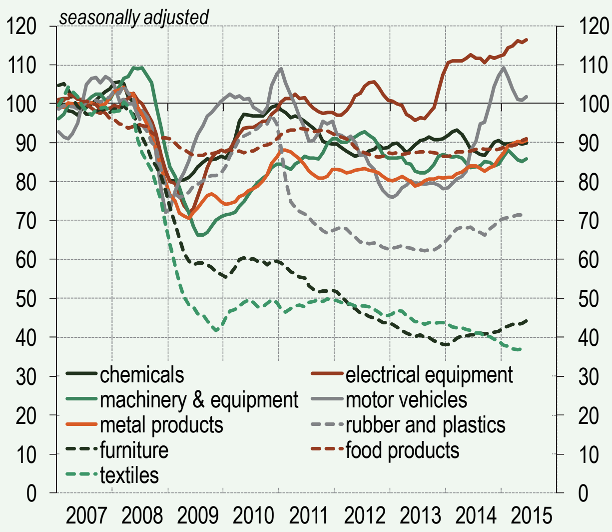
In addition to the likely leading role of the pharmaceuticals sector, growth has been notable throughout the period following 1995 in the motor vehicles and the electrical industry, in which the production index is approximately 260 for the overall 20-year period (while the indices for textiles and furniture are 20 and 50 respectively). The motor vehicles sector deserves particular attention. Its output almost doubled over a very short period between 2003 and 2007, since when it has undergone two consecutive cyclical spikes in which this former highest level was regained, before declining again; on average or on a rough trend, growth agter 2008 has stopped. Within this trend it has displayed very strong cyclical dynamics, giving rise to major fluctuations in year-on-year growth rates. These reached up to 40% at the most recent turn of the year. The strong acceleration of industrial growth, export growth and overall economic growth in the second half of 2014 was in a large part attributable to this latest cycle in the motor vehicles sector, which is now already slowly fading.

Figure 3: Production in manufacturing, 1995 = 100



Source: SORS, seasonal adjustment Bank of Slovenia.

Figure 4: Production in manufacturing, 2007 = 100



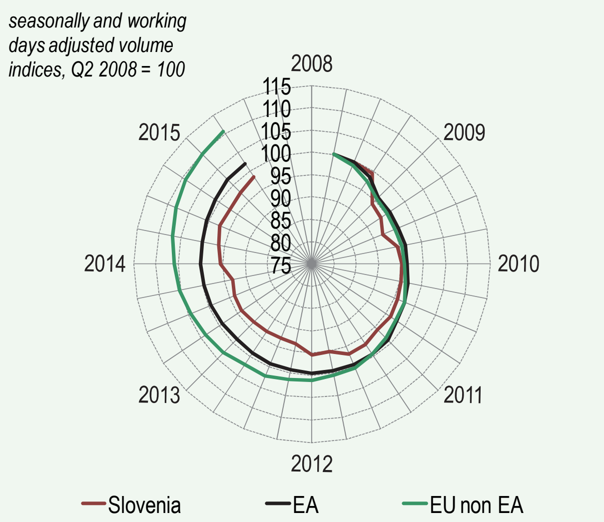
Source: SORS, seasonal adjustment Bank of Slovenia.

The increasing sectoral differentiation and the trend of a narrowing zone of strong manufacturing performance reflect primarily differentials in technological levels and a narrowing base of sufficient technological advance. A significantly greater account of this should be taken in analyses of Slovenian growth constraints and in the design of economic policies. At present the prevailing focus is primarily on labour costs and costs of government on the one hand, and on credit and other financing constraints on the other. Very little attention is in the meantime devoted to the country's most central growth problems.

[1] The original SORS figure is 4.7%. This figure is overstated because of an understatement of employment growth, due to the fact that employment via employment agencies is statistically recorded in another sector. The adjustment applied is explained in the Bank of Slovenia's Economic and Financial Developments publication of July 2015 (p 26).
[2] The catching-up with advanced economies, entailing outperforming these economies' growth rates, which are normally relatively weak at their already high levels of per capita GDP, should be seen as normal and essential for Slovenia. This is even more the case after the crisis, in which Slovenia lagged behind even further.

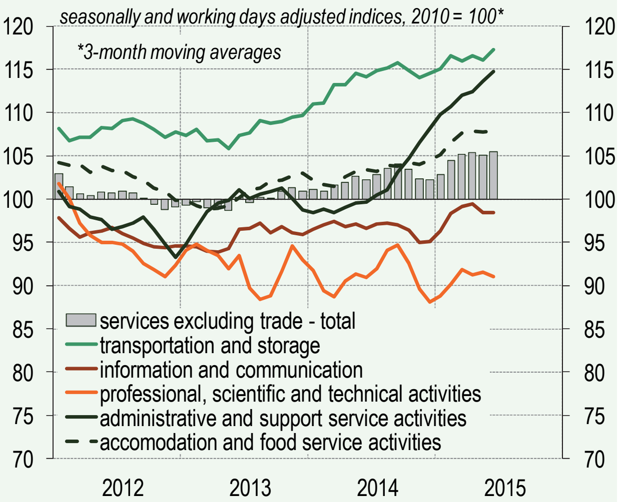
Year-on-year growth in value-added in private-sector services in the first half of this year was outpaced by overall economic growth. After outpacing economic growth overall in the second half of last year, which was largely attributable to professional, scientific and technical activities, wholesale and retail trade, transportation and storage, and accommodation and food service activities, year-on-year growth in activity in private-sector services slowed down in the first half of this year. Growth in value-added stood at 2.3%, 1.7 percentage points lower than in the second half of last year. The main reason is likely related to the renewed crisis in construction, which had an adverse impact on numerous architectural and engineering services. At the same time there was a significant deterioration in the situation in telecommunications, while value-added also declined more sharply in financial services. Growth in turnover in the transportation and storage sector slowed down, which coincided with a slight slowdown in growth in merchandise exports. By contrast, turnover in accommodation and food service activities strengthened more sharply, partly as a result of the recovery in private consumption, and partly as a result of

Figure 2.10: Recovery clock - Predominantly private services



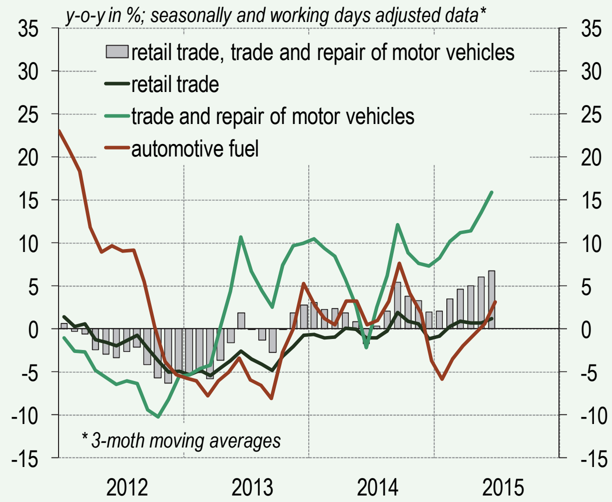
Source: Eurostat, Bank of Slovenia estimates and calculations.

Figure 2.11: Nominal turnover in private sector services excluding trade



Source: SORS, Bank of Slovenia calculations.

Figure 2.12: Volume turnover in trade

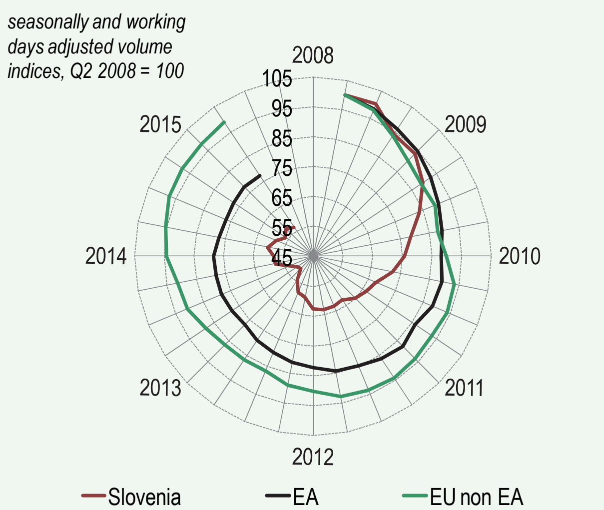


Source: SORS, Bank of Slovenia calculations.

an increase in the number of foreign travellers. Growth also strengthened in wholesale and retail trade, where sales of vehicles remained prevalent, while sales were up in year-on-year terms in some other segments as well. Other private-sector services that were notable in terms of growth were employment activities, where turnover was up almost 50% in the first half of this year alone. The proportion of GDP accounted for by private-sector services stood at just over 40%, 8 percentage points less than the euro area average. Value-added in private-sector services is now down just 1.6% on it pre-crisis peak.

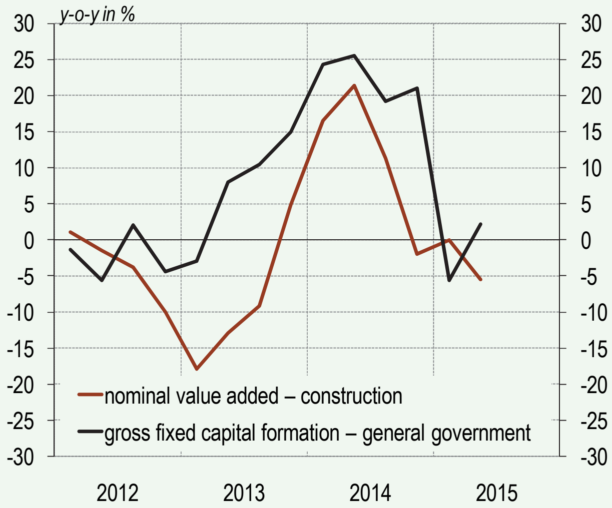
After recording high growth last year, construction has again been in crisis this year. In the wake of low growth in private-sector investment, the sector has recently been almost entirely dependent on public investment, which itself has been reliant on EU funding. The year-on-year decline of 3.6% in value-added in construc-

Figure 2.13: Recovery clock - Construction



Source: Eurostat, Bank of Slovenia estimates and calculations.

Figure 2.14: General government investment and value added in construction



Source: SORS, Bank of Slovenia calculations.

Table 2.1: Economic activity

	12 m. to Jul.14	12 m. to Jul.15	2015 May	2015 Jun.	2015 Jul.	2015 Apr.	2015 Jul.
			y-o-y in %			*monthly ++*	
Industrial production: - total *	0.8	3.6	6.2	3.8	3.3	2.1	1.0
- manufacturing	1.6	4.9	6.7	4.2	4.0	1.1	1.2
Construction: - total **	23.5	-2.1	-9.4	-11.9	-14.0	8.1	-7.8
- buildings	1.8	-2.3	-1.2	-2.7	-5.7	-1.5	4.7
- civil engineering	32.3	-1.8	-12.2	-15.0	-17.0	14.3	-16.2
Trade (volume turnover)							
Total retail trade	-1.2	0.6	2.8	1.8	0.1	0.9	0.0
Retail trade except automotive fuel	-2.0	0.9	1.7	0.7	2.1	0.3	-0.1
- food, beverages, tobacco	-2.7	0.5	0.5	0.9	1.2	-1.3	-0.9
- non-food (except automotive fuel)	-1.2	1.2	2.7	0.0	2.7	1.7	-0.2
Retail trade and repair of motor vehicles	6.3	11.4	18.6	18.7	11.8	2.9	4.0
Private sector services * +**	2.4	2.6	2.7	4.3	2.9	2.5	0.8
Transport and storage +	4.2	3.6	1.5	4.7	2.3	1.4	1.3

Source: SORS, Bank of Slovenia calculations.
Notes: Data are working days adjusted.
** Volume of industrial production. ** Real value of construction put in place. *** Excluding trade and financial services. + Nominal turnover.*
++: 3-month moving average compared to the corresponding average 3 months earlier. Data are seasonally and working days adjusted (except for construction where data are seasonally adjusted).

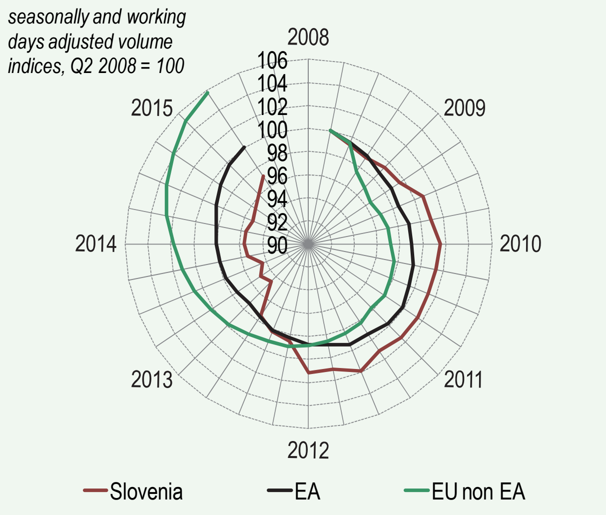
tion in the first half of the year was the result of a decline in civil engineering work, which was slightly unexpected, at least in light of the government's investment plans. There was a slight increase in the amount of non-residential construction put in place in the first half of the year, partly as a result of the expansion of certain retailers. At the same time there was a sharp decline in the amount of residential construction put in place. The proportion of GDP accounted for by construction stood at 4.6%, the same as the euro area average.

Aggregate demand

Within domestic demand, final household consumption is strengthening, while gross fixed capital formation was unchanged in year-on-year terms in the first half of this year. Year-on-year growth in domestic consumption stood at 2.5% in the first quarter, higher than last year's average, albeit primarily as a result of the large contribution made by changes in inventories. After stagnating in the final quarter of last year, final household consumption has increased again. In contrast to last year's developments, investment in machinery and equipment has also begun to strengthen in year-on-year terms. Growth in domestic consumption declined to merely 1% in the second quarter, albeit again largely as a result of inventories, the impact of which was merely neutral compared with the first quarter. At the same time final household consumption strengthened significantly: at 1.7% its rate of growth was the highest since the first quarter of 2010. Construction investment declined sharply, as gross fixed capital formation declined by 1.5% in year-on-year terms despite continuing growth in investment in machinery and equipment. The impact of final government consumption on GDP growth remained neutral overall in the first half of this year. Aggregate domestic demand reached its lowest level in the third quarter of 2013, since which it has increased by just under 4%.

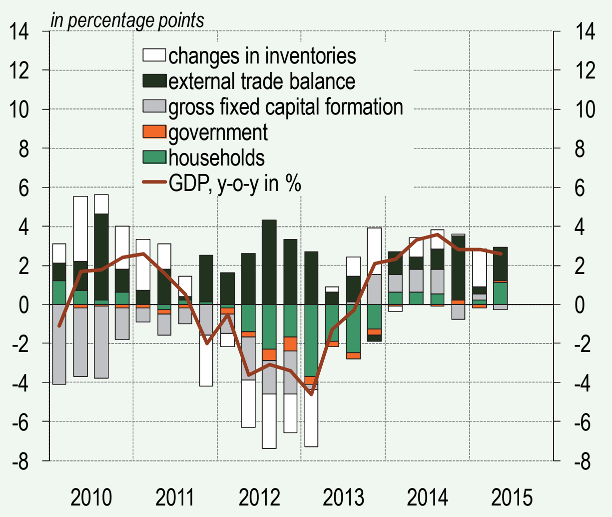
After the revision of the national accounts, estimated growth in final household consumption is more in line with the recovery in the real wage bill and the increased confidence, although it remains relatively weak. According to new SORS estimates, household

Figure 2.16: Recovery clock – Final consumption of households and NPISH



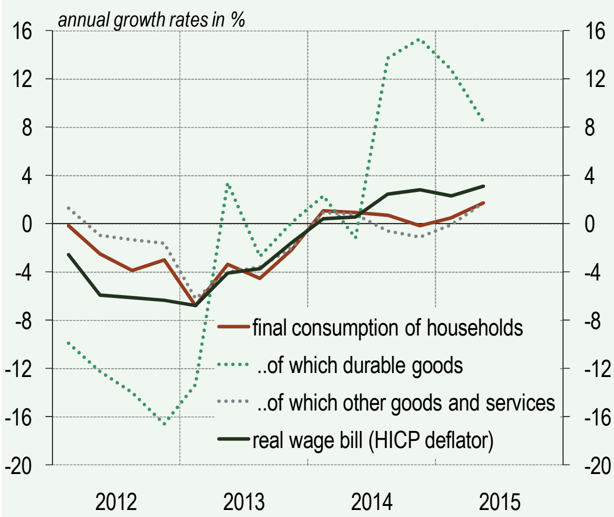
Source: Eurostat, Bank of Slovenia estimates and calculations.

Figure 2.15: Contributions to y-o-y GDP growth, expenditure side



Source: SORS.

Figure 2.17: Final consumption of households and wage bill



Source: SORS, Bank of Slovenia calculations.

Box 2.2: Situation on the Slovenian housing market and comparison with the euro area

Residential real estate sales in Slovenia have increased significantly in the last year and a half, but the short-term outlook for investment in residential construction remains poor. The number of transactions in housing has been rising since the third quarter of 2013. This is attributable to the more favourable conditions on the market, real estate prices and interest rates on housing loans having fallen sharply. Household lending via housing loans is increasing, although the stock remains the lowest in the euro area. Investment in residential construction is also among the lowest in the euro area. The supply of new residential buildings will not improve, at least in the short term, as the value of new contracts is extremely low, and the number of issued building permits also remains low.

The housing market is primarily recovering as a result of an increase in transactions in used housing. Sales of the latter in the second quarter of this year were up 76% on the low recorded in the third quarter of 2013. New-build housing sales increased by around 13% over the same period. The number of transactions in used real estate in the second quarter was down just 1.4% on the peak quarterly average recorded in 2007, while new-build real estate sales were down 51%. The proportion of the total number of transactions accounted for by new-build real estate declined from more than 20% to a tenth reflecting low investment in residential construction.

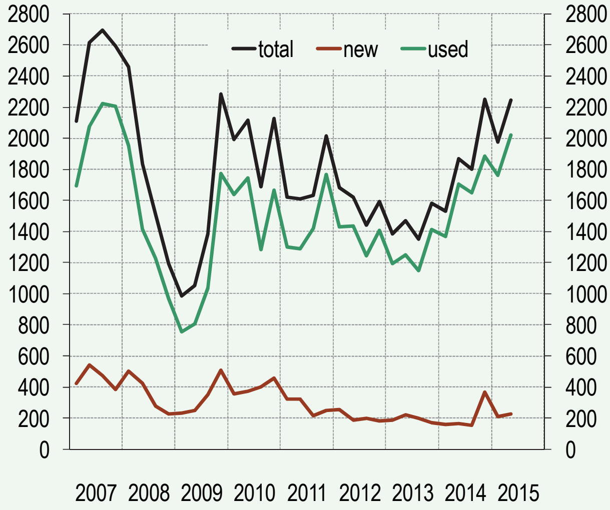
Price correction on the Slovenian housing market during the crisis was one of the sharpest in the euro area. In the second quarter they were down 21% on the average in 2008, when prices peaked. Prices of new-build housing were down 23% from their peak, while prices of used housing were down 19%. Year-on-year growth in prices stood at 3.6% in the second quarter of this year, having housing prices risen for the first time since 2011. Price corrections were significant in the Netherlands, Portugal, Slovakia, Cyprus and Italy as well, while the largest corrections were seen in Ireland, Spain and the Baltic states. Prices have resumed growth or have at least stabilised in the euro area countries with the largest falls. Prices in the first quarter of this year were significantly higher than before the outbreak of the crisis in Germany, Austria, Belgium, Luxembourg and Finland.

The fall in interest rates on housing loans in Slovenia was the largest in the euro area. Interest rates peaked in 2008 before the crisis at 7.5%, 2.3 percentage points more than the euro area average. Growth in interest rates tracked the rapid increase in prices with a lag. This was followed by a sharp fall in 2009, and then again after 2012, when expansionary monetary policy was a factor in the fall. At the same time the banks tried to focus as much as possible on household lending, given that housing loans in Slovenia are a lower-risk source of revenue, particularly when it is borne in mind that the reduced level of prices now accords more with purchasing power than it did before the crisis. Interest rates on housing loans averaged 2.6% in the second quarter of this year, 0.4 percentage points less than the euro area average. The euro area average is being raised by interest rates in the Netherlands, France and Germany.

Although the stock of housing loans in Slovenia has increased sharply in the last decade, its ratio to GDP remains the lowest in the euro area. Given the very low basis, annual growth in housing loans ranged from 30% to 50% between 2005 and 2008. Despite a significant slowdown, growth continued during the crisis, the rate reaching around 3% this year. Growth averaged 2% across the euro area at the end of the first half of the year, but the figure conceals large variation from country to country. The stock of loans is declining in Spain, Greece, Italy, Cyprus, Portugal and Ireland, but is increasing sharply in Luxembourg, Austria, Belgium, Slovakia and Malta. The stock of loans in Slovenia stood at just EUR 800 million or 3% of GDP at the end of 2004, but had risen to EUR 5.5 billion or 14.5% of GDP by the end of the second quarter of this year. Over the same period the figure across the euro area increased from around 31% of GDP to just over 38% of GDP. Spain, Portugal, the Netherlands and Cyprus were notable for figures ranging from 54% to 66%.

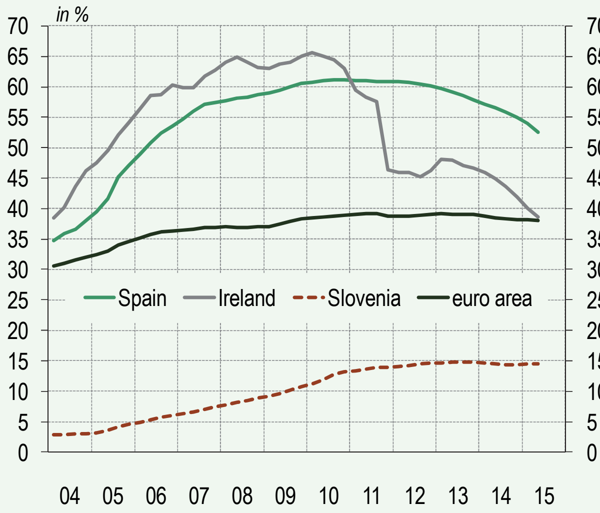
Investment in residential construction in Slovenia is among the lowest in the euro area, and no major reversal is expected, at least in the short term. Annual growth in investment in residential construction averaged in excess of 10% between 2004 and 2008, albeit from a low basis. This was followed by a period of sharp decline, which has continued this year. Residential investment to GDP ratio peaked in 2008 at just under 5%, and had declined to just over 2% by the second quarter of this year, 2.5 percentage points less than the euro area average. The largest declines when the real estate bubble burst were seen in Spain, Cyprus and Ireland, where the residential investment to GDP ratio declined by 8 to 11 percentage points. The number of building permits in Slovenia is falling in year-on-year terms and was down 56% on the average between 2000 and 2014 in the second quarter of 2015. There was a pronounced fall across the euro area during the crisis. Developments varied greatly across countries, from a fall of 90% in Spain to a rise of 10% in Germany.

Figure 1: Number of transactions with dwellings – Slovenia



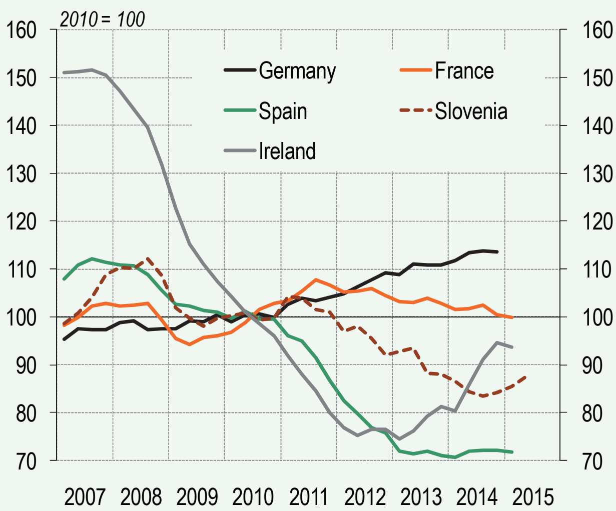
Source: SORS.

Figure 4: Housing loans given to households as a share of GDP



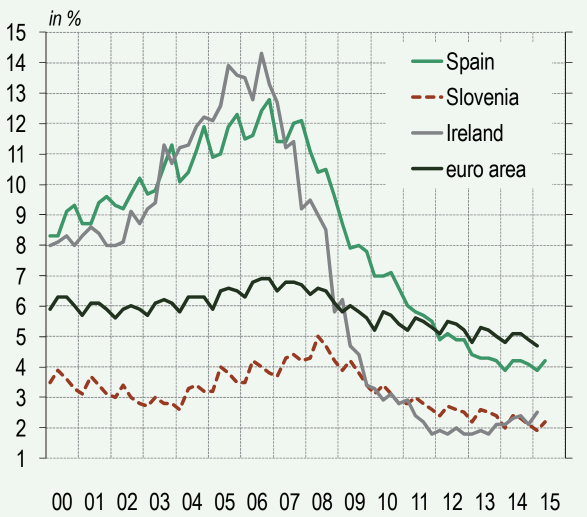
Source: ECB, Eurostat, Bank of Slovenia calculations.

Figure 2: House price indices



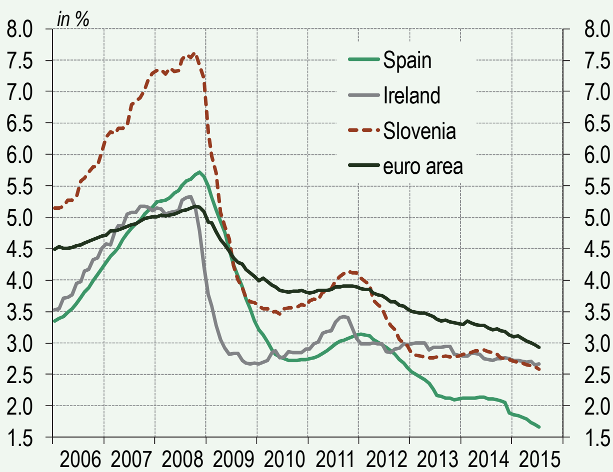
Source: Eurostat.

Figure 5: Residential investment as a share of GDP



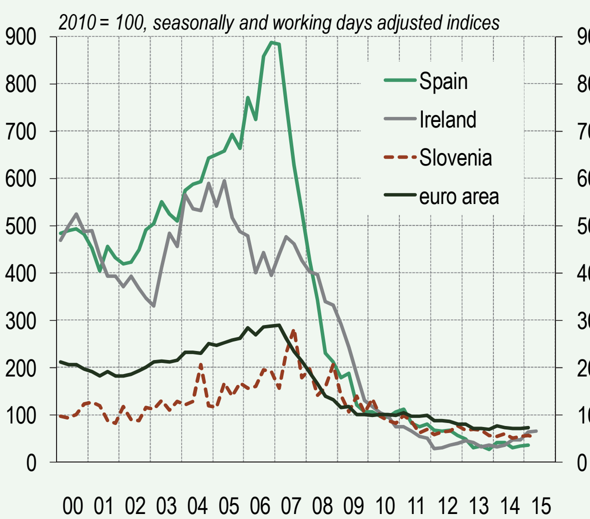
Source: Eurostat.

Figure 3: Interest rates on housing loans for consumers



Note: Annual interest rates for stock of housing loans given to households and NPISH.
Source: ECB.

Figure 6: Number of building permits for residential buildings

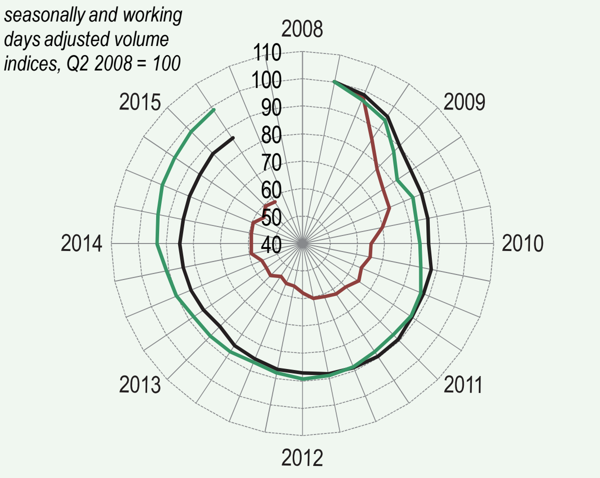


Source: Eurostat.

consumption increased by 0.6% last year, which contributed 0.3 percentage points to GDP growth. The growth was entirely the result of increased purchases of durable goods. These strengthened by 7.5% last year; according to turnover in wholesale and retail trade, households primarily spent their money on furniture, household appliances and motor vehicles. Growth in final household consumption strengthened to 1.1% in the first half of this year, contributing 0.7 percentage points to GDP growth. This was primarily the result of high growth in the second quarter, when in addition to durables households also increased their purchases of food products and clothing, and above all have begun spending more on leisure activities this year.[3] Household consumption habits are also changing: an increasing proportion of retail purchases are now made online. Final household consumption has increased by 2.7% since its low of the third quarter of 2013, but remains 5% down on its peak in the third quarter of 2011. However, the growth in household consumption is being outpaced by the growth in the real wages and is an indication that households are still being cautious.

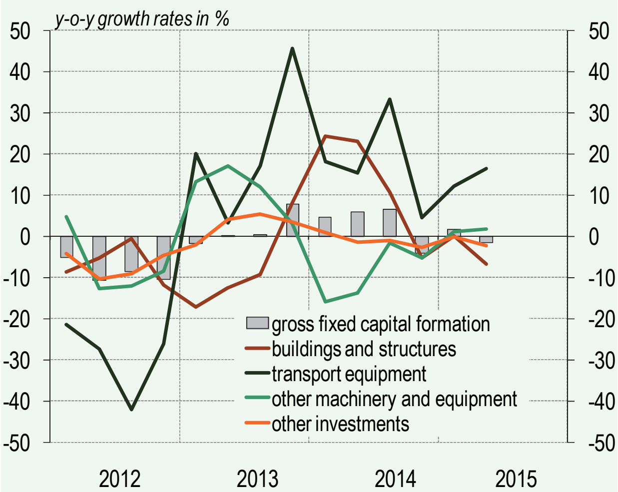
After recording high growth last year conditioned by public financing, gross fixed capital formation in the first half of the year was unchanged in year-on-year terms, although there was a significant improvement in its structure. Gross fixed capital formation increased by more than 3% last year, albeit mostly as a result of public investment work co-financed by EU funding. Investment in buildings and infrastructure, where civil engineering work was predominant, was up just over a fifth. The rapid decline in investment in residential construction continued, while investment in intellectual property products also declined to a lesser extent.[4] In the segment investment in machinery and equipment only investment in transport equipment recorded an increase. Overall, investment in the first half of this year was unchanged. There was a decline in investment in buildings and infrastructure, where government investment accounts for a large proportion. These developments in the first half of the year do not for the moment reflect the government's

Figure 2.18: Recovery clock – Gross fixed capital formation



Source: Eurostat, Bank of Slovenia estimates and calculations.

Figure 2.19: Gross fixed capital formation



Source: SORS.

budget plans, which envisage an increase of approximately 10% in investment this year. Investment in machinery and equipment increased by almost 5% over the same period. Investment in transport equipment continues to grow, which has been facilitated by further growth in exports of transport services and turnover in the transport sector. In contrast to last year, investment in production capacities also recorded a moderate increase, but nevertheless remained weak compared with capacity utilisation, growth in demand and the improvement in

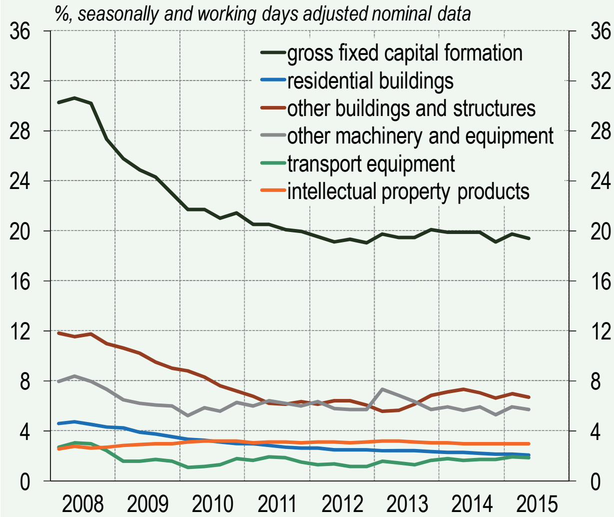
[3] Revenues of travel agencies and tour operators in the second quarter were up more than 13% in year-on-year terms. After declining for three years, the number of arrivals by domestic travellers in the first half of the year was up more than 8% in year-on-year terms, while their number of overnight stays was up almost 6%.

[4] Investment in computer software and databases and in research and development declined by just over 1% last year, and continued to undergo a moderate decline in the first half of this year.

financing conditions. This indicates that firms are not yet sufficiently confident that the current economic growth will be sustained, while the level of investment is also being affected by the uncertainty surrounding privatisation and ongoing deleveraging of part of the economy.

The ratio of gross fixed capital formation to GDP remains low compared with its long-term average. It remained below 20% in the first half of this year, at the level of the euro area average. The principal reason is the significant decline in construction investment, which is primarily related to the development of the trade sector and road infrastructure in the decade before the crisis, which has now largely been completed. More unfavourable is the decline in investment in machinery and equipment from more than 10% to less than 8%, which could have negative consequences for the economy's technological development.

Figure 2.20: Investment as a share of GDP



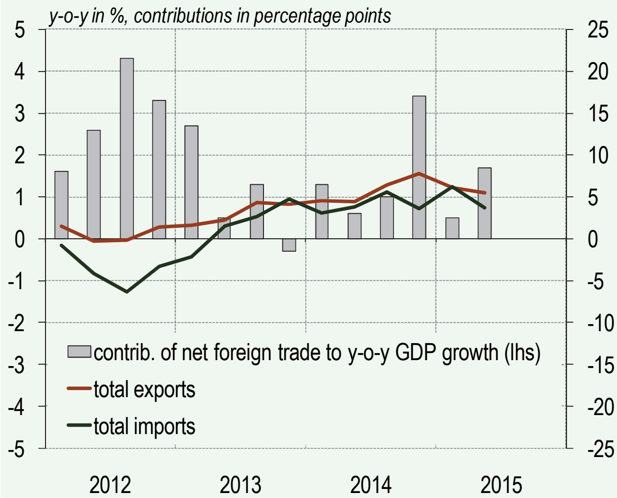
Source: SORS, Bank of Slovenia calculations.

The contribution to GDP growth made by net trade in the first half of the year remained high, despite the faster recovery in domestic final consumption. Given the simultaneous developments in aggregate domestic demand, the high growth in imports in the first quarter was mostly related to changes in inventories. Growth in imports slowed significantly in the second quarter, which was in the context of rising final household consumption again related to inventories, and also to the decline in gross fixed capital formation. Growth in exports remained high, in line with manufacturing output and turnover in transport and travel services. The contribution made to year-on-year GDP growth by net trade thus strengthened from 0.5 percentage points in the first quarter to 1.7 percentage points in the second quarter.

Economic developments in the third quarter of 2015

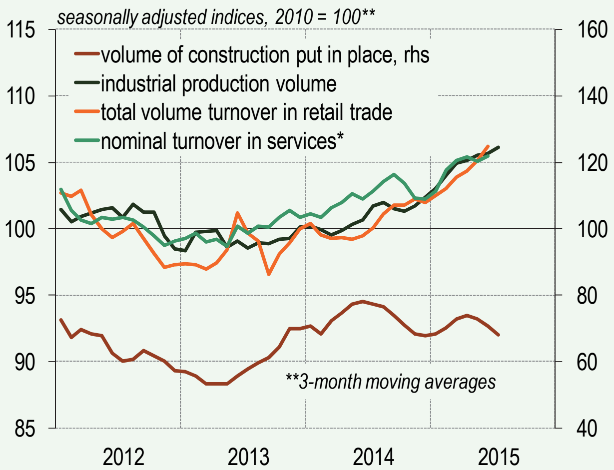
According to the available monthly indicators of activity, economic growth remained solid in the third quarter. Output remained at a solid level in July and August in the majority of manufacturing segments. Retail turnover also increased at the same time, albeit at a slower pace. Purchases of durables remained prevalent,

Figure 2.21: Foreign trade



Source: SORS – national accounts.

Figure 2.22: Monthly economic activity indicators



Source: SORS.
*Notes: *Private sector services excluding trade and financial services.*

Box 2.3: Non-standard ECB monetary policy measures and their impact on Slovenia

The financial crisis in 2008 changed the conduct of ECB monetary policy. In light of the banks' increased liquidity and credit risk, the standard framework of ECB monetary policy via the management of interest rates was no longer adequate: there was a prevailing lack of confidence in transactions between banks, and the flow of liquidity on the money market ceased, which brought a significant deterioration in the functioning of the transmission mechanism in the euro area. The ECB responded with a series of (temporary) non-standard measures. It first ensured that euro area banks had sufficient liquidity, and limited the credit crunch on the interbank market. Next it addressed the issue of the debt crisis and fragmentation between euro area countries. In the third phase it introduced non-standard measures in the form of an expanded asset purchase programme to provide additional support to the transmission mechanism and to raise inflation to the target rate of close to 2%.

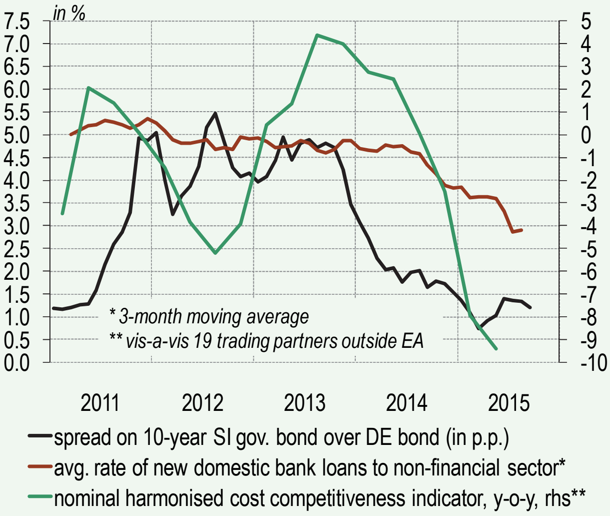
The scope of the non-standard measures adopted to date by the ECB has ranged from liquidity provision via longer-term tenders for monetary policy operations, currency swaps, the easing of collateral requirements, and forward guidance on interest rates (and negative interest rates), to euro-denominated securities purchase programmes (CBPP, SMP, OMT, ABSPP and PSPP). The measures have aimed to strengthen the functioning of the transmission mechanism, as well as targeted specific problematic sectors and the easing of the situation on the financial markets.

The effects of the non-standard measures have been reflected most in the decline and convergence of interest rates in the euro area, and in a decline in bond yields and spreads of countries classed as higher-risk by the markets. This has had an impact on Slovenian government bonds, making refinancing significantly less expensive. The required yield on 10-year Slovenian government bonds is currently around 1.5%, having reached around 7% at the height of the crisis in 2011 and 2012.

In the wake of the general lack of confidence on the interbank market, Slovenian banks primarily made use of non-standard measures to provide liquidity via the longer-term monetary policy operations, thereby ensuring their longer-term funding. However the prevailing assessment is that the ECB measures to date have only had a limited direct impact on the Slovenian economy, having failed to sufficiently overcome the lack of confidence and the lack of willingness on the part of the banking system to expand lending to the private sector, thereby allowing surplus liquidity to flow into the real economy. In the wake of the gradual recovery of economic growth, the need for alternative sources of corporate financing has increased, which has also been reflected in the divergence of the cycle of the real sector from the financial cycle. The limited effectiveness of the non-standard measures can also be attributed to some of them being targeted on specific financial markets that are not particularly developed in Slovenia (e.g. the securities purchase programmes such as the CBPP and the ABSPP).

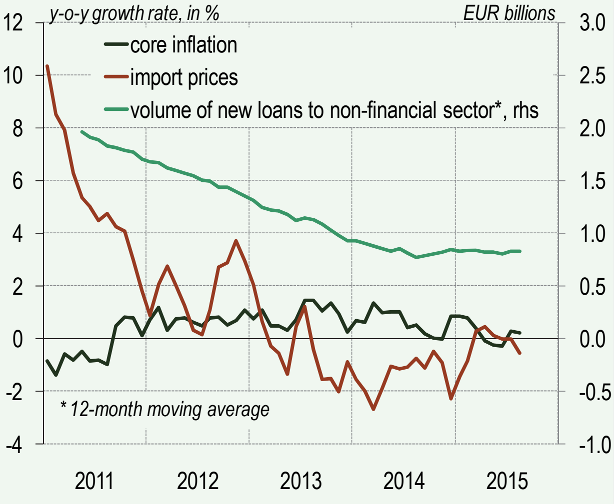
An indirect impact from the non-standard measures is currently prevalent in Slovenia, namely via the promotion of the export sector owing to increased demand from other euro

Figure 1: Effects of expansionary ECB monetary policy on selected indicators



Source: Bloomberg, ECB, Bank of Slovenia.

Figure 2: Selected indicators on which the expansionary ECB monetary policy has yet to have an effect



Sourse: SORS, Eurostat, Bank of Slovenia.

area countries on which the ECB measures are having a greater (direct) impact. Exports to economies outside the euro area are also more competitive in price terms as a result of the depreciation of the euro. The direct and indirect impacts of the expansionary monetary policy might already also be seen in the strengthening of final household consumption, although more precise assessments of the effects along all channels of monetary policy transmission will have to wait slightly longer.

in particular household appliances and cars. Turnover in other private-sector services also continued to grow. The most notable monthly rates of growth were recorded by architectural and engineering services. In light of the continuing rise in the number of domestic travellers, households have continued to spend more on leisure activities.

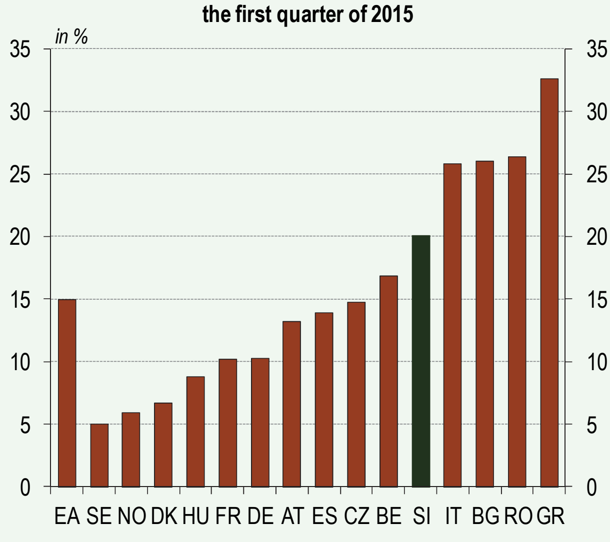
Employment

Total employment is continuing to rise, to a considerable extent as a result of a rise in the number of self-employed. Employment began rising gradually in the second quarter of last year, the rate of growth reaching 1.6% in the first half of this year, the highest figure since 2008. The number of employed persons in the first half of the year was up almost 1.5% in year-on-year terms, while the number of self-employed also recorded an increase.[5] On this occasion the self-employed accounted for a third of the increase in employment, the highest proportion since employment began rising in 2014. The proportion of self-employed among total employment in Slovenia accounted for a fifth, around 5 percentage points higher than the euro area average and significantly higher than in the most advanced European economies.

Employment in the private sector also increased in the first half of this year, and the contribution made by employment agencies was again prominent. The figure was up 1.8% in year-on-year terms. More than two-thirds of the increase in employment was attributable to professional, scientific and technical activities and administrative and support service activities, and most notably the increase in employment in employment activities.[6] There were also increases in the second quarter in employment in wholesale and retail trade, vehicle repair, transportation and storage, accommodation and food service activities, at 1.8%, and in manufacturing, at just over 1%. The number of employees in information and communication activities also increased, by more than 3%. Employment increased in the construction sector for the first time in six years, by 1.4%, although activity in the construction sector declined. Employment in financial and insurance activities has been falling for four years now owing to the restructuring of the banking sector, although the fall has slowed recently.

Employment in mostly public services is continuing to rise.[7] Employment in public services began rising last year, and was up 0.7% in the second quarter of this year.

Figure 2.23: Share of self-employed in EU countries in the first quarter of 2015



Source: Eurostat, Bank of Slovenia calculation.

[5] The employment analysis uses national accounts figures. According to the monthly figures, the workforce in employment in the first half of this year was up 1.2%. The discrepancy is the product of the different methodologies used to monitor employment. The national accounts figures for employment include permanent employees, self-employed and assisting family members in private farming, self-employed in other household activities, student work and other forms of temporary employment, employment in sea and coastal transport on Slovenian vessels, and employment at Slovenian diplomatic and consular offices in the rest of the world. The monthly figures only count employees with employment contracts and the self-employed in the workforce in employment.

[6] Employment in administrative and support service activities, which includes employment activities, increased by 7.8% in the second quarter. The employment activities segment includes employment agencies, which employ people but assign them to work at other firms. They constitute one of the uncertain forms of employment.

[7] Public administration and defence, education, human health and social work activities (Sectors O, P and Q under the SKD 2010).

Employment in the government sector was unchanged, while the number of employees in sectors not under direct government control, where private supply is also present, is continuing to rise. This is confirmed by the monthly SORS figures, which are not entirely comparable to the national accounts figures, and reveal that the workforce in employment in human health and social work and in education has been increasing in year-on-year terms since mid-2013. The total number of employees in July was up 1.9% in year-on-year terms in the human health and social work sector, and up 0.7% in the education sector.

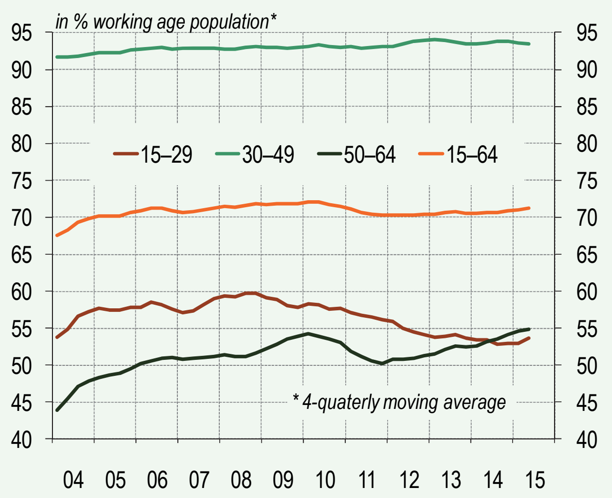
According to surveys, firms expect further increases in employment in the second half of this year. According to SORS survey figures, firms in manufacturing are expecting an increase in employment in the autumn. The Employment Service's *Employment Preview 2015/1* is forecasting that the largest hiring in the second half of the year will be by manufacturing firms, construction firms (in contrast to the SORS survey) and employment agencies, primarily manual workers. Research by Manpower, an employment agency, finds that the largest hiring in the final quarter will be by production firms, whose forecasts are the most optimistic of the last four years.

Box 2.4: Change in the structure of Slovenia's active population

There was no significant change in the activity rate during the crisis, but the structure of the active population did change profoundly. The activity rate measures the ratio of the workforce in employment and the unemployed to the total population able to work.[1] The overall activity rate stood at 71% in the second quarter of 2015, and had not changed significantly since the outbreak of the crisis. Neither have there been any major changes in the activity rate of those aged 30 to 49, which exceeds 90%. Changes have occurred in respect of young people (aged 15 to 29), where the activity rate has declined, and in respect of older people (aged 50 to 64), where it has increased. The activity rate among the young declined by almost 6 percentage points between the second quarter of 2008 and the second quarter of 2015 to stand at just 54%. Over the same period the activity rate among older people increased by almost 4 percentage points to 55%. The divergence in the activity rates between the two age groups is partly attributable to the pension reform[2] and the ban on hiring in the public sector, which is further reducing young people's employment opportunities. The activity rate among older people has exceeded that of young people since the middle of 2014, having been around 7 percentage points lower than that of young people at the outbreak of the crisis.

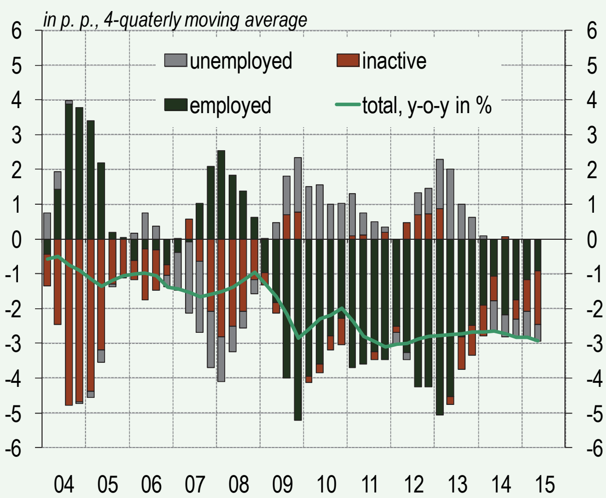
The decline in the population of young people has coincided for several years now with a decline in their activity, while the opposite trend has been prevalent in respect of older people. The number of young people (aged 15 to 29) has fallen by a fifth over the last ten years, primarily as a result of a fall in births since independence. It is cause for concern that the generational decline is being accompanied by a decline in active work and an increase in unemployment and inactivity. Even among those aged 30 to 49, it was mostly the number

Figure 1: Activity rates by age group



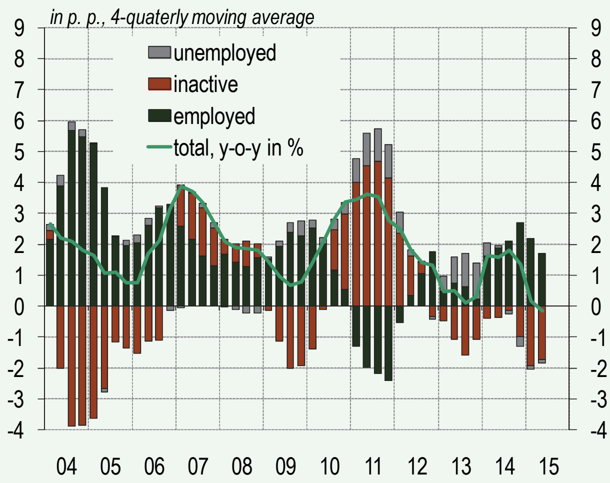
Source: Eurostat, Bank of Slovenia calculations.

Figure 2: Annual growth rates composition of working-age population – young (15–29 years)



Source: SORS – LFS, Bank of Slovenia calculations.

Figure 3: Annual growth rates composition of working-age population – older (50–64 years)



Source: SORS – LFS, Bank of Slovenia calculations.

of unemployed that rose during the crisis years. Meanwhile the structure improved in the rising older population, as the workforce in employment rose and the number of inactive workers fell. The exception was 2011, when mass outflows into inactivity were caused by the possibility of retirement under the old pension legislation.

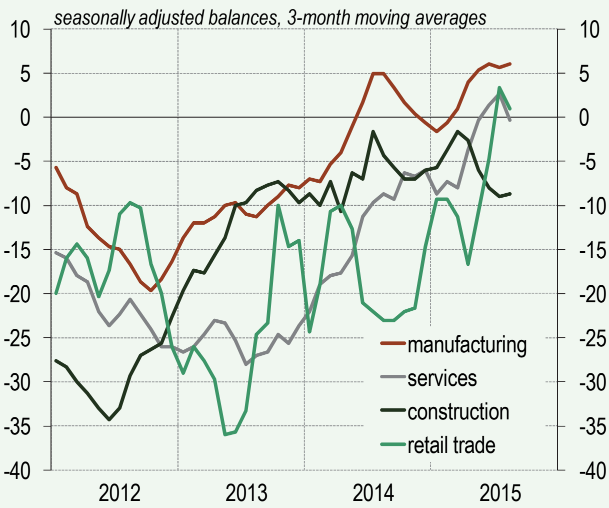
[1] All persons aged 15 to 64 who are primarily resident in Slovenia are classed as able to work. The population able to work consists of those in active work (employees, the self-employed, assisting family members), the unemployed and the inactive population.

[2] In addition to a rise in retirement ages and the extension of pensionable years of service, the pension reform in effect as of 1 January 2013 also brings benefits for those who meet the conditions but do not retire. In addition to their employment income, each month they are able to receive 20% of the pension to which they would have been entitled on the day that they met the conditions for retirement, up to the age of 65. They also receive a premium on the pension in the amount of 1% for every three months of extended years of service after meeting the conditions for retirement.

The improved economic developments are also being reflected in a rising number of notified vacancies. The number of vacancies in the second quarter was up almost a tenth on the previous quarter.[8] Employers in the sectors of manufacturing and construction notified the largest number of vacancies.

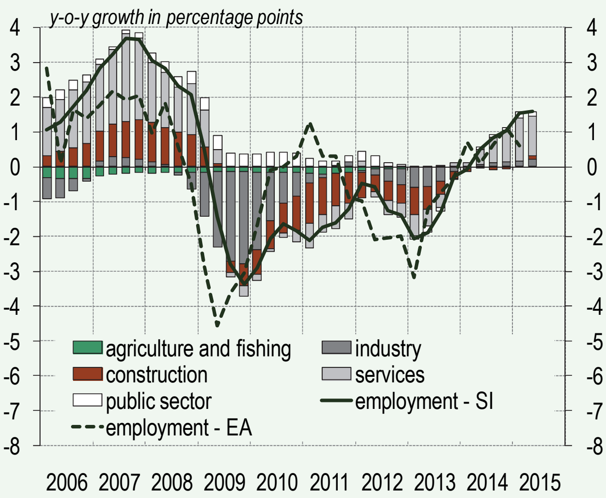
The structural mismatching on the labour market is increasing.[9] The gap between the shortage of skilled workers and the shortage of workers in general, which is one of the indicators of structural mismatching on the labour market, is widening, as a result of an increased shortage of skilled workers. The Employment Office's research states that there is primarily a shortage of vocational profiles for manual work (drivers of heavy goods vehicles and tractor units, welders, toolmakers, lathe operators, electricians, chefs, etc.).

Figure 2.24: Expected employment



Source: SORS.

Figure 2.25: Contributions to employment growth



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

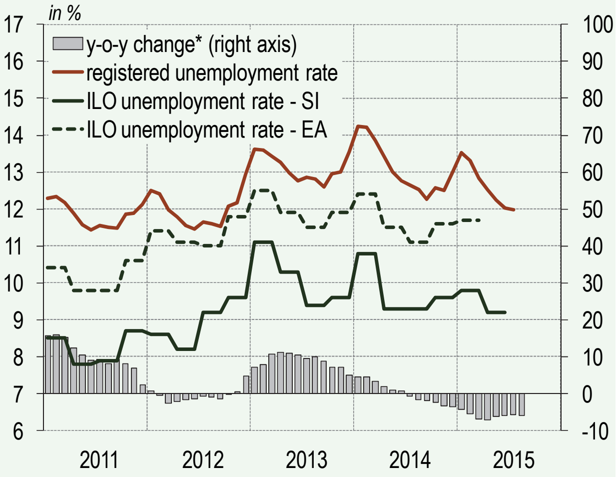
[8] In April 2013 the Labour Market Regulation Act abolished the mandatory notification of vacancies at the Employment Service for all employers other than the public sector and firms under majority government ownership. Between April 2013 and the end of 2014 the figures were no longer complete, for which reason the SORS introduced independent surveying of vacancies in the first quarter of 2015. Analysis of vacancies was thus only conducted for 2015. The sample framework included all business entities with at least one employee whose primary registered business activity was in one of Sectors B to S.

[9] The figure relates solely to manufacturing.

Figure 2.26: Labour shortage*

Source: SORS, Bank of Slovenia calculations.

Figure 2.28: Unemployment



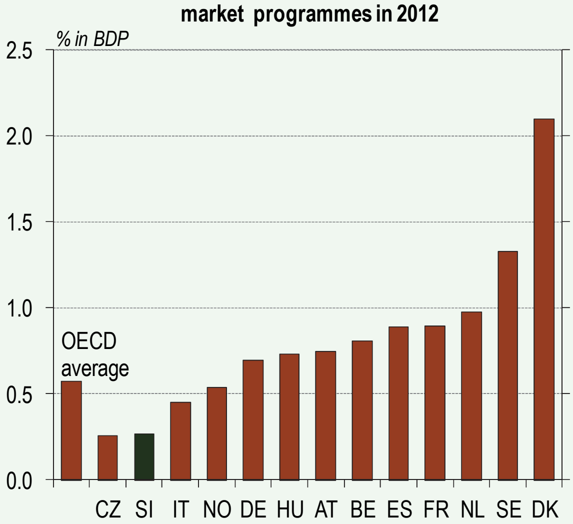
Note: * Number of registered unemployed persons, y-o-y change.
Source: Employment Service of Slovenia, SORS, Bank of Slovenia calculations.

Labour market flows and unemployment

The number of deregistrations from unemployment for reason of employment declined, while temporary employment remained prevalent among new hires. The average number of deregistrations from the Employment Office for reason of employment fell by 2.5% over the first eight months of the year, having risen by 16% over the same period last year. The fall in the number of deregistrations for reason of employment was also attributable to a halving of the funding for the active employment policy, which reduced the opportunities for the unemployed to enrol in programmes of subsidised employment and self-employment. The funding for active employment policy is already among the lowest in international comparisons. Slovenia earmarked just 0.3% of GDP for this purpose in 2012, just a half of the average of OECD members. The situation has not improved in subsequent years, on account of consolidation measures.

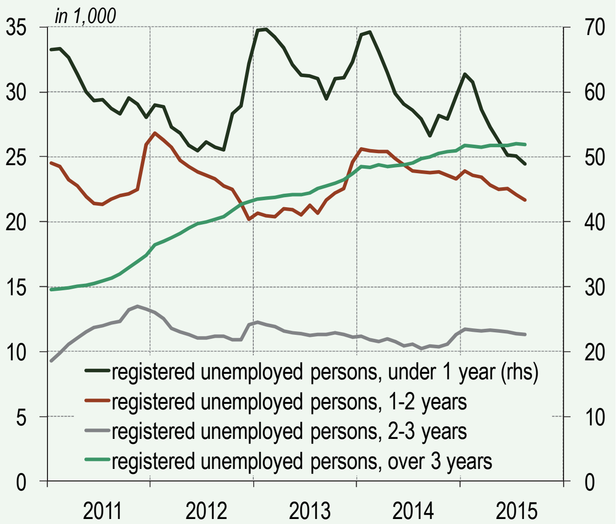
Temporary employment contracts remain prevalent among new hires. Employers are still cautious about hiring: three-quarters of all new hires in the first half of the year were in the form of temporary employment contracts, while among young people (aged 15 to 29) the figure is even higher, and is still rising. It stood at 82% in the second quarter.

Figure 2.27: Public expenditure on active labour market programmes in 2012



Source: OECD.

Figure 2.29: Long-term unemployed persons



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

The number of registered unemployed is falling rapidly this year, but unemployment is becoming increasingly structural. The fall in the number of unemployed over the first eight months of the year was in absolute terms the largest to date, and in relative terms the largest since 2007. The number of registered unemployed stood at 107,935 in August, down 6.0% in year-on-year terms. The registered unemployment rate has been falling for a year now, but remains high. It stood at 12% in July. The fall in the number of long-term unemployed since the beginning of the year is slightly more than in the same period last year, although the proportion of total unemployment that they account for increased in August to 55%, as a result of the decline in the number of people newly registering as unemployed, the highest figure since monitoring began in 2005. The deepening of structural employment is also evidenced in the continual increase in the number of unemployed people who have been registered at the Employment Service for more than three years, who now account for 44% of the total number of long-term unemployed. The proportion of the unemployed with tertiary qualifications is also increasing, while in terms of age groups there were increases in the proportions of those aged 30 to 39, and those aged 50 and over.

The decline in youth unemployment, which has been falling in relative terms for almost a year, is encouraging, and is partly attributable to the *Guarantee for*

Table 2.2: Unemployment and employment

	2010	2011	2012	2013	2014	14Q2	14Q3	14Q4	15Q1	15Q2
					in 1,000					
Registered unemployed persons	100.5	110.7	110.2	119.8	120.1	120.2	114.5	116.9	121.6	112.5
Unemployment rate					*in %*					
- LFS	7.3	8.2	8.9	10.1	9.8	9.3	9.3	9.6	9.8	9.2
- registered	10.7	11.8	12.0	13.1	13.1	13.1	12.5	12.7	13.2	12.3
Probability of transition between employ. and unemployment					*in %*					
- probability to find a job[1]	14.2	13.8	13.2	13.6	15.4	17.8	14.5	13.1	17.9	16.9
- probability to lose a job[2]	2.8	2.6	2.8	2.8	2.6	2.2	2.2	2.9	3.1	2.0
					in 1,000					
Total employment[3]	962.1	946.0	937.2	924.3	929.6	926.0	940.1	939.0	927.4	940.7
					year-on-year growth in %					
Persons in paid employment	-2.7	-2.0	-1.3	-2.8	0.6	0.5	0.9	1.3	1.3	1.3
Self-employed	0.7	-0.1	0.8	4.9	0.4	0.6	0.6	0.0	2.4	2.6
By sectors										
A Agriculture, forestry and fishing	-2.1	-2.4	-1.1	0.0	-0.2	-0.1	-0.1	0.0	0.0	0.0
BCDE Manufacturing, mining and quarrying and other industry	-5.6	-0.2	-1.1	-1.9	0.3	0.2	0.4	0.6	0.7	0.9
F Construction	-9.1	-11.7	-7.5	-7.0	-1.1	-0.6	-1.2	-1.1	0.0	1.4
GHI Trade, accommodation, transport	-2.2	-2.6	-1.2	-1.3	-0.3	-0.7	0.3	0.8	1.5	1.8
J Information and communication services	0.8	0.3	2.1	2.3	2.6	2.7	2.7	3.0	3.8	3.4
K Financial and insurance activities	-0.8	-2.7	-1.7	-2.8	-2.1	-2.5	-2.1	-2.1	-1.7	-0.9
L Real estate activities	0.0	-2.7	-1.4	0.5	0.9	0.0	1.9	1.9	1.9	0.0
MN Professional, technical and other business activities	2.3	0.9	0.4	-2.2	3.7	3.8	4.1	4.2	5.9	4.4
RST Other activities	1.1	-1.3	0.2	6.0	3.2	3.2	3.5	4.0	3.7	3.7
- mainly private sector (without O..Q)[3]	-3.0	-2.3	-1.4	-1.6	0.6	0.5	0.9	1.2	1.7	1.8
- mainly public services (O..Q)[3]	2.2	1.0	1.0	-0.6	0.4	0.5	0.5	0.6	0.8	0.7
Total employment[4]	-2.1	-1.7	-0.9	-1.4	0.6	0.5	0.8	1.0	1.5	1.6

[1] Newly employed as a share of registered unemployed persons according to Employment Service of Slovenia. The higher the indicator's value, the better chance of finding a job.
[2] Newly registered unemployed due to a job loss as a share of total employment. Calculation is based on Employment Service of Slovenia's data and registered data of total employment. The higher the indicator's value, the higher chance of losing a job.
[3] Employed and self-employed persons.
[4] Public administration, education, human health and social work services according to NACE rev. 2.
Source: SORS, Employment Service of Slovenia, Bank of Slovenia calculations.

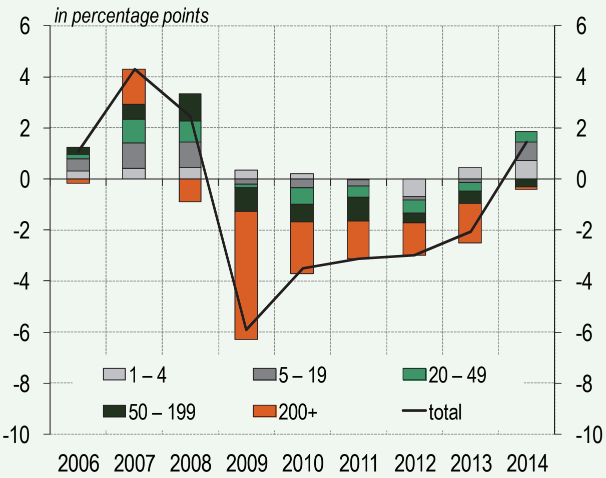
Box 2.5: It was mainly large firms that laid off workers during the crisis, while small firms are contributing to renewed employment growth

Employment on the basis of AJPES reports on the performance of firms in the private sector fell by 16.4% between 2009 and 2013, of which around two-thirds was accounted for by the fall in employment at firms employing more than 200 workers. The proportion of employment accounted for by the largest firms thus fell from 43% in 2008 to 38% in 2014.

Employment rose in 2014, mainly due to hiring at smaller firms (fewer than 50 employees). Employment at such firms rose by 4.8%, accounting for 1.9 percentage points of overall growth in employment in the corporate sector. It is interesting that despite the economic crisis the number of employees at the very smallest firms (one to five employees) rose every year in the period 2003-2014, other than in 2011 and 2012.

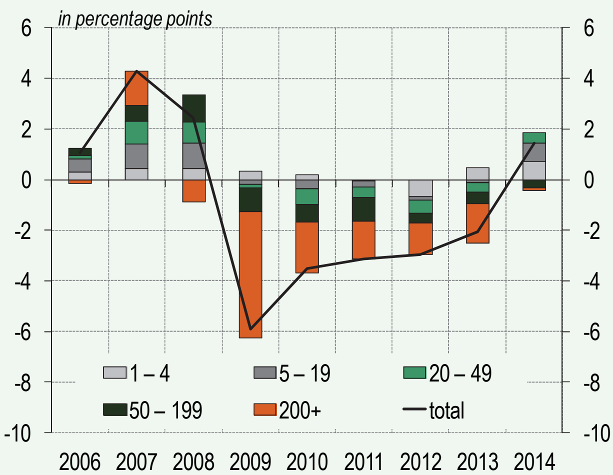
Further evidence of the archetypal developments in which the main contribution to the fall in employment after 2009 came from large firms, which were also far behind smaller firms in the renewed employment growth in 2014, is presented by the figures broken down by sector. The vast majority (82%) of the fall in employment in manufacturing between 2008 and 2013 can be ascribed to the largest firms, whose share of net employment in 2014 was negligible. The proportion of employment in manufacturing accounted for by the largest firms thus declined from 56% in 2008 to 50% in 2014. Despite a fall in overall employment in manufacturing of almost a fifth between 2008 and 2014, the number of employees at firms with one to 19 employees increased by 9% over this period.

Figure 1: Contributions to employment growth by firm size



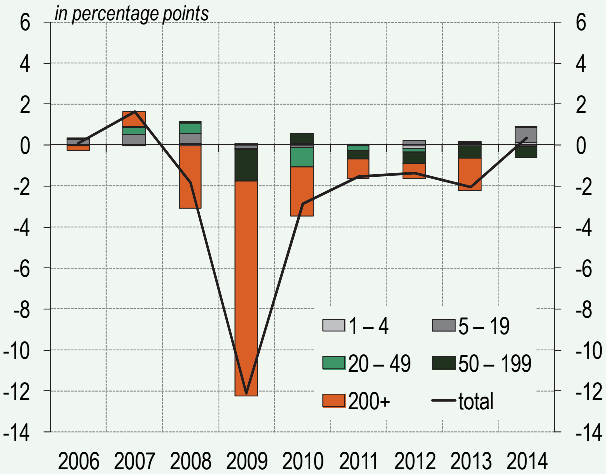
Source: AJPES – annual reports on the performance of companies, Bank of Slovenia calculations.

Figure 3: Contributions to employment growth by firm size - wholesale and retail trade



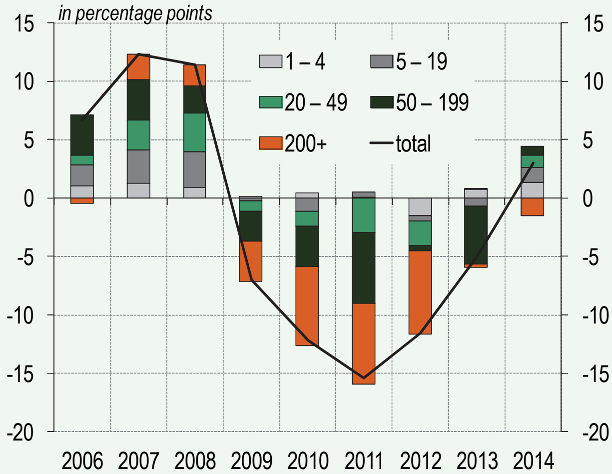
Source: AJPES – annual reports on the performance of companies, Bank of Slovenia calculations.

Figure 2: Contributions to employment growth by firm size - manufacturing



Source: AJPES – annual reports on the performance of companies, Bank of Slovenia calculations.

Figure 4: Contributions to employment growth by firm size - construction



Source: AJPES – annual reports on the performance of companies, Bank of Slovenia calculations.

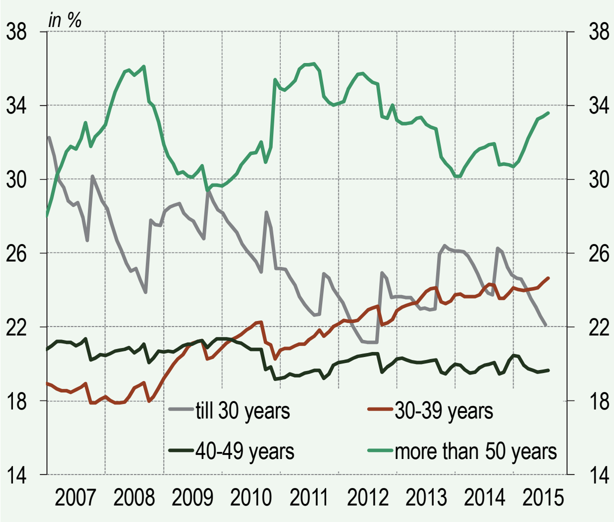
the Young **scheme,[10] although the proportion of unemployment accounted for by those aged 30 to 39 is increasing persistently.** One of the many reasons is that funding for active employment policy is being directed to those aged 29 and under or 50 and over, which is causing a relative increase in unemployment in the 30 to 39 age group. Given the limited funding for active employment policy, which relates to advice, training and employment for the unemployed, there is a need for a national employment and education strategy that ensures that the education system is producing employable school leavers.

The total number of people newly registering as unemployed at the Employment Office is falling, but the number of those registering as unemployed as a result of the loss of temporary employment has begun to rise. The number newly registering as unemployed over the first eight months of the year was down 6.0% in year-on-year terms. The largest factors in this decline were falls of a fifth in inflows from bankruptcies and redundancies, and 17% delcine in inflows of first-time jobseekers. By contrast, inflows from loss of temporary employment were up 2.5% during the first eight months of the year, and were up 7.7% between May and August. Inflows from loss of temporary employment between May and August last year were down 7.1%. This is an indication that the labour market reforms[11] are not having the desired effects.

Wage developments

Nominal wage growth has aligned with price developments this year. The average nominal gross wage in the total economy rose over the first seven months of the year by just 0.5% in year-on-year terms, comparable to the second half of 2013. The average wage in the private sector was up 0.7%. The rise was the result of a rise of 2.1% in wages in primarily export-oriented manufacturing, and a rise of 2.7% in financial and insurance activities. After last year's pronounced growth, wages declined significantly in the mining sector. Wages in the accommodation and food service activities sector were also down, by 1.5%. Wages in mostly public services have been rising moderately in year-on-year terms since the middle of last year. Wages rose most notably in public administration and defence, by 1.2%, but were unchanged in education and health.

Figure 2.30: The share of unemployed by age



Source: Employment service of Slovenija, Bank of Slovenia calculation.

Figure 2.31: Total wage bill and average monthly gross wage per employee

*Note *The wage bill is calculated as the product of the average gross wage for employees of legal persons who received pay and the total number of employees of legal persons.*
Source: SORS, Bank of Slovenia calculations.

[10] The *Guarantee for the Young* action plan for 2014 and 2015 aims to improve the position of young people on the labour market. It combines 36 measures from various government departments, the aim of which is to improve youth employability and to help young people activate themselves on the labour market.

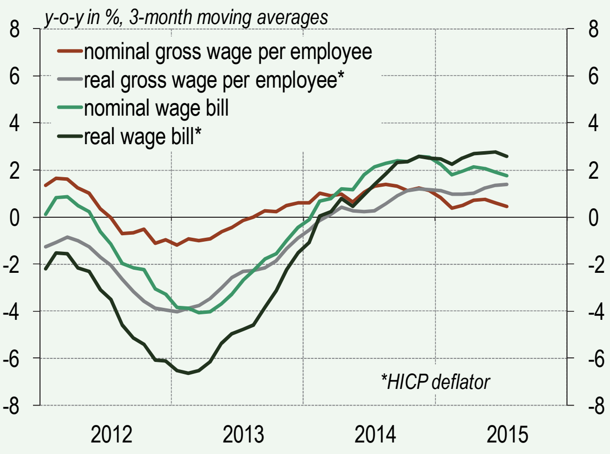
[11] The labour market reforms passed on 5 March 2013 incentivised against temporary employment by limiting the chaining of contracts for the same job to a maximum of two years, introducing severance pay in the event of termination of temporary employment at a level comparable to severance pay for permanent employment, increasing the employers' contributions to unemployment insurance on temporary contracts, and exempting employers from paying this contribution for the first two years after hiring an employee permanently.

Table 2.3: Labour costs indicators

	2010	2011	2012	2013	2014	14Q2	14Q3	14Q4	15Q1	15Q2
					in EUR					
Average gross wage	1495	*1525*	1526	1523	1540	1528	1524	1581	1535	1537
					nominal year-on-year growth, %					
Average net wage	3.9	2.1	0.4	0.6	0.8	0.8	0.9	0.9	0.1	0.3
Average gross wage	3.9	2.0	0.1	-0.1	1.1	1.1	1.3	1.1	0.5	0.6
- mainly private sector (excl. O..Q)[1]	5.0	2.6	0.9	0.7	1.4	1.3	1.4	1.4	0.5	0.9
- mainly public services (O..Q)[1]	-0.1	0.0	-2.2	-2.3	0.2	0.2	1.1	0.7	0.8	0.2
Average gross wage in manufacturing	8.9	3.9	2.5	2.8	3.3	2.8	3.1	3.2	2.1	2.3
Average real net wage[2]	1.8	0.1	-2.3	-1.3	0.5	0.0	0.8	0.9	0.7	1.2
Labour costs per hour worked[3]	1.0	2.0	-0.3	-2.1	2.0	2.2	2.2	1.0	2.4	2.0
Labour costs per hour worked in manufacturing[3]	3.2	1.9	2.9	0.6	3.7	2.6	5.9	3.2	1.9	2.1
Gross wage per unit of output[4]	0.4	-0.4	1.9	-0.5	-1.3	-1.7	-1.4	-0.6	-0.7	-0.4
Gross wage per unit of output in manufacturing[4]	-4.8	0.7	4.0	1.2	-1.5	-1.6	-2.1	-3.4	-3.9	-2.2
Unit labour costs[4,5]	0.6	-0.8	0.8	0.2	-1.3	-2.0	-1.2	-0.3	-0.8	-0.1
Labour costs per employee[5]	4.0	1.5	-1.0	0.5	1.1	0.7	1.6	1.4	0.4	0.9
Output per employee	3.4	2.4	-1.8	0.3	2.5	2.8	2.8	1.8	1.2	1.0
Output per employee - manufacturing	14.3	3.2	-1.4	1.6	4.8	4.5	5.3	6.8	6.2	4.6
HICP	2.1	2.1	2.8	1.9	0.4	0.8	0.1	0.0	-0.5	-0.8
GDP deflator	-1.0	1.1	0.3	0.8	0.8	0.7	0.6	0.6	0.6	0.1

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

Figure 2.32: Total wage bill and average gross wage per employee



Note: Wage bill is calculated as the product of average gross monthly wages for employees of legal persons who received pay and the total number of employees of legal persons.
Source: SORS, Bank of Slovenia calculations.

Growth in employment and wages has also been reflected in a rise in the nominal wage bill. The nominal wage bill over the first seven months of the year was up 2.1% in year-on-year terms, having increased by 2.6% in the private sector and by almost 1% in mostly public services. Deflation meant that growth in the real wage bill approached 3%.

3 Current Account and Competitiveness Indicators

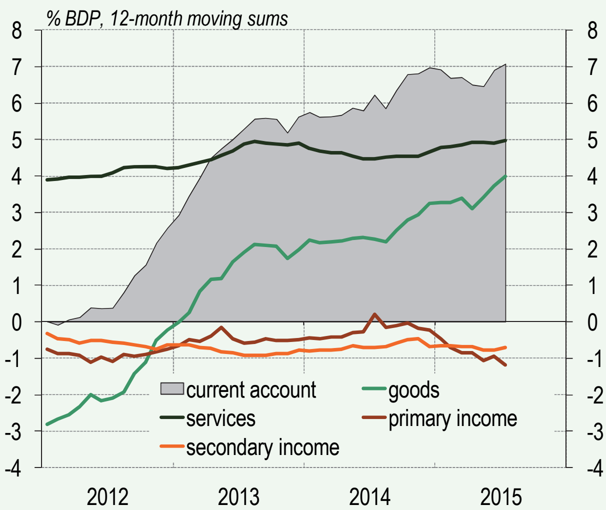
The improved competitiveness of the Slovenian economy has been reflected via current account surplus that is large, even without consideration of the terms of trade. The cost competitiveness of the export sector is already significantly ahead of the euro area average, which simultaneously with the geographical diversification of markets allows for rapid growth in merchandise exports despite the crisis on the Russian market. Export growth is continuing to outpace import growth, as the impact of the recovery in private consumption on imports is relatively small for the moment, which is contributing to the generation of a large surplus in merchandise trade. The surplus of trade in services is also gradually widening; the largest factor is this year's significant rise in the number of foreign travellers. The only deficit widening this year is that in primary income, which remains strongly under the influence of reinvested earnings. The deficit in secondary income remains relatively stable at the same time, primarily as a result of solid inflows of EU funds.

Slovenia's competitiveness is continuing to strengthen relative to all major trading partners. The year-on-year fall in domestic prices increased further, while developments in domestic labour costs were more favourable than in the majority of the partners from the perspective of export competitiveness. Exchange rate developments in particular had a positive impact on the competitiveness of euro area countries in the Asian and US markets.

Current account position

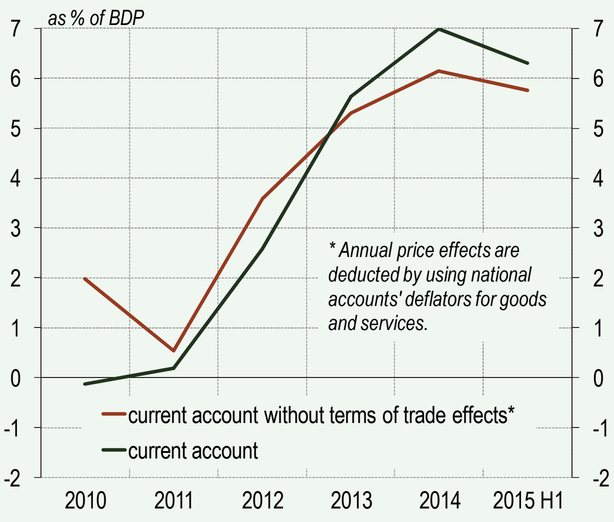
The current account surplus has remained at a high level this year, even without consideration of the terms of trade. The 12-month surplus exceeded 7% of GDP in July, up just over 1 percentage point on a year earlier. The increase is primarily attributable to a widening merchandise trade surplus, where export growth continues to significantly outpace import growth, despite the slightly faster recovery in domestic final consumption. At the same time the surplus of trade in services also widened slightly, as a result of an increased surplus in transport and travel services, and a base effect in imports of business services. Only the widening deficit in primary

Figure 3.1: Current account components



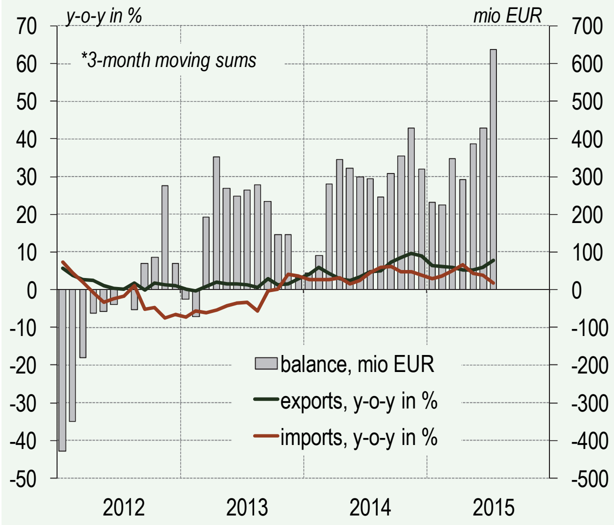
Source: Bank of Slovenia.

Figure 3.2: Terms of trade effects on the current account balance



Source: SORS, Bank of Slovenia.

Figure 3.3: Goods trade*



Source: Bank of Slovenia.

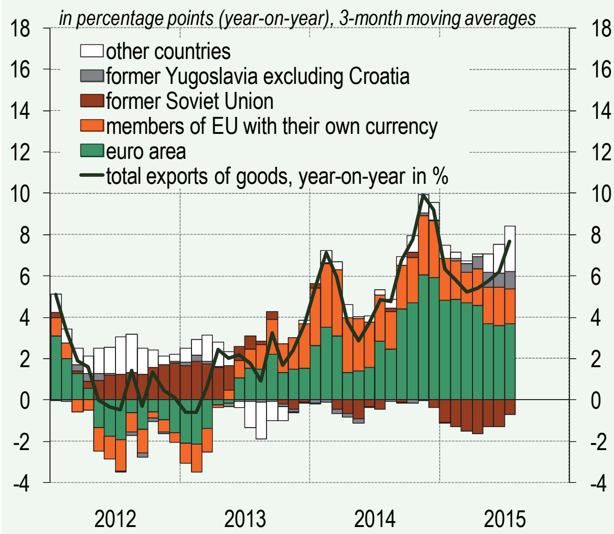
income, where a large net outflow on the basis of reinvested earnings has been forecast for this year, is holding down the growth in the current account surplus. The 12-month deficit in secondary income remains stable. The current account surplus would be high even in the context of neutral terms of trade, and would amount to just under 6% of GDP.

Merchandise trade

Growth in merchandise exports remains solid, and significantly above growth in imports. After slowing in the early part of the year, year-on-year growth in merchandise exports has strengthened again slightly in recent months. It averaged 5.8% over the first seven months of the year, while growth in merchandise imports stood at 3.7%. Both figures were comparable to last year's averages. The merchandise trade surplus thus continued to widen rapidly. Over the first seven months of the year it increased by EUR 306 million in year-on-year terms.

Growth in merchandise exports has increased in recent months as a result of exporters' increasing focus on non-traditional markets. The contribution made to overall growth in merchandise exports by non-traditional markets strengthened over the three months to July to around 2 percentage points. Growth in exports to the US, Switzerland and Turkey was high, although export flows to non-traditional markets are highly diversified in geographical terms. Exporters are thereby demonstrating their great flexibility in compensating for the loss of demand on key markets, Russia on this occasion. Exports to Serbia and to Bosnia and Herzegovina have also strengthened. The majority of growth remains attributable to exports to other EU countries, but so far has remained at lower levels compared with the final quarter of last year.

Figure 3.4: Contributions to export growth by country groups

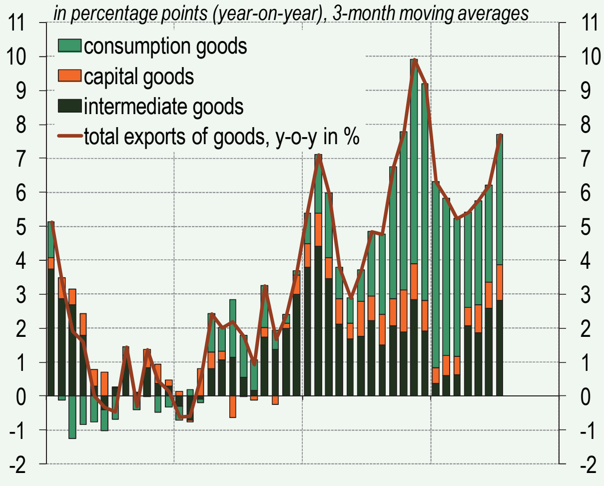


Source: SORS, Bank of Slovenia calculations.

This year's developments in nominal exports have been profoundly affected by price factors and the cycle of the domestic automotive industry. The significant decline in year-on-year growth in merchandise exports in the first quarter was largely a reflection of a slow-

Figure 3.5: Contributions of main BEC groups to export growth

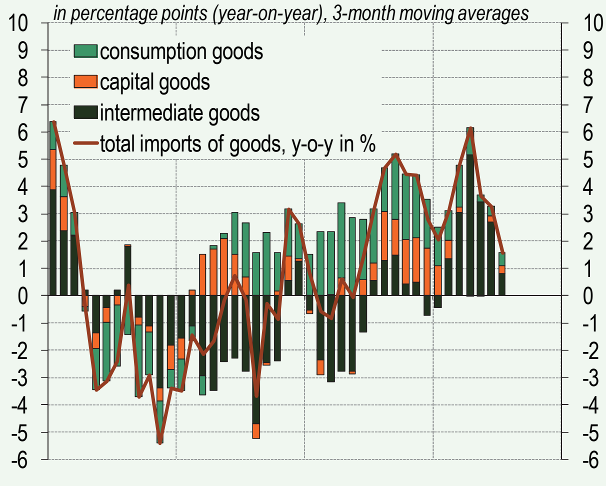
in percentage points (year-on-year), 3-month moving averages



Source: SORS, Bank of Slovenia calculations.

Figure 3.6: Contributions of main BEC groups to import growth

in percentage points (year-on-year), 3-month moving averages



Source: SORS, Bank of Slovenia calculations.

down in exports of intermediate goods[12] as a result of a nominal decline in oil re-exports and exports of organic chemical products and plastics. The latter coincided with a fall in oil prices on the global market. At the same time there was a decline in wood exports, most likely as a result of a base effect. The decline in exports of the aforementioned products had mostly dissipated by the second quarter, while exports of other major intermediate goods continued to rise, including various products of the metals industry and the automotive industry. The contribution made to exports of consumer goods by automotive exports is declining, from 4.2 percentage points in the first quarter to just 0.7 percentage points in July, although it is gradually being compensated for growth in exports of pharmaceutical products. Exports of food products increased at the same time. Growth in exports of capital goods increased in the second quarter, as a result of positive contributions by most segments of the machinery industry.

This year's nominal growth in merchandise imports is attributable to a base effect in intermediate goods, unchanged investment, and inventories of merchandise. The contribution made to overall nominal growth in imports by intermediate goods[13] was strongly negative in the first half of last year, primarily as a result of price factors and a fall in electricity prices owing to high domestic production. The sharp fall in import prices of various commodities (other than oil) was a major factor in the negative contribution made by imports of various metals and metal products. Import prices of commodities stabilised in the second half of last year, and have begun rising in year-on-year terms this year. As a result of a base effect, this contributed to an increase in nominal growth in imports of intermediate goods for the purposes of the metals industry in the first half of this year. The contribution made by electricity imports was also positive in the first half of the year, as a result of a deterioration in hydro power conditions and the refitting of the nuclear power station. The effect of the fall in oil prices on nominal imports was particularly pronounced at the turn of the year, although the contribution made to overall growth in nominal imports by oil imports has been negative since the beginning of 2013. Imports of consumer goods began rising in the second half of 2013, and were primarily directed into inventories, judging by the developments in domestic demand aggregates. Imports of cars, furniture, and clothing and footwear strengthened last year, which coincided with the recovery in final household consumption. Growth in imports of consumer goods has slowed sharply this year, and the increased consumption in the second quarter was most likely covered from inventories.

[12] Intermediate goods accounted for approximately 55% of total merchandise exports over the first seven months of the year, consumer goods for 34% and capital goods for around 10%.

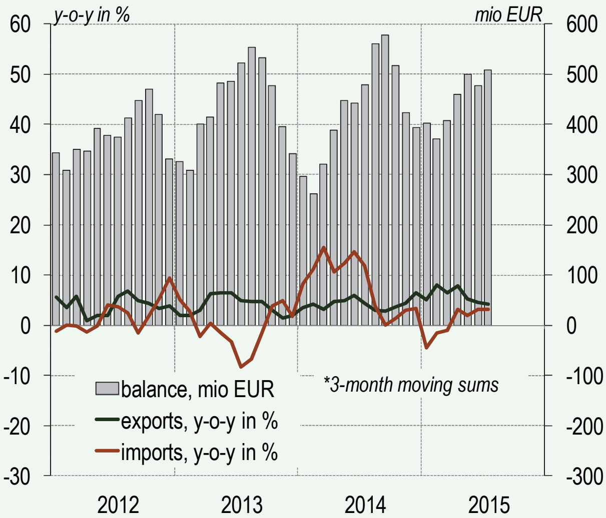
[13] Intermediate goods accounted for approximately 60% of total merchandise imports over the first seven months of the year, consumer goods for 28% and capital goods for around 12%.

Growth in imports of capital goods has also slowed sharply this year, in line with weaker gross fixed capital formation.

Trade in services

After a temporary year-on-year decline in the first half of last year, the surplus of trade in services is again gradually strengthening. The narrowing of the surplus in the first half of last year was primarily the result of one-off factors in imports of services, while the renewed growth is primarily attributable to positive developments in trade in transport and travel services. Trade in construction services is also generating a large surplus, albeit primarily as a result of changes on the import side. The deficit in trade in business services also narrowed for similar reasons. The overall surplus of trade in services over the first seven months of the year widened by EUR 152 million in year-on-year terms.

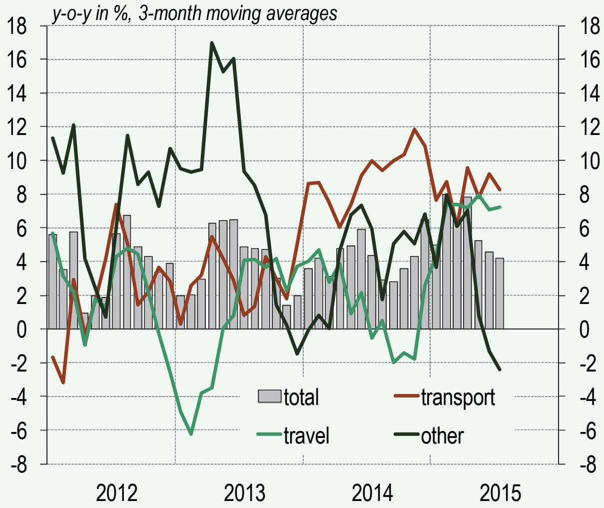
Figure 3.7: Trade in services*



Source: Bank of Slovenia.

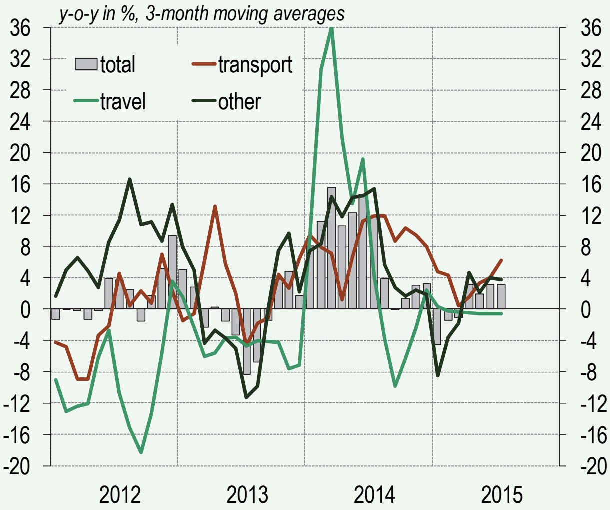
This year's overall growth in exports of services remains solid, as a result of extra impetus in travel services and the maintenance of high growth in exports of transport services. Growth in exports of services strengthened significantly in the second half of last year as a result of increased growth in transport services. Exports of construction services and business services increased as well, while exports of travel services increased sharply at the end of the year. Growth strengthened further at the beginning of this year, as a result of increased arrivals of foreign travellers. Alongside construction services and business services, there was also a jump in exports of telecommunications, computer and information services. Growth in exports of services slowed in the second quarter of this year, despite the maintenance of high growth in exports of transport and travel services. The main reason was a fall in exports of telecommunications, computer and information services, and construction services. Exports of the latter continued to decline in July. Overall exports of services over the first seven months of the year were up 5.4% in year-on-year terms, a higher rate than last year's average growth. Exports of travel services recorded pronounced growth in excess of 7%, as the number of arrivals by foreign travel-

Figure 3.8: Services exports



Source: Bank of Slovenia.

Figure 3.9: Services imports



Source: Bank of Slovenia.

lers was up 12%, while the number of their overnight stays was up 8%. Growth in exports of transport services remained close to last year's level, at just under 8%. Overall growth in exports of other services slowed sharply, to just under 2%.

After declining in the first quarter, imports of services have strengthened slightly during the remainder of the year. Growth in imports of services was already slowing sharply in the second half of last year, as a result of a decline in imports of travel services and business services. Imports of services in the first quarter actually de-

Table 3.1: Components of the current account

				in 12 months to							
	2012	2013	2014	Jul.14	Jul.15	14Q1	14Q2	15Q1	15Q2	Jul.14	Jul.15
						in EUR million					
Current account balance	930	2,023	2,607	2,291	2,690	505	666	425	759	307	378
1. Goods	-81	708	1,210	832	1,516	281	299	349	429	135	243
2. Services	1,509	1,761	1,736	1,641	1,888	321	443	407	477	191	223
2.1. Transport	633	660	727	694	781	164	188	185	215	74	80
2.2. Travel	1,278	1,345	1,325	1,311	1,406	256	303	286	338	130	147
2.3. Other	-401	-243	-315	-363	-299	-99	-48	-63	-77	-13	-4
3. Primary income	-271	-172	-87	74	-448	67	-7	-166	-39	37	-58
3.1. Labour income	376	385	420	420	415	94	129	91	126	32	31
3.2. Investment income	-890	-867	-717	-614	-1,020	-109	-215	-277	-259	-1	-93
3.3. Other income	243	310	209	268	158	83	79	20	93	6	4
4. Secondary income	-227	-275	-252	-256	-266	-165	-68	-166	-107	-55	-30
						in % of BDP					
Current account balance	2.6	5.6	7.0	6.2	7.1	5.8	7.0	4.7	7.7	9.5	11.4
1. Goods	-0.2	2.0	3.2	2.3	4.0	3.2	3.1	3.9	4.4	4.2	7.3
2. Services	4.2	4.9	4.7	4.5	5.0	3.7	4.6	4.5	4.8	5.9	6.7
2.1. Transport	1.8	1.8	1.9	1.9	2.1	1.9	2.0	2.1	2.2	2.3	2.4
2.2. Travel	3.6	3.7	3.6	3.6	3.7	3.0	3.2	3.2	3.4	4.0	4.4
2.3. Other	-1.1	-0.7	-0.8	-1.0	-0.8	-1.1	-0.5	-0.7	-0.8	-0.4	-0.1
3. Primary income	-0.8	-0.5	-0.2	0.2	-1.2	0.8	-0.1	-1.8	-0.4	1.1	-1.8
3.1. Labour income	1.0	1.1	1.1	1.1	1.1	1.1	1.3	1.0	1.3	1.0	0.9
3.2. Investment income	-2.5	-2.4	-1.9	-1.7	-2.7	-1.3	-2.2	-3.1	-2.6	0.0	-2.8
3.3. Other income	0.7	0.9	0.6	0.7	0.4	1.0	0.8	0.2	0.9	0.2	0.1
4. Secondary income	-0.6	-0.8	-0.7	-0.7	-0.7	-1.9	-0.7	-1.8	-1.1	-1.7	-0.9
						nominal year-on-year growth rates in %					
Export of goods and services	1.6	2.4	5.7	3.4	6.6	4.1	3.8	6.0	5.7	5.3	4.8
Export of goods	1.0	2.1	6.0	3.2	7.0	4.3	3.4	5.9	6.0	5.6	4.8
Export of services	4.1	4.1	4.5	3.9	5.1	3.1	5.9	6.5	4.6	3.9	5.0
Transport	2.9	3.9	9.4	6.9	8.9	7.5	9.1	6.1	9.2	9.1	7.9
Travel	1.7	1.5	0.8	2.7	3.8	2.8	2.1	7.4	7.1	-1.3	6.9
Other	8.0	7.1	5.0	3.0	3.4	0.0	7.3	6.1	-1.3	7.8	0.2
Import of goods and services	-2.3	-1.6	4.3	3.4	3.5	4.3	4.2	4.1	3.8	6.7	-0.7
Import of goods	-3.1	-1.7	3.8	2.6	4.0	2.7	2.6	4.9	4.0	6.9	-0.6
Import of services	2.8	-1.2	7.5	8.5	0.8	15.5	14.7	-1.1	3.1	5.4	-1.2
Transport	-1.6	3.4	8.8	6.6	5.7	7.2	11.3	0.5	4.0	2.9	8.1
Travel	-10.6	-4.9	5.4	4.9	-2.2	36.0	19.1	-0.4	-0.6	-10.4	-0.5
Other	10.0	-1.6	7.8	10.3	0.1	14.4	14.5	-1.8	4.0	18.7	-4.7

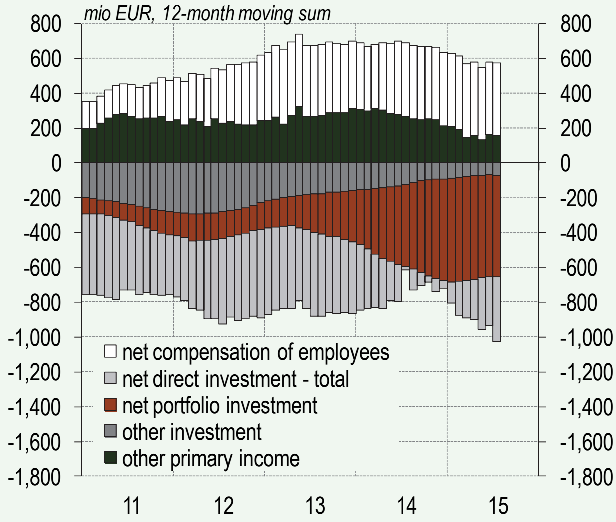
Source: Bank of Slovenia.
Note: Shares in GDP are calculated on the basis of monthly estimates of GDP.

clined in year-on-year terms, albeit primarily as a result of strong base effects. These were primarily related to the high growth in imports of travel services, business services and construction services recorded in the first half of last year, which was attributable to one-off factors (the Winter Olympics, payments for services during the recovery and resolution of the domestic banking system, increased construction of public infrastructure). Imports of services have strengthened slightly during the remainder of the year, as a result of increased imports of transport services and financial services. Imports of services over the first seven months of the year were merely up just under 1% in year-on-year terms. Imports of travel services were down 0.5% as a result of a fall in estimated spending in the rest of the world by residents, while imports of transport services were up just over 3%, and imports of all other services were up just 0.3%.

Primary and secondary income

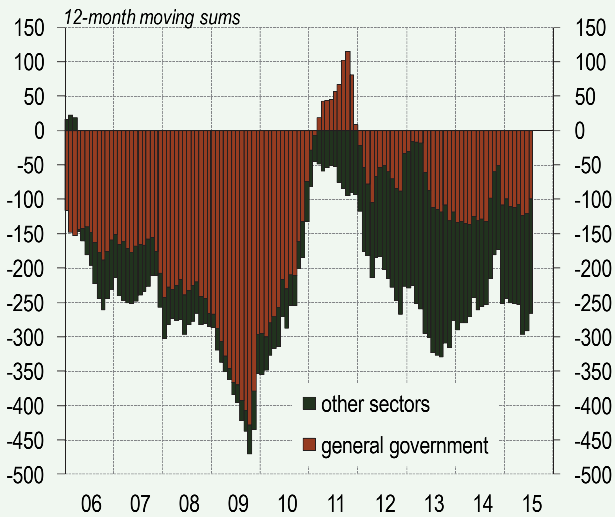
After narrowing last year,[14] the deficit in primary income has been widening rapidly this year as a result of net outflows of income on FDI. The deficit in primary income narrowed by EUR 84 million last year to just EUR 87 million. This was attributable to a year-on-year narrowing of EUR 384 million in the deficit in income on equity to just EUR 30 million. The narrowing deficit was attributable to reinvested earnings, which in methodological terms were disclosed as a positive net inflow in the amount of more than EUR 450 million, but whose actual value was the result of the decline in the equity of non-resident firms in Slovenia being larger than the decline in domestic firms' equity in the rest of the world. The decline in equity was concentrated in the financial sector and, in part, in the real estate sector. Judging by the current estimate of reinvested earnings,[15] the decline in non-resident firms' equity in Slovenia has slowed, while the decline in domestic firms' equity in the rest of the world has increased, which contributed EUR 375 million to the year-on-year deterioration in the primary income position over the first seven months of the year from a surplus of EUR 97 million to a deficit of EUR 263 million. At the same time the net outflow of dividends declined by EUR 50 million in year-on-year terms to EUR 149 million, while growth in net outflows of interest on debt securities slowed as a result of the improved terms of government financing on international markets. The net outflow of interest over the first seven months of the year amounted to EUR 360 million. The net outflow of interest on other investments, predominantly loans, continued to decline, which was related to domestic banks' repayments of debt in the rest of the world and the fall in interest rates. The government

Figure 3.10: Net primary income



Source: Bank of Slovenia.

Figure 3.11: Net secondary income



Source: Bank of Slovenia.

[14] This year's revision to the balance of payments significantly reduced the deficit in primary income in 2014, as a result of a change of EUR 421 million in reinvested earnings.
[15] The forecast for reinvested earnings is based on a three-year average of operating results minus current dividend payments.

Box 3.1: Recording of reinvested earnings in external statistics

Reinvested earnings are an imputed transaction that is recorded in balance of payments statistics under primary income, and is simultaneously a transaction in the financial account under FDI. According to the Balance of Payments Manual (BPM6), imputed transactions are only created in exceptional cases when the transactions are not booked by economic entities, or need to be eliminated from the sum of transactions and rerouted to clearly illustrate the underlying economic relationship.

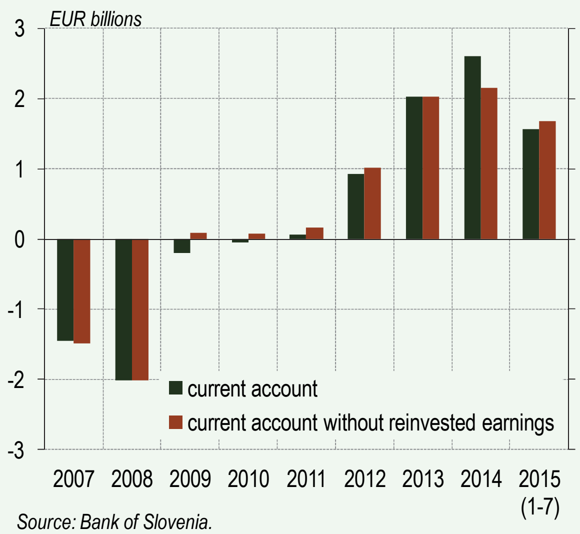
The logic of reinvested earnings is that the retained earnings of an economic entity that is under foreign ownership are attributed to a foreign investor (in proportion to the investor's equity holding), and are treated as if they had been paid and then invested in the equity of the economic entity. Because an essential attribute of FDI is that a foreign investor has control and a decisive role in the decision on profit distribution, this imputed transaction discloses the scope of the investor's decision to reinvest in the controlled enterprise.

Reinvested earnings may be negative or positive. If they are negative, it means that distributed profits exceeded the net earnings in the period in question (net profit or loss), or that the entity in question is operating at a loss.

Inward FDI in Slovenia recorded negative reinvested earnings over the 2009 to 2014 period at aggregate level, which entails divestment in the financial account of the balance of payments (a decline in liabilities from equity belonging to foreign investors). The balancing transaction in the current account consists of expenditure of primary income with a negative sign. The negative reinvested earnings were largely attributable to foreign owners' losses in firms in the sectors of financial and insurance activities, real estate activities and construction. By contrast, profit distributions to foreign owners increased over the aforementioned period in particular in the sectors of manufacturing, and the wholesale and retail trade, maintenance and repair of motor vehicles.

A similar situation can be seen on the side of Slovenia's outward FDI. Outward investors also recorded negative reinvested earnings over the 2009 to 2014 period at aggregate level, thereby reducing equity in the financial account of the balance of payments (a decline in equity holdings). The balancing transaction in the current account consists of negative receipts of primary income. The negative reinvested earnings were largely attributable to losses in the rest of the world recorded by domestic owners in the sector of financial and insurance activities. By contrast, the level of profit distributions to domestic owners was maintained over the aforementioned period. The largest profit distributions were recorded by investors in the sectors of manufacturing, and wholesale and retail trade.

Figure 1: The impact of reinvested earnings on the current account balance



Source: Bank of Slovenia.

Table 1: Current account and reinvested earnings of direct investment

EUR millions	2007	2008	2009	2010	2011	2012	2013	2014	2015 (1-7)
Current account	-1,451	-2,017	-203	-43	68	930	2,023	2,607	1,562
Current account without reinvested earnings	-1,493	-2,010	87	72	158	1,016	2,031	2,152	1,672
Net reinvested earnings	-42	7	290	115	90	86	9	-454	110
Expenditures (reinvested earnings on foreign direct investment in Slovenia)	84	18	-5	-252	-85	-340	-499	-646	-114
Receipts (reinvested earnings on direct investment of Slovenia in the rest of the world)	125	11	-295	-367	-175	-426	-507	-192	-223

Source: Bank of Slovenia.
*Note: * Data on reinvested earnings in 2015 are estimated on the basis of a three-year average of total earnings less dividends and other profits, paid in 2015. The estimate will be replaced by actual data by June 2016, when financial statements for 2015 are available.*

Reinvested earnings are a component of primary income that is a part of current account and contributes to the current account balance. As is evident from the table and the figure, in 2007 and 2014 reinvested earnings contributed to a wider current account surplus (by fully EUR 454 million in 2014), while in all the other years they acted to worsen the current account position, most notably in 2009.

sector's surplus in primary income over the first seven months of the year narrowed by EUR 60 million in year-on-year terms to EUR 125 million. Net taxes of products are in deficit, while inflows of EU funds for agriculture also declined. There was no significant year-on-year change in the surplus in labour income.

The deficit in secondary income widened slightly over the first seven months of the year.[16] It amounted to EUR 302 million, up EUR 14 million in year-on-year terms. Only the private sector's deficit widened in year-on -year terms, by EUR 23 million to EUR 102 million. The government sector's deficit narrowed by EUR 9 million over the same period to EUR 200 million. The government sector's deficit was attributable to payments into the EU budget on the basis of VAT and gross national income, which over the first seven months of the year were down EUR 16 million in year-on-year terms. The net inflow of EU funds for the implementation of certain common policies also declined slightly at the same time.

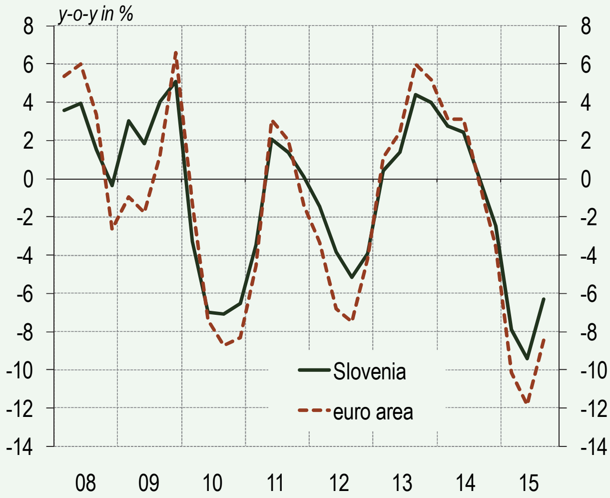
Selected competitiveness indicators

The price competitiveness of exports on markets outside the euro area increased, primarily as a result of a sharp fall in the euro. Slovenia's harmonised competitiveness indicator against 19 major trading partners outside the euro area as measured by the HICP/CPI deflator recorded its largest decline since 2000 over the first nine months of the year. This was largely attributable to the euro's fall against the Chinese yuan and the US dollar. The impact of the fall in the euro on the decline in the aforementioned indicator for the euro area was even greater, as a result of the larger role played in foreign trade by non-euro-area partners, and the corresponding higher weights in export structure.

The year-on-year fall in domestic prices strengthened over the first nine months of the year, which again increased Slovenia's price competitiveness against all its major trading partners in the euro area. Only Greece and Cyprus recorded larger price falls in the euro area. The harmonised indicator of Slovenia's price competitiveness against other euro area countries fell again in year-on-year terms, largely as a result of a greater price rises in Germany and Austria.

From the perspective of export competitiveness, developments in unit labour costs (ULCs) in the first half of the year were more favourable than in the majority of euro area countries. The year-on-year decline in ULCs slowed in the second quarter, and came to a halt when seasonal effects were excluded. This was primarily attributable to growth in labour costs in manufacturing as

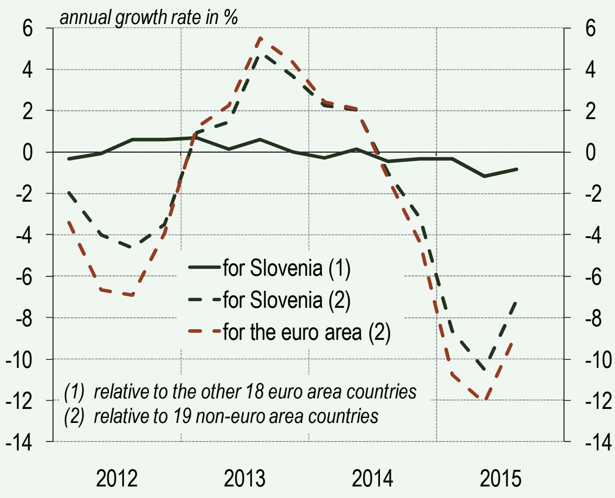
Figure 3.12: Nominal harmonised competitiveness indicator (vis-a-vis 19 trading partners outside the euro area)



Source: ECB.

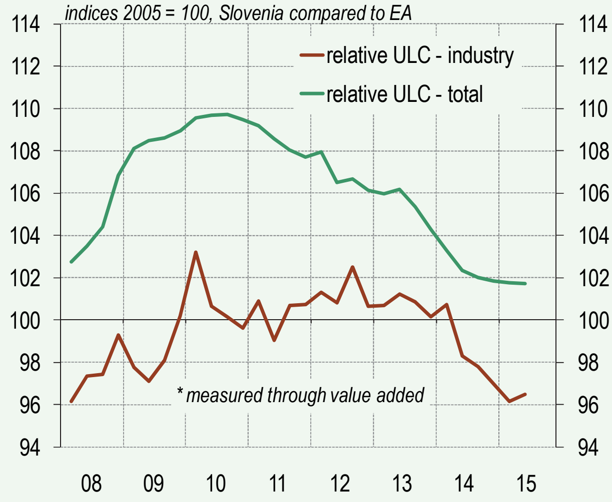
[16] Over the longer term the largest factor in the government sector's position in secondary income is the ability to make use of EU funds for the implementation of various common policies. In methodological terms these funds are classed as "miscellaneous current government transfers", in which the surplus increased sharply in 2010 and 2011, but has been gradually declining in recent years. At the same time the deficit in social transfers and payments into the EU budget on the basis of VAT and gross national income increased. The widening of the private sector's deficit in secondary income since 2010 is the result of a deficit in taxes on income and wealth, and in social security contributions and various types of insurance.

Figure 3.13: Harmonised price competitiveness indicators (based on HICP/CPI deflators)



Source: ECB.

Figure 3.14: Nominal unit labour costs* in relative terms



Source: Eurostat, Bank of Slovenia calculations.

growth in activity slowed slightly, and a fall in value-added in construction. However year-on-year growth in labour costs across the euro area was again higher than in Slovenia, as ULCs increased in all major economic sectors.

With productivity growth outpacing wage growth, nominal ULCs in Slovenia in the last two years have remained below the average from 2010. Labour productivity per employee rose by 5% in real terms over this period. Labour productivity across the euro area increased more slowly. By the middle of 2015 real labour productivity and nominal ULCs across the euro area were up 2% and just under 6% on their respective averages from 2010.

Figure 3.15: Harmonised cost competitiveness indicators* (based on ULC deflators)

Source: ECB.

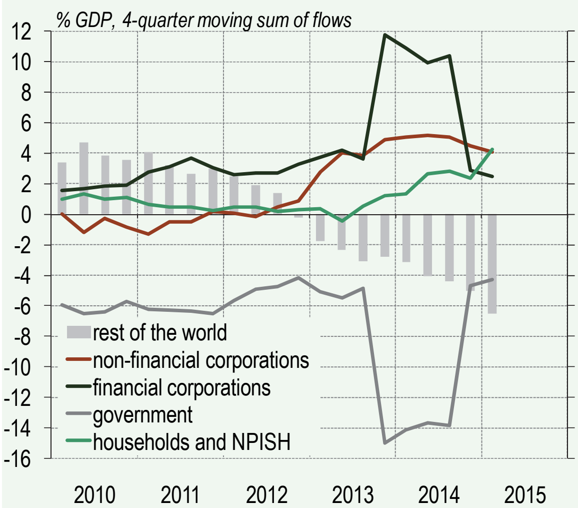
4 Financing

Slovenia's financial surplus with the rest of the world totalled 6.5% of GDP in the first quarter of 2015, an indication of the surplus in national saving over investment, whereby saving of corporations has already returned to its pre-crisis level, but their investment is just over a half of its pre-crisis level. With the exception of the general government sector, all the domestic institutional sectors have recorded financial surpluses over the last two years. The non-financial corporations sector primarily used its surplus to repay debt, while households directed their surplus into currency and bank deposits. The restoration of confidence in the banks has improved their funding structure, thereby reducing systemic risks. Despite favourable financing conditions and increasing demand for loans, the banks have remained cautious with regard to investments.

Financing of domestic institutional sectors and the rest of the world

The large surplus in the current account is an indication of a surplus in national saving over investment. The domestic institutional sectors' financial surplus against the rest of the world increased from 2.8% of GDP in 2013 to 5.0% of GDP in 2014, and amounted to 6.5% of GDP on an annualised basis in the first quarter of 2015. Saving remains larger than investment in the non-financial corporations sector and has already returned to its pre-crisis level, while investment is just over half of its level of 2008. The non-financial corporations sector's surplus remained at the level of 4% of GDP, as non-financial corporations primarily directed the surplus to repayment of their debt and improving their financing structure. Households remain cautious with regard to consumption. The household sector's surplus has been increasing since the middle of 2013, and passed 4% of GDP in the first quarter on an annualised basis, which primarily turned out as an increase in bank deposits. After temporarily increasing because of the measures to stabilise the banking system in late 2013, the financial corporations sector's surplus and the government sector's deficit have returned to a stable level. Financial corporations recorded a surplus of 2.5% of GDP on an annualised basis in the first quarter of 2015. The banks, with a surplus of just under 2% of GDP, continued to reduce their

Figure 4.1: Financing of institutional sectors



Source: Bank of Slovenia - nonconsolidated financial accounts, SORS.

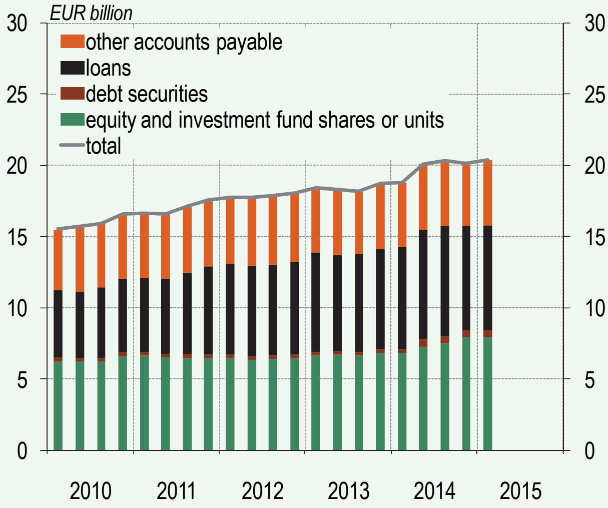
total assets. The government sector's deficit amounted to 4.3% of GDP. The rest of the world has recorded a deficit against financial corporations and households over the last year, and a surplus against the government sector and non-financial corporations.

Corporate financial assets and financing

Corporate financial assets amounted to EUR 41 billion at the end of the first quarter of 2015, which is EUR 0.6 billion more than at the end of 2014, but EUR 1.5 billion less than at the end of 2013. The figure was EUR 4.5 billion lower than at the end of 2010, with the largest decline being recorded in 2014, at EUR 2.1 billion. Non-financial corporations increased their trade credits and advances in the first quarter of 2015, particularly vis-à-vis the rest of the world, while domestic business-to-business lending continued to decline. There was a slight increase in other claims, most notably claims against the government sector and intra-sectoral claims, and in loans granted, both business-to-business loans and loans to the rest of the world, while bank deposits remained at their level from the end of 2014. Investments in equity, which account for the largest proportion of non-financial corporations' financial assets, declined slightly as a result of negative revaluations.

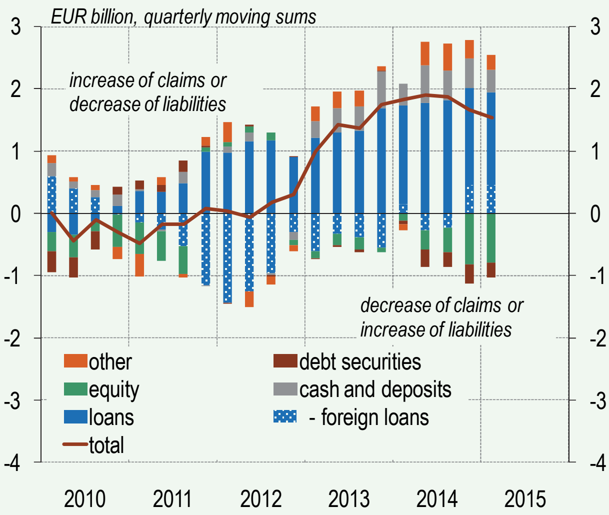
Non-financial corporations' liabilities amounted to EUR 79.2 billion at the end of the first quarter of 2015, broadly unchanged from the end of 2014, but up

Figure 4.3: Financial liabilities of NFCs (S.11) to rest of the world



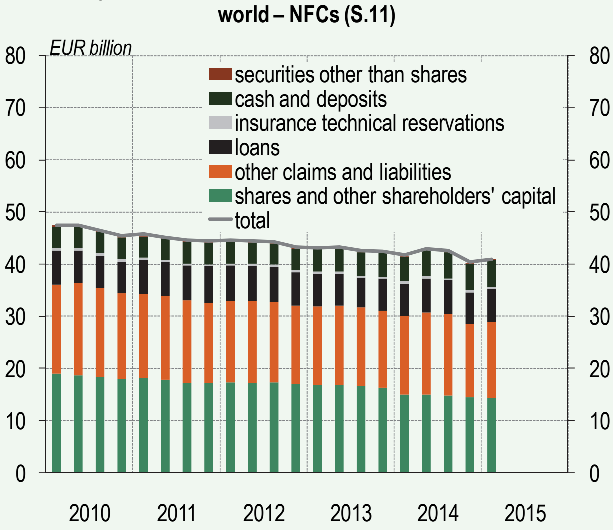
Source: Bank of Slovenia, non-consolidated data.

Figure 4.4: Net financial transactions of NFCs (S.11)



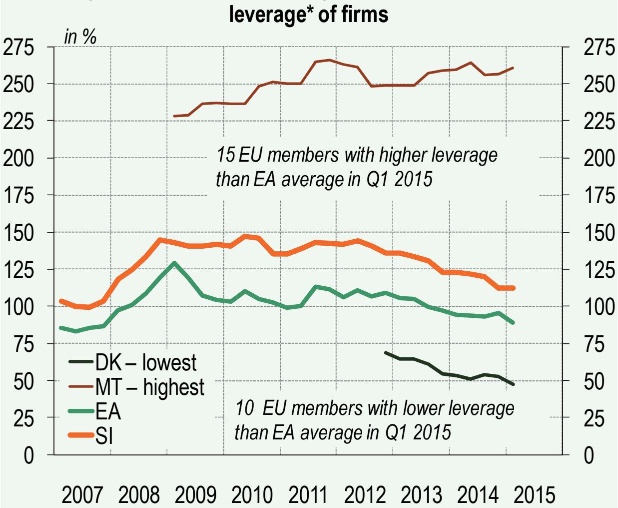
Source: Bank of Slovenia, consolidated data.

Figure 4.2: Financial claims towards the rest of the world – NFCs (S.11)



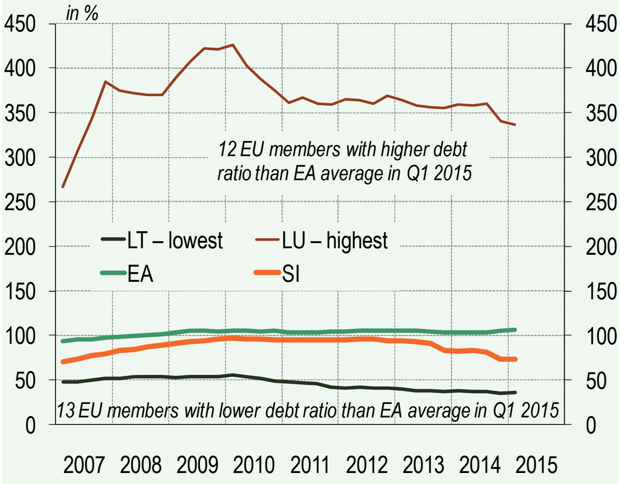
Source: Bank of Slovenia.

Figure 4.5: Cross EU-country comparison of financial leverage* of firms



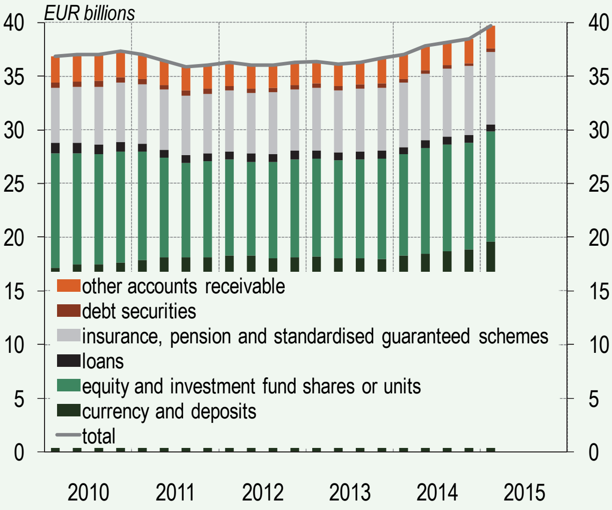
Source: ECB, Bank of Slovenia calculations.
Note: * Debt to equity ratio.

Figure 4.6: Cross EU-country comparison of indebtedness* of firms



Source: ECB, Bank of Slovenia calculations.
Note: * Debt (loans + debt securities) to GDP ratio.

Figure 4.7: Financial assets of households (S.14 and S.15)



Source: Bank of Slovenia, non-consolidated data.

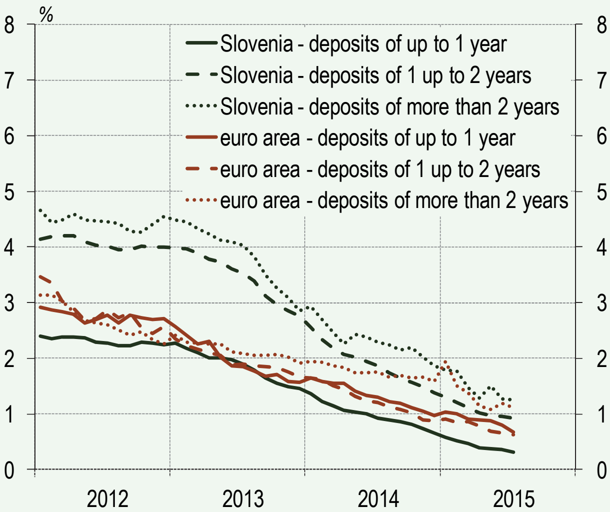
EUR 1.7 billion on the end of 2013. The figure was down EUR 10.5 billion on the end of 2010, the largest decline being recorded in 2013. Non-financial corporations reduced their liabilities via trade credits and advances in the first quarter of 2015, most notably their intra -sectoral liabilities. Non-financial corporations' debt repayments at domestic banks slowed, while there was an increase in business-to-business financing via loans and a decline in financing from the rest of the world.

Slovenian corporate indebtedness as measured by the debt-to-equity financing ratio is declining, but it remains high. It stood at 112% in the first quarter, 35 percentage points less compared to the peak in the second quarter of 2010. The corporate indebtedness indicator as measured by the ratio of debt to GDP stood at 73%, less than the euro area average.

Household financial assets and financing

Household financial assets amounted to EUR 39.7 billion at the end of the first quarter of 2015, exceeding the end of 2013 for EUR 3.0 billion. Households remain cautious with regard to consumption, and are primarily investing their surpluses in currency and deposits. The increase in household deposits is an indication of the increased confidence in the domestic banks. The majority of deposits are still sight deposits, an indication of households' prudence.

Figure 4.8: Interest rates on household deposits, by maturity

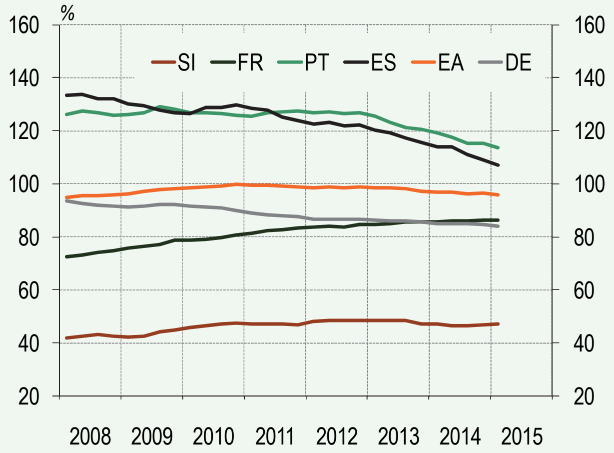


Source: ECB, Bank of Slovenia.

In addition to caution, the lowering of interest rates remains an additional factor in the shortening of average deposit maturity. Interest rates on deposits of all maturities fell last year in Slovenia and in the other euro area countries. With the additional ECB measures, the fall has continued this year. Interest rates on short-term deposits in Slovenia stay below the euro area average, while by contrast interest rates on medium-term and long-term deposits in Slovenia remain above the euro area average.

Despite the favourable financing situation, households have not undertaken additional borrowing, and remain among the least-indebted in the euro area. Household financial liabilities amounted to just over EUR

Figure 4.9: Cross country comparison of household indebtedness *



Source: ECB.
*Note: * Indebtedness is calculated as debt (loans+debt securities) over gross disposable income.*

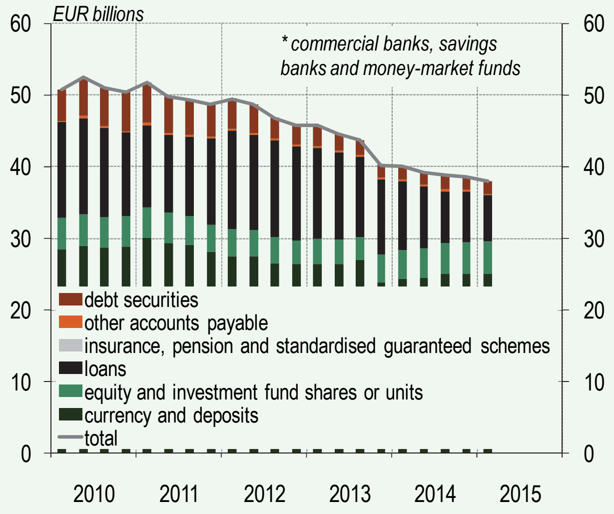
12 billion at the end of the first quarter of 2015, virtually unchanged over the last two years. The stock of bank loans as the most important form of household borrowing also remained unchanged in the first quarter.[17] Household indebtedness in Slovenia thus remains low, and is barely half of the euro area average.

Bank funding and investments

Debt repayments on foreign markets and the increased confidence in the banking system are bringing a gradual improvement in the structure of bank funding. With a gradual rise in deposits by the non-banking sector, particularly households, is restoring the confidence in the domestic banks. Because deposits are the most reliable and stable source of bank funding, the systemic risks associated with refinancing on foreign markets are also diminishing. In the first quarter of this year the banks succeeded in repaying a part of the liabilities to the ECB, which as a ratio to total assets are now below their pre-crisis level, while loan liabilities to domestic and foreign banks have also declined. The structure of bank funding has altered significantly in the last year, and is becoming similar to that seen before the period of increased borrowing in the rest of the world by the banks.

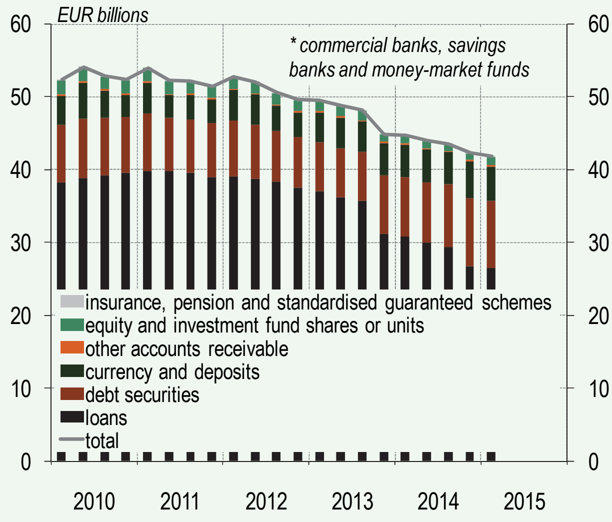
Despite favourable financing conditions, the banks have remained cautious with regard to investments. The banking sector's financial assets amounted to EUR 41.8 billion at the end of the first quarter of 2015, EUR 0.5 billion less as at the end of 2014. This was the result of a decline in deposits (in the rest of the world and at the central bank), a decline in investments to debt securities (government securities in particular), and a decline in loans granted (between banks in particular). Despite the fall in asset interest rates and the narrowing spread with average euro area interest rates, the banks' credit standards remain a strong limiting factor on the supply side.

Figure 4.10: Financial liabilities of banks* (S.122 and S.123)



Source: Bank of Slovenia, non-consolidated data.

Figure 4.11: Financial assets of banks* (S.122 and S.123)



Source: Bank of Slovenia, non-consolidated data.

[17] Household loans began increasing in year-on-year terms after the first quarter. In addition to the continuing growth in housing loans, there is also a reversal of the negative dynamic in consumer loans.

Box 4.1: Bank performance in the first half of 2015

The pace of contraction in the Slovenian banking system's total assets has strengthened slightly in 2015. The ongoing contraction in wholesale funding increased in the second quarter of this year as issued debt securities matured at several banks. Growth in deposits by the non-banking sector slowed, while the average maturity of deposits has shortened in the situation of low deposit rates, which is reducing the stability of this source of bank funding. Household lending has been recording positive growth since May of this year, while the contraction in corporate lending is maintaining the same pace, but is not worsening. The quality of the credit portfolio has remained stable this year, with further reductions in both classified claims and claims more than 90 days in arrears.

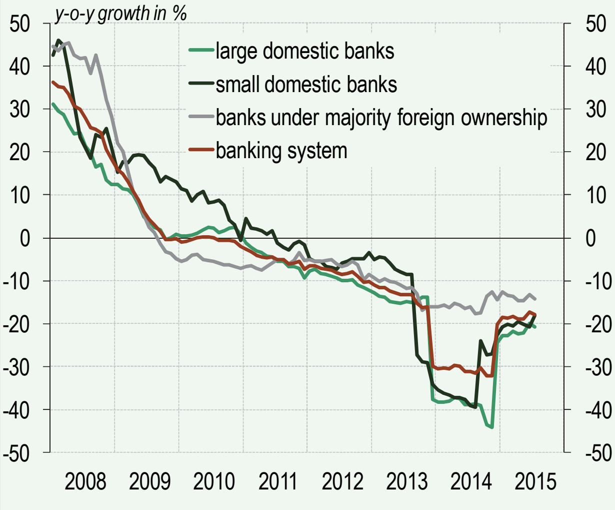
The year-on-year contraction in loans to the non-banking sector has gradually slowed in 2015, reaching 10.1% in July, or 7.5% if the transfers to the BAMC at the end of last year are excluded. The amount of new long-term corporate loans over the first seven months of this year was similar to the same period last year, while the amount of short-term corporate loans was down just under a third. The banks' high credit standards on corporate loans have remained unchanged (according to the BLS), while demand for corporate loans is continuing to increase. Interest rates on loans of up to EUR 1 million fell by 1.3 percentage points over the first seven months of the year, more than the fall over the whole of last year (1.1 percentage points). which is increasing Slovenian banks' competitiveness relative to the rest of the euro area.

Household loans have been increasing since May of this year, year-on-year growth reaching 0.3% in July. The growth in household loans is the result of stable growth in housing loans, while the pace of the contraction in consumer loans is slowing. The banks slightly relaxed their credit standards on both consumer loans and housing loans in the second quarter of this year, and there were reports (BLS) of increased demand for both types of loan for the first time after a long period of decline.

Non-performing claims (those more than 90 days in arrears) remained stable over the first six months of the year at an average level of 11.5% of the banking system's total classified claims, and then declined to 11.1% in July. Given the relatively low quality of the claims against these clients, the banks are continuing to reduce their exposures to them, although they are improving the quality of the remaining part of the portfolio via forbearance and, in part, via write-offs of non-performing claims. The most notable declines in non-performing claims against non-financial corporations in terms of stock and proportion were recorded by firms in manufacturing (down 2.6 percentage points at 9.8%) and wholesale and retail trade (down 2.5 percentage points at 15.9%), which this year are contributing most to economic growth.

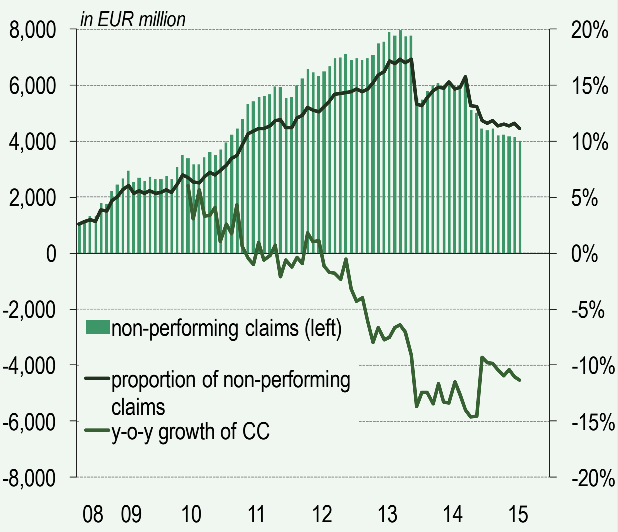
Debt repayments on the wholesale markets over the first seven months of this year were up significantly in year-on-year terms, as a result of the increased maturing of debt securities at the large domestic banks. During this period the banks under majority foreign ownership in particular continued repaying liabilities to banks in the rest of the world with

Figure 1: Loans to non-financial corporates



Source: Bank of Slovenia.

Figure 2: Non-performing claims



Source: Bank of Slovenia.

the same intensity. The proportion of total funding accounted for by funding on the wholesale markets stood at just 12.2% in July, merely a third of the figure at the end of 2008.

Growth in deposits by the non-banking sector has been positive this year, albeit with a slower dynamic. The rate stood at just 1.2% in July. The government sector's overnight placements and corporate deposits have been the main factors in the fluctuation in the stock of deposits by the non-banking sector. Growth in household deposits is also slowing, but was still 3.3% in July. Low deposit interest rates are acting to shorten the average maturity of these deposits. The proportion accounted for by sight deposits had risen to 54% by the end of July, up 6 percentage points on the end of 2014.

The net interest margin on interest-bearing assets has maintained a trend of decline, albeit very slow, and it remains above 2%. The interest margin calculated on interest-bearing assets over the 12 months to July stood at 2.12%, while the margin on total assets was 2.02%. The banking system's net interest income has continued to decline, but the contraction in total assets means that the decline in the net interest margin is smaller than it might otherwise have been. The margin at the banks under majority foreign ownership is around 2%, while the margin at the banks under majority domestic ownership is 0.2 to 0.3 percentage points higher.

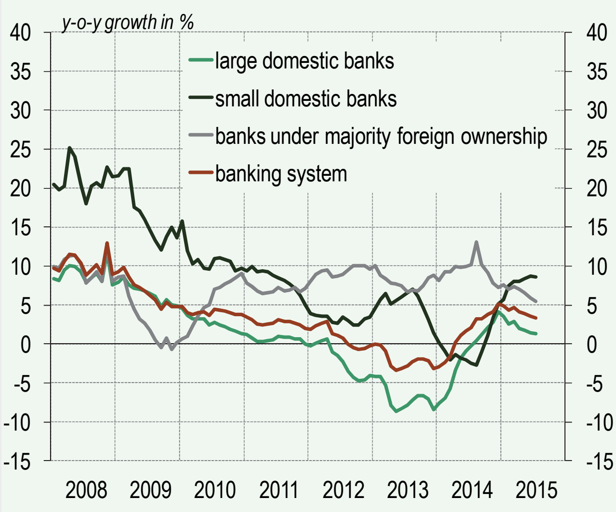
The net interest margin has again become a significant factor in the banks' profitability, in a situation of stability in the ratio of impairment and provisioning costs to total assets and a decline in operating costs. After a rise in the net interest margin at the beginning of the recovery and resolution process and the stabilisation of the situation, following which the structure of the banking portfolio improved, the banks' asset interest rates have for some time remained at the levels attained, while the liability interest rates have continued to decline. The proportion of deposits by the non-banking sector accounted for by (unremunerated) sight deposits has increased sharply over the same period.

In an environment of persistently low interest rates, the banks are increasingly facing downward pressures on the interest margin in the future. On the asset side these pressures comprise a contraction in lending activity, a fall in asset interest rates, and the maturing of the portfolio of debt securities, which the banks will have to replace with lower-yielding investments in the coming years. By contrast, the banks are constrained in making further reductions in interest expenses, the level of liability interest rates having already fallen sharply, while the proportion of sight deposits is higher.

The banks recorded a solid pre-tax profit over the first seven months of this year. It amounted to EUR 182 million, and was attributable to reduced impairment and provisioning costs. The banking system's gross income over the first seven months of the year was down 9.7% in year-on-year terms, as net interest declined by 10.6% and net non-interest income declined by 8.2%. Interest expenses were down 40%, while interest income was down 22%.

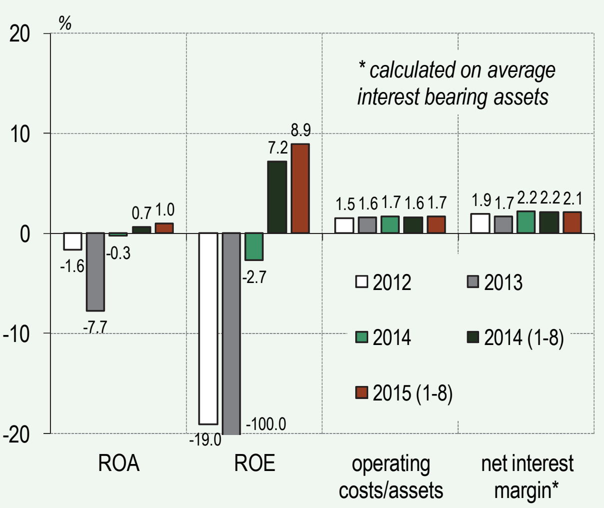
As the trend of declining net interest income was maintained, the increased profitability in the banking system was attributable to the decline in impairment and provisioning costs, which were just half of those in the same period last year. Operating costs were down 1.2% in year-on-year terms. The ratio of operating costs to average total assets increased slightly, as a result of the faster contraction in total assets. The banks recorded a pre-tax ROE of 7.5%.

Figure 3: Household deposits



Source: Bank of Slovenia.

Figure 4: Bank performance indicators



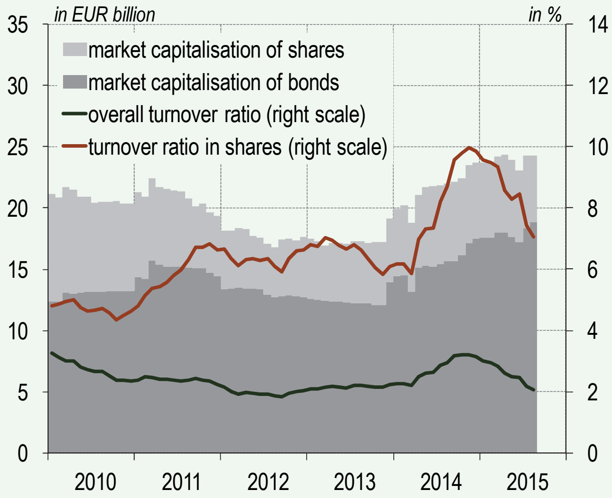
Source: Bank of Slovenia.

Domestic financial market

The cumulative volume of trading in shares on the Ljubljana Stock Exchange over the first eight months of this year amounted to EUR 221 million, down 44.2% in year-on-year terms. The negative trend in the volume of trading in shares is having a negative impact on the turnover ratio, which has fallen sharply over the recent period. Shares in five issuers were delisted from the stock exchange over this period, while there were no new issues. The market capitalisation of the delisted issuers amounted to EUR 269.2 million at the end of last year. The delisting merely had a minor impact on the market capitalisation of shares on the domestic stock exchange, which declined by 13.0% over the first eight months of the year to EUR 5.4 billion. This was largely attributable to the fall of 11.7% in the SBI TOP, Slovenia's main share index, as a result of adverse developments on international capital markets. The SBI TOP lost 5.7% in July and August alone. The proportion of investments in shares held by non-residents stood at 25.3% at the end of August.

The volume of trading in bonds on the Ljubljana Stock Exchange over the first eight months of this year amounted to EUR 32.3 million, down 31.8% in year-on-year terms. The market capitalisation of bonds increased by 7.7% over the first eight months of the year to EUR 18.9 million. During this period three new Slovenian government bonds were issued on the domestic market with a total nominal value of EUR 2.55 billion, and maturities of 10, 20 and 30 years. Given that the state budget borrowing requirement for 2015 had been covered by the 20-year bond issued in March, with the two subsequent bond issues (in the second half of July) Slovenia has continued its pre-financing of the budget borrowing requirements for 2016. Four more bonds with a total nominal value of EUR 189.8 million were issued on the Ljubljana stock exchange in July and August.

Figure 4.12: Market capitalisation on the LJSE in EUR billion and annual turnover ratios (TR)



Source: Ljubljana Stock Exchange.

5 Public Finances

This year the key target in the fiscal realm is permanently eliminating the excessive general government deficit, and thus abrogating the excessive deficit procedure. This is a prerequisite for Slovenia to move from the corrective arm to the preventive arm of the Stability and Growth Pact, where a country is required to pursue an improvement in its structural fiscal position. The country will also be subject to a transitional period in the debt reduction benchmark. This means that the key for the remainder of the year is maintaining a fiscal policy that ensures that the deficit is less than 3% of GDP, and taking measures within the framework of the adoption of the budgets for 2016 and 2017 to further improve the structural position.

The general government debt is forecast to reach 84.0% of GDP by the end of the year. This year's increase again reflects also borrowing in order to increase cash buffers for future debt repayments. The high level of debt means that a large part of resources is needed for interest payments, and therefore cannot be used for other purposes. This year's borrowing has been undertaken at lower interest rates due to the favourable market situation, and the government has also borrowed via bonds with very long maturities, 30 years in the case of the longest.

The risks in the fiscal realm are related to macroeconomic developments potentially being less favourable than those expected when the fiscal plans were prepared, to the upward pressure on expenditure from various interest groups, to potential one-off factors, and to the high level of implicit and potential obligations.

General government deficit

According to government plans, the general government deficit is forecast to reach 2.9% of GDP this year. A primary surplus is forecast again, after seven years of deficit. Alongside the minor negative impact of one-off factors, the narrowing deficit is a consequence of the improved economic situation. In 2014 one-off factors widened the general government deficit by 1.7% of GDP. The factors that widened the deficit included the recapitalisation of Abanka and Banka Celje (0.9% of GDP), the recognition of liabilities to LB depositors on the basis of a judgment by the European Court of Human Rights in the amount of 0.7% of GDP, and capital transfers for covering past corporate losses and net purchases of real estate in the amount of 0.3% of GDP,[18] while the concession fees for the mobile telephony radio spectrum narrowed the deficit by 0.2% of GDP. Interest is forecast at 3.0% of GDP this year, which means that a minimal primary surplus is forecast for the year according to the plans. According to the European Commission's forecasts from May of this year, the general government deficit across the euro area is expected to stand at 2.0% of GDP, less than the figure for Slovenia.

[18] The latter relates to BAMC transactions in the process of consolidating the bad loans. Transactions in the form of capital transfers increased the general government deficit by EUR 61 million in 2014, and by EUR 82 million in the first half of 2015. The capital transfers are a consequence of debt-to-equity conversions.

Table 5.1: General government deficit and debt in Slovenia 2012–2019

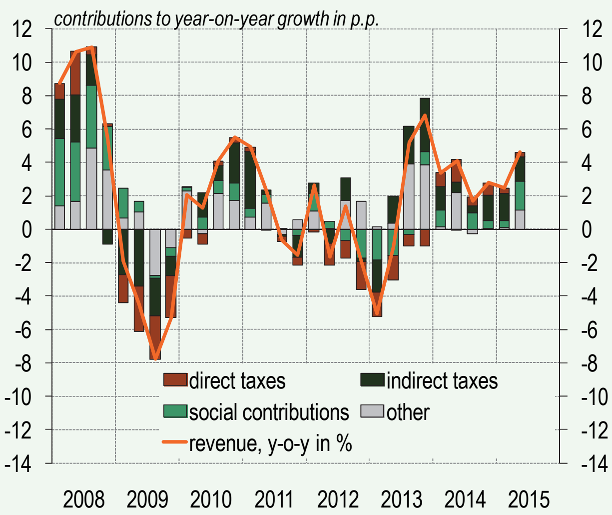
	SORS				Draft Budgetary Plan		Stability Programme					EC	
as % BDP	**2012**	**2013**	**2014**	**2015(1-6)**	**2014**	**2015**	**2015**	**2016**	**2017**	**2018**	**2019**	**2015**	**2016**
Revenue	44.5	45.3	44.9	43.8	45.3	44.4	44.7	43.1	42.5	42.0	41.5	44.8	43.4
Expenditure	48.6	60.3	49.8	47.6	49.7	47.2	47.6	45.3	44.3	43.4	42.4	47.7	46.2
of which: interest	2.0	2.6	3.2	3.2	3.3	3.2	3.1	2.9	2.6	2.5	2.4	3.1	2.9
Net lending (+) / borrowing (-)	-4.1	-15.0	-5.0	-3.8	-4.4	-2.8	-2.9	-2.3	-1.8	-1.4	-0.9	-2.9	-2.8
excl. support to fin. Institutions	-3.9	-4.9	-4.0	-3.8	-3.5	-2.8	-2.9	-2.3	-1.8	-1.4	-0.9	-2.9	-2.8
Structural balance	...	...	...	...	-2.8	-2.4	-2.2	-1.6	-1.3	-1.0	-0.8	-2.4	-2.9
Debt	53.7	70.8	80.8	80.8	82.2	83.2	81.6	78.7	79.6	79.4	78.2	81.5	81.7
Real GDP (growth, %)	-2.7	-1.1	3.0	2.7	2.0	1.6	2.4	2.0	2.1	2.2	2.2	2.3	2.1

Source: SORS (realization), Ministry of Finance – Draft Budgetary Plan 2015 (October 2014) and Stability Programme (April 2015), European Commission (EC, May 2015).

General government revenues increased in the first half of the year, primarily as a result of the improved economic situation. Revenues were up 3.6%, and primarily reflect the improved situation on the labour market, which has also been reflected in slightly higher growth in private consumption this year. The largest increase was recorded in indirect taxes, which were up 4.7%, however VAT revenues recorded slightly lower growth. Rises in excise duty rates have also brought increased inflows. Other factors behind the increased revenues from indirect taxes are the rise in carbon dioxide emissions tax, and the rise in the tax on financial transactions and insurance services. Revenues from personal income tax were up 0.5%, while revenues from corporate income tax were up just over 12%. At 3.3%, growth in net social security contributions was higher than growth in personal income tax because of the introduction of health and pension insurance contributions for students, which have been payable on income from student work since February 2015.

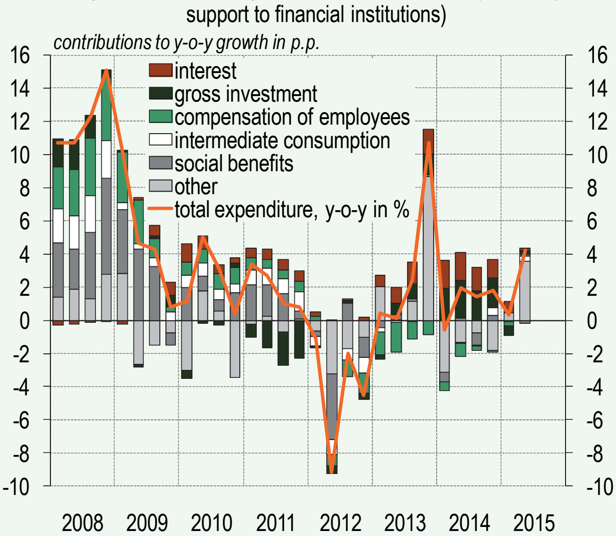
General government expenditure (after the exclusion of one-off factors) in the first half of the year was up slightly in year-on-year terms, primarily as a result of further growth in interest expenditure, while the changes in the other major categories of expenditure were minor. General government expenditure in the first half of the year was up 2.3% in year-on-year terms, or up 0.7% after one-off effects have been excluded. Interest expenditure was up 6.6%. Government investment in the

Figure 5.1: General government revenue



Source: SORS, Bank of Slovenia calculations.

Figure 5.2: General government expenditure (excluding support to financial institutions)

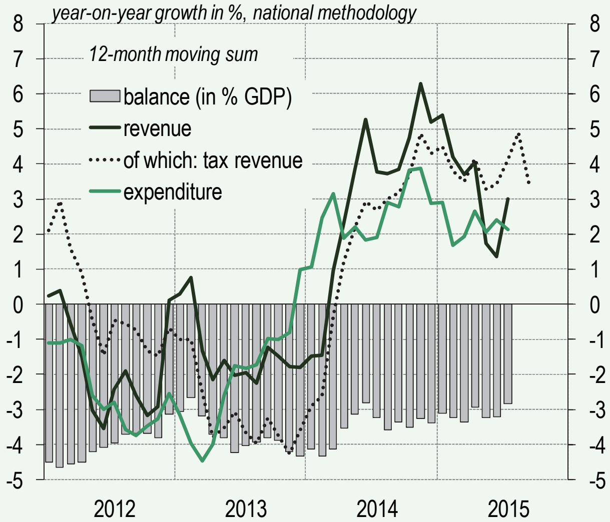


Source: SORS, Bank of Slovenia calculations.

Box 5.1: Public finance developments according to cash flow methodology, January to July 2015

The consolidated general government deficit is narrowing this year, most notably as a result of higher revenues from taxes and contributions. It amounted to EUR 760 million over the first seven months of the year, having narrowed by EUR 184 million in year-on-year terms, and according to the provisional figures revenues from taxes and contributions continued to rise in August, before declining in September as a result of the timing of excise duties inflows. Primarily as a result of higher taxes and contributions, and inflows from the EU budget, the state budget disclosed a surplus in August, a year -on-year improvement of EUR 145 million. The movements in the state budget are the main reason for the narrower deficit in the consolidated position. Wider surpluses were also recorded by the Health Insurance Institute over the first eight months of the year (by EUR 14 million year on year), and by local government over the first seven months of the year (by EUR 48 million year on year). Non-tax revenues are down on last year, primarily as a result of the absence of last year's one-off revenues from the concession fees for the mobile telephony radio spectrum and a decline in the inflow from the surplus of the single treasury account.

Figure 1: Public finance developments



Source: SORS, Ministry of Finance, Bank of Slovenia calculations.

Table 1: Consolidated general government (GG) balance*

	2014	last 12 months to Jul.15			2014 Jan.-Jul.	2015 Jan.-Jul.	Jan.-Jul.15
	EUR millions		% GDP	y-o-y, %	EUR millions		y-o-y, %
Revenue	**15,494**	**15,697**	**41.4**	**3.0**	**8,715**	**8,918**	**2.3**
Tax revenue	13,193	13,563	35.7	4.1	7,494	7,864	4.9
- goods and services	5,191	5,317	14.0	2.3	2,960	3,086	4.2
- social security contributions	5,272	5,378	14.2	3.4	3,043	3,149	3.5
- personal income	1,916	1,947	5.1	2.8	1,081	1,112	3.0
- corporate income	468	547	1.4	22.3	277	356	28.3
From EU budget	1,040	1,087	2.9	16.7	438	486	10.8
Other	1,261	1,046	2.8	-18.2	783	568	-27.5
Expenditure	**16,755**	**16,774**	**44.2**	**2.1**	**9,659**	**9,678**	**0.2**
Current expenditure	7,043	7,088	18.7	4.2	4,132	4,178	1.1
- wages and other personnel expenditure (incl. contributions)	3,610	3,609	9.5	0.2	2,127	2,127	0.0
- purchases of goods, services	2,233	2,212	5.8	0.8	1,278	1,258	-1.6
- interest	1,097	1,118	2.9	24.4	677	698	3.1
Current transfers	7,592	7,571	19.9	-1.0	4,550	4,529	-0.5
- transfers to individuals and households	6,335	6,354	16.7	0.1	3,775	3,794	0.5
Capital expenditure, transfers	1,717	1,713	4.5	10.0	692	689	-0.5
To EU budget	403	402	1.1	-2.8	284	283	-0.4
GG surplus/deficit	**-1,261**	**-1,077**	**-2.8**		**-944**	**-760**	

Source: Ministry of Finance, Bank of Slovenia calculations.
*Note: * Consolidated central government budget, local government budgets and social security funds (pension and disability insurance fund and health insurance fund) in cash accounting principle.*

Overall growth in revenues over the first seven months of the year stood at 2.3%, primarily as a result of a decline in non-tax revenues, while growth in revenues from taxes and contributions stood at 4.9%. There were several factors behind the revenue growth. First, the favourable situation on the labour market has been reflected in higher inflows of social security contributions and personal income tax, while indirect taxes are also increasing via the impact of household consumption. Second, good corporate performance in 2014 resulted in an increase in settlements of corporate income tax, while tax prepayments were also higher than last year. Third, certain tax rates and levies have been raised (e.g. tax on financial services, increased taxation of student work). Revenues from the EU budget over the first eight months of the year were up EUR 90 million in year-on-year terms.

The rise of 0.2% in general government expenditure continues to reflect growth in interest expenditure, which however was very slow compared with last year. Interest expenditure over the first seven months of the year was up 3.1% in year-on-year terms. Expenditure on goods and services and on subsidies was down, while transfers to individuals and households increased slightly as a result of higher payments to ensure social security.

first half of the year was down just over 1% on the same period last year, despite a major increase having been planned for 2015. An increase in investment is thus expected in the second half of the year, as the inflow of EU budget funds on the basis of the 2007-2013 financial perspective comes to a close. Expenditure on employee compensation declined slightly and the number of employees remained unchanged in year-on-year terms, while expenditure on intermediate consumption increased by just over 1%. Expenditure on social benefits again declined slightly, this time by 0.3%. The year-on-year rise in the number of pensioners has slowed significantly this year to around 0.5%, while pensions have not been aligned with wage growth or inflation. Unemployment benefits declined significantly, as a result of the improved situation on the labour market and decrease in eligibility.[19] By contrast, payments to ensure social security increased.

General government debt and government guarantee

The general government debt remained at 80.8% of GDP at the end of the first half of the year. The government took advantage of the favourable situation on the financial markets to pre-finance obligations falling due next year. The general government debt amounted to EUR 30,595 million or 80.8% of GDP at the end of June, up EUR 462 million on the end of last year. It will rise further by the end of the year, reaching EUR 32,375 million or 84.0% of GDP according to Ministry of Finance forecasts. The majority of borrowing over the first nine months of the year was undertaken via bond issues. A 20-year bond with a nominal value of EUR 1 billion and a coupon rate of 1.5% was issued in March. Issues of 10-year and 30-year bonds followed in July and August. The issuance of the 10-year bond amounted to EUR 1.25 billion and a coupon interest rate was 2.125%, while the issuance of the 30-year bond amounted to EUR 300 million at an interest rate of 3.125%. The 30-year bond issue was increased to EUR 575 million in September. The bond issues were related in part to the pre-financing of financing needs falling due in 2016. In addition to the bond issues, budget borrowing was also undertaken via loans and treasury bill issues, although the amounts were significantly smaller than the bond issues (just under EUR 700 million over the first nine months of the year). According to the consolidated general government figures, around EUR 2.1 billion of debt was repaid over the first seven months of the year, while the government's deposits at banks were reduced by EUR 83 million.

Government guarantees and sureties declined slightly. They amounted to EUR 7,973 million or 21.1% of GDP at the end of June, down around EUR 300 million on the end of last year. The majority of the decline was related to the maturing of two bank bonds and loans raised by DARS d.d., all liabilities having been settled by the borrowers. A portion of the guarantees in the amount of 6.5% of GDP is included in the general government

[19] At the end of June only approximately a fifth of the unemployed were entitled to benefits, while an average of just over 22% of the unemployed were entitled to benefits last year.

debt (a portion of the guarantees for the EFSF and the BAMC bonds), for which reason the potential increase in the debt from guarantees being called is actually lower than the aforementioned total guarantee amount. According to the state budget figures, just over EUR 5 million of guarantees were called over the first eight months of the year, while repayments of government guarantee calls in the past amounted to almost EUR 23 million. The latter were mostly related to the repayment of a guarantee that was called last year for the two banks undergoing the orderly wind-down process.

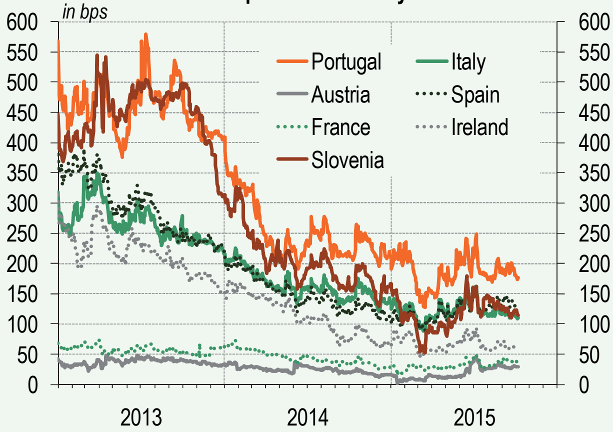
The required yield on 10-year Slovenian government bonds remained at a relatively low level in the third quarter. The main story of the summer months was the situation in Greece (negotiations on a new bailout, the resignation of the Greek prime minister), which put upward pressure on the required yields on the bonds of euro area periphery countries on the financial markets. After the aforementioned uncertainty diminished, the yields returned to their previous levels. The yield on 10-year Slovenian government bonds was around 1.9% in September and the spread over the benchmark German bond was averaging 121 basis points over the month.

Forecasts for general government deficit

This year's key target in the fiscal realm is to eliminate the excessive general government deficit. Slovenia has been in the excessive deficit procedure since 2009, and according to plans is set to reduce the deficit by the stipulated deadline of 2015. Under the revision to the state budget for 2015 adopted in February of this year, a deficit of 2.9% of GDP was forecast. In the October report on the general government deficit and debt, this year's general government deficit is also forecast at 2.9% of GDP, while the debt is forecast to stand at 84.0% of GDP at the end of the year.

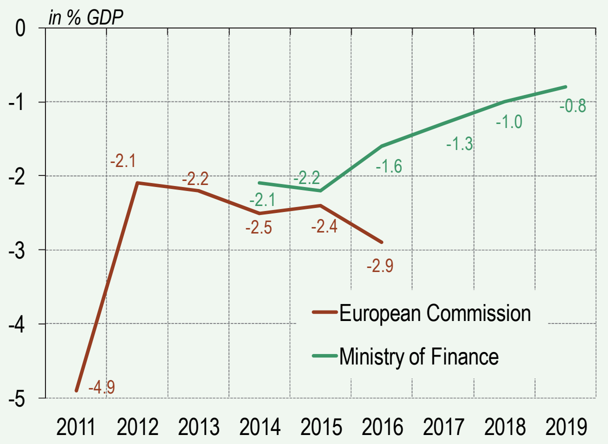
After the elimination of the excessive deficit, in accordance with the preventive arm of the Stability and Growth Pact Slovenia will have to pursue the appropriate fiscal structural improvement. The preventive arm of the Stability and Growth Pact sets a structural

Figure 5.3: Spreads on 10-year government bonds as compared to Germany



Source: Bloomberg, Bank of Slovenia calculations.
Note: Spread is calculated as a difference between yield of 10-year government bond and the yield of reference German bond on a daily basis and is used as a measure of country's credit risk.

Figure 5.4: Public finance structural balance



Source: EC, Ministry of Finance - Stability Programme, April 2015.
Note: Structural balance estimate by the MoF reflects targeted dynamics, while the EC estimate only includes adopted measures.

adjustment benchmark of 0.5% of GDP for meeting the medium-term budgetary objective. Given that Slovenia's debt exceeds 60% of GDP and that the output gap is estimated to be less than 1.5% of GDP in 2015 and is forecast to remain so, a slightly larger structural improvement of 0.6% of GDP will be required. According to the European Commission's latest forecasts of May 2015, the general government sector's structural deficit stood at 2.5% of GDP in 2014 and is forecast to decline to 2.4% of GDP in 2015. Slovenia's medium-term objective is a balanced structural position, which means that further structural adjustments are required to meet this objective. The National Assembly adopted the Fiscal Rule Act on the basis of Article 148 of the Constitution. It pursues the aforementioned commitments, and also regulates the establishment of the Fiscal Council. The procedure for selecting members of the Fiscal Council, which is expected to play a major role in monitoring and analysing fiscal policy and issuing recommendations, is currently in progress.

Under the draft budgets for 2016 and 2017, the government is planning to further reduce the general government deficit. The government adopted the draft state budgets for 2016 and 2017 on 20 September 2015. The deficits are forecast at 1.98% of GDP in 2016 and 1.74% of GDP in 2017, according to the cash flow methodology. According to the ESA methodology, the deficits are forecast at 2.24% of GDP and 1.75% of GDP. The principal measures to reduce the deficit include a planned agreement with public sector trade unions with regard to restraints on wage expenditure, the maintenance of current VAT rates as a permanent measure, the extension of certain measures in the area of social transfers, an agreement with the municipalities with regard to the local government funding, and an agreement on pension adjustments. In both years there is significantly less funding earmarked for investment expenditure, which is related to the slow start of drawings from the new 2014-2020 European financial perspective. The reduction of the general government deficit is relieved by an economic situation that is better than previously expected. Given that economic situation is subject to risk, cautious planning of general government expenditures is needed.

There are various risks to the realisation of the planned targets. Throughout the projection horizon the risks are related to the potential deterioration in the macroeconomic situation and the adverse impact of one-off factors (e.g. the refugee crisis, BAMC transactions). The risks are particularly large this year, given the size of the forecast deficit, which is only marginally below the reference value of 3% of GDP. There is also the uncertainty related to the calculation of the deficit under the ESA 2010.[20] In light of the improved economic situation, there are pressures to end certain austerity measures. The wage agreement only applies until the end of 2015, after which temporary measures would have to be relaxed.[21] The agreement releases promotions in December 2015 (first payment in January 2016) that are estimated at EUR 180 million, or just over 4% of employee compensation. The release of other wage elements would entail an even more significant increase in wage expenditure, although the government wishes to ensure that growth remains low by means of the extension of the measures and/or additional measures. The uncertainty is also related to the agreement to end or extend certain measures in the area of social transfers in 2016, in light of the economic growth recorded in 2014. The government is proposing a rise in cash social assistance, a rise in the limit for government scholarship, a rise of 10% in child benefit in the fifth and sixth bands, and for pensioners an extraordinary pension increase of 0.7% in January 2016 and the maintenance of the annual allowance at this year's level.

[20] The uncertainty surrounding the calculation under the ESA 2010 is partly related to information (e.g. personal income tax and corporate income tax annual settlements, final accounts) that will only be available after the end of the budgetary year.

[21] The measures include reductions in wage classes, the freezing of ordinary performance-related pay, reduced performance-related payments for workload, lower annual leave allowance and lower premiums for collective supplementary pension insurance.

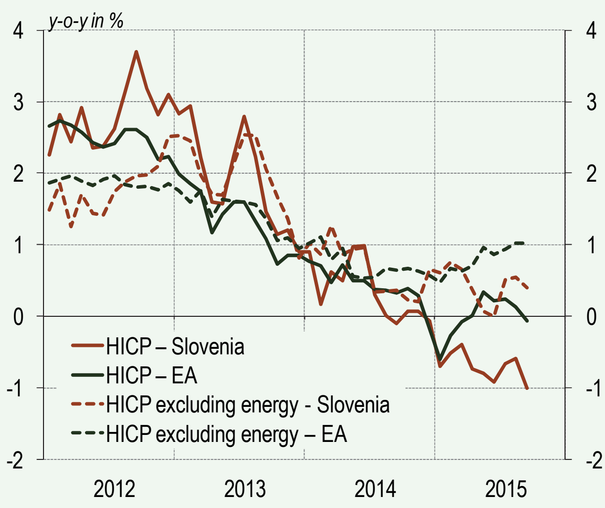
6 Price Developments

The decisive factor in this year's moderate deflation is the fall in oil prices on global markets. Prices of other commodities are also falling, which is additionally impeding the meeting of the monetary policy target, which is defined as an inflation rate of close to but below 2%. The fall in commodity prices is reducing firms' input costs, which in conjunction with the alignment of wage growth with deflation is reducing pressures on prices of final products. At the same time the impact of the fall in the euro caused by the ECB's quantitative easing is still relatively small for the moment. However, falling prices of refined petroleum products have freed a portion of household income, thereby contributing to growth in private consumption, which has perhaps already been reflected in a slight rise in core inflation. Inflation across the euro area is meanwhile fluctuating around zero, although core inflation is significantly higher than in Slovenia, primarily as a result of the higher level of domestic consumption.

Structure of price developments

The fall in prices slowed slightly in the third quarter of this year. This was primarily attributable to a smaller fall in prices of non-energy industrial goods and a rise in prices of unprocessed food. The deflation continues to be maintained primarily by the fall in energy prices as a result of low global oil prices. There were no other major changes in the structure of price developments.

Figure 6.1: Inflation in Slovenia and euro area



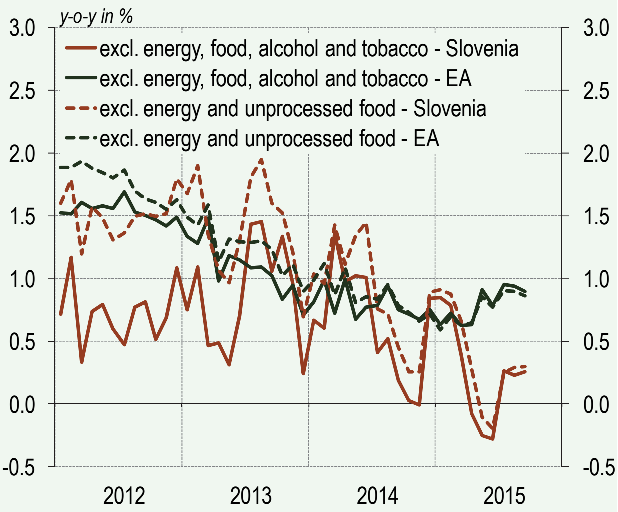
Source: Eurostat.

Macroeconomic factors and core inflation indicators

Core inflation turned positive again in year-on-year terms in the third quarter, although the rate was significantly less than the euro area average. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged 0.3% in the third quarter, up 0.5 percentage points on the second quarter. The fall in prices of non-energy industrial goods slowed slightly, while the slowdown in growth in services prices halted at a low level. Growth in the narrowest core inflation indicator was thereby 0.7 percentage points less than the euro area average. This was mainly attributable to the low level of final domestic consumption and investments. Average year-on-year growth in the two other core inflation indicators in the third quarter was also significantly less than the euro area average.

The low core inflation is the result of both supply-side and demand-side factors. The recovery in the labour market is based on uncertain forms of employment with low income. The rise in employment and moderate deflation caused that the real wage bill over the first seven months of this year nevertheless increased further, while the fall in prices of refined petroleum products is contributing to an increase in real disposable income. Together with rising consumer confidence this has brought a slight strengthening in final consumption. Households nevertheless remain cautious, and are maintaining a high level of saving. There are no signs of any major upward pressure on prices on the supply side: productivity growth is still outpacing wage growth, while firms' input costs are continuing to fall.

Figure 6.2: Core inflation in Slovenia and euro area



Source: Eurostat, Bank of Slovenia calculations.

Microeconomic factors and the structure of inflation

Oil prices on global markets fell further in the third quarter, increasing the year-on-year fall in energy prices. After falling sharply in the early part of the year, oil prices on global markets rose slightly in the second quarter, although the maintenance of unchanged pumping in the wake of declining demand led to further price falls in the summer months. This was a major factor in the additional year-on-year fall in energy prices, and was the

Table 6.1: Breakdown of the HICP and price indicators

	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2015	2011	2012	2013	2014	2015	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15
HICP	*100.0%*	2.1	2.8	1.9	0.4	-0.7	0.8	0.1	0.0	-0.5	-0.8	-0.8
Breakdown of HICP:												
Energy	*14.2%*	8.8	9.0	1.8	-1.4	-7.0	0.2	-1.5	-2.0	-7.5	-6.4	-7.9
Food	*22.9%*	4.8	4.7	4.9	0.8	0.9	0.7	0.3	0.6	0.7	1.1	1.2
processed	*15.9%*	5.0	4.7	3.6	1.8	1.1	2.4	1.7	1.1	1.4	0.7	0.4
unprocessed	*7.0%*	4.3	4.5	7.6	-1.5	0.7	-2.8	-2.6	-0.7	-0.6	2.0	2.8
Other goods	*26.5%*	-0.9	-0.2	-0.9	-1.0	-0.9	-0.6	-1.3	-1.4	-0.8	-1.1	0.0
Services	*36.3%*	0.0	1.5	2.2	1.8	1.1	2.3	1.5	1.5	1.7	0.4	0.5
Core inflation indicators:												
HICP excl. Energy	*85.8%*	1.0	1.8	1.9	0.7	0.4	0.9	0.3	0.4	0.7	0.1	0.5
HICP excl. energy and unprocessed food	*78.7%*	0.7	1.5	1.4	0.9	0.4	1.3	0.6	0.5	0.8	0.0	0.3
HICP excl. energy, food, alcohol and tobacco	*62.9%*	-0.4	0.7	0.9	0.6	0.2	1.0	0.4	0.3	0.7	-0.2	0.3
Other price indicators:												
Industrial producer prices on domestic market		3.8	1.0	0.3	-1.1	-0.2	-1.4	-1.1	-0.8	-0.3	0.0	...
GDP deflator		1.1	0.3	0.8	0.8	0.3	0.7	0.6	0.6	0.6	0.1	...
Import prices[1]		5.7	2.1	-1.5	-1.1	-0.7	-1.2	-1.1	-0.3	-1.4	0.1	...

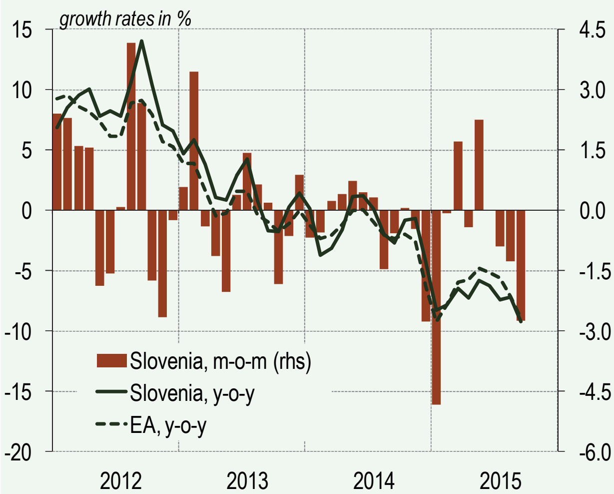
Source: SORS, Eurostat, Bank of Slovenia calculations.
Note: [1] National accounts figure.

main reason for the deflation in Slovenia. The year-on-year fall in energy prices increased by 1.5 percentage points to 7.9% in the third quarter, and made a negative contribution of 1.2 percentage points to inflation. The largest year-on-year fall was recorded by prices of refined petroleum products and gas. In the energy category electricity prices were alone in recording a year-on-year rise over this period, the contribution for more sustainable production of electricity having risen in August.

Despite a fall in food prices on global markets, year-on-year growth in food prices remained unchanged in Slovenia in the third quarter. This was attributable to the expected year-on-year rise in prices of unprocessed food, as a result of a low basis. Growth in unprocessed food prices was up 0.8 percentage points on the previous quarter at 2.8%. By contrast, average year-on-year growth in prices of processed food declined slightly over this period, primarily as a result of last year's rise in excise duties on tobacco products dropping out of the calculation, and slower year-on-year growth in prices of dairy products. Food prices thus contributed 0.3 percentage points to headline inflation in the third quarter.

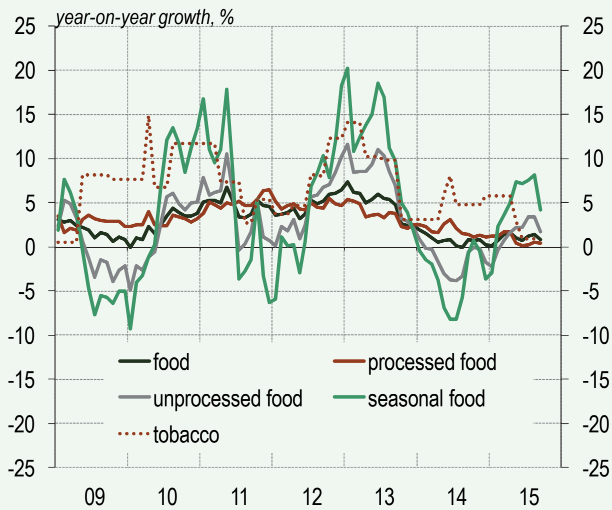
Year-on-year growth in services prices remained at low levels in the third quarter. It was almost unchanged from the previous quarter, and contributed 0.2 percentage points to headline inflation. Growth in prices of public services increased, while the fall in prices of market services deepened. The main price rises in public services

Figure 6.3: Energy prices



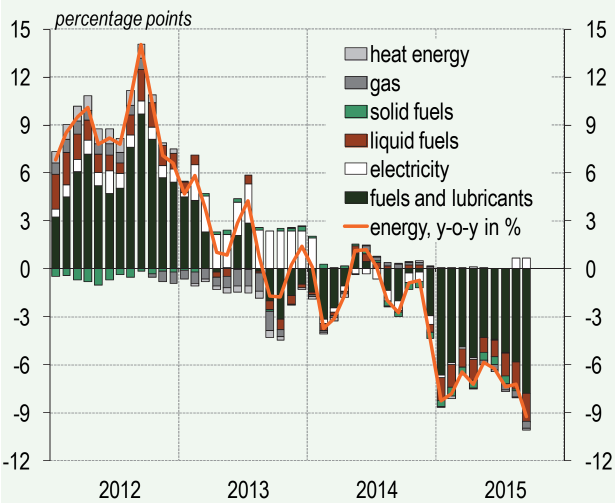
Source: Eurostat, Bank of Slovenia calculations.

Figure 6.5: Food prices



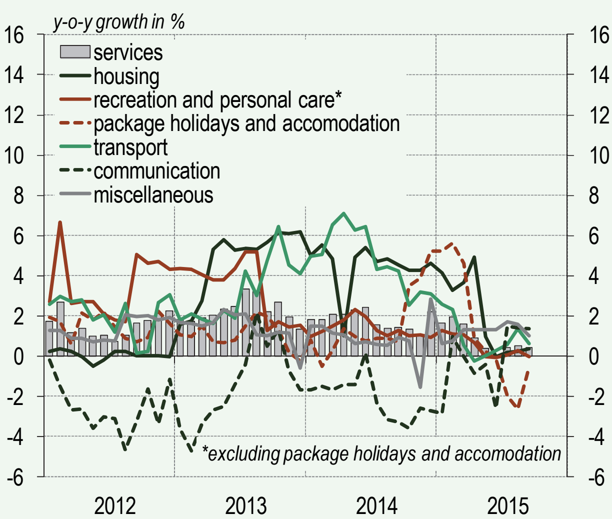
Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.4: Contributions to energy inflation



Source: ECB.

Figure 6.6: Prices of categories of services



Source: Eurostat.

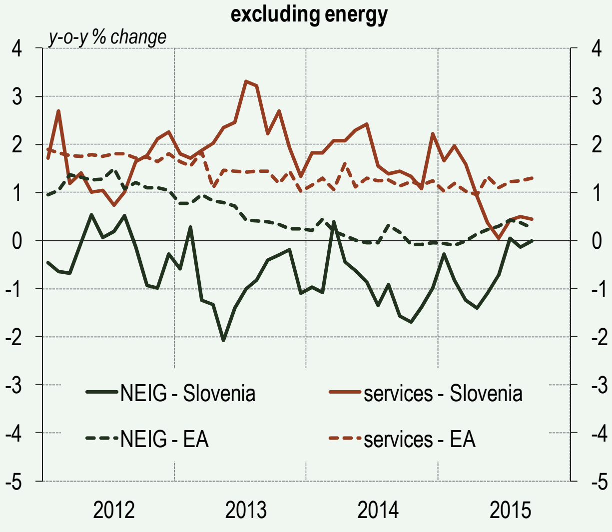
were recorded by cultural and other services. The main factor in the fall in prices of market services was prices of package holidays and air transport, which were impacted by developments in oil prices. By contrast, prices of telephone and internet services rose.

The fall in prices of non-energy industrial goods came to a standstill in the third quarter, an indication of the favourable developments in this segment after several years of decline. Prices in this category were down 1.1% in year-on-year terms even in the second quarter, but were unchanged in the third quarter, for the first time after three years of falls. This was largely attributable to prices of semi-durables, in particular clothing and footwear. The contribution made by prices of non-durables also increased, while the negative contribution made by prices of durables diminished, even though prices of cars fell further. These developments are in line with the slightly stronger increase in household consumption in recent months, and, in part, with the fall in the euro.

Industrial producer prices

Industrial producer prices on the domestic market have been falling again since June, primarily as a result of lower commodity prices. Prices fell by an average of 0.2% in year-on-year terms over the first eight months of the year, 0.9 percentage points less than in the same period last year. After the year-on-year fall in industrial producer prices slowed over the first five months of the year, it strengthened again in June. This primarily reflected the fall in global commodity prices, which via import prices is reducing domestic producer prices, despite the fall in the euro. Prices of wood also fell more sharply, which was primarily attributable to surplus domestic supply. Year-on-year growth in prices of capital goods also declined. The fall in energy prices and prices of consumer non-durables slowed slightly. Growth in prices of durables increased sharply, as all sectors in the broad economic category made a contribution to growth.

Figure 6.7: Prices of services and industrial goods excluding energy



Source: Eurostat, SORS, Bank of Slovenia calculations.

Figure 6.8: Producer prices on domestic market

Source: SORS, Bank of Slovenia calculations.

7 Projections of Economic Trends and Inflation 2015–2017[22]

The structure of economic growth has become more balanced compared with the figures available when the previous projections were drawn up, and is therefore more robust and less sensitive to individual shocks. Net exports have remained solid and final household consumption has began to strengthen, which is providing ground for growth in numerous service sectors. GDP is forecast to increase by more than 2.5% this year, with comparable contributions made by domestic consumption and net exports. Later in the projection horizon economic growth will exceed 2%, despite the reduced level of public investment. Growth will increasingly be driven by sectors whose focus is on the domestic market.

The revision of national accounts for 2014, and faster-than-expected growth in employment and private consumption in the first half of this year have been reflected in these projections with a rise in the contributions to GDP growth from private consumption. Growth in private consumption is forecast to reach approximately 2% towards the end of the projection horizon, but will remain constrained by the structure of new employment, where flexible, poorer-paid forms of work are prevalent. At the same time growth in investment will remain relatively low, although its structure will improve. Government infrastructure investment is still forecast to grow this year, but then to decline significantly in 2016 with the transition to the new European financial framework. Over the projection horizon the decline in government investment will gradually be compensated for by growth in private-sector investment in machinery and equipment, as the conditions for investment will continue to improve. This will improve the output structure of the economy, and will strengthen export potential. Growth in government consumption will be weak, in keeping with the closing of the general government deficit.

Consumer prices as measured by the HICP will fall overall this year. This is primarily attributable to oil prices, which are holding at a level of USD 50 per barrel, and to an ongoing decline in primary commodity prices. Core inflation also fell significantly in this context. Inflation is expected to gradually increase over the next two years, as commodity prices rise gradually and private consumption strengthens, but will remain below the ECB monetary policy target level until the end of the projection horizon.

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[22] The projections were made on the basis of the statistical methodologies and data available on 16 September 2015. The projections of macroeconomic factors presented in this report are based on assumptions of developments in variables from the international environment and on certain domestic factors dependent on economic policy decisions. The assumptions on variables from the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (September 2015), the European Economic Forecast (European Commission, spring 2015), the OECD Economic Outlook and Interim Economic Outlook (September 2015), and the IMF WEO update (July 2015). The assumptions used in the projections are not necessarily the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the appendix in the April 2008 Price Stability Report.

Risks to the realisation of these growth projections are relatively balanced. The largest negative risk derives from the external environment, and is related to the potential deepening of the recession in Russia, and above all to possible additional deterioration in economic trends in China, which could have an adverse impact on the German economy. By contrast, the ECB's quantitative easing programme could have strongly positive effects. The largest risk in the domestic environment is the actual outturn of government investment over the entire projection horizon.

Risks with regard to inflation are also basically balanced. The main upside risk from the international environment is a potentially stronger impact on the exchange rate from the quantitative easing programme, while the risk with regard to oil prices relates to the impact of Iran's entry into the market following the ending of sanctions. In the domestic environment the wage negotiations in the public sector could result in a slight rise in core inflation, while at the same time pressure on prices will be constrained by the continuing prevalence of the uncertain forms of employment.

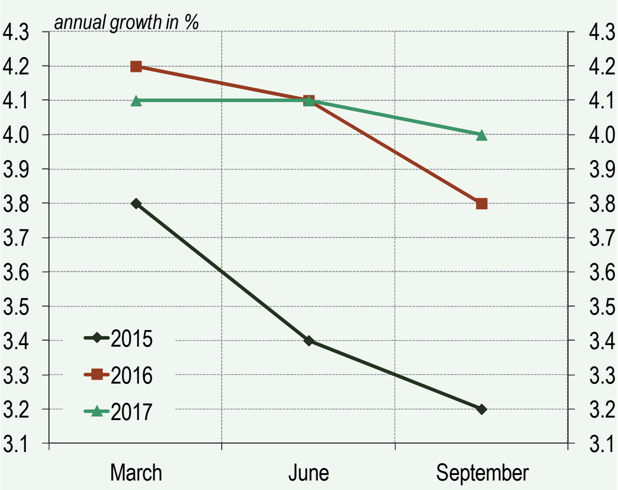
International environment and external assumptions

The forecast for growth in foreign demand has been revised slightly downwards compared with the previous projections. The less favourable forecasts by international institutions regarding global economic growth and trade constitute the basis for the downward revision. Foreign demand is forecast to increase by 2.1% this year, and by 2.7% in 2016, down 0.3 and 0.5 percentage points respectively on the April projections. The forecast for 2017 is unchanged.

The assumptions for prices of oil and primary commodities have again declined significantly since the previous projections. In contrast to expectations, oil prices fell again between April and September, down to their level in January. Based on information on current production and prices of oil futures, oil prices are expected to remain at a level of around USD 55 per barrel this year and next, rising to USD 60 in 2017. Prices of other commodities will fall more sharply this year than was forecast in the previous projections. Next year the fall in prices of primary commodities is expected to slow slightly, and prices are then forecast to gradually rise in line with futures contracts and economic growth.

Prices in the euro area will remain practically unchanged overall this year, primarily as a result of falling energy prices and prices of primary commodi-

Figure 7.1: Projections of global economic growth excluding euro area



Source: ECB.

Figure 7.2: Projections of global economic growth

Source: OECD.

Table 7.1: Assumptions for the international environment

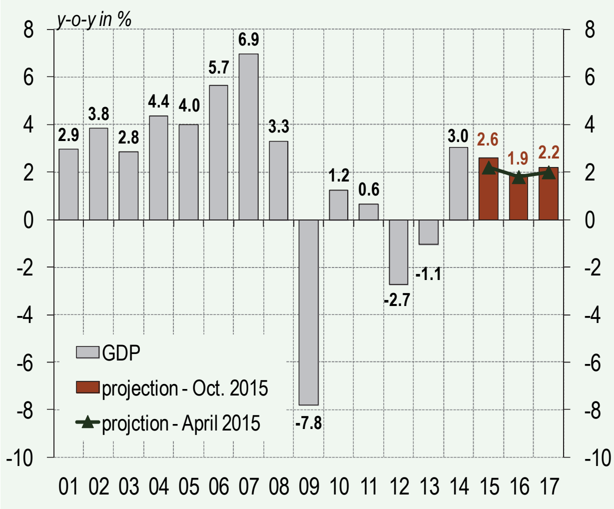
						Assumptions					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
	growth rates, % (if not specified otherwise)										
Foreign demand*	10.0	6.8	0.7	1.8	2.2	**2.1**	-0.3	**2.7**	-0.5	**3.4**	0.0
Oil (USD per barrel)	80	111	112	109	99	**53**	-9	**54**	-14	**60**	-12
Non-oil commodities	36.9	22.2	-14.3	-6.1	-8.6	**-19.7**	-8.7	**-4.6**	-7.2	**4.4**	-0.4
EMU inflation	1.6	2.7	2.5	1.4	0.4	**0.1**	-0.2	**1.1**	0.0	**1.7**	0.0
PPI Germany	1.5	5.1	1.7	0.0	-1.0	**-0.8**	-0.3	**1.3**	-0.2	**1.5**	-0.3

** Volume of imports from the basket of foreign partners.*
Δ: Difference between current assumptions and assumptions in April 2015 Economic and Financial Developments with Projections.
Source: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Economic Outlook.

Figure 7.3: Commodity prices

Source: ECB, Bloomberg, Bank of Slovenia assumptions.

Figure 7.4: GDP growth projections



Source: SORS, Bank of Slovenia projections.

ties. The inflation forecasts have been revised downwards from the previous projections, in light of the continuing fall in energy prices and the fall in prices of primary commodities. Producer prices in Germany are expected to continue falling this year, while for the next two years Consensus forecasts are predicting gradual growth that will not exceed 2%.

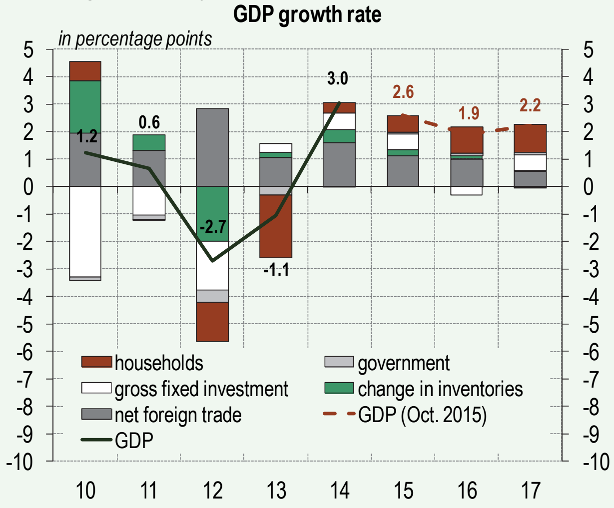
GDP growth

Economic growth is forecast to average over 2% over the projection horizon. This year it is forecast to be higher than predicted previously, which is attributable to the revision to the national accounts for 2014 and the outturn in the first half of 2015, which was higher than forecast, particularly with regard to private consumption. GDP growth is forecast to reach 2.6% this year, an upward revision of 0.4 percentage points. The fall in government investment in connection with the start of the new European financial framework will act as the main brake on faster economic growth next year, for which growth is forecast to remain close to 2%. The recovery in domestic demand is now forecast to be slightly faster than expected in the previous projections, both in terms of private consumption and private-sector investment. The latter will nevertheless not fully compensate for the decline in government investment in 2016, for which reason the overall contribution to GDP growth from investment will be negative. Growth in private consumption will strengthen to around 2% by the end of the projection horizon, as the improvement in the situation on the labour market has a stronger impact on consumption than previously forecast. Growth in government consumption will remain very modest, as a result of the ongoing fiscal consolidation process in a situation of relatively high public debt.

Aggregate demand

The contribution to GDP from private consumption is increasing, making economic growth more balanced. In the revised national accounts for 2014, growth in final household consumption was raised upwards and is now more in line with the parallel recovery in incomes and purchasing power. Employment growth in the first half of this year was also higher than first forecast. Together with moderate deflation, this contributed to a further recovery in purchasing power as measured by the real wage bill. A gradual recovery in consumer lending is also expected.

Figure 7.5: Projection of expenditure contributions to GDP growth rate



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

Survey based consumer confidence has strengthened further, and is only now beginning to pass through into slightly higher consumption, with a significant lag. Growth in final household consumption is forecast to strengthen further over the projection horizon, more than predicted in the previous projections, but will still lag behind GDP growth owing to the structural imbalances on the labour market and the prevalence of uncertain forms of employment. The slower growth in final household consumption relative to the growth in the real wage bill, and the continuing growth of bank deposits despite the extremely low interest rates, is further evidence that households nevertheless remain cautious with regard to consumption.

Stronger growth in gross fixed capital formation is not forecast over the projection horizon, and the actual dynamic will be particularly subject to government investment. Growth in investment will merely be around 3% this year. It will mostly be driven by the completion of public infrastructure projects co-financed through the current and expiring European financial framework. At the same time a weaker reversal is expected in private-sector investment in machinery and equipment, which will not contribute significantly to overall growth. A moderate decline in overall investment is forecast for 2016: past experience suggests that heavy inflows of funds from the new financial framework will not yet have started, and growth in private-sector investment will be too weak to fully compensate for the loss of government investment. The growth forecast for private-sector investment over the projection horizon is based on the expectation of further improvement in corporate performance, given that production capacity utilisation was already high at the end of 2014. Further ground for mod-

Table 7.2: Components of domestic demand

						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
	real growth rates, %										
Domestic consumption	-0.8	-0.7	-5.8	-2.2	1.6	**1.6**	0.4	**0.9**	0.1	**1.8**	0.4
Private consumption	1.3	0.0	-2.5	-4.1	0.7	**1.1**	0.6	**1.8**	0.6	**2.0**	0.7
Government spending	-0.5	-0.7	-2.3	-1.5	-0.1	**0.3**	-0.1	**0.4**	-0.1	**0.5**	0.0
Gross fixed capital formation	-13.3	-4.9	-8.8	1.7	3.2	**2.9**	1.0	**-1.7**	-1.6	**3.2**	0.9

Δ: Difference between current projections and projections in April 2015 Economic and Financial Developments with Projections.
Source: SORS, Bank of Slovenia.

erate optimism is the number of building permits for non-residential construction, which has risen significantly this year. There nevertheless remain significant barriers to growth in private-sector investment, which are related to the corporate restructuring process and uncertainties in connection with the privatisation process. In light of price corrections, the high number of vacant properties, the prevalence of flexible forms of employment and the merely moderate growth in lending, investment in residential construction will remain weak throughout the projection horizon, and largely dependent on the implementation of the Housing Fund's plans.

Despite an improved outlook with regard to growth in components of domestic demand, exports remain the key element in economic growth over the projection horizon. Export growth in the first half of this year was higher than expected, which has slightly raised the annual forecast. By contrast, the faster than expected recovery in domestic demand has produced a higher forecast for this year's import growth. Export growth will slow slightly in 2016, primarily as a result of a base effect related to the cycle of Slovenia's automotive industry. Import growth in 2016 is forecast to remain close to this year's level, as the decline in public investment and slight decline in export growth are compensated for by growth in private-sector components of domestic demand. Export growth will continue to average around 5% over the projection horizon, but a gradual decline is expected in the contribution to GDP growth by net exports owing to the faster recovery in domestic demand.

Government consumption will be low over the projection horizon, on account of the need for further fiscal consolidation. Annual growth in government consumption is forecast to remain around 0.4% over the projection horizon. Employment in the government sector is forecast to fall minimally this year, and to remain unchanged over the next two years. Average compensation per employee in the government sector is forecast to rise by 0.4% this year, before growth picks up to 3.9% and 2.9% over the next two years as promotions are applied at the end of 2015 and 2016 and other measures[23] are extended. Measures to limit expenditure on intermediate consumption are expected to contribute to fiscal consolidation, including savings achieved by the centralisation of public procurement.

Output side

The export sector will remain the key factor in economic growth throughout the projection horizon. Growth in industrial production will remain at a level of around 5%, in line with export growth, while stronger demand on the domestic market means that exposure to fluctuations in foreign demand will be slightly smaller than in previous years. Growth in industrial production and exports will outperform growth in foreign demand throughout the period, a reflection of the increased competitiveness of the export sector, which has been reflected in growth in market shares and the large merchandise trade surplus. At the same time growth in the export sector is having a positive impact on numerous domestic suppliers of goods and services, which additionally encourages economic growth.

Value-added in construction will decline over the projection horizon. As a result of delays in the implementation of planned government investment, construction activity has declined this year. The amount of construction put in place over the first seven months of the year was down 7% in year-on-year terms, and only an exceptional impetus in the completion of government projects in the remaining months of the year could result in positive annual growth in value-added in the sector. The short-term outlook also remains weak: the value of new contracts is very low for all types of construction. At the same time the new European financial framework earmarks a smaller amount of resources to be used for different purposes to Slovenia. For these reasons a significant decline in the amount of construction put in place is thus forecast in 2016. Growth will be weak in 2017, and largely related to private-sector investment.

[23] The measures include extensions of reduced wage grades, the freezing of ordinary performance-related pay and reduced performance-related payments for workload. The government also proposed the extension of the reduced annual leave allowance and the extension of lower premiums for collective supplementary pension insurance.

The contribution to GDP growth by services will strengthen over the projection horizon somewhat more than previously forecast. This will be attributable to faster growth in domestic demand, while the contribution of the export sector to services growth will remain approximately at this year's level. Growth in transport services is forecast to increase slightly again, as the strengthening of domestic business-to-business operations begins to contribute more to growth, alongside merchandise exports. Growth in exports of travel services will strengthen further. In addition to an increase in arrivals of non-residents as a result of positive developments in the promotion of tourism and the increased tension in the Middle East and North Africa, domestic spending on leisure activities will also begin to strengthen significantly. Growth in turnover in wholesale and retail trade is expected to peak next year, when the cycle of increased purchases of cars and other durables is expected to end. This cycle is proving to be relatively strong, primarily on account of the deferral of major purchases during the crisis. On the other hand, the situation in service sectors and segments of wholesale and retail trade linked to construction will deteriorate, at least temporarily. The implementation of more growth-friendly fiscal consolidation is expected to bring weak growth in value-added in public services.

Labour market

Employment will rise over the projection horizon significantly faster than previously forecast. Employment growth in the first half of this year was higher than forecast. This strong employment growth is being driven entirely by the private sector, where flexible forms of employment will remain prevalent. The main factor in higher employment growth is a change in the forecast structure of economic growth, with an increased contribution by services.[24] These are more labour-intensive, and are also notable for slower productivity growth, which is also reflected in the forecast lower productivity growth in the total economy. The slightly slower employment growth in 2016 will primarily be attributable to a decline in construction investment, which is usually labour-intensive. Employment is then forecast to strengthen again in 2017, as a result of faster growth in private consumption and a recovery in investment. There will be no significant change in employment in the government sector.

Continued moderate wage growth in the private sector is predicted for the projection horizon, while the government sector is also expected to significantly contribute to wage growth in 2016 in particular. The

Table 7.3: Activity, employment and wages

						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
	growth rates, %										
GDP (real)	1.2	0.6	-2.7	-1.1	3.0	**2.6**	0.4	**1.9**	0.1	**2.2**	0.2
Employment	-2.1	-1.7	-0.9	-1.4	0.6	**1.4**	0.8	**1.1**	0.7	**1.3**	0.9
Compensation per employee	4.0	1.5	-1.0	0.6	1.1	**0.7**	-0.4	**1.9**	0.6	**2.2**	0.8
Productivity	3.4	2.4	-1.8	0.3	2.5	**1.1**	-0.5	**0.8**	-0.5	**0.9**	-0.7
ULC (nominal)	0.6	-0.8	0.8	0.2	-1.3	**-0.4**	0.1	**1.1**	1.1	**1.3**	1.5
Contribution to GDP growth	*percentage points*										
Domestic demand, excl. chg. in inventories	-2.7	-1.2	-3.7	-2.3	1.0	**1.2**	0.5	**0.7**	0.0	**1.7**	0.5
Net exports	2.0	1.3	3.0	1.1	1.6	**1.1**	0.0	**1.0**	0.0	**0.6**	-0.1
Changes in inventories	1.9	0.6	-2.0	0.2	0.5	**0.2**	-0.2	**0.1**	0.1	**0.0**	0.0

Δ: Difference between current projections and projections in April 2015 Economic and Financial Developments with Projections.
Source: SORS, Bank of Slovenia.

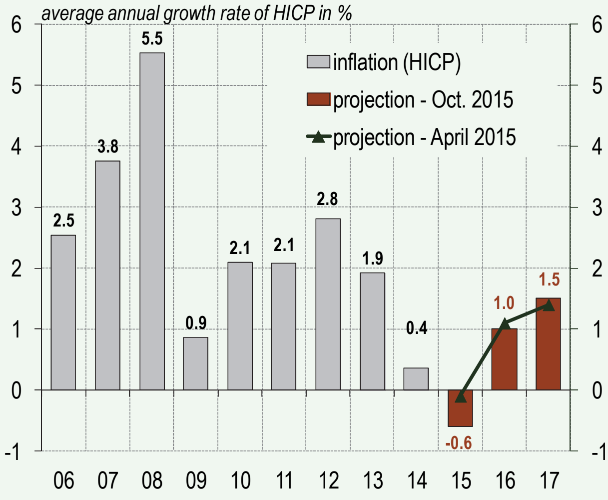
[24] The hiring of workers through employment agencies is clouding the picture of the sectoral breakdown of current employment, which is hindering projections of employment across individual sectors, industry and construction in particular.

forecast for this year's wage growth[25] is slightly lower than in the previous projections, as a result of changes in the structure of the workforce, and above all the noticeable alignment of wage growth with deflation. Growth in private-sector wages in the coming years will mostly be attributable to export-oriented sectors, although alignment with higher inflation will also be a key factor. Wages in the government sector are forecast to rise significantly compared with previous years, as a result of the relaxation of certain austerity measures, although the government has at this moment not yet completed negotiations with the trade unions.

Price developments

Prices are forecast to decrease by 0.6% overall this year, after which inflation is projected to rise slightly in 2016 and 207, but to remain below the medium-term monetary policy target. The inflation projection is down 0.5 percentage points on the previous projection, as a result of a fall in core inflation and a further fall in energy prices. Inflation developments this year will remain under the influence of falling commodity prices on the global markets, despite the quantitative easing and depreciation. Inflation is forecast to gradually increase over the next two years, in line with developments in domestic consumption and the gradual closing of the output gap. Average annual inflation is forecast at 1.0% in 2016, and 1.5% in 2017.

Figure 7.6: Inflation projection



Source: SORS, Bank of Slovenia projections.

Energy prices have been the main factor in this year's deflation. Growth in energy prices has also been revised downwards in the current projections, owing in part to lower outturn and in part to reduced expectations

Table 7.4: Inflation projections

						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Oct.	Δ	Oct.	Δ	Oct.	Δ
						average annual growth, %					
Consumer prices (HICP)	2.1	2.1	2.8	1.9	0.4	**-0.6**	-0.5	**1.0**	-0.1	**1.5**	0.1
food	2.5	4.8	4.7	4.9	0.8	**1.2**	0.6	**1.6**	0.2	**1.7**	0.0
energy	13.9	8.8	9.0	1.8	-1.4	**-7.3**	-1.3	**-0.2**	-1.2	**0.9**	0.1
other goods	-2.2	-0.9	-0.2	-0.9	-1.0	**-0.5**	-0.6	**0.3**	-0.2	**0.8**	0.0
services	1.2	0.0	1.5	2.2	1.8	**0.8**	-0.9	**1.6**	0.1	**2.2**	0.3
Core inflation indicators (HICP)											
excluding energy	0.3	1.0	1.8	1.9	0.7	**0.5**	-0.4	**1.2**	0.0	**1.6**	0.1
excl. energy and unprocessed food	0.2	0.7	1.5	1.4	0.9	**0.4**	-0.7	**1.1**	-0.1	**1.7**	0.2
excl. energy, food, alcohol and tobacco	-0.4	-0.4	0.7	0.9	0.6	**0.3**	-0.8	**1.1**	0.0	**1.6**	0.2

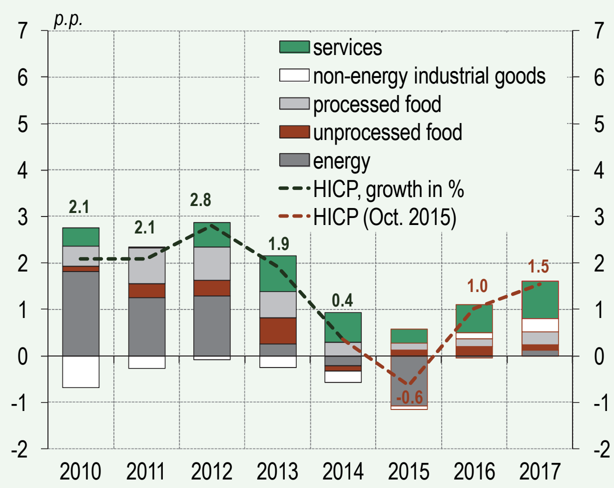
Δ: Difference between current projections and projections in April 2015 Economic and Financial Developments with Projections.
Source: SORS, Bank of Slovenia.

[25] Over the last seven years the number of small individual entrepreneurs rose by approximately 14,500 to 83,000 according to AJPES figures. Because their earnings are not included in wage statistics, the credibility of computations of the impact of wage developments on consumer purchasing power declined. At the same time increased employment via employment agencies is clouding the actual picture of wage developments in each sector. The two factors make it difficult to accurately formulate a projection of wage developments.

for their future growth. Oil prices in the summer months were lower than previously forecast, and oil is also trading at lower prices in futures contracts. The impact of low oil prices is forecast to fade slightly in the early part of next year owing to the low base. The growth forecast for energy prices in 2016 nevertheless remains slightly negative. Energy prices are forecast to fall by 7.3% overall this year and by 0.2% in 2016. Growth will be positive again in 2017. In contrast to energy prices, food prices rose by more than forecast in the most recent projections, which was largely attributable to the large fluctuations in prices of seasonal food. Food prices are forecast to record moderate growth over the projection horizon, a reflection of firms' low input costs and moderate wage growth.

During the projection horizon core inflation will be subject to low commodity prices and the strengthening of private consumption. Core inflation has been lower this year than previously forecast as a result of lower growth in services prices and prices of non-energy industrial goods. Core inflation will remain relatively low over the remainder of the projection horizon because of the prevailing impact of low oil prices and other commodity prices, which are reducing firms' input costs and thus pressures on final prices. However, domestic factors such as the forecast growth in households' purchasing power and the reduction of the negative output gap are expected to encourage domestic consumption. Growth in prices of market services will also be higher, and the main factor will be wage growth. Core inflation as measured by HICP excluding energy, food, alcohol and tobacco is forecast at around 0.3% this year, before rising to 1.1% in 2016 and to 1.6% in 2017.

Figure 7.7: Projections of contributions to inflation by components



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

The overall direct impact of government measures on inflation will be negligible. Government measures are forecast to contribute around 0.1 percentage points to inflation this year, and to make a neutral contribution next year. The positive contribution to inflation comes from the pass-through of last year's spring rise in excise duties on alcohol and tobacco, and this year's rises in tax on financial transactions and insurance services and in the carbon dioxide emissions tax, which together account for 0.15 percentage points. The overall contribution is reduced by 0.05 percentage points by excise duties on refined petroleum products, should the government leave them unchanged.

Foreign trade

The current account surplus will remain high over the projection horizon. Import growth will remain lower than export growth throughout the projection horizon, despite faster growth in domestic demand. Another reason for the slightly larger current account surplus relative to the previous projections is the most recent revision of the balance of payments, and consequently the upward revision of the current account surplus for 2014 to 7.0% of GDP.

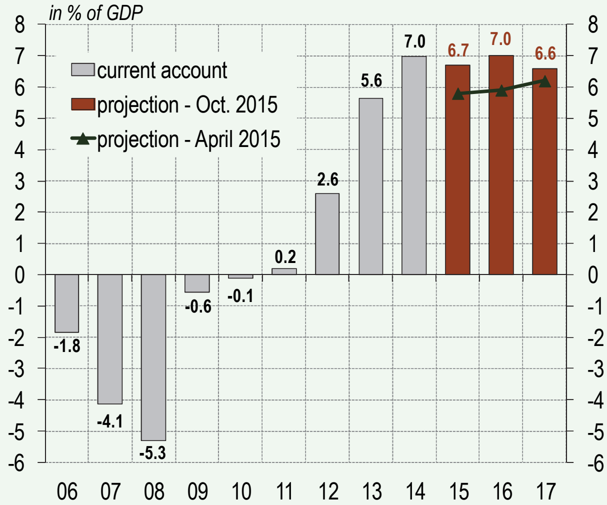
The favourable developments in the balance of trade will allow for the financing of the projected growth in the deficit in primary income. The surplus of trade in goods and services is forecast to widen from 8.1% of GDP last year to 9.7% of GDP this year, and then to 10.1% by the end of the projection horizon in 2017. The terms of trade will be a major factor in this year's surplus, and will remain positive in 2016. They will turn negative in 2017, primarily as a result of the slightly higher growth forecast in import prices. The deficit in primary and secondary income is forecast to widen from 1.0% of GDP in 2014 to just under 3.5% of GDP by the end of the projection period, although growth in the gross external debt will slow as a result of austerity measures. The interest payments burden will be reduced by low interest rates. The deficit in secondary income will be unchanged, while the

Table 7.5: Current account projections

	2010	2011	2012	2013	2014	Projections 2015 Oct.	2015 Δ	2016 Oct.	2016 Δ	2017 Oct.	2017 Δ
	growth rates, % (if not specified otherwise)										
Exports of merchandise and services	10.2	6.9	0.6	3.1	5.8	**5.0**	0.3	**4.7**	-0.2	**5.0**	-0.1
Imports of merchandise and services	6.8	5.0	-3.7	1.7	4.0	**4.0**	0.4	**3.9**	-0.2	**4.8**	0.1
Current account: EUR billion	0.0	0.1	0.9	2.0	2.6	**2.6**	0.4	**2.8**	0.5	**2.7**	0.2
as % GDP	-0.1	0.2	2.6	5.6	7.0	**6.7**	0.9	**7.0**	1.1	**6.6**	0.4
Terms of trade*	-4.0	-1.4	-1.1	0.8	1.0	**1.3**	0.9	**-0.1**	0.6	**-0.8**	-0.1

** Based on national accounts deflators.*
Δ: Difference between current projections and projections in April 2015 Economic and Financial Developments with Projections.
Source: SORS, Bank of Slovenia.

Figure 7.8: Current account projection



Source: SORS, Bank of Slovenia projections.

Figure 7.9: Terms of trade projections

Source: SORS, Bank of Slovenia projections.

increased outflow of profits to the rest of the world as a result of privatisation will be a significant factor in the widening deficit in primary income.

Risks and uncertainties

The risks to the GDP growth projections are relatively balanced at this time. The main risks to export growth are the potential additional deterioration of the economic situation in Russia and the maintenance of a weak ruble, and further cooling in China, a deepening recession in Brazil and a deterioration of the situation in Turkey. In the cases of Russia and Turkey the consequences would be direct, while in the cases of China and Brazil the consequences would be indirect via their impact on German exporters. The Volkswagen scandal could have an adverse impact on exports, as it is an important customer for Slovenia's automotive industry. At the same time the possibility of a slowdown in trade flows across Europe is being increased by the introduction of border controls in response to the worsening refugee issue. A larger impact from the ECB's quantitative easing, which is by way of the euro depreciation improving exporters' price competitiveness on markets outside the euro area, could act in the opposite direction. In the domestic environment the main risks to the growth projection for domestic demand are the outcome of the negotiations between the trade unions and the government, and the potential additional decline in expenditure on intermediate consumption in the case that compensation of public sector employees

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

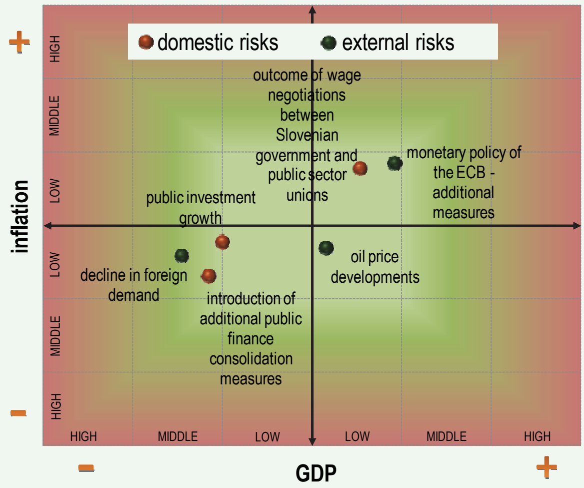
	Publication of new/previous forecast	GDP growth rate, %				Inflation annual average, %				Current account % of GDP			
		2015		2016		2015		2016		2015		2016	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Oct. 15/Apr. 15	**2.6**	0.4	**1.9**	0.1	**-0.6**	-0.5	**1.0**	-0.1	**6.7**	0.9	**7.0**	1.1
IMAD	Sep. 15/Mar. 15	**2.7**	0.3	**2.3**	0.3	**-0.4**	-0.2	**0.8**	-0.2	**6.2**	0.3	**7.2**	1.2
Consensus Forecasts	Sep. 15/Aug. 15	**2.2**	0.0	**2.0**	-0.1	**-0.3**	-0.3	**1.0**	-0.3	**...**	...	**...**	...
European Commission	May 15/Feb. 15	**2.3**	0.5	**2.1**	-0.2	**0.1**	0.4	**1.7**	0.8	**5.4**	-0.3	**5.6**	0.2
OECD	May 15/Nov. 14	**2.1**	0.7	**1.9**	-0.3	**-0.4**	-1.0	**0.7**	-0.3	**7.8**	1.8	**7.7**	1.2
IMF	Oct. 15/Apr. 15	**2.3**	0.2	**1.8**	-0.1	**-0.4**	0.0	**0.7**	0.0	**6.7**	-0.4	**6.2**	-0.3

Δ: Difference between current and previous forecasts.
Source: Bank of Slovenia, IMAD, European Commission, Consensus Economics, IMF, OECD, Bank of Slovenia calculations.

grows more than presently planned by the government. The uncertainty in the investment projection primarily relates to the amount of government investment, and to the uncertainties surrounding the construction of a second rail track between Divača and Koper.

The risks included in the inflation projections are also relatively balanced. Future developments in oil prices are uncertain, as the increased geographical diversification of production means that oil prices now react differently to conflicts in oil-rich regions than they might otherwise have done in the past, and above all because the impact of Iran's re-entry into the market after the ending of sanctions is unclear. By contrast, in the event of a sustained fall of the euro caused by ECB's quantitative easing, import prices could begin rising more quickly. Higher-than-expected domestic pressures could be exerted on prices as a result of faster wage growth in the public sector, while a downward impact could come primarily from further cuts in public spending for the purpose of fiscal consolidation.

Figure 7.10: Risks to projections



Source: Bank of Slovenia estimates.