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EUROSYSTEM

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Table of contents

Tables and Figures

Table:*

Figures:

*Excludes financial statements

Introduction

Slovenia's economy grew by a high 5.2% in 2006, the rate reaching 5.5% in the second half of the year (or 5.8% when seasonally adjusted and adjusted for working days). Growth in this cycle is driven primarily by strong exports, in connection with the favourable European business climate. This picture was slightly modified by the second half of the year, with domestic consumption, investment in particular, contributing more to aggregate growth than exports as a powerful new wave of infrastructure investment was added to the already strong programme of housebuilding. Year-on-year growth in real value-added in the construction sector exceeded 20% in the final quarter, while the sector's employment growth was almost 10%. The typical convergence factors, credit expansion on the basis of external borrowing, etc., are already having a strong factor behind the high economic growth. Such patterns may include risks.

In 2006 the Bank of Slovenia endeavoured to maintain monetary control under conditions of high economic growth. Interest rates had fallen considerably in the previous years, followed by strong credit growth, which reached 27% by 2006. With a selected array of instruments the Bank of Slovenia had succeeded in controlling the speed of nominal convergence in the period when European interest rates were at a low of practically 2%. Slovenia's short-term market rates averaged at 3.6% in 2005, then fell slightly, to finally converge with European rates in the second half of 2006, when these were already rising towards the end-year level of 3.7%. The exchange rate was stable throughout this period.

The basic framework for the policies applied until Slovenia joined the euro area was the Programme for ERM II Entry and Adoption of the Euro, which was adopted by the government and the Bank of Slovenia in November 2003. Concern for maintaining fundamental macroeconomic equilibria has been a constant in Slovenian policies. Average annual inflation as measured by the harmonised index of consumer prices (HICP) had fallen to 2.5% already by the end of 2005, and remained around this level throughout 2006. The forecasts for the next year are similar. Provisional figures put the current account deficit in 2006 at 2.6% of GDP, while the general government deficit was 1.4% of GDP. The public debt is moderate.

Meeting the inflation convergence criterion was made difficult by the high growth in world oil prices. Motor fuels and other liquid fuels account for a relatively large proportion of Slovenia's final consumption, which also defines the make-up of the inflation basket. Energy prices accounted for 1.4 percentage points of the average annual inflation rate of approximately 2.5% in the middle of 2006. Also around this time – actually a little earlier – core inflation reached its low under the influence of the Slovenian economy joining the European Union in May 2004. This saw the abolition of the remaining customs duties, thus increasing competition.

Towards the end of 2006 there was a turnaround in core inflation from its very low levels, fortunately parallel with a substantial lessening of pressure from the oil markets. Risks nevertheless remain, both in the international and in the domestic environment. With regard to the latter, there should be full awareness that the system no longer has any instruments for a national monetary or exchange rate policy. When the euro was adopted, the task of ensuring stability and long-term sustainability was passed in full to fiscal and structural policies.

The convergence report issued by the ECB and the European Commission on 16 May 2006 confirmed that Slovenia met the Maastricht criteria for joining the euro. On this basis, after consultations with the European Parliament and following a decision by the European Council, the council of finance ministers passed a resolution on 11 July, abolishing the derogation on 1 January 2007, and a resolution on the tolar-euro conversion rate. The conversion rate was set at the rate at which Slovenia entered the ERM II on 28 June 2004, i.e. 239.64 tolars to the euro.

The final phase of preparations followed in the second half of the year. The actual changeover on new year's day proceeded smoothly. Banks' balance sheets and all customer accounts were converted by afternoon on 2 January 2007 as planned, while incorporation into payments proceeded without problems. The changeover was also carried out similarly by other systems, the Ljubljana Stock Exchange and the CSCC, the companies regulated by the SMA, issuers of sovereign and private securities, etc. Even by the end of the first day there were more euro banknotes than tolar banknotes in circulation in value terms, while the number of cash withdrawals at ATMs returned to its usual level in the first week of the changeover.

A second package of Bank of Slovenia activities consisted of the final operations for joining the Eurosystem. On 2 January 2007 the relevant proportion of dollar foreign exchange reserves was transferred to the ECB, with the relevant proportion of gold reserves following a day later, while the remaining capital was subscribed to the ECB on 2 January. All monetary operations were being conducted as part of the institutions and instruments of the Eurosystem by 2 January, the supply of cash having commenced a few minutes after midnight on 1 January. The starter kits of coins were distributed to households and businesses in December.

Ljubljana, April 2007

Deputy-President of the Governing Board of the Bank of Slovenia

Ivan Ribnikar, Ph.D.

1 THE ECONOMIC ENVIRONMENT

1.1 External economic factors

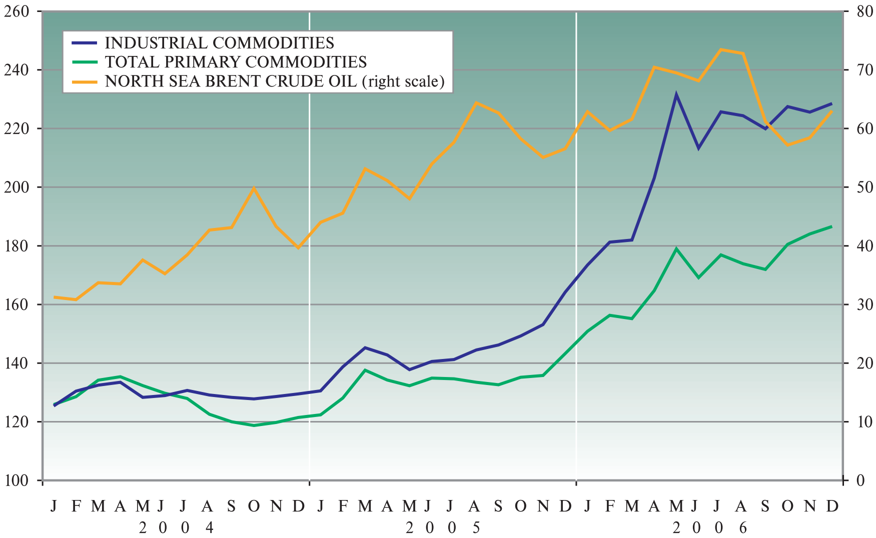
Economic growth in 2006 reached 5.1% globally, and 2.7% in the euro area

Global economic growth strengthened in 2006 to reach a relatively high 5.1% for the year as a whole according to IMF estimates. Economic growth also gradually improved in the euro area, to reach 2.7% for the year overall. Higher domestic consumption was the main factor in this good economic growth, as in the previous year. Investment grew notably faster than household spending. Towards the end of the year the gaps in economic growth between the major euro area members narrowed. In contrast to the euro area, economic growth in the USA and Japan slowed slightly during the year, while other large Asian countries recorded faster growth. Initial estimates are that economic growth in the USA slowed to 3.4% last year, primarily as a result of the cooling of the real estate market.

Economic growth in the main European trade partners improved sharply

Economic activity in Slovenia's main EU trade partners improved during the year. Germany, Slovenias' most important trading partner, stood out in particular, economic growth there rising to 2.7% according to initial figures, up from 0.9% the previous year. Economic growth in Italy also improved strongly to 2.0%, partly as a result of the low basis from the previous year, when growth stood at just 0.1%. Growth was faster in the new EU member-states than in the old member-states. Of these, extremely high rates were recorded by Slovakia (8.2%) and the Czech Republic (5.9%), where foreign investment in the automotive industry has a significant impact. Growth in the new states in the Balkans was similar to the previous year, averaging around 4.7%. Serbia recorded a faster rate of 5.8%, while Macedonia was behind the average with 3.5% growth.

Figure 1: **Prices of commodities and oil on the world market**



Note: Index 2000 = 100; oil price is for North Sea Brent in USD per barrel.
Sources: The Economist, London; Reuters

Oil prices were 20% higher on average, but slowed towards the end of the year and then declined

Oil prices continued to rise rapidly until the end of the summer, but then slowed towards the end of the year. A barrel of Brent crude stood at USD 65 on average, up around 20% on the previous year. The growth in oil prices was primarily the result of rapid growth in demand, which pumping and refining capacity was unable to keep up with. In addition, other major factors in the rapid growth in oil prices before the summer were the Iranian nuclear question and the unrest in Nigeria. Prices jumped sharply in August as a result of the conflict between Lebanon and

Israel. The summer jump in prices was partly seasonal, as flights increase at this time of year and also the risk of hurricanes in the Gulf of Mexico intensifies, where there is a high density of oil wells. After the summer seasonal factors ceased and the Iranian nuclear question eased, oil prices fell in September. Given the decline in oil prices, OPEC members decided at their meetings in October and December to cut pumping quotas, which again forced prices upwards towards USD 65 per barrel at the end of the year. The pace of economic growth meant that other commodities prices also rose rapidly, metals in particular, although growth in metals prices slowed towards the end of the year.

Inflation in the euro area and the USA was strongly affected by oil prices

Inflation in both the euro area and the USA was primarily under the influence of the rapid growth in oil prices. It averaged 2.2% in the euro area in 2006, and 3.2% in the USA. Price growth slowed in both economies towards the end of the year as a result of the decline in oil prices. During the year core inflation also rose in the euro area and the USA, partly as a result of high oil prices feeding through into other prices. Another factor in the USA, where the rise in core inflation was more pronounced, was the rapid growth in owners' equivalent rent. Japan finally saw positive inflation in 2006 after seven years of deflation, with the rate averaging 0.2% during the year.

The ECB gradually raised interest rates through the year, while the Federal Reserve's rises ceased in the middle of summer

The ECB gradually reduced the level of accommodation in its monetary policy in 2006. It raised interest rates five times, taking the key central bank rate to 3.50% at the end of the year. The rise was the result of increased inflationary pressures originating in the improved economic growth, high liquidity and growth in monetary and credit aggregates in the euro area, while there was also the possibility of the rapid growth in oil prices feeding through into other prices. The Federal Reserve in the USA maintained the restrictive monetary policy stance since June 2004 all the way to June 2006. After a final rise in June, the key interest rate remained at 5.25% until the end of the year. The rise in the key interest rate in the USA in the first half of the year was still primarily under the influence of good economic growth and high inflation. The end to interest rate rises in the middle of the year was a result of the slowdown in economic growth, which arose partly in response to the tightening of monetary policy and the cooling of the real estate market. Japan's central bank finally brought an end to its policy of zero interest rates after five years. In the middle of the year it raised the key interest rate to 0.25%, where it remained until the end of the year. The main reasons for its decision were the gradual improvement in economic growth since 2003 and the end of deflation in 2006.

The euro gained approximately 11% against the dollar in 2006

The euro appreciated significantly against the dollar in 2006, gaining around 11% till the end of the year as compared to December 2005. This appreciation was primarily the result of the financial markets' expectations that the ECB would gradually raise interest rates during the course of the year, while an end to interest rate rises was anticipated in the USA, and this came to pass in the middle of the summer. The expectations in connection with interest rates followed the trends in economic growth, which slowed in the USA, while the euro area recorded a gradual improvement in economic growth.

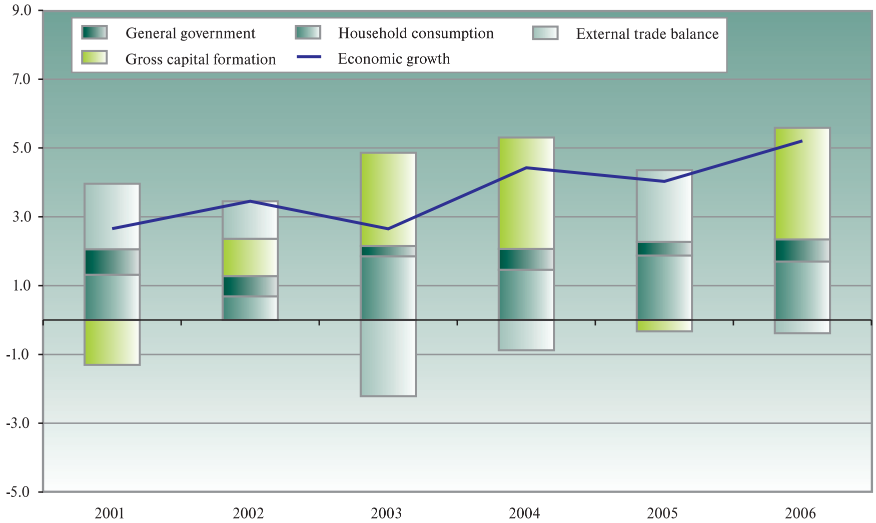
1.2 Gross domestic product, employment and labour costs

Economic growth in 2006 was the highest since 1999

Economic growth in Slovenia picked up in 2006 to reach its highest level since 1999. At 5.2%, GDP growth exceeded the estimated growth in potential GDP. The largest increases in value-added were recorded by the sectors of financial intermediation (8.1%), construction (7.6%), transport, storage and communications (7.3%) and manufacturing (7.1%). This breakdown of economic growth is an indication of the favourable business cycle inside and outside Slovenia, where a large shift in growth in value-added was recorded both by companies tied primarily to domestic demand and by companies producing primarily for foreign markets.

A significant factor in the high economic growth was the increase in domestic demand, which picked up in the final quarter of 2005 and gradually increased further over the course of 2006. Most prominent of the components of domestic consumption was gross fixed capital investment, which having recorded negative growth in the first three quarters of 2005 rose sharply in the final quarter, and then averaged 12% growth in 2006. The main factors in the strong investment spending were the favourable terms of financing during nominal interest rate convergence, the expected growth in domestic and foreign demand, certain one-off factors, and the anticipated end of the transitional period of lower VAT for housebuilding and house repairs in 2008. A prominent feature in the breakdown of investment was the high investment in residential and non-residential buildings, while investment in transport equipment also rose sharply after recording negative growth in 2005. Household spending overall in 2006 was almost unchanged from the previous year, despite the improved conditions on the labour market, increasing consumer optimism and more favourable terms of lending. After two years of negative growth, spending by private non-profit institutions increased in 2006, while growth in government spending was also 1 percentage point faster than in the previous year at 3.2%. Year-on-year growth in exports of goods and services in 2006 slowed slightly from the previous two years, while growth in imports of goods and services accelerated slightly, which was one of the factors in the widening of the balance of payments deficit in 2006.

Figure 2: **Contributions to economic growth (%)**



Sources: SORS, Bank of Slovenia calculations

Table 1: **Contributions to economic growth**

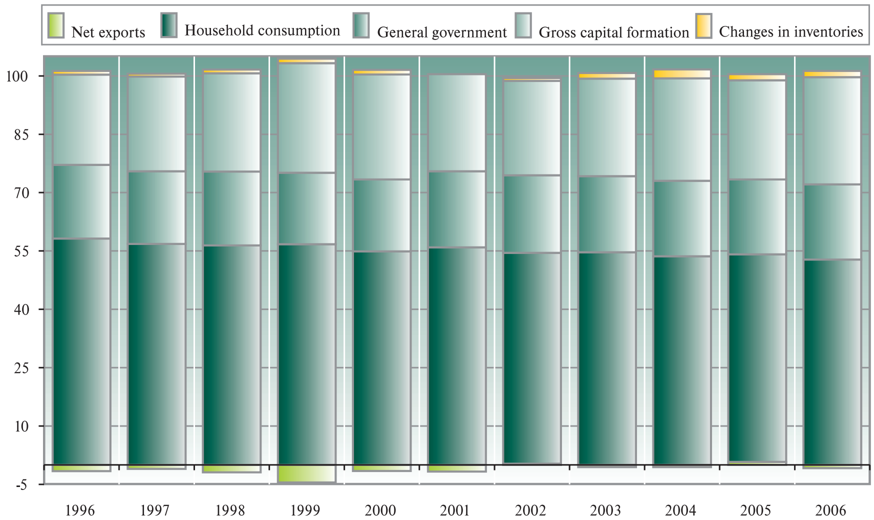
in %	2001	2002	2003	2004	2005	2006
Household consumption	1.3	0.7	1.9	1.5	1.9	1.7
Gross capital formation	-1.3	1.1	2.7	3.2	-0.3	3.2
General government	0.7	0.6	0.3	0.6	0.4	0.6
External trade balance	1.9	1.1	-2.2	-0.9	2.1	-0.4
Economic growth	2.7	3.5	2.7	4.4	4.0	5.2

Sources: SORS, Bank of Slovenia calculations

High growth in industrial production, particularly in manufacturing

In line with the high growth in value-added in manufacturing in 2006 (7.1%), there was also high growth in industrial production (7.6%), which slowed slightly only at the end of the year. The largest increases in industrial production in 2006 were recorded by export-oriented-sectors, in particular in the manufacture of electrical and optical equipment (16%), chemicals, chemical products and man-made fibres (13.7%), basic metals and fabricated metal products (12.2%), and machinery and equipment not elsewhere classified (9%), while a small decline in industrial production was recorded by the manufacture of transport equipment, in addition to the manufacture of food products, beverages and tobacco and textiles and textile products. The car industry had recorded year-on-year growth of 21% in 2005. The acceleration of industrial production was seen for all types of goods, capital goods and consumer goods in particular. Growth in turnover in industry (6%) was also higher in 2006 than in 2005, slowing slightly on foreign markets (7.8%), but rising to 2.5% on the domestic market after a negative rate in 2005. Total inventories in industry increased by just 1.8% in 2006, slightly less than in the previous year, with inventories of consumer goods declining, while inventories of capital goods increased, particularly in the second half of the year.

Figure 3: **Composition of gross domestic product (%)**



Source: SORS

Wage growth was not inflationary

Despite the higher economic growth, nominal growth in the average gross wage in 2006 was almost unchanged from the two previous years at 4.8%. The highest growth in average gross wages was recorded by the financial and tradable sector, with the public administration recording the lowest growth. The average gross wage grew by 2.3% in real terms, less than estimated productivity growth. The year-long average of year-on-year rates shows average wages growing by 2.4% in real terms in 2006, and productivity by 3.5%, i.e. real gross wage growth trailing productivity growth by 1.1 percentage points. Growth in labour costs was significantly lower than in the previous years, averaging just 2.7% in 2006, with labour costs in public administration declining, and those in the sectors of financial intermediation, agriculture and fishing increasing by more than 10%.

Table 2: **Selected economic indicators**

	2001	2002	2003	2004	2005	2006
Real GDP growth[1] (%)	2.7	3.5	2.7	4.4	4.0	5.2
GDP (EUR million)	20,028	22,348	24,259	26,172	27,625	29,736
GDP per capita (EUR)	10,049	11,200	12,150	13,104	13,797	14,824
Composition of GDP (%)						
Agriculture, forestry and fishing	2.6	2.8	2.2	2.5	2.1	2.0
Industry and construction	31.7	31.5	30.9	30.6	30.2	30.4
– Manufacturing	23.5	24.5	25.5	26.5	27.5	28.5
Services	52.9	53.2	53.6	53.8	54.6	54.9
Total value added	87.2	87.5	86.7	86.9	86.9	87.3
Compensation of employees	53.4	52.7	51.8	52.0	52.2	...
Taxes on production and imports less subsidies	14.6	15.1	14.9	14.4	14.3	...
Gross operating surplus and gross mixed income	32.0	32.2	33.3	33.6	33.4	...
– Exports of goods and services	57.6	59.0	57.4	60.1	63.7	67.5
– Imports of goods and services	59.3	58.7	58.0	60.7	62.9	68.3
Net trade	-1.7	0.3	-0.6	-0.6	0.8	-0.8
Household final consumption expenditure	56.0	54.2	54.7	53.6	53.4	52.8
General government final consumption expenditure	19.5	19.9	19.6	19.4	19.2	19.3
Gross capital formation	25.0	24.3	25.1	26.4	25.5	27.6
Labor force (ILO)[2] **in thousands**	977	971	961	1,007	1,015	1,025
Self-employed persons and persons in paid employment by natural persons (ILO)	916	910	897	943	949	963
Unemployed (ILO)	60.2	61.3	64.2	63.3	66.0	61.4
Unemployment rate (ILO, in %)	6.2	6.3	6.7	6.3	6.5	6.0
Real growth in gross wages per employee (%)	3.3	2.1	1.9	1.0	2.3	2.2
Growth in labour productivity (%)	1.8	3.6	2.6	4.2	3.0	4.0

1 National accounts figures given in previous year prices, except for compensation of employees, taxes on production and imports less subsidies, gross operating surplus and gross mixed income, which are given in current prices.
2 Internationally comparable data by ILO methodology.
Source: SORS

Constantly improving conditions on the labour market

Conditions on the labour market improved significantly in 2006 in line with the favourable business cycle. The labor force was approximately 833,000 in December 2006, up 2.4% year-on-year. There was a sharp increase in employment from the previous year both at companies (2.3%) and in the small business sector (3.8%), the latter consisting of the self-employed persons and persons in paid employment by natural persons. The largest increases in employment were recorded by the sectors of construction (7.0%) and real estate, renting and business activities (5.0%), while there were declines in agriculture, hunting and forestry (2.9%), mining and quarrying (4.0%) and manufacturing (2.1%). As in previous years, within the manufacturing sector the largest decline in employment was recorded in labour-intensive sectors, in the manufacture of food products, beverages and tobacco, textiles and textile products, and leather and leather products in particular, while there was also a decline in primarily export-oriented-sectors in the second half of 2006, despite high exports. The number of unemployed in December 2006 was down by 14,270 or 15.4% on a year earlier, with December's unemployment rate of 8.6% down by 1.6 percentage points on a year earlier. There was also a sharp decline in the surveyed level of unemployment (ILO methodology), which in the second half of 2006 fell to a record low of 5.6%. According to the Labour Force Survey, the activity rate increased by 0.1 percentage points in 2006 to 59.3% of the population , while the employment rate increased by 0.4 percentage points to 55.8%.

1.3 Prices

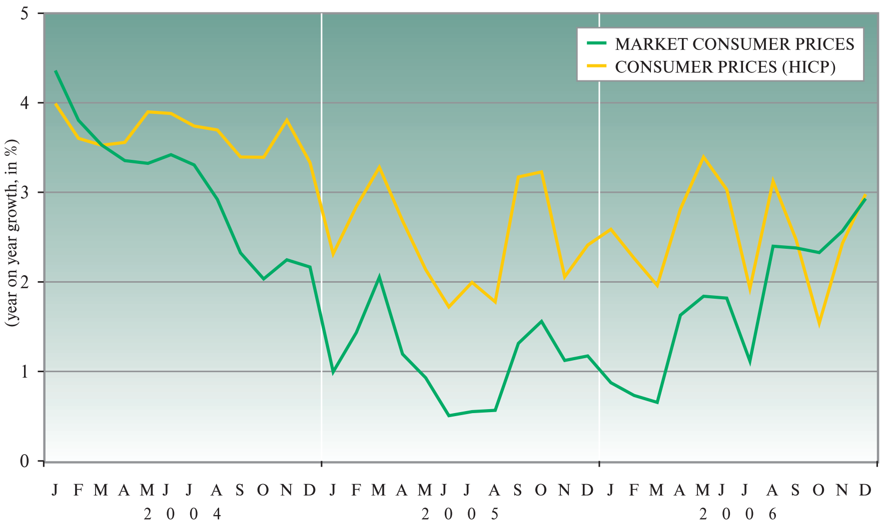
At 2.5% inflation was lower in 2006 than in 2005…

Average inflation as measured by the HICP stood at 2.5% in 2006, unchanged from 2005. The sustained low inflation rate has allowed Slovenia to constantly meet the Maastricht criteria since the end of 2005, thus confirming its macroeconomic readiness to join the euro area. Although average inflation remained unchanged, the dynamics of the individual components of the inflation rate did change slightly.

… while core inflation was slightly higher than in the previous year at 1.2%

Core inflation increased,[1] but growth in energy prices began to slow. Average core inflation was up 0.5 percentage points in 2006 at 1.2%. This, nonetheless, still represents a relatively low level compared with previous trends as well as compared with a number of other euro area member states. Average year-on-year growth in energy prices fell from 11.9% in 2005 following the oil shocks to 8.5% in 2006. The latter was a significant factor in the stability of average inflation. Average year-on-year growth in prices of seasonal produce rose from 2.2% in 2005 to 4.9% in 2006. The tax effects on inflation were negligible, the only noteworthy effects being July's rise in excise duties on tobacco products.

Figure 4: **Prices**



Sources: SORS, Bank of Slovenia

While services are rising in price, prices of industrial goods excluding energy are still subdued…

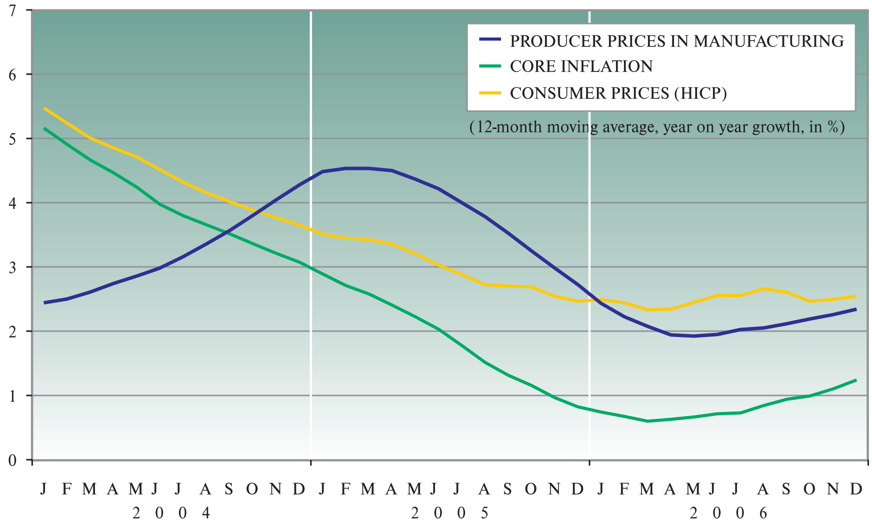
Among inflation sub-categories, prices of industrial goods excluding energy prices continued to fall in 2006, while growth in prices of services gradually increased. Average year-on-year growth in prices of industrial goods excluding energy prices was below zero throughout almost the whole year, only turning positive towards the end of the year. Overall growth in these prices was 0.9%. A slightly different picture is given by the movement of prices of services, average growth in which has been increasing since April, pushing overall growth to 3.5% in 2006. The higher growth in prices of services can primarily be attributed to the increase in domestic demand while services are subject to less competition from the rest of the world. Relatively low in 2005, growth in food prices picked up throughout 2006 to reach 2.7%, up 2.5 percentage points on the previous year. To a great extent this was a correction of a temporary basis effect, as there was a significant decline in food prices in 2004 and 2005 as a result of Slovenia joining the EU and the consequent price adjustment.

[1] Core inflation equals consumer prices excluding energy prices, food prices and the effects of tax changes.

…and producer prices of manufactured goods are also recording low growth

Producer prices of manufactured goods rose by 2.3% overall in 2006, less than the rise of 2.7% in 2005. The main factor in this rise was growth in prices of intermediate goods, primarily as a result of higher commodities prices. By contrast overall year-on-year growth in prices of capital goods fell sharply, from 3.1% in 2005 to 0.2% in 2006. Prices of consumer goods also recorded low overall year-on-year growth, down to 1.5% in 2006 from 2.0% in 2005. As in other euro area member states, the low growth in prices of manufactured goods is most probably the result of the high level of international competition, which in recent years has increased as a result of emerging countries' growing involvement in international trade.

Figure 5: **Price movements**



Sources: SORS, Bank of Slovenia

Administered prices rose in line with government plans

Growth in administered prices in 2006 was in line with the government's plan for forming administered prices. The Ministry of the Economy estimates[2] that regulated prices rose by 1.6% in the first eleven months of the year. A distinction can be drawn between products under the direct control of the Slovenian government, prices of which declined by 0.4%, and those under indirect control, which recorded price growth of 2%. According to the Ministry of the Economy, regulated prices accounted for 17.4% of the consumer price index in total, with prices under direct control accounting for 7.8%. Of particular note among administered prices were the prices of liquid fuels, on which the government raised excise duties in August and September, in the context of a decline in the purchase prices of refined petroleum products on world markets in the later months of 2006. Retail electricity prices were also raised by 2.3%, in line with the plan.

Labour costs remain moderate in Slovenia

The main factors in the low inflation in Slovenia remained the moderate growth in labour costs and the favourable state of the labour market. Growth in labour costs trailed productivity growth in 2006, thus restricting supply-side price pressures, as a result of the relatively low wage growth and the rise in employment. Note should be taken of the fluctuations in year-on-year inflation rates, which were, measured by the standard deviation, similar in 2006 and 2005, and significantly larger than in 2004. Larger fluctuations are mostly a result of an increase in oil prices in 2005 and at the beginning of 2006.

[2] See Report on the Realisation of the Plan for Managing Regulated Prices for 2006 and 2007. http://193.2.236.95/dato3.nsf/OC/0701202118509/$file/105v1_15.doc

1.4 Balance of payments

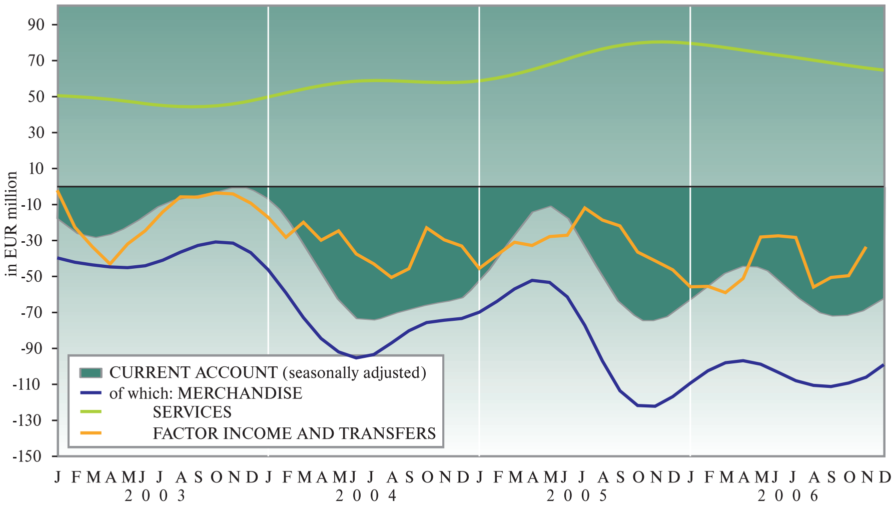
The current account deficit stood at 2.5% of estimated GDP in 2006

Slovenia recorded a current account deficit for the fourth consecutive year. It stood at EUR 756 million in 2006, or 2.5% of GDP, just under one-half larger than the deficit recorded in 2005, the largest figure in the last ten years. The main factors in the current account deficit in 2006 were the net outflow of factor income and the widening of the deficit in transfers. With the surplus in trade in services almost unchanged, movements in merchandise trade also contributed to the current account deficit, particularly in the second half of the year when merchandise imports picked up as domestic consumption increased slightly.

The deficit in merchandise trade rose slightly, but was close to its long-term average

Slovenia's trade deficit with the rest of the world stood at EUR 1.5 billion in 2006, or 5.2% of GDP, less than the long-term average of 5.4% but still slightly larger than that recorded in 2005. There was an above-average increase in merchandise trade in 2006 in terms of both volume and value. Merchandise exports totalled EUR 16.7 billion, up 16.4% from 2005. Merchandise imports grew slightly more slowly than exports, and were up 15.9% from 2005 at EUR 18.3 billion. The level of coverage of imports by exports increased by just under 0.5 percentage points to 91.6%.

Figure 6: **Current account**



Sources: SORS, ARC estimates, Bank of Slovenia

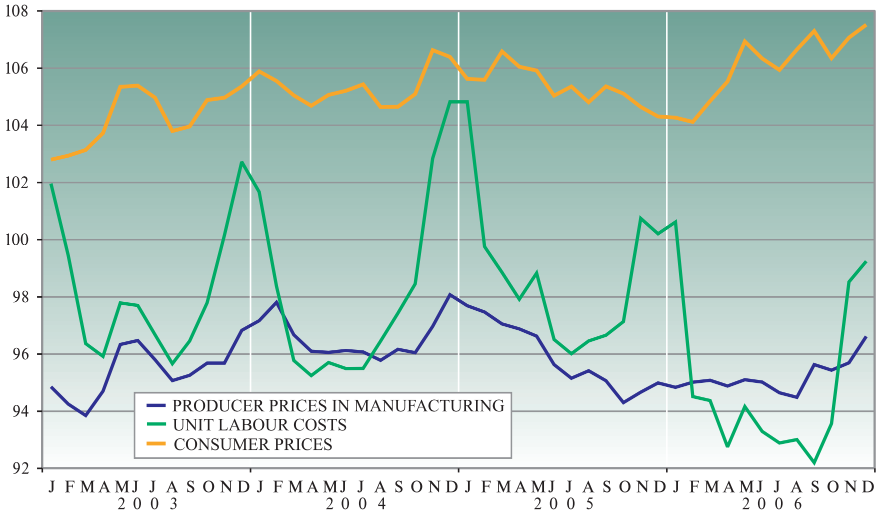
Growth in merchandise imports more than doubled from the previous year in volume terms

With both foreign and domestic demand good, growth in merchandise imports and exports in volume terms was higher in 2006 than in the previous year. Export growth in volume terms rose by 2.5 percentage points on the previous year to 10.2%, while import growth more than doubled from 3.8% in 2005 to 9.1% in 2006. Nevertheless, growth in merchandise trade in volume terms was lower than indicated by indices calculated from the value figures expressed in euros. The reason for this difference is that the average merchandise import-export value indices (import-export prices) calculated in euros in 2006 increased compared to 2005, with import prices growing slightly more quickly than export prices. The movement of import prices has been under the influence of the decline in oil prices and prices of refined petroleum products on world markets since the middle of August 2006. Euro oil prices on the spot market in the final quarter of 2006 were actually down 3% on a year earlier. High growth in euro prices of industrial metals on world markets under the influence of strong demand from Asia, China and India in particular, had a beneficial impact on exports by metals producers.

The terms of trade improved

Euro export prices rose by 5.6% year-on-year on average in 2006, and euro import prices by 6.2%. The terms of trade, which illustrate the gap between import and export prices, improved by just under 2 percentage points from -2.6% in 2005 to -0.6% in 2006. Without the improvement in the terms of trade, the total deficit in merchandise trade would have reached EUR 2.0 billion, or 6.7% of GDP.

Figure 7: **Real effective tolar exchange rate**



Note: Index 1995 = 100.
Source: Bank of Slovenia

The nominal effective tolar exchange rate appreciated in 2006

The nominal effective tolar exchange rate appreciated in 2006. The main factor in this was the movements of various foreign currencies on the markets, in particular the dollar's decline against the euro. The real effective tolar exchange rate appreciated by 3.1% as measured by the ratio of the domestic cost of living to the cost of living abroad, and by slightly less (1.7%) as measured by producer prices. With productivity growth outstripping wage growth, competitiveness improved solely in the manufacturing sector. The real effective tolar exchange rate as measured by relative unit labour costs was down 1% year-on-year in December 2006.

In industry real sales revenues on foreign markets grew at three times the pace of sales revenues on the domestic market

Foreign demand, from EU member-states in particular, has been the most important factor in export growth and economic growth in Slovenia in the last three years. Further evidence of this comes from real sales revenues in industry growing more quickly on the foreign market than on the domestic market. Sales revenues in industry increased by 5.9% in 2006, with sales on foreign markets rising by 7.6% and sales on the domestic market by one-third of this, 2.6%. The largest real increases in revenues were recorded by production of intermediate goods and capital goods, while production of consumer goods recorded the smallest increase, which also corresponds to the changes in the dynamics and breakdown of merchandise exports in terms of purpose of use.

Higher economic growth in the rest of the world, higher demand for intermediate goods and capital goods

The good economic performance in the rest of the world, particularly in Slovenia's most important trade partners in the euro area, had a significant impact on the structure of demand and merchandise exports in terms of economic purpose of use in 2006. Only exports for productive use in the rest of the world recorded an above-average increase. Exports of intermediate goods and capital goods recorded the largest increases, each of 21%. Exports of consumer goods increased by 9.6%, with those to euro area members actually declining by 2% year-on-year. Another factor in this slightly lower growth was the high basis from the previous year, when exports of consumer goods grew by 17.4%, primarily as a result of an increase of 36% in exports of road vehicles. High investment spending was the main component of GDP growth in 2006, and this had a profound impact on the structure of merchandise imports. The largest increase was recorded by imports of capital goods (17.2%), while there was a slightly smaller increase in imports of intermediate goods (16%). There were major price factors in the latter figure, in particular growth in commodities prices and energy prices. As on the export side, imports of consumer goods recorded the smallest increase in 2006, of 14.4%.

Above-average growth in exports to EU member-states

The regional breakdown of merchandise trade shifted towards EU member-states in 2006. The EU accounted for 68.5% of total merchandise exports, up 0.6 percentage points on the previous year, and for 80.3% of imports, down 0.6 percentage points. The proportion of merchandise trade accounted for by euro area members fell by 0.6 percentage points on both the import and export sides, while the proportion of merchandise exports accounted for by countries that joined the EU in May 2004 increased by just over 1 percentage point. Among Slovenia's important trade partners in the euro area, only merchandise trade with France contracted, exports having almost doubled in previous year as a result of exports by the automotive industry. Merchandise exports to France declined by 4% last year. Above-average increases were recorded by exports to Austria (25%) and Italy (19%). The favourable economic climate in Germany since the final quarter of 2005 was a factor in the demand for and the increase in Slovenian exports to Germany, which after several years of stagnation or slow growth increased by 15% in 2006. Exports to the new EU member-states recorded an above-average increase of 31%. Exports to Poland and Hungary were up by more than one-third, while exports to Slovakia were up 28%, and exports to the Czech Republic were up 22%. Among Slovenia's most important trade partners growth in imports from Germany was above-average (17.7%), that of imports from Austria was at average (15%), and that of imports from Italy was below-average (13.3%), while only merchandise imports from France declined, by 2.4%.

Imports from the former Yugoslav republics grew faster than exports for the third successive year

Imports from the former Yugoslav republics grew faster than exports for the third consecutive year. The moderate growth in exports can partly be attributed to outward FDI by Slovenian companies in these countries, which more than doubled between 2000 and 2004. Exports to these countries rose by 10% year-on-year, while imports rose by 30%. The former Yugoslav republics accounted for 16.3% of merchandise exports in 2006, just over 1 percentage point less than in the previous year, and 7.4% of imports, up 1 percentage point.

Table 3: **Regional breakdown of merchandise trade**

	EXPORTS			IMPORTS			TRADE BALANCE		
in EUR million	2004	2005	2006	2004	2005	2006	2004	2005	2006
European Union (25)	**8,505**	**9,770**	**10,583**	**11,646**	**12,789**	**13,368**	**-3,141**	**-3,018**	**-3,215**
Euro area	**6,897**	**7,867**	**8,338**	**9,913**	**10,908**	**11,401**	**-3,016**	**-3,040**	**-3,479**
Austria	955	1,160	1,332	1,864	1,953	2,047	-908	-793	-797
France	822	1,185	1,048	1,166	1,157	1,039	-344	28	9
Italy	1,664	1,818	2,000	2,673	3,014	3,103	-1,009	-1,195	-1,252
Germany	2,760	2,863	3,046	2,872	3,163	3,362	-112	-300	-425
New member-states	**1,068**	**1,244**	**1,490**	**1,274**	**1,448**	**1,503**	**-206**	**-204**	**-24**
Czech Republic	245	320	360	345	380	362	-101	-59	-10
Hungary	249	284	351	540	603	613	-292	-319	-286
Poland	344	364	453	189	239	278	155	125	187
Slovakia	174	213	250	173	211	237	1	3	15
EFTA	**166**	**219**	**198**	**220**	**220**	**274**	**-54**	**-1**	**-76**
Non-European OECD members	**633**	**561**	**654**	**596**	**550**	**604**	**38**	**11**	**50**
USA	400	294	381	175	145	189	224	149	192
Canada	20	26	35	38	43	33	-18	-17	3
South Korea	13	15	16	60	70	110	-47	-54	-94
Former Yugoslav republics	**2,251**	**2,476**	**2,735**	**814**	**1,034**	**1,348**	**1,437**	**1,442**	**1,387**
Bosnia-Herzegovina	491	515	485	152	208	311	339	307	174
Croatia	1,167	1,304	1,464	521	609	736	646	695	728
Serbia-Montenegro	139	134	126	26	29	38	113	105	87
Macedonia	455	523	661	115	188	263	340	335	398
Countries of the former Soviet Union	**604**	**686**	**867**	**346**	**390**	**431**	**258**	**297**	**436**
Russia	420	467	597	288	334	353	132	133	244
Other countries	624	685	827	520	823	963	103	-139	-134
China	624	685	827	520	823	963	103	-139	-134
TOTAL	**12,783**	**14,397**	**15,864**	**14,143**	**15,805**	**16,988**	**-1,360**	**-1,408**	**-1,552**

Note: Export f.o.b. and import c.i.f..
Source: SORS; provisional figures for 2006

Trade increased most with Serbia-Montenegro and Croatia

The largest increases in trade in 2006 were recorded by Serbia-Montenegro (exports up 27%, imports up 40%), and Croatia (exports up 12%, imports up 21%). Merchandise exports to Macedonia have been declining for several years, and were joined in this by exports to Bosnia-Herzegovina in 2006, but merchandise imports from these countries have been recording above-average growth for a number of years. Imports from Macedonia rose by 32% in 2006, while those from Bosnia-Herzegovina were up fully 50%.

Growth in merchandise trade with countries outside Europe also

Merchandise trade with Russia has recorded above-average growth for several years now (exports up 28% in 2006, imports up 6%), and was joined last year by merchandise trade with the USA (exports up 30%, imports up 30%) and China (exports up 47%, imports up 24%).

Trade in services grew significantly more slowly than merchandise trade

The favourable economic climate in the rest of the world was reflected primarily in increased demand for Slovenian industrial exports. There was no major impact on trade in services, other than those directly associated with merchandise trade. Trade in services grew more slowly than merchandise trade in 2006. Growth in exports of services was 6.5 percentage points slower than that of merchandise exports, while the gap was just over 3 percentage points on the import side. Under these dynamics in trade in services, the proportion of total exports accounted for by exports of services fell by 0.8 percentage points to 17.2%, and the proportion of total imports accounted for by imports of services fell by 0.4 percentage points to 12.8%, which took the figures on both the import and export sides to those recorded in 2001. Export of services were up 10.2% in 2006 at EUR 3.5 billion, while imports were up 12.7% at EUR 2.7 billion. These movements in imports and exports of services meant that the trade surplus rose by just EUR 30 million during the year to EUR 885 million.

Stagnation of surpluses in tourism

The main factor in the stagnation of trade in services was poor results in the tourism sector. Tourism revenues were up 3.8% at EUR 1.5 billion, slightly less than the increase in the number of foreign visitors. A significant factor in the high growth in tourism revenues in 2004 and 2005 was the growth in revenues at casinos (36% in 2004 and 28.5% in 2005), which ceased in 2006, when revenues stagnated at their level of the previous year at EUR 225 million. Alongside the stagnation of revenues from casinos, other factors in the poor tourism results were the decline of 30% in sales revenues from border duty-free shops, and the decline of 22% in other card payments. Expenditure on tourism grew faster than revenues last year, and was up 10.5% on 2005 at EUR 850 million. The tourism trade surplus of EUR 652 million was down just under EUR 30 million on 2005.

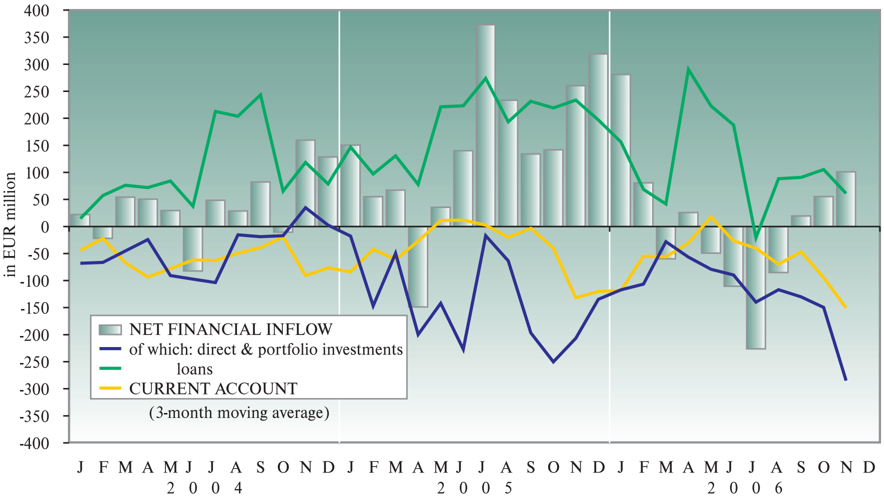
The surplus in transport increased by just over one-sixth

There were good results in the transport sector. The dynamics of transport services are closely associated with merchandise trade. Revenues from transport grew by 14.5% year-on-year, while expenditure on transport was up 13.3%, taking the surplus up more than one-sixth to EUR 462 million. Other services increased most on the expenditure side in 2006. Services other than tourism and transport recorded a net deficit of EUR 250 million, up one-quarter (EUR 50 million) on 2005. The largest increase on the export side, of more than one-half, was recorded by financial services and trade intermediation services, while alongside financial and insurance services, which increased by just under 20%, the largest increase on the import side was recorded by expenditure on patents, licences and copyrights (34%).

The net deficit in factor income accounted for almost one-half of the current account deficit

There has been a net deficit in factor income since 2001. The net deficit was EUR 349 million in 2006, and accounted for just under one-half of the current account deficit. Net inflows of labour income have been declining for several years, and fell by EUR 9 million in 2006 to EUR 124 million. The deficit in capital income was up EUR 58 million on 2005 at EUR 473 million. As a result of high lending activity in previous years and the rise in interest rates on world financial markets, the largest increase in 2006 was recorded by interest payments: 75% on the inward side, and 45% on the outward side. Among capital income, only investments in securities recorded a net inflow. The net inflow is actually increasing, having risen by just under EUR 50 million last year to EUR 187 million. Among income from equity, the largest increases were recorded in July and September in payments of dividends and profits distributed to the rest of the world, which rose from EUR 134 million in 2005 to EUR 366 million in 2006. By the end of the year the rise in outward payments had been almost entirely balanced by the decline in estimated reinvested earnings in 2006. The total outflow of income from inward FDI in Slovenia was down EUR 5 million on 2005 at EUR 366 million.

Figure 8: **Financial account and current account**



Source: Bank of Slovenia

The deficit in current transfers doubled

The deficit of EUR 171 million in current transfers was more than double that in 2005, and was a major factor in the deterioration in the current account. The largest deterioration was recorded by other transfers, which went from a surplus of EUR 15 million in 2005 to a deficit of EUR 63 million in 2006. Although there was a net outflow of EUR 108 million in official transfers in 2006, the use of the funds available from the EU budget is improving. The actual revenues from the EU budget reached 78% of their projected sum (compared with 63% in 2005), while expenditure on the EU budget reached 92% of its projected sum, and the overall effect was a net inflow (in current and capital transfers) in the amount of EUR 62 million.

The financial flows in the capital account were almost in balance

The net financial inflow fell sharply in 2006 from its high value in 2005, to one of the lowest values to date. The main factor in the sharp decline was the private sector, which in contrast to previous years recorded a net financial outflow, while the government sector increased its borrowing from the rest of the world in 2006 after reducing debt in previous years.

High growth in outward private sector investments

In 2006 the private sector increased its investments and reduced its liabilities to the rest of the world, which turned the large financial inflow recorded by the private sector in 2005 into a financial outflow in 2006. The private sector recorded a 39% increase in its outward investments to EUR 4.26 billion, with growth in trade credits and loans and (estimated) growth in holdings of foreign cash by households particularly notable, while reducing its liabilities to the rest of the world by 12% to EUR 4.19 billion.

Slowdown of growth in outward portfolio investments

Extremely high in 2004 and 2005, growth in Slovenian outward portfolio investments slowed slightly in 2006, but they still represent the most important item of outward private sector investments. The sharp increase in outward portfolio investments in 2005 originated primarily in the comprehensive restructuring of the portfolios of mutual funds following the abolition of the limits on their investments in foreign securities. The portfolio restructuring gradually came to an end in 2006, and the rapid growth in returns on the Slovenian stock exchange was probably also a factor in the slowdown in outward portfolio investments. Total outward portfolio investments amounted to EUR 1.26 billion in 2006, equities accounting for approximately 60% of this. Banks also invested EUR 0.85 billion in first-class securities that are classed as part of the banks' foreign exchange reserves and are not included in the aggregate of portfolio investments.

Table 4: **Balance of payments**

in EUR million	2001	2002	2003	2004	2005	2006
A. CURRENT ACCOUNT	**38**	**247**	**-196**	**-720**	**-547**	**-756**
- in % of GDP	***0.2***	***1.0***	***-0.8***	***-2.7***	***-2.0***	***-2.5***
1. Goods	-684	-265	-543	-1,009	-1,026	-1,121
2. Services	536	620	540	688	856	885
2.1. Transport	203	249	260	324	398	462
2.2. Travel	504	508	522	608	678	652
- exports	1,105	1,143	1,186	1,312	1,448	1,502
2.3. Other	-171	-137	-243	-245	-221	-229
3. Income	43	-168	-219	-322	-283	-349
3.1. Labour income	167	160	135	138	132	124
3.2. Investment income	-124	-328	-353	-460	-415	-473
4. Current transfers	144	60	26	-76	-94	-171
B. NET FINANCIAL INFLOW	**1,724**	**1,196**	**264**	**587**	**1,753**	**143**
- in % of GDP	***7.8***	***5.1***	***1.1***	***2.2***	***6.3***	***0.5***
1. Private sector:	1,510	1,595	220	606	1,673	-72
1.1. Claims	296	-1,426	-1,763	-2,517	-3,073	-4,263
Capital transfers	0	-237	-245	-247	-279	-321
Outward FDI	-161	-166	-421	-441	-503	-590
Portfolio investments	-87	-144	-160	-532	-1,140	-1,256
Trade credits[1]	-249	-135	-116	-237	-196	-431
Loans	19	-174	-223	-281	-413	-722
Households	797	-587	-515	-630	-270	-821
1.2. Liabilities	1,213	3,021	1,983	3,123	4,746	4,191
Capital transfers	0	74	81	132	141	161
Inward FDI	412	1,722	270	665	445	303
Portfolio investments	11	27	-13	181	210	176
Trade credits[1]	-	94	58	210	237	448
Loans	649	935	1,189	1,666	2,676	2,171
Deposits at banks	152	130	428	236	1,012	991
1.3. Other, net	-34	57	-114	-117	-247	-182
2. Government[2]	114	-97	-83	-149	-159	383
3. Bank of Slovenia	-10	-51	-24	108	94	69
4. Net errors and omissions	110	-250	150	22	144	-254
C. CHANGE IN RESERVES:	**-1,762**	**-1,443**	**-68**	**133**	**-1,205**	**630**
1. Bank of Slovenia	-1,436	-1,840	-241	239	-283	1,280
2. Banks	-326	397	173	-106	-922	-650

1 Before 2002 trade credits were represented as net trade credits (claims netted by liabilities).
2 The transactions of domestic banks with government bonds are excluded.
Source: Bank of Slovenia

Moderate growth in Slovenia's outward FDI

Growth in outward FDI was slightly higher in 2006 than in the previous year, however the structure of the investments changed. While equity was prevalent in 2004 and 2005, equity investments declined slightly in 2006, while there was a sharp increase in debt claims against afiliated companies. There was a total of EUR 590 million in outward FDI in 2006, of which approximately 70% went to the former Yugoslavia, and 17% to the EU.

Strong growth in trade credits approved in the rest of the world

Lending to the rest of the world via trade credits increased sharply in 2006 (partly as a result of better take-up), and reached its highest value to date of EUR 431 million. Trade credits approved in 2005 totalled just EUR 196 million, and the high total of trade credits approved in 2006 is an indication of the growing importance of trade credits in export deals. The majority of credits approved in 2006 remained short-term, while the regional breakdown remained similar to previous years, with the EU accounting for the largest proportion (52%).

Higher outward loans and capital transfers

There was an increase of 75% in lending to the rest of the world via financial loans in 2006 to EUR 722 million. The banking sector approved the majority of these loans. In terms of growth in loans approved, companies are particularly notable, having approved loans in 2006 more than double the total recorded in 2005, primarily short-term. Lending to the former Yugoslav republics accounts for fully 78% of loans made to the rest of the world. Outward capital transfers, which in particular include discounts agreed subsequently on exported merchandise, are also increasing constantly. The total rose to EUR 321 million in 2006.

Portfolio investments by non-residents into the private sector down, into the government sector up

Portfolio investments into the private sector by non-residents declined in 2006 to below their level of 2004, when such investments first reached a significant value. The main factor in the decline in portfolio investments was the decrease in investments in banking sector debt securities, while demand for corporate equities from non-residents almost doubled. Demand from non-residents for government debt securities was greater than that for private sector investments in 2006. After two years of making net repayments, the government sector increased its debt to the rest of the world on the basis of portfolio investments by EUR 532 million.

The decline in inward FDI continued

Inward FDI by non-residents has been gradually declining since 2004, and reached EUR 303 million in 2006. Equity was prevalent in the breakdown, while estimated reinvested earnings were down on 2005, primarily as a result of a change in the way that they are estimated. Reinvested earnings are now estimated on the basis of the total profit generated in the preceding three years, and not only from the reinvested portion as previously. The total of foreign investment in the form of borrowing from non-resident owners was also below-average in 2006 compared with previous years. The euro area accounted for approximately 87% of all inward FDI in Slovenia in 2006.

Trade credits on imports almost doubled

In financing imports Slovenian companies recorded trade credits in the amount of EUR 448 million in 2006, almost double those in 2005. These were primarily short-term trade credits. Slovenian importers continue to receive the majority of their trade credits from exporters in the EU. With imports increasing, capital transfers also increased slightly to EUR 161 million.

A decline in the banking sector's borrowing via loans from the rest of the world

The total of loans approved to the private sector fell by approximately EUR 505 million in 2006 to EUR 2,171 million. In 2005 this financial inflow was the main source of financing for the banking sector, which sought additional resources in the rest of the world to finance its domestic lending. In 2006 the banking sector reduced significantly its borrowing, by EUR 930 million (to EUR 1.4 billion), while companies, in particular other financial institutions (OFIs), more than doubled their borrowing in the form of loans to EUR 716 million. The inflow of deposits by non-residents, primarily foreign banks, declined by approximately 2%. Towards the end of 2006 the banking sector expanded its resources for financing the rapid growth in domestic lending from the maturing Bank of Slovenia bills. The government sector made net repayments in 2006, of long-term loans in particular, its repayments outweighing its new loans.

The largest factor in the increase in the debt remains banking sector borrowing in the rest of the world

The gross external debt amounted to EUR 23.7 billion at the end of 2006, equivalent to 76.3% of GDP, having recorded an increase of EUR 4.1 billion, similar to that in 2005. The banking sector was the main factor in the increase in the debt, accounting for EUR 2.6 billion, approximately EUR 1 billion less than in the previous year. The smaller increase in the banking sector's debt in 2006 was primarily a reflection of a decrease in loans taken in the rest of the world. The banking sector has nevertheless seen its proportion of the gross external debt continue to increase, from 26% in 2003 to 46% at the end of 2006. Companies and OFIs are increasingly contributing to the increase in the gross external debt, their debt rising by EUR 1.4 billion in 2006 to EUR 9.2 billion at the end of the year. Companies and OFIs recorded most of their additional borrowing via short-term trade credits, but also recorded a sharp increase in their debt via long-term loans. Despite the increase in their debt, the proportion of the gross external debt that they account for is declining, having fallen by 8 percentage points from 2003 to 39% at the end of 2006. After making significant repayments in recent years, the government sector recorded net borrowing of EUR 268 million in 2006, primarily via long-term debt securities, nevertheless the proportion of the gross external debt accounted for by the government declined by 8 percentage points from 2003 to 10% at the end of 2006. In the maturity breakdown, 75% of the gross external debt was long-term debt at the end of 2006.

Table 5: **Slovenia's external debt and foreign exchange reserves**

Stock at the end of period, in EUR million	2001	2002	2003	2004	2005	2006
Gross external debt	**10,386**	**11,524**	**13,225**	**15,343**	**19,614**	**23,718**
1. Long-term debt	7,369	8,229	9,590	11,552	14,773	17,680
in % of GDP	*70.9*	*71.4*	*72.5*	*75.3*	*75.3*	*74.5*
- of which: bonds and notes	1,934	1,935	2,070	2,096	2,070	2,456
loans	5,117	5,909	6,927	8,627	11,197	13,274
1. Short-term debt	2,213	2,327	2,475	2,659	3,603	4,997
in % of GDP	*21.3*	*20.2*	*18.7*	*17.3*	*18.4*	*21.1*
- of which: trade credits	1,690	1,693	1,663	1,862	2,316	3,062
currency and deposits	396	416	588	579	918	1,372
3. Intercompany lending	804	969	1,160	1,132	1,238	1,040
in % of GDP	*7.7*	*8.4*	*8.8*	*7.4*	*6.3*	*4.4*
Short term debt by remaining maturity[1]	**4,569**	**4,484**	**4,590**	**5,358**	**6,581**	**7,765**
Net external debt[2]	**-1,427**	**-2,555**	**-1,716**	**-882**	**411**	**2,411**
Foreign exchange reserves	6,513	7,842	7,703	7,484	8,833	8,005
FX reserves/GDP (%)	*29.7*	*33.4*	*31.0*	*28.5*	*32.0*	*27.0*
FX reserves/imports (months)	*6.1*	*7.1*	*6.7*	*5.6*	*5.9*	*4.7*
Gross debt/GDP (%)	*47.7*	*48.8*	*53.2*	*58.4*	*71.0*	*76.3*
FX reserves/short-term debt by maturity (%)	**142.6**	**174.9**	**167.8**	**139.8**	**134.2**	**103.1**

[1] Short-term debt by residual maturity consists of non-equity debt to the rest of the world with a remaining maturity of 12 months or less.

[2] Gross external debt minus gross external claims. Starting with 2002 are also included claims belong to the fund SOD.

Sourc: Bank of Slovenia

In 2006 gross external claims against the rest of the world increased by less than the gross external debt, by EUR 2.1 billion to EUR 21.3 billion, owing to which the net external debt increased by EUR 2 billion to EUR 2.4 billion. These figures already take into consideration the updated methodology for monitoring households' holdings of foreign currency approved in July 2006, which raised the level of gross claims against the rest of the world (i.e. reduced the net debt) by approximately EUR 2 billion. The Bank of Slovenia accounted for the largest portion of the increase in the net external debt, EUR 1.5 billion, as a result of a decline in its gross external claims. This was primarily the result of structural adjustments in monetary policy instruments, in particular the decline in foreign currency bills. The stock of foreign currency bills declined by EUR 1.2 billion in 2006. This was tracked by banks, who widened the gap between debt and claims by EUR 1.2 billion. Other sectors, which comprise companies, OFIs and households, reduced their net debt to the rest of the world by EUR 0.5 billion, with their investments growing faster than borrowing.

A decline in Slovenia's foreign exchange reserves

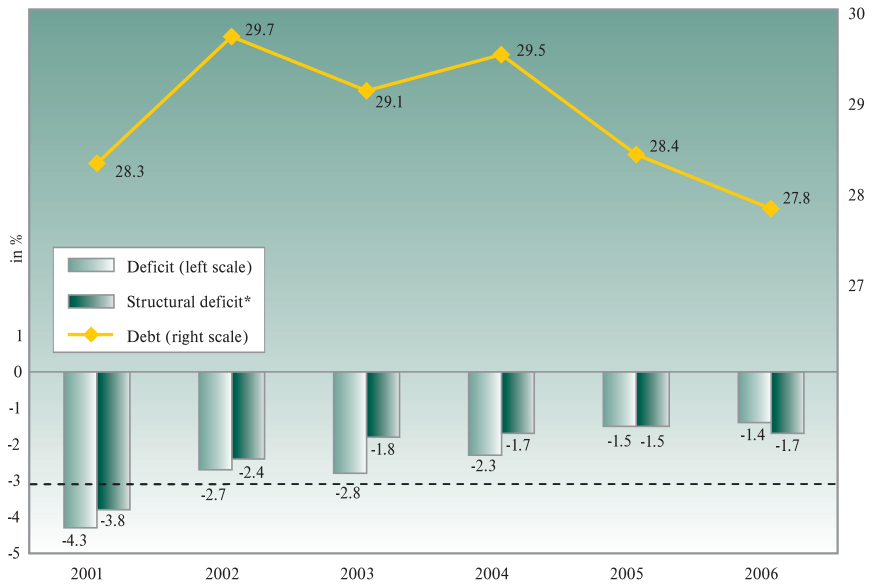
The current account deficit and the small net financial inflow brought a decline of EUR 0.83 billion in the foreign exchange reserves in 2006 to EUR 8 billion. Thus at the end of 2006 foreign exchange reserves were equivalent to just 27% of GDP, and sufficed to cover 4.7 months of imports of goods and services. There was also a sharp decline in the surplus of foreign exchange reserves over the debt maturing in up to one year, to just 3.1%, significantly less than in previous years.

1.5 Public finances

The general government deficit stood at 1.4% of GDP, and general government debt at 27.8% of GDP

The general government deficit in 2006 according to the ESA95[3] methodology stood at 1.4% of GDP. The general government debt stood at 27.8% of GDP at the end of 2006, slightly lower than a year earlier. These figures also form the basis for verifying that the reference values for the deficit and the general government debt are met.

Figure 9: **Government sector deficit and debt according to ESA95 methodology**



* The structural deficit for the 2001 to 2004 period is based on Bank of Slovenia calculations on the basis of the figures up to October 2005 (see Monetary Policy Report, Bank of Slovenia, November 2005), while that for the 2005 to 2006 period is based on calculations in the December 2006 Stability Programme.

Sources: SORS, Ministry of Finance

[3] The 1995 European System of Accounts methodology ensures that countries follow the same standards and the same definitions of categories and classifications, and the same accounting rules. The ESA95 methodology sets out in detail the criteria for classifying units into institutional sectors and reporting individual transactions. An important element of the methodology is the time when a transaction is booked. The accrual basis is used, which entails booking transactions at the moment when a claim or liability arises.

The general government deficit stood at 0.8% of GDP according to the national methodology

The general government deficit calculated according to the national methodology[4] stood at SIT 59 billion or 0.8% of GDP in 2006, down 0.3 GDP percentage points from 2005 in the context of slightly higher economic growth. The structural general government deficit thus increased slightly. The state budget and local government budgets recorded deficits of SIT 56 billion and SIT 7 billion respectively, while the Pension fund was in balance. The Health fund recorded a surplus of SIT 3 billion. The public finance position according to the national methodology was in deficit in the first quarter (SIT 31 billion), in surplus between April and November (SIT 37 billion), and in deficit in December (SIT 65 billion), partly as a result of seasonal factors.

Growth in revenues outstripped growth in expenditure

Growth in general government revenues in 2006 outstripped growth in general government expenditure. General government revenues were up 8.2% in 2006, 0.6 percentage points more than the increase in general government expenditure.

Revenues from corporate income tax recorded the fastest growth

General government revenues amounted to SIT 3,105 billion in 2006, or 43.6% of GDP. Tax revenues, which account for more than 90% of all general government revenues, rose by 8.1% in 2006. Of the major types of tax revenue, social security contributions increased by 6.1%, VAT revenues by 7.1%, and personal income tax revenues by 8.8%. Of these, the largest surge towards the end of the year was recorded by VAT revenues, which recorded year-on-year growth of 3.6% in the first half of the year, 4.3% in the third quarter and 15.5% in the final quarter. This dynamic growth was to a great extent associated with the pace of economic growth. Of the other revenues, the largest increase of 58.6% was recorded by revenues from corporate income tax, which stood at SIT 226 billion. This increase was primarily the result of changes in legislation, and the associated high tax settlements. Of the tax revenues, only revenues from payroll tax and labour tax were lower in 2006 than in 2005, by 10.1%, as a result of the gradual abolition of taxes on paid wages. The relatively strong growth in all the main categories of tax revenue is primarily the result of the relatively good economic growth, which stood at 5.2% in 2006.

Increase in receipts from the EU

In 2006 non-tax revenues, which account for less than 5% of total revenues, remained at their level of 2005. Receipts from the EU totalled SIT 83 billion, SIT 15.2 billion more than in 2005.

Expenditure on goods and services grew fastest, expenditure on wages and other employee expenditure grew slowest

General government expenditure amounted to SIT 3,164 billion in 2006, or 44.4% of GDP. The largest increase among the major expenditures last year was recorded by expenditure on goods and services, while the smallest was recorded by wages and other public sector employee expenditure. Expenditure on goods and services stood at SIT 507 billion, up SIT 53 billion on 2005, an increase of 11.8%. Wages and other employee expenditure rose by 3.7% in 2006 to SIT 637 billion.

Growth in pensions affected by the increase in the number of pensioners

Transfers to individuals and to households, which remain the largest category on the expenditure side, accounting for approximately 40% of all expenditure, were 5.8% higher than in 2005, with pension expenditure rising by 6.0%. Old age pensions were the most important factor in this increase. The number of old age pensioners increased by 2.4% in 2006. Growth in expenditure on the unemployed gradually slowed during 2006. The year-on-year rate was 13.9% in the first quarter, but expenditure in the final quarter of last year was almost 5% less than in the same period of 2005. This change was in line with the decline in the number of unemployed from the second quarter of 2006 on.

[4] The consolidated public finance position, which includes the state budget, Pension fund, Health fund and local government budgets, is compiled on the cashflow principle in line with IMF methodology. Owing to the methodological differences (mainly in sectorisation and the cashflow principle), these figures differ from those required to verify that the fiscal criterion for the general government deficit is being met, which are presented at the beginning of this section.

Net borrowing in Slovenia, and repayments to the rest of the world

On the financing side, the government continues to restructure from foreign to domestic borrowing. In the context of a deficit of SIT 59 billion and a decline of SIT 11 billion in capital holdings, the government sector recorded net borrowing of SIT 86 billion in 2006, while increasing its bank balances by SIT 38 billion. In its borrowing it recorded net borrowing of SIT 118 billion in Slovenia, but made a net repayment of SIT 32 billion in the rest of the world.

The public debt stood at 24.7% of GDP at the end of 2006

The state budget debt amounted to SIT 1,762 billion at the end of 2006, or 24.7% of GDP. More than three-quarters of the debt was owed to domestic sectors, while the reminder was external debt. A significant portion of the debt consists of government securities, mostly of a long-term nature. Over 90% of the total debt is in the form of securities, and over 90% is long-term debt.

The Ministry of Finance continues to issue short-term and long-term securities

The Ministry of Finance continued to issue short-term and long-term securities in 2006. It released 12 issues of 3-month treasury bills, six issues of 6-month treasury bills, and six issues of 12-month treasury bills. The individual issues amounted to approximately SIT 7 billion, with the interest rates ranging from 3.17% to 3.65%. Two long-term securities were issued in the early part of 2006: the RS61 and RS62 bonds, with interest rates of 3.25% and 3.50%.

Table 6: **General government consolidated position and debt**

	2005			2006			y-o-y
	in billion SIT	(% GDP)	share	in billion SIT	(% GDP)	share	growth
Consolidated general government*							
Revenue	2,870	43.4	100.0	3,105	43.6	100.0	8.2
Taxes	2,608	39.4	90.9	2,819	39.6	90.8	8.1
- on goods and services	938	14.2	32.7	977	13.7	31.5	4.2
- contributions	956	14.4	33.3	1,014	14.2	32.7	6.1
- income	537	8.1	18.7	655	9.2	21.1	22.0
EU inflows	72	1.1	2.5	83	1.2	2.7	15.2
Rest	189	2.9	6.6	203	2.9	6.5	-1.5
Expenditure	**2,942**	**44.4**	**102.5**	**3,164**	**44.4**	**101.9**	**7.6**
Current expenditure	1,283	19.4	44.7	1,363	19.1	43.9	6.2
Current transfers	1,342	20.3	46.7	1,420	19.9	45.7	5.8
Investment expenses and transfers	249	3.8	8.7	313	4.4	10.1	1.9
Payment into EU budget	68	1.0	2.4	69	1.0	2.2	0.8
Balance	**-72**	**-1.1**		**-59**	**-0.8**		
Central government debt	**1,674**	**25.3**		**1,762**	**24.7**		
Debt of the Republic of Slovenia (ESA 95)	**1,879**	**28.4**		**1,983**	**27.8**		

* Data in the table are based on national methodolgy, except for the general government's debt, which is based on ESA 95.
General government comprises the state budget, the Health fund, the Pension fund and the local government budgets.

Sources: Ministry of Finance, SORS

2 MONETARY POLICY

2.1 The conduct of monetary policy

The Bank of Slovenia's primary objective is price stability

The Bank of Slovenia's primary objective is price stability. In 2006 the Bank of Slovenia conducted its monetary policy in accordance with the Bank of Slovenia Act, its monetary policy guidelines adopted in November 2001, and the Programme for ERM II Entry and Adoption of the Euro. The last of these was adopted by the Bank of Slovenia and the Slovenian government in November 2003, and in it they committed themselves to joining the ERM II by the end of 2004 and to creating the conditions to allow the introduction of the euro at the beginning of 2007.

The tolar exchange rate against the euro was again stable in 2006

The Bank of Slovenia's monetary policy in 2006 focused on maintaining the stability of the nominal tolar exchange rate against the euro necessary to meeting the convergence criterion. Having joined the ERM II, the convergence achieved in the key interest rates, while the macroeconomic equilibria were maintained, gave sufficient guarantee that this target would be met. Only minor adjustments were necessary in the process of final convergence with euro interest rates, these coinciding with changes in the ECB's interest rate policy.

The deviations in the tolar's market exchange rate against the euro from the central rate set when Slovenia joined the ERM II were again negligible in 2006. The largest deviation in the spot exchange rate from the central rate was just 0.06%.

The Bank of Slovenia achieved final interest rate convergence as the ECB's rates grew

The Bank of Slovenia ensured the final convergence of its key interest rates with those of the ECB in 2006. In so doing it took into consideration the rise in the ECB's interest rates during the year, which allowed it to maintain tolar interest rates at levels appropriate to controlling inflationary expectations.

The Bank of Slovenia first cut its refinancing rate, which is calculated as the sum of the ECB's refinancing rate and the Bank of Slovenia's foreign exchange swap rate, from 3.75% to 3.25% in March, before raising it again to 3.75%. In so doing it gradually and proportionately reduced the foreign exchange swap rate from 1.5% to 0.25%, which brought tolar interest rates entirely into line with euro interest rates, the ECB's moves having taken its interest rate to 3.5% by the end of 2006.

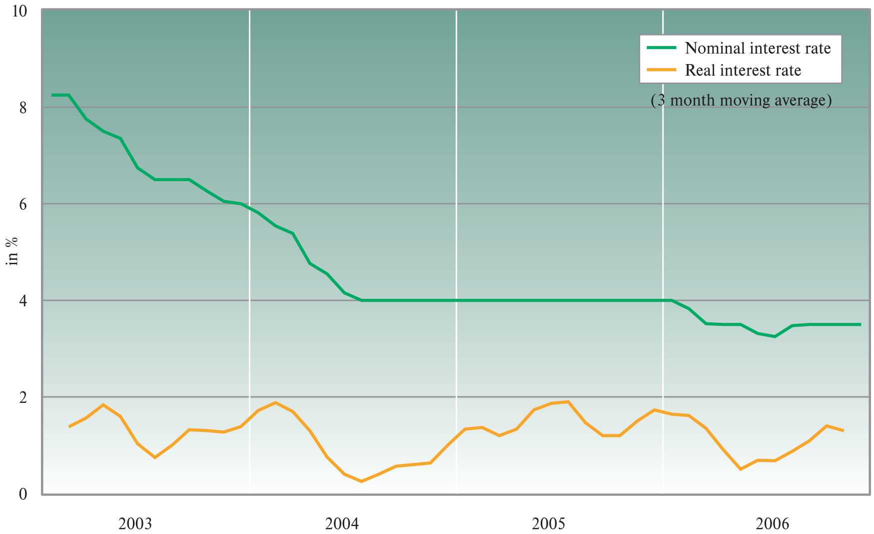
The interest rate on 60-day tolar bills fell by 0.5 percentage points in 2006

The interest rate on 60-day tolar bills went from 4.0% at the start of the year, to 3.5% in August, where it remained for the rest of the year. During the intervening period the Bank of Slovenia temporarily cut it to 3.25% in June for the purpose of a structural adjustment, before raising it again in August to signal the end of the period of interest rate cuts.

The upcoming introduction of the euro necessitated further adjustments…

Owing to the planned introduction of the euro, the Bank of Slovenia continued to make certain structural adjustments to monetary policy instruments in 2006, the purpose of which was to ease the changeover to the conditions of business in the Eurosystem. These adjustments relate to the minimum foreign currency liquidity within the framework of the liquidity ladder, the stock of swapped foreign exchange, and the system of the reserve requirement.

Figure 10: **Bank of Slovenia interest rates (60-day tolar bills)**



Source: Bank of Slovenia

Structural adjustments in the liquidity ladder instruments…

The gradual adjustments in the liquidity ladder to the conditions of operations in the Eurosystem meant that the Bank of Slovenia ordered banks to switch to the new arrangements on 1 January 2006. This abolished the possibility of including A-rated tolar lending with a maturity of more than 180 days in the liquidity ratios in the first category, and established weights of 85% in the first category and 60% in the second category for corporate and household sight deposits. In addition, the Bank of Slovenia has allowed lending to direct state budget spending units and lending covered by Republic of Slovenia guarantee to be included in the two categories of the liquidity ladder since September 2006.

… the minimum foreign currency liquidity requirement…

With the aim of giving banks more flexibility in transactions on the foreign exchange markets the Bank of Slovenia continued the process of gradually relaxing the minimum requirements for foreign currency liquidity that began in 2004, and offered to replace foreign exchange swaps with outright purchases. The level of liquid foreign currency assets that banks must secure to cover current foreign currency liabilities was cut from 70% to 50% in April 2006, and to 30% in July, and the requirement was finally abolished on 1 October. In parallel the Bank of Slovenia offered banks the possibility of outright sales of foreign exchange from the cumulative stock of reverse foreign exchange swaps and the possibility of outright purchases of foreign exchange from the cumulative stock of forward foreign exchange swaps. It made a net outright purchase of SIT 151 billion of foreign exchange from banks via such offers in 2006.

… and the reserve requirement

The Bank of Slovenia also brought its reserve requirements finally into line with ECB rules in 2006. In line with this, in September 2006 it modified the calculation of the reserve requirement, which is now calculated on the basis of the final day of the month rather than the average. It also adjusted the maintenance period to the calendar used for the reserve requirements in the Eurosystem, and adjusted the treatment of the period of notice on time deposits with the contractual possibility of early withdrawal and the treatment of instalment-based saving to the arrangements used in the Eurosystem.

2.2 Money and credit

Slow growth in base money

Between December 2005 and December 2006 base money increased by SIT 22 billion, or 6.9%. It averaged 6.0% more than in the previous year, at SIT 307.4 billion. There was a significant decline in the proportion of base money accounted for by cash in circulation towards the end of the year, while bank deposits at the Bank of Slovenia increased, which was primarily the result of the gradual changeover from tolars to euros from the middle of December on.

Table 7: **Base money supply**

	As at 31 December			Quarterly changes during 2006				
in SIT billion	**2004**	**2005**	**2006**	**I**	**II**	**III**	**IV**	**Total**
1. Net foreign assets	1,429.1	1,637.7	1,290.3	9.2	-85.8	-158.3	-112.5	-347.4
2. Domestic liabilities in foreign currency	-552.2	-392.8	-129.4	53.8	59.6	85.6	64.4	263.4
– foreign currency bills	-500.8	-323.9	-32.4	57.8	49.8	94.4	89.4	291.5
– Budgetary foreign currency deposits	-51.4	-68.9	-97.0	-4.0	9.8	-8.9	-25.0	-28.1
3. Net foreign currency assets (1+2)	**876.9**	**1,244.9**	**1,160.9**	**63.0**	**-26.2**	**-72.7**	**-48.1**	**-84.0**
4. Budgetary time deposits	**-127.5**	**-2.7**	**-1.3**	**0.8**	**0.1**	**-0.3**	**0.8**	**1.4**
5. Loans to banks	**0.2**	**0.2**	**1.6**	**1.0**	**-1.1**	**0.1**	**1.4**	**1.4**
6. Tolar bills and long-term deposit	**-428.1**	**-730.2**	**-727.9**	**-87.4**	**42.3**	**54.4**	**-6.9**	**2.3**
7. Other net liabilities	**-24.1**	**-195.3**	**-94.4**	**3.3**	**16.9**	**-18.9**	**99.6**	**100.9**
8. Net tolar assets (4 to 7)	**-579.4**	**-928.0**	**-822.0**	**-82.3**	**58.2**	**35.3**	**94.8**	**106.0**
9. Monetary base (3+8)	**297.5**	**316.9**	**338.9**	**-19.3**	**32.0**	**-37.4**	**46.7**	**22.0**
– currency in circulation	197.7	217.3	152.8	-9.8	13.2	-7.6	-60.3	-64.5
– bank deposits at BS	99.8	99.6	186.1	-9.5	18.8	-29.8	107.0	86.5

Note: Accrued interests not included.
Source: Bank of Slovenia

The Bank of Slovenia issued base money via net tolar assets

Net foreign currency assets declined by SIT 84.0 billion in 2006, while net tolar assets increased by SIT 106.0 billion. The stock of tolar bills, long-term deposits, loans to banks and budget time deposits remained almost unchanged. The decline in net other liabilities was primarily the result of the changeover from tolars to euros at the end of the year. Of the total decline in net foreign assets in the amount of SIT 347.4 billion, SIT 291.5 billion was the result of the decline in the stock of foreign currency bills.

Growth in the broad monetary aggregates remained slow

Growth in the broad monetary aggregates was slow in 2006, but growth in M1 was significantly higher. The average rate of growth in M2 was 8.4% in 2006, while that of M3 was 4.0%. The low growth in the broad monetary aggregates was to a great extent the result of the increase in alternative forms of saving such as mutual funds and outward investments. Growth in M1 was significantly higher: its year-on-year rate averaged 15.0%, but declined towards the end of the year, partly as a result of the changeover from the tolar to the euro. The slightly higher growth in M1 was associated with the relatively strong economic growth.

Deposit structure unchanged

Foreign currency deposits, tolar time deposits and tolar sight deposits contributed equally to growth in M3. The proportions of M3 accounted for by the various types of deposit were approximately the same at the end of 2006 as they had been a year earlier: foreign currency deposits stood at 34%, tolar time deposits at 36% and tolar sight deposits at 26%. The slightly higher growth in foreign currency deposits in the first half of the year was probably the result of uncertainty before the final setting of the tolar/euro conversion rate and the continuation of tolar interest rate convergence. In the third quarter tolar time deposits again grew significantly more quickly than foreign currency deposits, as tolar interest rates remained higher than foreign currency rates. In the final quarter the increase in foreign currency deposits and simultaneous decline in tolar time deposits were the result of the conversion of tolars to euros. Another consequence of this process was a decline in cash in circulation and an increase in tolar sight deposits at the end of the year. Cash in circulation declined by SIT 60.3 billion in the final quarter, while tolar sight deposits increased by SIT 102.6 billion.

Table 8: **Supply of M3: consolidated balance sheet of the monetary system**

	As at 31 December			Quarterly changes during 2006				
in SIT billion	**2004**	**2005**	**2006**	**I**	**II**	**III**	**IV**	**Total**
1. Net foreign assets	**900.7**	**421.7**	**-178.8**	**-156.8**	**-154.3**	**-84.4**	**-204.9**	**-600.5**
2. Domestic assets	**3,882.4**	**4,681.3**	**5,702.4**	**243.5**	**265.1**	**242.3**	**270.3**	**1,021.1**
General government: bonds	426.6	639.8	640.2	-12.6	5.1	21.8	-13.9	0.4
loans	338.1	163.8	161.4	0.1	1.8	-17.2	12.8	-2.5
Enterprises: debt securities	122.7	177.0	251.8	2.1	20.4	13.9	38.4	74.8
loans	2,173.7	2,674.7	3,359.3	199.2	161.1	151.9	172.4	684.5
Households: loans	821.4	1,025.9	1,289.8	54.6	76.7	72.0	60.5	263.8
3. Other net liabilities	**-300.2**	**-929.9**	**-1,012.2**	**-25.6**	**1.0**	**-47.7**	**-10.1**	**-82.3**
4. M3 (1 to 5)	**4,483.0**	**4,173.2**	**4,511.4**	**61.0**	**111.7**	**110.2**	**55.3**	**338.3**
– foreign currency deps. at banks and BS	1,828.4	1,394.9	1,539.0	37.4	21.4	21.0	64.3	144.1
5. M2	**2,654.5**	**2,778.2**	**2,972.5**	**23.6**	**90.4**	**89.2**	**-9.0**	**194.2**
– time deposits at banks	1,589.6	1,551.2	1,625.1	30.3	-0.6	95.4	-51.3	73.9
6. M1	**1,064.9**	**1,227.1**	**1,347.4**	**-6.7**	**91.0**	**-6.2**	**42.3**	**120.3**
– sight deposits at banks	867.1	1,009.8	1,194.6	3.1	77.7	1.4	102.6	184.8
– currency in circulation	197.7	217.3	152.8	-9.8	13.2	-7.6	-60.3	-64.5

Source: Bank of Slovenia

Negative contribution to growth in broad money by balance of payments flows

In 2006 M3 rose entirely on account of domestic investments by banks, as the contribution of flows with the rest of the world to M3 growth was negative. Net foreign assets (NFA), which shows the contribution made by balance of payments flows to growth in M3, fell by SIT 600.5 billion. The decline in NFA was primarily the result of increased outward portfolio investments and bank borrowing in the rest of the world, and the simultaneous foreign currency lending to domestic non-banking sectors, and partly a reflection of the current account deficit.

Gradual increase in corporate and household borrowing…

Bank lending increased by SIT 1,021.1 billion in 2006, of which SIT 759.4 billion was in the corporate sector and SIT 263.8 billion in the household sector, while the government sector reduced its borrowing by SIT 2.1 billion. The increase in total bank investments in 2006 was 27.8% higher than in 2005, the year-on-year rate of growth rising from 20.6% in December 2005 to 21.8% in December 2006. Corporate borrowing and household borrowing gradually increased during the course of the year.

… as a result of the process of deepening financial intermediation

The increase in domestic lending to companies in 2006 was 36.7% higher than that in 2005, the year-on-year rate of growth rising from 24.2% in December 2005 to 26.6% in December 2006. Household borrowing was strong, and was almost one-third higher than that in 2005. The relatively high growth in corporate borrowing and household borrowing can to a great extent be attributed to the process of the deepening of financial intermediation as Slovenia catches up with the wealthier members of the EU, to the gradual decline in interest rates, particularly in the early part of the year, and to the relatively good economic growth. Another factor in the increase in corporate borrowing was the replacement of foreign sources of finance with domestic sources, while other factors for households were the increase in housing loans and increased competition on the lending market.

Prevalent foreign currency borrowing

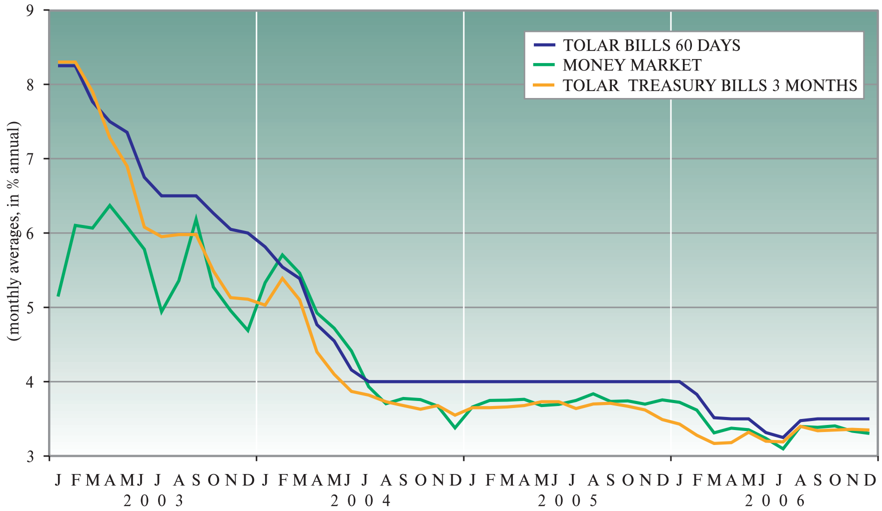
Foreign currency loans again prevailed in borrowing in 2006. The proportion of the increase in loans that they account for was approximately the same as in 2005 at around 90%. The net borrowing by companies was almost entirely in foreign currency. Foreign currency borrowing by households also strengthened, with foreign currency accounting for more than three-quarters of household borrowing during the year.

2.3 Interest rates and money market

Short-term nominal interest rates converged with rates in the Eurosystem, while on longer maturities the decline in interest rates ended

Nominal tolar interest rates declined slightly in 2006, in line with the process of nominal interest rate convergence. One feature was that the trend of declining interest rates on short-term deposits and loans continued, while the trend of declining interest rates on long-term maturities ended in 2006, these rates beginning to increase. This movement was in line with two simultaneous phenomena impacting in opposite ways on interest rates in Slovenia. On the one hand there was the final convergence of the Bank of Slovenia's key interest rates with those of the ECB, which put downward pressure on market interest rates, while on the other hand the financial markets' expectations of higher interest rates in the future applied upward pressure.

Figure 11: **Bank of Slovenia and money market interest rates**



Source: Bank of Slovenia

The Bank of Slovenia cut its key interest rate from 4% to 3.25%, then raised it to 3.5%

In 2006 the Bank of Slovenia gradually cut the interest rate on 60-day tolar bills from 4% in January to 3.25% in early June, before raising it again to 3.5% in August, where it remained for the rest of the year. This narrowed the spread between its own key interest rate and that of the ECB. The ECB simultaneously raised the refinancing rate in the euro area from 2.25% to 3.5%.

Table 9: **Bank of Slovenia and money market interest rates**

	Lombard loan	Bank of Slovenia tolar bills	Inter-bank market	Treasury bills		
	1 day	60 days	up to 30 days	3 months	6 months	12 months
January	5.00	4.00	3.72	3.43	3.50	3.37
February	4.75	3.75	3.62	3.28	3.32	3.37
March	4.50	3.50	3.31	3.17	3.32	3.36
April	4.50	3.50	3.37	3.18	3.35	3.36
May	4.50	3.50	3.35	3.32	3.35	3.36
June	4.50	3.25	3.24	3.20	3.30	3.36
July	4.50	3.25	3.10	3.19	3.30	3.25
August	4.75	3.50	3.40	3.40	3.37	3.25
September	4.75	3.50	3.39	3.34	3.37	3.61
October	4.75	3.50	3.41	3.35	3.47	3.61
November	4.75	3.50	3.33	3.36	3.47	3.65
December	4.50	3.50	3.31	3.35	3.61	3.65

Note: Monthly averages for 2005; value as at final day of month for lombard loan and tolar bills; in %, annual.
Source: Bank of Slovenia

The money market tracked the Bank of Slovenia's key interest rates on shorter maturities, but the ECB's on longer maturities…

Short-term money market interest rates closely followed the movement of the Bank of Slovenia's key interest rates, but on longer maturities rates responded far more to the movement of the ECB's interest rates. Thus the Sionia, the average interest rate on inter-bank overnight deposits, averaged between a range of 3.6% and 3.8% in the first two months of 2006, between 3.2% and 3.4% in the period to June, between 3.0% and 3.2% in the period to August, and then again between 3.2% and 3.4% for the rest of the year. There were similar movements in the Sitibor, the short-term inter-bank interest rates, with a maturity of up to 3 months. The expectations of the introduction of the euro meant that the movements on maturities of 6 months, 9 months and 12 months were far more subject to the movement of the Euribor inter-bank rates, and thus the rise in the ECB's key interest rates. The interest rate on loans with a maturity of 12 months fell from approximately 3.8% at the beginning of 2006 to 3.4% in March, and then gradually rose again to 4% at the end of the year. A similar picture was presented by yields on treasury bills. While the yield on 3-month treasury bills fell from 3.43% at the beginning of the year to 3.2% in June, and then rose again to 3.35% in the last four months of 2006, the yield on 12-month treasury bills fell from 3.37% in January to 3.25% in August, then rose sharply to reach 3.65% in December.

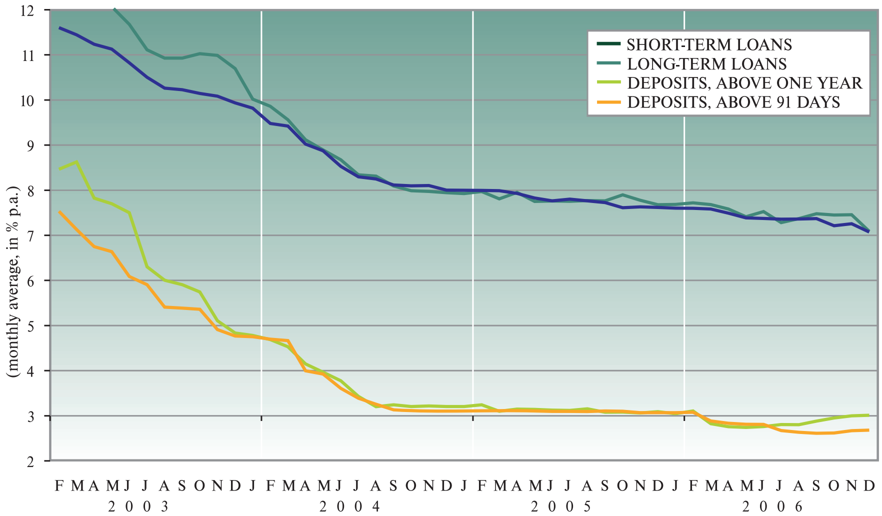
… which was reflected in yields on long-term bonds …

Expectations of higher interest rates in the upcoming medium term were also evident from the yields on government bonds. The RS60 and RS61 5-year government bonds recorded slightly higher yields beginning in March and April. While their yields ranged between 3.55% and 3.6% in January, by the end of the year they ranged between 3.95% and 4.05%. From the yields on these bonds, and even more so from the 11-year RS59 and RS62 bonds, there was also evidence of a further decline in the risk premium on Slovenian securities. After the convergence reports by the European Commission and the ECB made a positive assessment of Slovenia's ability to introduce the euro in 2007, the yields on the 11-year bonds fell by approximately 0.3 to 0.4 percentage points.

… and which also caused an increase in interest rates on tolar deposits towards the end of the year…

There was also a decline in declared interest rates on short-term tolar deposits throughout the period to August, while on maturities of more than two years a gradual rise in interest rates began in March. The interest rates on deposits with all maturities of more than 3 months displayed a rising trend, which is in line with the directions of the ECB's monetary policy. A rising yield curve was also a feature of interest rate trends in the final months of the year. This means that interest rates on deposits increased with longer maturities, as is customary in an economic environment with stable inflationary expectations.

Figure 12: **Declared interest rates on loans and deposits**



Source: Bank of Slovenia

Declared interest rates on loans mostly continued to decline in 2006, which indicates that these interest rates were slightly less subject than other rates to the rising trend in the euro area. Interest rates on household loans showed a gradual decline, then a rise, from July on housing loans and from November on shorter consumer loans. Declared interest rates on corporate loans gradually fell throughout the year, on both short-term and long-term loans. Interest rates realised on loans rose slightly faster. Interest rates on euro consumer, housing and corporate loans gradually rose during 2006, while rates realised on tolar loans grew slightly in the final two months of the year.

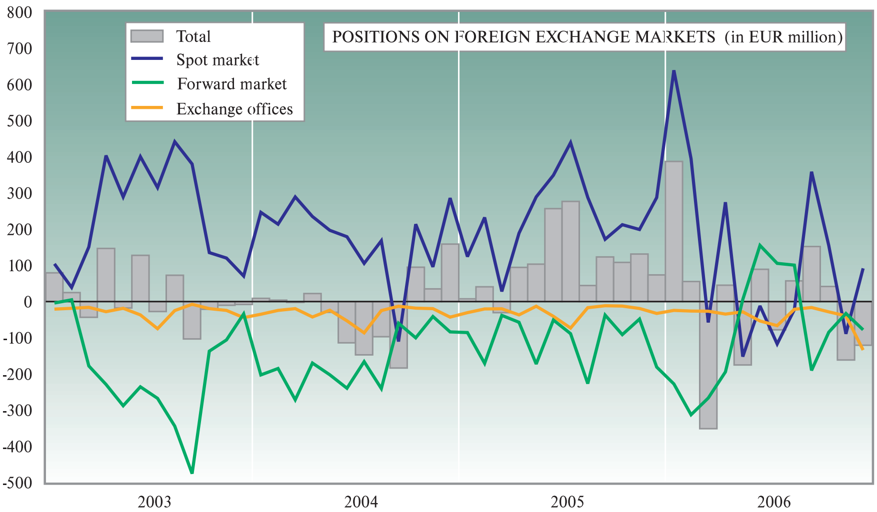
… while this also had a lesser impact on lending rates

2.4 Foreign exchange market and exchange rate

Small excess demand on the foreign exchange markets

After a high surplus supply of foreign exchange in the amount of 4.5% of GDP was recorded in 2005, the foreign exchange market was close to a balanced position in 2006, demand for foreign exchange exceeding supply by just EUR 59 million, a very low 0.1% of estimated GDP. The largest changes in the supply of and demand for foreign exchange came in the first quarter, with supply exceeding demand by EUR 350 million in January and demand exceeding supply by the same amount in March. Supply and demand on the foreign exchange markets had equalised by the end of the first half of the year. Then excess supply of foreign exchange prevailed in the third quarter, partly from inflows in current transfers and partly from non-residents' portfolio and direct investments. Excess demand increased in the final quarter, particularly for foreign currency at exchange offices, which in the final two months of 2006 accounted for more than one-half of the net demand for foreign exchange in the amount of EUR 282 million. This demand reflected the public's desire to convert their tolars into euros in advance.

Figure 13: **Foreign exchange flows**



Source: Bank of Slovenia

Excess supply on the spot market, and excess demand on the forward market and at exchange offices

The excess demand for foreign exchange came primarily from transactions on the forward market and the net demand for foreign currency at exchange offices, while excess supply was prevalent on the spot foreign exchange market. The spot market recorded a net supply of EUR 1.5 billion from non-residents and EUR 271 million from private individuals. Only companies recorded a net demand for foreign exchange, of EUR 323 million. The forward market recorded demand for foreign exchange of EUR 1.0 billion, just over one-third less than the supply on the spot market. Non-residents made forward purchases of EUR 1.5 billion from banks, the same as their sales on the spot market. Companies made forward sales of EUR 470 million of foreign exchange to banks, just over one-third more than their simultaneous excess demand on the spot market, and seven times more than in 2005. There has been a net demand for foreign currency at exchange offices since 2001, and in the final months of 2006 this increased further, taking the total for the year to EUR 0.5 billion, just over EUR 0.2 billion more than in 2005.

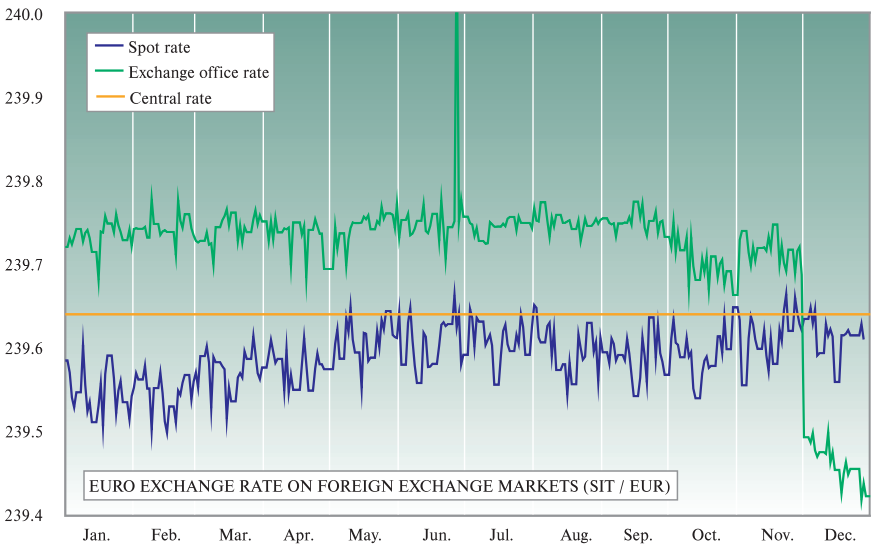
The deviations in market foreign exchange rates from the central rate were negligible

The short-lasting minor deviations between supply and demand on the foreign exchange markets did not have a significant impact on the movement of the tolar exchange rate. The deviations in foreign exchange rates from the central rate were small. The market exchange rate appreciated compared with the central rate in 2006. The maximum deviation of 0.04% in the exchange rate on the spot market from the central rate was recorded in the first two months of 2006. The gap by which the market rate was under the central rate gradually reduced, and remained at 0.02% between June and October. In the context of excess demand for foreign exchange, the gap narrowed in the final two months of the year and remained at 0.01% below the central rate. Unlike the exchange rate on the spot market, which fluctuated on the appreciation side of the central rate throughout last year, the exchange rate for foreign currency fluctuated on the depreciation side in the first eleven months of the year, with an average deviation of 0.05% above the central rate. The only exception was the average exchange rate in December, when with the euro buy rate remaining unchanged the sell rate fell to the central rate of SIT 239.640 to the euro, owing to which December's average exchange rate was 0.04% below the central rate, as illustrated in the figure below.

Transactions in Bank of Slovenia instruments increased the net supply of foreign exchange in 2006

The increase in the supply of foreign exchange came primarily from the decline of EUR 1.25 billion in the stock of foreign currency bills at the Bank of Slovenia. The Bank of Slovenia neutralised the decline of EUR 668 million in banks' foreign exchange swaps at the Bank of Slovenia by making an outright purchase of EUR 632 million from banks.

Figure 14: **Euro exchange rate on foreign exchange markets**



Source: Bank of Slovenia

2.5 Use of monetary policy instruments

2.5.1 Exchange rate policy instruments

The Bank of Slovenia's agreement on cooperation with commercial banks on interventions on the foreign exchange markets allowed the participating banks unlimited access to the foreign and reverse foreign exchange swaps at the Bank of Slovenia. The agreement was terminated in September owing to the introduction of the euro, ceasing to be in force after the end of the three-month period of notice at the end of December 2006.

The Bank of Slovenia's agreement on cooperation with commercial banks ceased to be in force in December 2006

The amount outstanding of foreign exchange swaps fell from SIT 165 billion at the end of 2005 to zero in the middle of October 2006, remaining at this level until the end of 2006. The amount outstanding of reverse foreign exchange swaps was insignificant throughout 2006, with the exception of the final few weeks before the introduction of the euro, when it stood at up to SIT 46 billion.

In the process of adjustments for joining the Eurosystem the Bank of Slovenia in 2006 offered the participating banks the option to purchase outright from the stock of foreign exchange swaps and the option to sale outright from the stock of reverse foreign exchange swaps on the first Friday of each month from October until the introduction of the euro. The Bank of Slovenia made outright purchases of SIT 217 billion of foreign exchange and outright sales of SIT 66 billion of foreign exchange in 2006 from this source.

In the adjustments for joining the Eurosystem, as part of the agreement on cooperation, the Bank of Slovenia made outright purchases of SIT 217 billion of foreign exchange, and outright sales of SIT 66 billion

The foreign exchange swap rate was cut four times in 2006, and the reverse foreign exchange swap rate three times. This changed the refinancing rate (the sum of the foreign exchange swap rate and the ECB's main refinancing rate). The openness of the interest rate spread between the refinancing rate and the interest rate on tolar bills was in line with market expectations.

The refinancing rate was changed during the year

2.5.2 Monetary policy instruments

The implementation of the Bank of Slovenia's monetary policy was conditioned by a significant structural surplus of the money market, which required the use of absorption monetary policy instruments. The structural surplus began to shrink in the second half of 2006, primarily as a result of the decline in domestic interest rates and the rise in foreign interest rates, and banks' increased demand for foreign currency owing to the upcoming introduction of the euro, but it still stood at a high SIT 814 billion in December 2006 (compared with SIT 859 billion in January 2006).

High structural surplus of the money market

The instruments used by the Bank of Slovenia to absorb excess liquidity in 2006 were the 60-day tolar bill and the overnight deposit. The Bank of Slovenia also allowed banks and savings banks to make short-term deposits at the end of 2006 in order to smooth the changeover to the new currency. In September 2006 the Bank of Slovenia continued with its adjustments of the reserve requirements to the Eurosystem arrangements, which by December had had little impact on the reserve requirements calculations. The exclusion of liabilities to institutions subject to the Eurosystem reserve requirements from the basis for the reserve requirements reduced the reserve requirements by SIT 6 billion in December, which had the effect of increasing the surplus liquidity of the money market. The maintenance periods of reserve requirements were also changed in the third quarter of 2006, thus adjusting them to the periods used in the Eurosystem.

Bank of Slovenia instruments for the absorption of excess liquidity

Possibility of an interest-free loan at the end of 2006

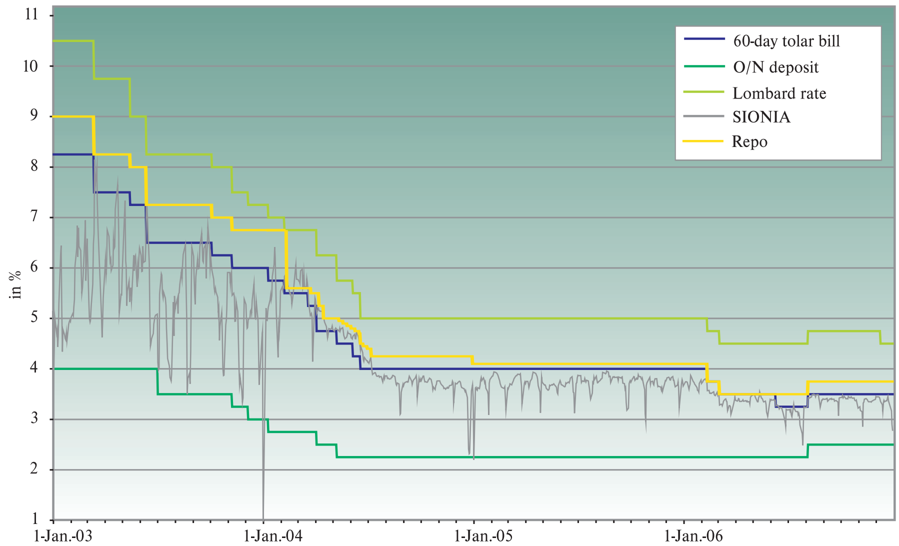
Banks and savings banks had the possibility of accessing liquidity via the repo and the lombard loan. Owing to the need to finance the frontloading of euro cash, at the end of 2006 the Bank of Slovenia granted banks and savings banks an interest-free secured loan (using the banks' assests at the Bank of Slovenia as collateral) that they repaid in three equal tranches by the end of January 2007.

The Bank of Slovenia abolished all the tolar instruments at the end of December at the introduction of the euro, but some abolished sterilisation instruments were gradually maturing over the period to April 2007 (tolar bills, long-term and short-term deposit).

Final convergence of interest rates

In the process of the convergence of its interest rates with those of the European Central Bank, the Bank of Slovenia made several adjustments to the rates on its instruments in 2006. Like the interest rate on bills, the Bank of Slovenia twice cut the repo rate in the first half of the year, before raising it in the second half of the year. In the period to December the interest rates on the overnight deposit and the lombard loan gradually equalised with the interest rates on the ECB's marginal deposit and marginal lending facilities. The spread between the two interest rates thus during the year fell from 2.75% to 2%, while the corridor of the Bank of Slovenia's main interest rates (overnight deposit, tolar bills and lombard loan) became symmetrical, as is typically seen at the ECB.

Figure 15: **Rates of Bank of Slovenia instruments**



Source: Bank of Slovenia

Decline in and compensation for liquidity surplus

The surplus liquidity began to decline in the second half of the year, and was entirely compensated by the subscription of tolar bills. The amount outstanding of tolar bills fell from SIT 525 billion at the end of 2005 to SIT 402 billion at the end of 2006. At the end of December 60-day tolar bills accounted for 66% of all instruments for absorbing liquidity (compared with 72% a year earlier), and the long-term deposit for the remaining 34% (compared with 28% a year earlier).

Table 10: **Use of monetary policy and exchange rate policy instruments**

	Stock as at	Average stock in 2006 quarters				Stock as at
in SIT million	31-Dec.-05	I.	II.	III.	IV.	31-Dec.-06
Monetary policy instruments						
Tolar bills	525,184	617,336	622,942	517,042	524,044	402,381
Long-term deposit	203,490	203,490	203,490	203,490	203,490	203,490
Short-term deposit	0	0	0	0	11,683	26,870
Overnight deposit	1,500	893	1,407	1,835	7,113	95,159
Lombard loan	0	13	23	0	0	0
7-day temprary purchase of securities	0	228	1,156	0	699	0
Reserves of credit institutions		79,717	81,369	81,838	82,041	
Required		79,456	80,860	81,145	80,210	
Excess		261	509	692	1,832	
Exchange rate policy instruments						
Foreign exchange swap	164,766	177,274	149,095	15,109	2,552	0
Reverse foreign exchange swap	4,791	1,930	0	947	6,512	0
Memo:						
Foreign currency bills	325,943	289,135	240,225	175,407	81,847	32,629
Government time deposits	0	0	0	0	0	0

Note: Excludes valuation and interest effects; at transaction prices; foreign currency bills at nominal value.
Source: Bank of Slovenia

2.5.3 Prudential control

Liquidity ladder

Abolition of mandatory subscription to tolar bills and of tolar credit allowance

The Bank of Slovenia continued to adjust the regulation on the minimum level of liquidity to be maintained by banks in 2006, as a result of the anticipated introduction of the euro and in order to ease the transition to the conditions of business in the euro area for banks. On 1 January 2006 a regulation entered into force that abolished the mandatory subscription of foreign bills and the tolar credit allowance, and introduced weights for household and corporate sight deposits of 85% in the first category and 60% in the second category.

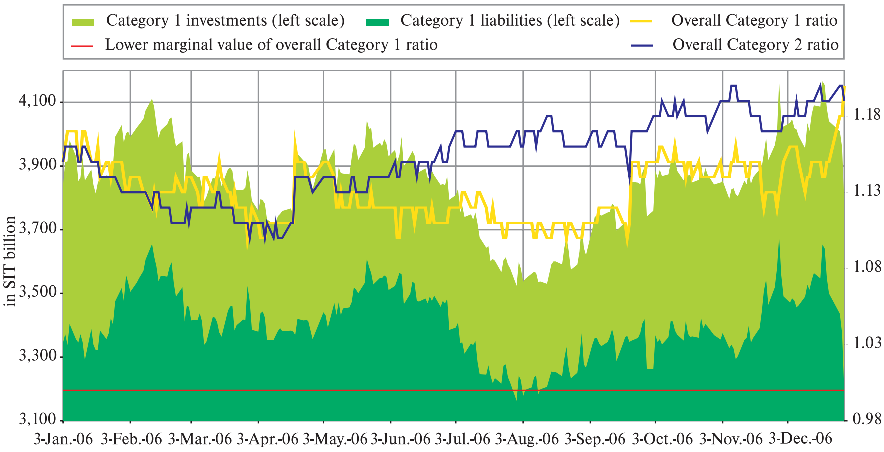
Gradual lowering of the foreign currency minimum

The foreign currency minimum was gradually cut in the period leading up to its abolition on 1 October: from 70% to 50% on 1 April, and from 50% to 30% on 11 July. Lending to the government and corporate lending with a government guarantee were included among the investments that are included in the calculation of the ratios in the first and second liquidity categories irrespective of the principle of residual maturity in the second half of September.

Abolition of the foreign currency credit allowance, and exclusion of securities for guarantees

Upon the transition to the new regulation, or by 1 January 2007, the foreign currency credit allowance was abolished, securities were excluded for guarantees, and the weights of household sight deposits were reduced to 50% for the first category and 45% for the second category. Under the new regulation banks only have to meet the first liquidity ratio, while the liquidity ratio for the second category is merely informative in nature.

Figure 16: **Liquidity ratio for first and second categories, and investments and liabilities for first liquidity category**



Source: Bank of Slovenia

Banks' changeover to the new regulation improved the ratios for the first and second liquidity categories

By the end of the year banks had maintained the liquidity ratio in the first category at a value similar to that at the beginning of the year, while the ratio in the second category ended the year slightly higher. The increase in the two liquidity ratios was evident in the second half of April, when there was a notable increase in liabilities to foreign banks. There was also a notable rise in the two ratios in September. This was the result of changes to the inclusion of lending to the government and lending with a government guarantee. A growing number of banks (eight in total) switched to the new regulation in November and December, their liquidity ratios in the first and second categories improving as a result. The amendment of the regulation should release liquidity of approximately SIT 234 billion into the system, raising the liquidity ratio for the first category by approximately 0.11 percentage points.

Foreign currency bills

Gradual abolition of offer for all forms of foreign currency bills

The Bank of Slovenia issued foreign currency bills in three maturities (60 days, 90 days and 120 days) and in two currencies (euros and US dollars) in 2006. The Bank of Slovenia gradually abolished its offer for all forms of bills during the course of 2006. The possibility of subscribing to US dollar bills of all maturities was abolished at the beginning of June, while 120-day euro bills were abolished in August, 90-day euro bills in September, and the last remaining euro bills with 60-day maturity in November. The last of these matured for payment at the end of January 2007.

The stock of foreign currency bills fell sharply from SIT 326 billion at the end of 2005 to SIT 33 billion as at 31 December 2006.

Special liquidity loans granted with the participation of banks

Continuation of the agreements on willingness to participate in liquidity lending

The purpose of the liquidity loan with banks participation is to prevent systemic risk caused by unforeseen liquidity problems at solvent banks and savings banks. The Bank of Slovenia renews the agreement on willingness to participate in liquidity loans with banks annually. It was renewed for 2006 in the middle of 2005 with 16 banks, with take-up ending in 2007. The banks participation mechanism was not triggered while the agreement was in force, as has been the case since the loan has existed. Before the end of 2006 the Bank of Slovenia concluded a new agreement on willingness to participate in liquidity loans with 17 banks and savings banks. The one-year agreement runs from January 2007 to January 2008, and is the eleventh successive agreement.

2.5.4 Supervision overinstruments implementation

Supervision of reserve requirements

Suvervision of banks' implementation of the reserve requirements led to one decision being issued to a bank for not meeting the reserve requirement, and the measure imposed was a payment of penalty for the shortfall.

Oversight of currency exchange operations

The Bank of Slovenia conducted 67 examinations of transactions by contracted traders, and 10 indirect examinations at contracted banks of the oversight of contracted traders. The oversight procedures did not identify any irregularities in the trades that would necessitate measures in respons.

Bank of Slovenia's collateral system

The Bank of Slovenia credit operations with banks and savings banks, based on monetary policy instruments and intra-day standing facility are based on adequate collateral, i.e. underlying assets provided by them.. As a result of Slovenia joining the euro area, it was necessary to adjust the Bank of Slovenia's collateral system to that used by the Eurosystem by the end of 2006.

By the end of the first half of 2006, each credit transaction with the Bank of Slovenia was based on specially defined eligible assets, provided in the form of the transfer of ownership or in a form of a pledge. The Bank of Slovenia required 110% coverage of the amount granted. Banks and savings banks used bills and the long-term deposit at the Bank of Slovenia alone, despite the legal basis set out by the Regulation on the general rules for concluding transactions by which the Bank of Slovenia exercises monetary policy and exchange rate policy (the General rules regulation) also allowing the use of other debt securities with a credit rating of at least AA for the issuer or the security. The amount of bills and long-term deposits at the Bank of Slovenia was sufficiently large for there to be no need for banks to use other securities. Another reason for acting this way was that it is simplier to use Bank of Slovenia assets, which did not require additional transaction costs.

By July 2006 the Bank of Slovenia had changed over to a new collateral system that applied the eligibility criteria used by the Eurosystem, but that also allowed some features specific to Slovenia. The main changes in the new system were the introduction of the list and the pool of eligible assets. The list of eligible collateral is a list of the financial assets that the banks can use to collateralise the credit operations provided by the Bank of Slovenia , while the pool of eligible assets is a record of the eligible assets held by banks at the Bank of Slovenia on which a maximum pledge has been established in favour of the Bank of Slovenia. The list of eligible assets included banks' financial assets at the Bank of Slovenia and debt securities of other issuers that meet the criteria set out in the General rules regulation, the most important of which are listing on a regulated market and a credit rating for the issuer or guarantor of at least A- or A3 from one of Fitch, Moody's or Standard & Poor's credit assessment institutions. Under these criteria the list included Nova Ljubljanska banka bonds, Nova kreditna banka Maribor bonds and two DARS bonds with a government guarantee alongside government securities. The introduction of the pool of eligible assets changed the way in which credit operations are collateralised, with individual credit transaction no longer being earmarked with specifically defined asset, but rather with the pool of eligible assets. At the same time the Bank of Slovenia also changed over to the active valuation of collateral on a daily basis, taking risk management measures into consideration. The new risk management measures include valuation haircuts, while the 110% coverage was abolished.

The Bank of Slovenia had been preparing for the changeover to a new collateral system in line with the Eurosystem collateral system since 2005. The change in the collateral system and the management of eligible collateral required through preparations and work with outside institutions. The Bank of Slovenia was active in the legal area and in the implementary area, and in 2006 organised two workshops.

3 BANKING SECTOR

3.1 Composition of the banking sector

The banking sector is dominated by banks

Slovenia's banking sector is dominated by banks. Banks had a market share of 99.4% at the end of 2006 as measured by total assets (compared with 99.5% a year earlier), with savings banks accounting for the remainder.

At the end of 2006 there were 20 banks, three savings banks and two branches of foreign banks operating in Slovenia

As at 31 December 2006 there were 20 banks operating in Slovenia (eight of which were subsidiaries), three savings banks, and two branches of foreign (Austrian) banks. There was an increase in the number of credit institutions subject to direct Bank of Slovenia supervision during the course of the year, which occurred when the branch of Klagenfurt's Kärtner Sparkasse AG was converted into a subsidiary, Banka Sparkasse d.d., Ljubljana.

SID – Slovenska izvozna in razvojna banka d.d., Ljubljana was entered in the companies register on 24 October 2006, while the Ljubljana branch of RCI Banque SA was entered on 17 November 2006, commencing trading as a bank branch on 1 January 2007.

The proportion of equity accounted for by non-residents increased slightly in 2006

In addition to the eight subsidiary banks and two branches that were under majority foreign ownership as at 31 December 2006, there were five banks under full domestic ownership, and seven banks under majority domestic ownership (of these seven banks, two had less than 1% foreign equity). The proportion of capital held by non-residents as measured by equity rose from 34.9% (of which the proportion held by non-residents holding more than 50% stood at 19.4%) to 37.7% (of which the proportion held by non-residents holding more than 50% stood at 27.7%). The reason for the increase in the proportion held by non-residents was the conversion of Kärtner Sparkasse into Banka Sparkasse d.d., while the reason for the increase in the proportion held by non-residents holding more than 50% was Banka Koper d.d. There was an increase in foreign currency at six banks, but the increases were all very small. The proportion held by non-residents as measured by total assets was 2.4 percentage points more than the proportion held by non-residents as measured by equity as at 31 December 2006. The country's second-largest bank (as measured by total assets), Nova Kreditna banka Maribor d.d., and the 14th-largest bank, Poštna banka Slovenije d.d., remain under majority state ownership.

Table 11: **Ownership structure of banking sector (by equity)**

	31-Dec.-2004	31-Dec.-2005	31-Dec.-2006
Non-residents (more than 50% management rights)	16.5%	19.4%	27.7%
Non-residents (less than 50% management rights)	15.9%	15.5%	10.0%
Central government	19.1%	18.2%	17.9%
Other domestic persons	48.5%	46.9%	44.4%

Source: Bank of Slovenia

Table 12: **Ownership structure of banking sector (by total assets)**

	31-Dec.-2004	31-Dec.-2005	31-Dec.-2006
Non-residents (more than 50% management rights)	19.1%	21.1%	27.3%
Non-residents (less than 50% management rights)	17.1%	17.6%	12.8%
Central government	23.5%	22.7%	22.3%
Other domestic persons	40.3%	38.6%	37.6%

Source: Bank of Slovenia

The ratio of total assets of banks and savings banks to GDP is rising from year to year, although it remains considerably below the EU average. It reached 106.4% in 2006.

Table 13: **Average total assets and GDP**

in SIT million	2003	2004	2005	2006[1]
Average total assets of banks and savings banks	4,793,626	5,340,683	6,289,747	7,583,335
GDP at current prices	5,813,540	6,271,795	6,620,145	7.126.012[2]
Average total assets (as % of GDP)	82.5	85.2	95.0	106.4

1 Figures exclude NLB branches in Italy.
2 Estimate for 2006.
Source: Bank of Slovenia

The Bank of Slovenia issued 21 authorisations in 2006, and did not deny any applications

In 2006 the Bank of Slovenia issued a total of 21 authorisations for various types of banking and financial services, for qualifying holdings, for concluding shareholders agreements, and for holding office as a member of the management board. The most common (nine authorisations issued) in 2006 were for holding office as a member of the management board of a bank or savings bank. The number of authorisations to provide other financial services issued was significantly lower than in 2005 (just five), with three banks being issued with authorisations to broker the sale of insurance policies under the law governing insurance, and two newly established banks being issued with authorisations to provide a range of selected financial services. The authorisations to provide a range of selected financial services were obtained in a procedure combined with the procedure for obtaining the authorisation to provide banking services. Five authorisations to obtain a qualifying holding were issued to applicants in 2006, and one authorisation to conclude a shareholders agreement.

The Bank of Slovenia received one notification of the provisions of services via a branch and 29 notifications of direct provision

Pursuant to Directive 2006/48/EC (previously: Directive 2000/12/EC) and Annex I (List of activities subject to mutual recognition), a bank of a member-state that is entitled to provide banking services and other (mutually recognised) financial services may also provide these services in Slovenia. It can provide them via a branch *(in the case of permanent pursuit of business)* or directly *(in the case of occasional provision of services without elements of a permanent presence in Slovenia)* without an authorisation from the Bank of Slovenia, which must be notified in writing by the relevant supervisory authority in the home member-state. In 2006 the Bank of Slovenia received one notification of the provision of services via a branch, and 29 notifications of the direct provision of services. A list of banks of EU member-states that have carried out the notification procedure for the provision of banking services and other financial services in Slovenia via their home banking supervisors is available on the Bank of Slovenia's website. Different arrangements apply to banks of third countries (previously: foreign banks). Banks of third countries may only provide banking and other (mutually recognised) financial services via a branch, a Bank of Slovenia authorisation being required to establish the branch. The Bank of Slovenia may request that the bank of a third country deposit a specific sum of cash or other eligible collateral in Slovenia, or provide other appropriate collateral as a guarantee for the settlement of liabilities from transactions concluded in Slovenia.

3.2 Income statement

The changeover to the IFRS had an impact on the banking system's operating results

The changeover from using the Slovenian Accounting Standards to the International Financial Reporting Standards (IFRS) had a major impact on the banking system's operating result in 2006. There was a change in the categories used in the income statement, owing to which the figures for 2006 are not entirely comparable with those for previous years. A change in the valuation of trading-book items meant that banks recorded high growth in net profit from the trading book, and created less impairments of financial assets and provisions than in previous years.

The conversion of a branch into a bank also had an impact on the banking system's income statement. The bank took over all the branch's claims and liabilities, while the branch's profit at conversion was included in the parent bank's operating result. The new bank began trading at the beginning of October, and all its income, expenses and costs consequently relate solely to three months of trading.

Real growth of 47% in the banking system's operating result

The operating result[5] recorded by the banks[6] and branches in 2006 amounted to SIT 94.3 billion (pre-tax profit). This was SIT 31.7 billion up on the banking system's profit in the previous year, a real[7] growth rate of 47% (nominal growth of 50.6%).

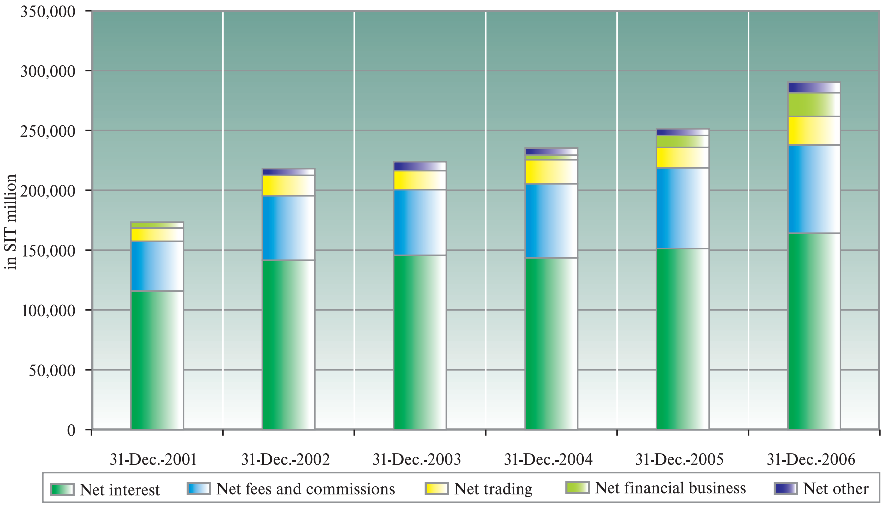
Real growth of 12.8% in gross income

The banking system's gross income amounted to SIT 290.4 billion in 2006, up SIT 39.2 billion on the previous year, a real growth rate of 12.8%. The proportion of gross income accounted for by earnings from interest continues to decline, even though earnings from interest and from fees and commissions still account for 81.9% of gross income (compared with 87.1% in 2005), the proportion accounted for by net fees and commissions having remained stable at one-quarter.

Real growth of 5.8% in net interest

Net interest amounted to SIT 164.2 billion in 2006, its rate of growth increasing from the previous year to reach a real rate of 5.8%. Although net interest still accounts for the largest proportion of gross income, this proportion is falling, with certain other categories of gross income growing faster. Net fees and commissions increased for the third successive year, recording real growth of 6.9% in 2006 (compared with 6.0% in 2005). Net earnings from other categories[8] of gross income grew by 57.8% in real terms, to account for 18.1% of gross income. The majority of other earnings were generated by trading gains.

Figure 17: **Gross income**



Source: Bank of Slovenia

Net provisions were down SIT 4.6 billion

In 2006 banks created SIT 29.0 billion of net provisions, down SIT 4.6 billion on 2005 as a result of the changeover to the IFRS.

5 All 2006 figures are unaudited.
6 All figures in the income statement and balance sheet exclude the NLB branches abroad.
7 Based on the average increase in consumer prices in 2005 (2.5%).
8 The introduction of the IFRS means that the individual categories are not mutually comparable between years.

The effects of the introduction of the IFRS on banks' operating results

In June 2002 the European Parliament and Council adopted Regulation EC/1606/2002, which inter alia requires EU banks to apply the International Financial Reporting Standards (IFRS) to their consolidated financial statements for financial years after 2005. Slovenian banks have been obliged since January 2006 to apply the IFRS in compiling their financial statements for the 2006 financial year.

Accounting in accordance with the IFRS requires that banks monitor the values of certain accounting items at fair value instead of a historical cost. This was the prevailing valuation method in the past. At the same time, the change in the concept for valuing balance sheet items means that the new accounting standards have also had an impact on the estimation of credit risk losses and on the creation of provisions or impairments of financial assets. The current creation of provisions and impairments is a direct result of a past event providing indisputable evidence of a downgrading in the claims against a individual debtor. This ensures that the values of claims are monitored in line with the bank's currently available information, and their fair values, and only to a lesser extent in line with the statistically determined probability of loss over the longer timeframe or assessments of the future performance and risks of a particular debtor.

To illustrate only the largest balance sheet changes, there was a 24% decline in provisions on the balance sheet and a 15% increase in capital as a direct result of the introduction of the IFRS to the accounting practices of Slovenian banks. Capital adequacy thus improved by a relatively high 1.6 percentage points merely because of a change in the methodology of the accounting standards, without any decrease in bank exposure to credit risk or other risks. In addition to the balance sheet changes, due the favourable economic climate in 2006 there was less need for current provisioning in accordance with the new criteria, even though there was no increase in the quality of the credit risk protection. Last year banks' provisioning as a proportion of gross income was merely one-half of that in the years before the introduction of the IFRS. This was a major factor in the improvement in performance indicators, which was first of all a reflection of changes in accounting standards and not only more effective governance.

In addition to the one-off changes in banks' financial statements and performance indicators described above, the introduction of the IFRS will also be reflected in changes in operational behaviour. Banks' lending activity is by its very nature cyclical, and dependent on the phase of the economic cycle. The introduction of the concept of fair value in the valuation of balance sheet items will further increase the pro-cyclical behaviour by banks. During a period of high economic growth, when banks generally overestimate the creditworthiness of their clients, their optimistic assessment of risk will also increase the fair value of loans and other assets. The gains realised or merely calculated from the higher asset prices and improved quality of loans will directly lead to a relative increase in profit, encouraging banks to further expand their lending activity. The reverse process will be seen during times of economic slowdown. Such fluctuations will be larger in banking systems that are monitored by relatively less efficient financial markets with larger fluctuations in prices of financial products, and the operating results of these banks will be more variable and less predictable. Major fluctuations in financial categories such as returns, prices, profits and financial subjects' balance sheet items themselves represent a risk to the maintenance of financial stability in the long term.

Table 14: **Principal items of adjusted income statement**

	Amount, in SIT million		Proportion, in %		Nominal growth, in %	
	2005	2006	2005	2006	2005/2004	2006/2005
Net interest	151,324	164,175	60.2	56.5	5.4	8.5
Net fees and commissions	67,509	73,753	26.9	25.4	9.1	9.2
Net trading	16,972	23,781	6.8	8.2	-15.7	40.1
Net financial business	10,001	19,805	4.0	6.8	165.9	98.0
Net other	5,490	8,934	2.2	3.1	-7.3	62.7
Gross income	**251,296**	**290,448**	**100.0**	**100.0**	**6.8**	**15.6**
Operating costs	155,141	167,213	61.7	57.6	5.8	7.8
– of which labour costs	82,069	87,277	32.7	30.0	5.0	6.3
Net income	**96,155**	**123,235**	**38.3**	**42.4**	**8.5**	**28.2**
Impairments and provisions	-33,572	-28,961	-13.4	-10.0	3.2	-13.7
Pre-tax profit	**62,583**	**94,274**	**24.9**	**32.5**	**11.5**	**50.6**
Net profit	**50,178**	**72,567**	**20.0**	**25.0**	**36.5**	**44.6**

Source: Bank of Slovenia

3.2.1 Net interest income

Net interest was up SIT 12.9 billion

Net interest was SIT 12.9 billion higher in 2006 than in 2005. The previous years having seen a decline in both interest income and interest expenses, both of these increased in 2006. Interest expenses recorded relatively higher growth (25.2% in real terms), but in the context of an expanded basis interest income recorded higher nominal growth.

Positive effects on growth in interest income

Interest income amounted to SIT 338.5 billion in 2006, up SIT 51.4 billion on the previous year. The growth in interest income was the result of still lively lending to non-banking sectors, and the rise in lending interest rates. The shift from lending in domestic currency to lending in foreign currency (primarily the euro) seen in 2005 continued in 2006, which had a beneficial impact on interest income. The reason was the rise in euro interest rates as a result of the increase in the reference interest rate at the ECB, while tolar lending rates actually declined slightly. It is thought that another significant factor in the growth in interest income was the change in the recording of costs of lending approval and management, which in accordance with the amortised cost method must be included in the effective interest rate, and are thus no longer classed as commissions but as interest income.

Income from government securities was down SIT 8 billion

Interest income from government securities declined by just over SIT 8 billion, despite the stock of securities remaining stable, as a result of the redemption of higher-yielding bonds and a decline in interest rates on treasury bills. The reverse effect could be seen on Bank of Slovenia bills, with interest income remaining at its level of the previous year, despite a significant decline in the stock of bills.

Interest expenses up 38.5% on the previous year

The banking system recorded interest rate expenses of SIT 174.3 billion in 2006, SIT 38.5 billion more than in the previous year. In 2006 the banking system's foreign currency borrowing at foreign banks was again higher than the increase in deposits by non-banking sectors. The rise in the ECB's reference interest rate in the context of the increase in foreign currency borrowing brought an increase in interest expenses, while interest expenses on domestic currency sources recorded a minor increase only.

3.2.2 Net non-interest income

Earnings from net fees and commissions increased by 6.6% in real terms

Earnings from net fees and commissions totalled SIT 73.8 billion in 2006, a rise of SIT 6.2 billion, or 6.6% in real terms. For the second successive year fees and commissions received increased primarily as a result of higher fees for administrative services and commissions on domestic payments, while commissions from securities transactions for clients also increased at certain banks. Banks include fees for administering transaction accounts, opening and closing accounts, making withdrawals at other banks' ATMs and brokering securities trading among these items. There was a significant decline in fees and commissions from credit transactions, as these are included in interest income via the effective interest rate. This also affected the net fee structure, with the proportion of fees for administrative services and fees for domestic payment transactions increasing to a level where banks acquired just over 60% of fees and commission income from these fees.

The changeover to the IFRS means that figures for other net income are not comparable

The changeover to the IFRS means that the figures for other net income in individual categories are not comparable with those from previous years. Banks generated SIT 52.5 billion of other income in 2006, with just under one-half coming from net trading (SIT 23.8 billion). Banks also generated more income from dividends, other net operating profits and gains on financial assets and liabilities not measured at fair value through profit or loss (a total of SIT 28.7 billion). Other net income accounted for 18.1% of gross income.

3.2.3 Operating costs

Real growth of 5.2% in operating costs

The banking system's operating costs increased for the second successive year in 2006, recording real growth of 5.2%. Labour costs, depreciation costs and other costs all increased. In the context of the major projects of the introduction of the IFRS and the introduction of the euro, which entailed an additional cost burden, banks were successful in controlling costs. Growth in costs was outstripped by growth in gross income by 7.8 percentage points, with banks covering just over two-thirds of their costs with net non-interest income. With faster growth in total assets, the trend of decline in the ratio of costs to average assets continued, the figure reaching 2.2%.

The introduction of the IFRS affected growth in operating costs

The introduction of the euro had a major impact on the costs of other services (real growth of 14.0%), while the introduction of the IFRS was reflected in growth in consultancy costs (25.4% in real terms).

Slight increase in labour costs

Labour costs strengthened slightly in real terms (3.8%). Gross wages increased in 2006 (by 5.2% in real terms), as did pension insurance contributions, while employee bonuses and costs for severance pay and early retirement declined.

3.2.4 Net provisioning

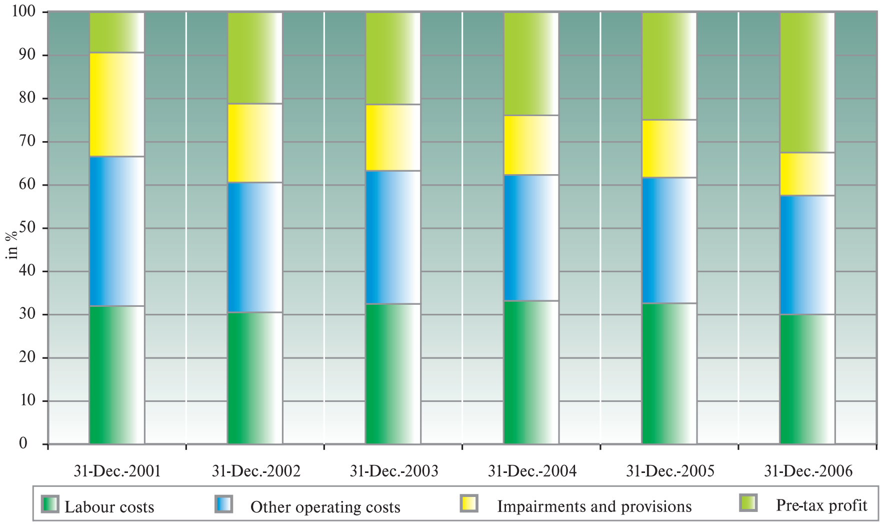
The introduction of the IFRS had an impact on impairments and provisions

The introduction of the IFRS had a major impact on the amount and policy of the creation of provisions and impairments, as the new standards only allow impairments if there is impartial evidence of the impairment of financial assets or of losses from assumed liabilities under off-balance-sheet items. In line with the above, banks released the special provisions for credit risk and other risks and for general banking risk on the liability side, and the special provisions for credit on the asset side of the balance sheet. Thus banks created significantly less provisions in 2006 than in the previous year.

Significant decline in provisioning

The banking system recorded net provisioning and impairments of SIT 29.0 billion in 2006, SIT 4.6 billion less than the provisioning calculated after the application of the new methodology for calculating net provisioning for 2005 owing to the changeover to the IFRS, and significantly less than in previous years, when banks created approximately SIT 40 billion of provisions each year under the Slovenian Accounting Standards. Banks released a portion of the provisions at the beginning of the year, and subsequently increased the amount of impairments and provisions on a monthly basis. By the end of the year, all but two banks have created more impairments and provisions than they had released during the year.

Figure 18: **Disposal of banks' gross income**



Source: Bank of Slovenia

Profit accounted for significantly more of the disposal of gross income in 2006

Having successfully controlled costs and reduced provisioning and impairments in comparison with 2005, banks recorded pre-tax profit of SIT 94.3 billion in 2006, an increase of 50.6%. Pre-tax profit accounted for just under one-third of the disposal of gross income, this proportion having fluctuated around one-quarter in previous years. The largest proportion of gross income still went to cover banks' operating costs (57.6%), while only 10% of gross income was used for impairments and provisioning.

3.2.5 Bank performance indicators

Growth in average ROA

In 2006, growth in profit outstripped growth in total assets by 30 percentage points as a result of the decline in impairments and provisioning in accordance with the IFRS. This was reflected in the average ROA, which increased by 0.3 percentage points. Eight banks recorded above-average indicators, while two saw declines in their indicators from the previous year.

Trend of decline in gross income per average assets and interest margin

Gross income per average total assets and the interest margin continued to display a declining trend. The reason was the rapid growth in total assets, which is being tracked by income categories, but not at a sufficient pace to maintain the values of the indicators. As a result of the changeover to the IFRS and different valuation methods, non-interest income strengthened in 2006, which brought an increase in non-interest margin. One feature was that the banks under foreign ownership recorded lower interest and non-interest margins.

Table 15: **Selected bank performance indicators**

in %	2001	2002	2003	2004	2005	2006
Gross income / average total assets	4.8	5.3	4.7	4.4	4.0	3.9
Return on average assets	0.5	1.1	1.0	1.1	1.0	1.3
Return on average equity	4.6	12.6	11.9	12.7	12.7	15.1
Net interest margin	3.4	3.4	3.1	2.7	2.4	2.2
Net non-interest margin	1.47	1.83	1.64	1.72	1.60	1.68
Operating expenses / average total assets	3.2	3.2	3.0	2.8	2.5	2.2

Source: Bank of Slovenia

Average ROE continues to strengthen

Average ROE improved by 2.4 percentage points, while the number of banks recording an above-average value in this indicator remained the same. ROE strengthened for the third successive year, as growth in the book value of the banking system's capital does not automatically track growth in total assets or growth in profit. Despite the inclusion of general risk and country risk provisions in capital during the changeover to the IFRS (with an appropriate adjustment in the figures for previous years), and individual capital injections in 2006, growth in the book value of capital did not track growth in pre-tax profit, on which the IFRS also had an impact. The capital for meeting a bank's capital requirements was generally obtained via the issue of subordinated capital-equivalent instruments and innovative instruments, with only certain banks under foreign ownership undergoing capital injections.

Growth in operating costs remained just under 8 percentage points behind growth in average assets

The cost efficiency indicator (the ratio of operating costs to average assets) continues to improve, banks having successfully controlled costs in 2006 despite the additional cost burden of the introduction of the euro. Growth in operating costs remained 13 percentage points behind growth in average assets, which had a beneficial impact on the indicator.

3.3 Interest rates and interest rate spread

The trend of a decline in the proportion of liabilities accounted for by deposits of non-banking sectors continued

Borrowing at foreign banks meant that the trend of an increase in the proportion of average interest-bearing liabilities accounted for by bank deposits increased at the expense of the proportion accounted for by deposits by non-banking sectors. The proportion of average interest-bearing liabilities accounted for by deposits by non-banking sectors fell from 66.2% at the end of 2005 to 59.6% at the end of 2006, while the proportion accounted for by bank deposits rose by 6.6 percentage points to 33.8% at the end of 2006.

The trend of an increase in the proportion of assets accounted for by lending to non-banking sectors continued

There was a continuation of the trend of an increase in the proportion of interest-bearing assets accounted for by lending to non-banking sectors, in particular that of lending to non-financial companies and other financial institutions. The increase came at the expense of the proportion accounted for by investments in debt securities, Bank of Slovenia securities in particular. The proportion of average interest-bearing assets accounted for by lending to non-banking sectors rose by 2.9 percentage points to 61.9% at the end of 2006, while the proportion accounted for by securities fell by 2.8 percentage points to 26.7%.

Table 16: **Effective lending and deposit interest rates**

in % p.a.	Dec.-05	Mar.-06	Jun.-06	Sep.-06	Dec.-06
Average lending rate	4.83	4.90	4.97	5.17	5.27
Average deposit rate	2.23	2.30	2.40	2.50	2.63
Interest rate spread (percentage points)	2.60	2.60	2.57	2.67	2.64

Source: Bank of Slovenia

Rise in euro interest rates

The ECB raised its interest rates by 0.25 percentage points five times in 2006, which also brought a rise in euro interest rates, with lending rates rising by 1.36 percentage points to 4.78% and deposit rates rising by 1.08 percentage points to 3.09%. Euro investments accounted for 53.1% of interest-bearing assets at the end of 2006, while euro liabilities accounted for 49.5% of interest-bearing liabilities.

Rise in Swiss franc interest rates

There was also a significant rise in Swiss franc interest rates in 2006, the lending rate rising by 1.47 percentage points to 3.48%, and the deposit rate by 1.08 percentage points to 1.7%. The Swiss franc accounted for just 2.1% of interest-bearing assets and 1.3% of interest-bearing liabilities at the end of 2006, but growth on both the asset and liability sides was very high at more than 120%.

Tolar interest rates declined overall

Tolar interest rates declined overall in 2006, both on the asset side and the liability side. Tolar lending rates declined by 0.24 percentage points to 5.98% primarily as a result of long-term lending, but at the end of the year were still just over 1 percentage point higher than euro interest rates on long-term loans, and 1.5 percentage points higher on short-term loans. Tolar deposit rates declined by 0.30 percentage points to 2.15%, primarily as a result of short-term deposits, while interest rates on long-term deposits actually rose by 0.2 percentage points. Tolar interest rates on both long-term and short-term deposits were lower than euro interest rates at the end of 2006.

Equal rises in effective lending and deposit rates

There was a rise in effective lending and deposit rates in 2006. The rise was approximately the same (0.44 percentage points compared with 0.40 percentage points), and the interest rate spread was thus only slightly different at 2.64 percentage points. The largest rise among lending rates was recorded by rates on long-term loans (0.5 percentage points), with rates on short-term loans recording a slightly lower rise (0.3 percentage points). The largest rise among deposit rates was recorded by rates on long-term deposits (0.89 percentage points), with rates on short-term deposits registering merely a symbolic rise (0.05 percentage points).

3.4 Balance sheet

Growth in total assets was significantly lower han in 2005

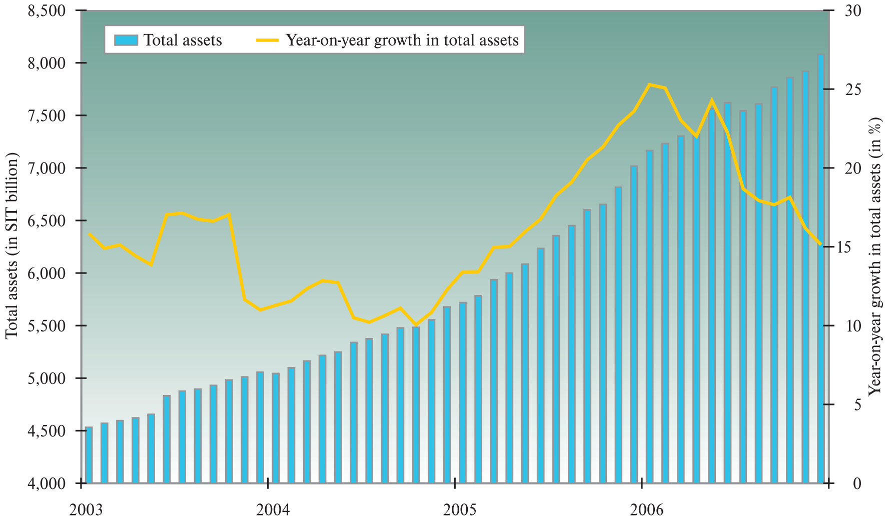
The total assets of the banking system[9] increased by SIT 1,061.9 billion[10] in 2006, to end the year at SIT 8,080.1 billion. Owing to a basis effect, year-on-year growth in total assets began to decline at the very beginning of the year, ending the year at 15.1% in nominal terms or 12.0% in real[11] terms. Growth in total assets was significantly lower than the above-average growth recorded in 2005 (23.6% in nominal terms, 20.8% in real terms), but was still higher than in 2003 and 2004. Eights banks recorded better growth in total assets that the banking system overall, while one bank failed to record any growth in total assets in real terms, despite a nominal increase. Growth in the total assets of the banks under majority foreign ownership has remained above-average for several successive years, and reached 50.7% in nominal terms if one bank that came under foreign ownership in 2006 is included (22.0% excluding this bank). The small domestic banks also recorded above-average growth.

The market shares of the foreign banks and the small domestic banks continued to strengthen

As in previous years, the market share of the foreign banks strengthened in 2006 (from 22.6% to 29.5%, including the aforementioned bank), primarily at the expense of the market share of the NLB Group. The market share of the small domestic banks is also strengthening.

9 Banks and branches of member-states.
10 In 2004 it increased by SIT 621 billion.
11 Allowing for inflation.

Figure 19: **Nominal and year-on-year growth in total assets**



Source: Bank of Slovenia

Borrowing in the banking sector remains the main source of finance

Banks primarily obtained the resources for their operations in 2006 by accepting deposits by non-banking sectors and by taking bank loans, which are valued for accounting purposes at amortised cost, the deposits covering 92.5% of the growth in total assets. As in previous years the main source was borrowing in the banking sector, but it is declining in intensity, accounting for SIT 564.2 billion or 53.1% of the increase in total assets (compared with 64.4% in 2005). The majority of the resources came from foreign banks, but the acquisition of resources at domestic banks also increased slightly compared with previous years. Bank deposits, which amounted to SIT 2,545 billion at the end of the year, accounted for 31.3% of liabilities, up 3.2 percentage points from the previous year.

Table 17: **Total assets and market shares**

Bank	Total assets (in SIT million)		Nominal growth (in %)		Market share (in %)	
	31-Dec.-2005	31.Dec.-06	2005/2004	2006/2005	31-Dec.-05	31-Dec.-06
Nova LB d.d. Ljubljana	2,219,177	2,450,777	19.0	10.44	31.6	30.3
Nova KB d.d. Maribor	716,987	879,277	18.9	22.63	10.2	10.9
Abanka Vipa d.d. Ljubljana	595,459	685,821	23.6	15.18	8.5	8.5
SKB banka d.d. Ljubljana	462,591	499,769	19.4	8.04	6.6	6.2
BA CA d.d. Ljubljana	451,225	524,162	50.7	16.16	6.4	6.5
Banka Koper d.d. Koper	434,454	454,186	30.4	4.54	6.2	5.6
Banka Celje d.d. Celje	413,226	469,631	14.5	13.65	5.9	5.8
Gorenjska banka d.d. Kranj	331,993	357,580	18.8	7.71	4.7	4.4
R. Krekova banka d.d. Maribor	217,295	229,511	36.3	5.62	3.1	2.8
Hypo Alpe-Adria-bank d.d. Ljubljana	203,206	271,429	49.7	33.57	2.9	3.4
Probanka d.d. Maribor	153,540	194,673	25.0	26.79	2.2	2.4
Poštna banka Slovenije d.d. Maribor	122,875	135,395	10.7	10.19	1.8	1.7
Deželna banka Slovenije d.d. Ljubljana	121,420	146,133	20.0	20.35	1.7	1.8
Kaerntner Spar.AG	111,065	172,193	60.1	55.04	1.6	2.1
Volksbank-Ljudska banka d.d. Ljubljana	99,045	116,172	17.4	17.29	1.4	1.4
Banka Domžale d.d. Domžale, BsNLB	94,910	103,374	11.7	8.92	1.4	1.3
Factor banka d.d. Ljubljana	91,781	125,953	25.6	37.23	1.3	1.6
Koroška banka d.d. Sl. Gradec, BsNLB	78,594	84,641	10.2	7.69	1.1	1.0
Banka Zasavje d.d. Trbovlje, BsNLB	60,260	60,994	17.8	1.22	0.9	0.8
BAWAG d.d. Ljubljana	26,644	92,236	0.0	0.00	0.4	1.1
BKS Bank AG Ban. Ljubljana branch	12,071	23,465	272.6	94.39	0.2	0.3
Zveza Bank Ljubljana branch	456	2,811	0.0	516.45	0.0	0.0
All banks	7,018,275	8,080,184	23.6	15.13	100.0	100.0

Note: The changeover to the IFRS also had a lesser impact on total assets, and the figures for banks' total assets and nominal growth are not the same as the figures published in the 2005 Annual Report.

Source: Bank of Slovenia

The proportion of total liabilities accounted for by deposits by non-banking sectors is constantly falling

Growth in deposits by non-banking sectors again failed to track growth in total assets in 2006, although at 9.2% it was the highest figure in the last four years. The proportion of total assets accounted for by deposits by non-banking sectors, which amounted to SIT 4,192.2 billion, has been falling for a long time, and was only just over one-half at the end of the year. The largest contribution to the increase in deposits by non-banking sectors came from household deposits, which totalled SIT 179 billion (SIT 82.6 billion in December alone), while there was also a significant increase of just over SIT 110 billion in the total of government deposits and deposits by other financial institutions. After initially stagnating, deposits by non-financial companies began to grow slowly in the second half of the year, achieving growth of 6.4% by the end of the year. Banks received just over 60% of their resources from non-banking sectors in domestic currency. The effects of the changeover to the euro could be seen on household deposits, which increased sharply in December, but the decline in government deposits meant that the effect was not noticeable overall. In terms of maturity, the largest increase in 2006 was again recorded by sight deposits, while long-term deposits grew by 8.3% after three years of stagnation.

Three banks opted to issue derivatives in 2006 to a larger extent than in previous years, while repurchase transactions proved to be a less attractive source for banks.

The issue of subordinated liabilities increased by 40.1%

Three banks opted to issue securities in 2006, but there was no increase in the total stock as a result of the maturity of individual issues. In aiming to increase their regulatory capital, several banks opted to issue subordinated liabilities,[12] which thus increased by just over SIT 68 billion, or 40.1%.

An increase of 14.3% in the book value of capital

The book value of capital stood at SIT 680.9 billion as at the final day of the year, an increase of 14.3%. The increase includes that part of profit transferred to the profit reserves in accordance with the Companies Act. Only five banks underwent capital injections in 2006. The conversion of a branch into a bank was also a factor in the increase in the nominal value of capital. A branch of a member-state is a constituent part of the parent bank, which provides the capital to cover the risks deriving from the branch's operations. During conversion, the capital required to establish the bank was provided by the parent bank, which is simultaneously the majority owner of the new bank.

Factors in the increase in capital

Capital increased by SIT 76 billion during the changeover to the IFRS. The release of the special provisions for credit risk and for general banking risk on the liability side, and the special provisions on the asset side of the balance sheet, and the revaluation of financial assets to fair value were the reason for this increase. The effect of the increase was partly neutralised by the negative effects of the abolition of the equity method, by the deferred corporate income tax calculated, and on other grounds.

[12] In the calculation of regulatory capital, liabilities that are booked as subordinated liabilities are partly included in original capital, and partly in subordinated debt.

Table 18: **Principal items in banking sector balance sheet**

BALANCE SHEET after conversion to the IFRS	Amount (in SIT million)		Proportion (in %)		Nominal growth (in %)		Real growth (in %)
	31-Dec.-05	31-Dec.-06	31-Dec.-05	31-Dec.-06	05/04	06/05	06/05
Assets	**7,018,276**	**8,080,185**	**100.0**	**100.0**	**23.6**	**15.1**	**12.0**
Cash	143,651	253,241	2.0	3.1	1.9	76.3	71.5
Lending	4,558,310	5,546,721	64.9	68.6	27.4	21.7	18.4
To banks	688,255	732,724	9.8	9.1	35.6	6.5	3.6
To non-banking sectors	3,870,055	4,813,997	55.1	59.6	26.1	24.4	21.0
of which non-financial companies	2,374,305	2,907,836	33.8	36.0	22.5	22.5	19.1
.....households	977,229	1,212,484	13.9	15.0	28.0	24.1	20.7
.....government	159,467	137,484	2.3	1.7	11.6	-13.8	-16.1
.....other financial institutions	176,060	299,161	2.5	3.7	70.4	69.9	65.3
.....non-residents	179,269	251,940	2.6	3.1	51.2	40.5	36.7
Financial assets held for trading	383,062	347,256	5.5	4.3	32.4	-9.3	-11.8
of which government securities	103,314	51,610	1.5	0.6	33.9	-50.0	-51.4
......Bank of Slovenia securities	45,500	0	0.6	0.0	143.5	-100.0	-100.0
Financial assets available for sale	1,228,605	1,303,741	17.5	16.1	24.6	6.1	3.2
of which government securities	477,901	513,268	6.8	6.4	19.0	7.4	4.5
......Bank of Slovenia securities	514,560	297,301	7.3	3.7	2.0	-42.2	-43.8
Financial assets held to maturity	363,706	241,763	5.2	3.0	-4.1	-33.5	-35.3
of which government securities	67,170	86,560	1.0	1.1	-45.1	28.9	25.4
......Bank of Slovenia securities	278,846	131,369	4.0	1.6	14.5	-52.9	-54.2
Other	340,942	387,463	4.9	4.8	11.9	13.6	10.5
Liabilities	**7,018,276**	**8,080,185**	**100.0**	**100.0**	**23.6**	**15.1**	**12.0**
Financial liabilities to central bank	0	0	0.0	0.0	0.0	0.0	0.0
Financial liabilities at amortised cost (deposits)	6,226,764	7,209,463	88.7	89.2	24.2	15.8	12.6
a) Liabilities to banks	1,981,019	2,545,257	28.2	31.5	77.3	28.5	25.0
of which foreign banks	1,860,021	2,381,136	26.5	29.5	83.3	28.0	24.5
b) Liabilities to non-banking sectors (deposits by non-banking sectors)	3,838,100	4,192,229	54.7	51.9	8.8	9.2	6.3
...of which non-financial companies	749,623	797,707	10.7	9.9	17.8	6.4	3.5
....households	2,475,441	2,654,533	35.3	32.9	5.7	7.2	4.3
...government	207,702	266,864	3.0	3.3	53.4	28.5	25.0
...other financial institutions	290,340	346,560	4.1	4.3	-1.8	19.4	16.1
c) Debt securities	237,712	233,883	3.4	2.9	5.7	-1.6	-4.3
d) Subordinated liabilities	169,933	238,094	2.4	2.9	18.4	40.1	36.3
Financial liabilities tied to financial assets without terms			0.0				
for derecognition (repo)	31,573	6,503	0.4	0.1		-79.4	-80.0
Capital	595,707	680,913	8.5	8.4	29.6	14.3	11.2
Provisions and other	164,232	183,306	2.3	2.3	-20.0	11.6	8.6
TOTAL ASSETS	**7,018,276**	**8,080,185**	**100.0**	**100.0**	**23.6**	**15.1**	**12.0**

Note: The changeover to the IFRS also had a lesser impact on total assets, and the figures for banks' total assets and nominal growth are not the same as the figures published in the 2005 Annual Report.

Source: Bank of Slovenia

Valuation under the IFRS

Under the IFRS, banks must classify a financial asset immediately upon acquisition in terms of its purpose of acquisition or valuation method. Financial assets are thus classed into the categories held for trading, held to maturity, available for sale, at amortised cost, and at fair value through profit or loss. In 2006 banks classed loans entirely into the at amortised cost category, while securities were classed into various categories.

The increase in total assets was almost entirely earmarked for lending to non-banking sectors…

Banks diverted almost 90% of the increase in total assets into lending to non-banking sectors, raising the stock of loans by 24.4% to SIT 4,814.0 billion. Owing to a basis effect, this was more than 1 percentage point down on growth in 2005 (26.1%), but at SIT 944 billion the nominal increase was just under SIT 150 billion higher as lending activities remained lively through the year. The banks under majority foreign ownership continued to record high relative growth in lending to non-banking sectors (32.0%), even though the domestic banks contributed more to the nominal increase (58.1%).

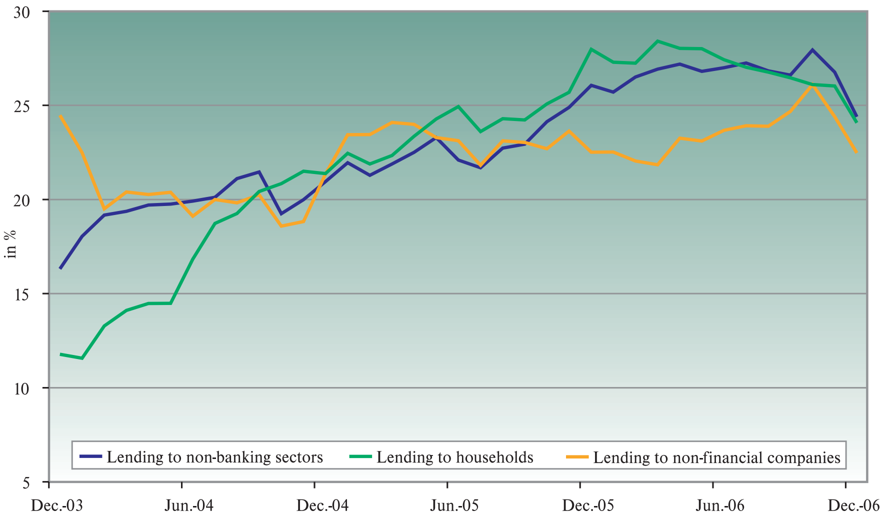
… primarily non-financial companies and households, and also non-residents

As in previous years, banks lent most heavily to non-financial companies in 2006. The stock of lending granted increased by SIT 533.5 billion, the growth rate remaining at its level of the previous year at 22.5%. Lending to households increased by just under one-quarter (SIT 235.3 billion). For the second successive year lending to other financial institutions grew at 70%, but the stock of such lending does not account for a significant proportion of total lending. Lending to non-residents also recorded above-average growth, while lending to the government declined slightly.

Only a small proportion of lending was approved in domestic currency in 2006

Just under 5% of new lending was in domestic currency, for which reason the proportion of total lending accounted for by tolar lending fell below one-half. Almost the entire increase in lending in domestic currency came from household lending, while the sectors of non-financial companies and the government made net tolar repayments. Growth in short-term and long-term lending was relatively equal at just over 24%, although a higher basis meant that long-term lending recorded a larger nominal increase.

Figure 20: **Year-on-year growth in lending to non-banking sectors**



Source: Bank of Slovenia

A decline in investments in Bank of Slovenia bills, and an increase in investments in securities of various issuers with high liquidity and low risk

During the changeover to the IFRS, banks had to classify their investments in securities according to the purpose of acquisition. The principal was included in the available for sale category. Securities acquired for trading purposes and for the generation of gains on this account were included in financial assets held for trading. Only a minor portion were classed as held to maturity. Irrespective of the aforementioned restructuring, the total stock of investments in securities declined by just over 5% to stand at SIT 1,817.7 billion at the end of 2006 (compared with SIT 1,918 billion a year earlier). The stock of Bank of Slovenia bills declined as a result of the changeover to the Eurosystem, owing to which banks directed the money released at maturity (in a total amount of SIT 410 billion) into purchases of other securities. They primarily favoured low-risk high-liquidity securities that could be included in the pool of eligible assets and used as collateral for obtaining resources at the central bank. Thus the stock of investments in other[13] debt securities increased by SIT 246.0 billion to SIT 523.0 billion, while the stock of equities increased by SIT 52.5 billion to SIT 135 billion. The stock of investments in government securities remained stable at SIT 651 billion. Banks also increased their capital investments by SIT 27.9 billion, taking the total stock to SIT 163.8 billion.

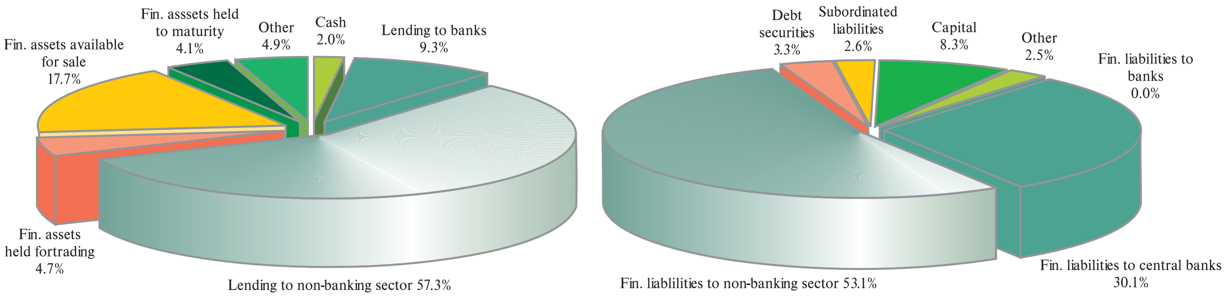
13 Securities not issued by the central bank or the government.

3.4.1 Structure of liabilities and investments

The structure of average liabilities is shifting towards liabilities to banks

The intensive borrowing at foreign banks has been changing the structure of average liabilities for several years in succession. Bank deposits accounted for just under one-third of all sources of finance in 2006, this proportion increasing by 6.28 percentage points last year alone. The shift towards liabilities to banks came almost entirely at the expense of liabilities to non-banking sectors, which despite a decline of 5.5 percentage points in the proportion of liabilities that they account for to 53.1% still remain the main source of finance for banks.

Figure 21: **Average structure of liabilities and investments**



Source: Bank of Slovenia

An increase in the proportion accounted for by lending to non-banking sectors

Lively lending to non-banking sectors was reflected in an increase of 2.8 percentage points in the proportion of investments accounted for by lending to non-banking sectors to 57.3%. There was a notable decline in the stock of financial assets held to maturity, under which banks classified Bank of Slovenia bills, the stock of which declined in 2006 as a result of the upcoming changeover to the Eurosystem. The proportion of investments accounted for by securities was not maintained, despite banks directing the majority of the money released from bills into further securities purchases. They did not opt for additional new investments in securities, and so growth in these investments was outstripped by growth in lending, which resulted in a decline in the structural proportion.

3.4.2 Breakdown of liabilities and investments by maturity and currency

The proportion accounted for by short-term deposits declined, while that of long-term time deposits remained the same

Short-term deposits account for the largest single proportion in the maturity breakdown of deposits by non-banking sectors, namely 46.7% (SIT 1,927.2 billion). This was down 1.2 percentage points, the proportion accounted for by sight deposits increasing correspondingly. After three years of decline, long-term deposits strengthened again in 2006 (by 8.3%), primarily as a result of an increase in the proportion of household long-term deposits. This maintained their stability in the maturity breakdown with a proportion of 12.4%, the stock of the deposits standing at SIT 518.8 billion at the end of the year. On the investment side, long-term loans strengthened more in nominal terms, despite equal growth rates. The stock of long-term loans was up SIT 632.5 billion (24.2%) to stand at SIT 3,252.0 billion at the end of the year. Growth in short-term loans was slightly higher at 24.9%, but the lower basis meant that the nominal increase was smaller. The stock of short-term loans stood at SIT 1,562.0 billion at the end of the year. The aforementioned changes resulted in the proportion accounted for by long-term loans increasing slightly.

Liabilities to banks are becoming by far the most important source of finance

For the fifth successive year liabilities to banks grew faster than liabilities to non-banking sectors, and have become by far the most important source of finance for banks. The proportion of deposits accounted for by deposits by non-banking sectors, on which the average maturity is shortening, declined by 3.5 percentage points in 2006 to 58.1%. The proportion accounted for by liabilities to banks is increasing, and had reached 41.9% by the end of the year (compared with 38.4% a year earlier).

Table 19: **Maturity breakdown of deposits by and lending to non-banking sectors**

in %	31-Dec.-03	30-Jun.-04	31-Dec.-04	30-Jun.-05	31-Dec.-05	30-Jun.-06	31-Dec.-06
Sight deposits by non-banking sectors	33.8	37.5	34.8	36.3	39.6	40.2	40.9
Short-term deposits by non-banking sectors	48.6	47.2	51.1	50.0	47.9	47.4	46.7
Long-term deposits by non-banking sectors	17.6	15.3	14.1	13.6	12.5	12.4	12.4
Total deposits by non-banking sectors	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Short-term lending to non-banking sectors	36.0	36.1	34.0	33.7	32.3	33.2	32.4
Long-term lending to non-banking sectors	64.0	63.8	65.9	66.3	67.7	66.7	67.5
Claims arising from guarantees	0.1	0.0	0.1	0.0	0.0	0.0	0.0
Total lending to non-banking sectors	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Note: Under the changeover to the IFRS, the current maturity item was abolished on both the investment and liability sides. Contracted long-term deposits and investments maturing in the next 12 months are thus included in the long-term categories in the table. The table has been fully adjusted to this, and is therefore not comparable with the table published in the 2005 Annual Report.

Source: Bank of Slovenia

Growth of 25.9% in foreign currency deposits, and just 6.5% in domestic currency deposits

Foreign currency deposits grew by 25.9% in 2006, significantly more than domestic currency deposits (6.5%), which as in previous years is a reflection of increased borrowing from foreign banks. Liabilities to banks in foreign currency increased by SIT 585.96 billion to SIT 2,175.5 billion. The proportion of liabilities that they account for consequently increased by 4.2 percentage points to 26.9%. Despite the approach of the euro, nominal growth in domestic currency deposits was livelier than that of foreign currency deposits in 2006, an indication of the confidence held in the tolar by the corporate and household sectors.

The proportion of lending to non-banking sectors in foreign currency strengthened

Bank resources obtained in foreign currency have been directed towards foreign currency lending to non-banking sectors for several years in succession now. Foreign currency lending to non-banking sectors increased by SIT 886.99 billion (50.6%), while domestic currency lending to non-banking sectors only increased by SIT 47.14 billion (2.2%), which brought a sharp increase in the proportion of lending to non-banking sectors accounted for by foreign currency (up 6.4 percentage points to 33.0%). For the second successive year the change in the currency breakdown as a result of tolar repayments was most prominent in lending to non-financial companies. Lending in foreign currency increased by 40.5%, and now accounts for 64.5% of the stock of lending to non-financial companies. The decline in the amount of Bank of Slovenia bills issued was reflected in the stock of investments in securities in both domestic currency and foreign currency. Despite the change in the portfolio, banks maintained the same currency breakdown in their investments, directing the money released from tolar bills into the purchase of domestic securities, and the money released from foreign currency bills into the purchase of foreign securities. The proportion of the stock of securities accounted for by domestic securities remained stable at 72.8%.

Table 20: **Currency breakdown of principal balance sheet items**

	Proportion as at 31-Dec.-05		Proportion as at 31-Dec.-06	
in %	domestic currency	foreign currency	domestic currency	foreign currency
Cash	1.8	0.2	2.9	0.2
Lending	33.3	31.6	30.3	38.4
- to banks	3.4	6.4	3.7	5.3
- to non-banking sectors	29.9	25.2	26.6	33.0
Financial assets held for trading	4.0	1.5	3.1	1.2
Financial assets available for sale	12.7	4.8	11.6	4.6
Financial assets held to maturity	3.6	1.6	2.6	0.4
Other assets	4.1	0.8	4.1	0.7
Total assets	**59.5**	**40.5**	**54.5**	**45.5**
Financial liabilities to central bank	0.0	0.0	0.0	0.0
Financial liabilities at amortised cost (deposits)	46.2	42.5	42.8	46.4
- deposits by banks	5.6	22.7	4.6	26.9
- deposits by non-banking sectors	36.6	18.1	34.6	17.3
- debt securities	3.3	0.1	2.9	0.0
- subordinated liabilities	0.7	1.7	0.8	2.2
Financial liabilities tied to financial assets without terms for derecognition	0.0	0.4	0.0	0.1
Other liabilities and provisions	2.2	0.1	2.0	0.2
Capital	8.5		8.4	
Total liabilities	**56.9**	**43.1**	**53.2**	**46.8**

Source: Bank of Slovenia

3.5 Asset quality

No limits on exposure were exceeded

The two vital elements of credit risk management are the monitoring of the credit rating structure of claims, and the prevention of concentrations of credit exposure. As at 31 December 2006, no bank had exceeded the limits on the maximum allowable exposure to individual clients (25% of capital), to groups of related clients (25% of capital), to other entities in the group (20% of capital) or to persons with a special relationship with the bank (20% of capital).

Table 21: **Bank exposure in relation to capital**

	2002	2003	2004	2005	2006
Ratio of sum of large exposures to capital (%)	195	214	196	228	223
Number of large exposures	256	296	253	305	333
Number of banks with large exposures of more than 300% of capital	4	4	3	5	4

Source: Bank of Slovenia

The total of large exposures declined

By the end of 2006 the total of large exposures in the banking system had been reduced to 223% of capital. The total number of large exposures was up 28 from the end of 2005. Four banks recorded a large exposure total of more than 300% of their capital.

Table 22: **Credit rating structure and level of coverage of rated claims by impairments and provisions**

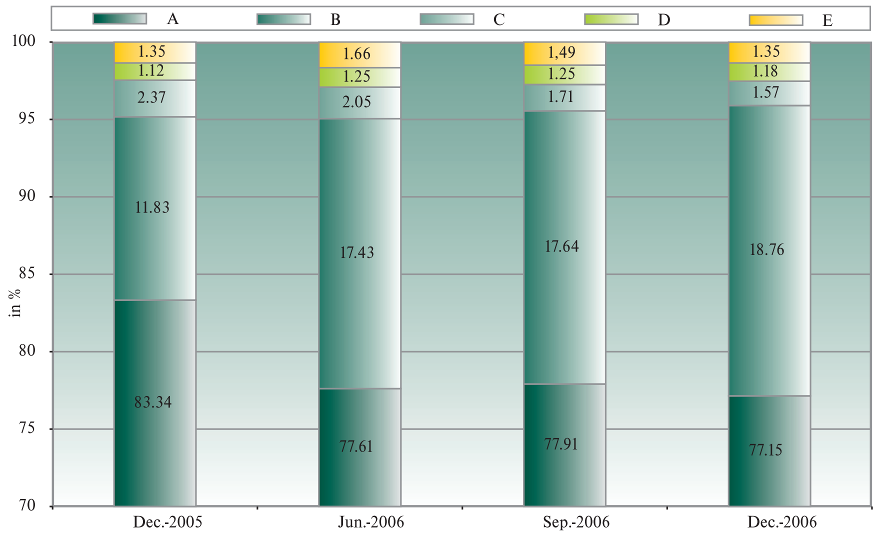
Credit rating	31-Dec.-05				31-Dec.-06			
	Rated claims		Impairments and provisions	Level of coverage	Rated claims		Impairments and provisions	Level of coverage
	in SIT million	in %	in SIT million	in %	in SIT million	in %	in SIT million	in %
A	5,034,519	83.3%	49,087	1.0%	5,838,615	77.1%	21,099	0.4%
B	714,666	11.8%	73,277	10.3%	1,419,423	18.8%	84,555	6.0%
C	143,037	2.4%	37,770	26.4%	118,446	1.6%	28,486	24.0%
D	67,406	1.1%	38,461	57.1%	89,403	1.2%	59,349	66.4%
E	81,492	1.3%	81,480	100.0%	102,188	1.4%	102,188	100.0%
Overall	6,041,120	100.0%	280,076	4.6%	7,568,075	100.0%	295,677	3.9%

Source: Bank of Slovenia

Total exposure increased by 17%

Total exposure in the banking system increased by 17% in 2006, 5.3 percentage points less than in 2005. It stood at SIT 9,652.1 billion at the end of 2006, of which 82.6% were on-balance-sheet claims, and 17.4% were off-balance-sheet claims. The amount of rated claims increased by 25.3%, to account for 78.4% of total exposure at the end of 2006.

Figure 22: **Structure of banking system's credit portfolio**



Vir: Banka Slovenije

The credit rating structure of claims deteriorated

By the end of the year the credit rating structure of rated claims[14] had deteriorated owing to an increase in the proportion of B-rated claims (up 6.93 percentage points) and D-rated claims (up 0.07 percentage points), at the expense of a decline in A-rated claims (down 6.19 percentage points) and C-rated claims (down 0.80 percentage points). The shift of claims, mostly as a result of changes in methodology owing to the changeover to the IFRS, from A-rated to B-rated[15] was more pronounced at the domestic banks (6.32 percentage points) than at the banks under majority foreign ownership (6.50 percentage points). The highest-quality credit portfolios are maintained by the banks under majority foreign ownership, with 84.2% of their claims being A-rated, 10.4 percentage points more than at the domestic banks.

Table 23: **Credit rating structure of banking system's credit portfolio (in % and SIT billion)**

Credit rating	Rated items	Proportion	Average impairment under IFRS
1 (1%)	5,839	77.1%	0.4%
2 (5%)	730	9.6%	2.8%
3 (8%)	239	3.2%	6.7%
4 (15%)	451	6.0%	10.6%
5 (25%)	84	1.1%	21.1%
6 (40%)	35	0.5%	31.0%
7 (75%)	57	0.8%	53.4%
8 (75% to 99%)	32	0.4%	89.3%
9 (100%)	102	1.4%	100.0%
OVERALL	7,568	100.0%	3.9%

Source: Bank of Slovenia

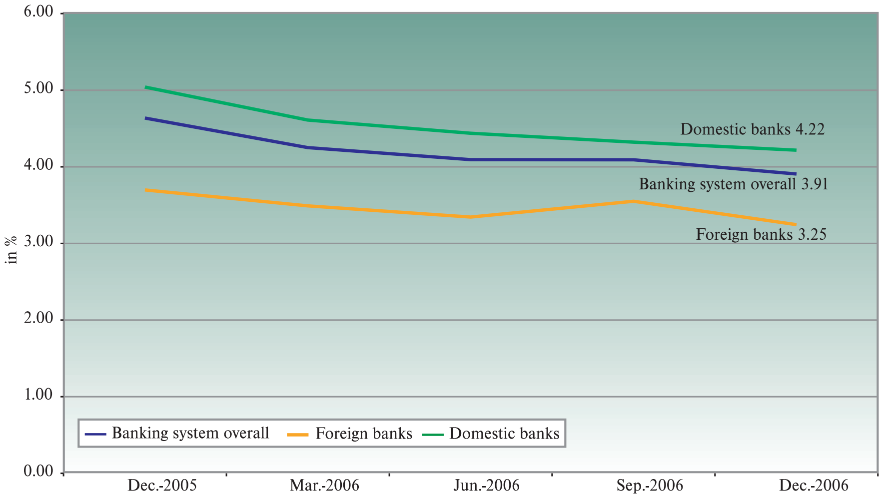
Rating structure of the banking system's credit portfolio

In the new credit rating structure of rated claims, which contains nine categories, the 1-rating accounts for the largest proportion (77.1% of the total), followed by the 2-rating and 4-rating (9.6% and 6% respectively). The remaining six credit ratings account for 7.2% of rated claims, of which 2.5% are classed as non-performing (rated 7, 8 and 9).

14 As a result of the changeover from the Slovenian Accounting Standards to the IFRS, the figures for the credit rating structure as at 31 December 2006 are disclosed under the old methodology, which envisages five credit rating categories, viz. A (impairments and provisions between 0% and 1.00%), B (1.01% to 15.00%), C (15.01% to 40.00%), D (40.01% to 99.99%) and E (100%), which allows for a comparison to be made with previous periods (as at 31 December 2005). Henceforth the figures as at 31 December 2006 are disclosed under the new methodology, which envisages nine credit rating categories, viz. 1 (impairments and provisions between 0% and 1.00%), 2 (1.01% to 5.00%), 3 (5.01% to 8.00%), 4 (8.01% to 15.00%), 5 (15.01% to 25.00%), 6 (25.01% to 40.00%), 7 (40.01% to 75.00%), 8 (75.01% to 99.99%) and 9 (100%).

15 In accordance with the new Regulation on the Assessment of the Credit-Risk Losses of Banks and Savings Banks, taking the IFRS into consideration, a bank can create any percentage impairment or provisioning (under the Slovenian Accounting Standards only certain percentages were allowed, namely 1% for A, 5% to 15% for B, 15% to 40% for C, 40% to 99% for D and 100% for E). Classifying claims with the new impairment or provisioning percentages (including the 1% to 5% range) into the old rating categories caused a migration of some A-rated claims to the B rating, which did not necessarily entail any deterioration in the quality of these claims.

Figure 23: **Average risk of claims in banking system overall and in individual groups**

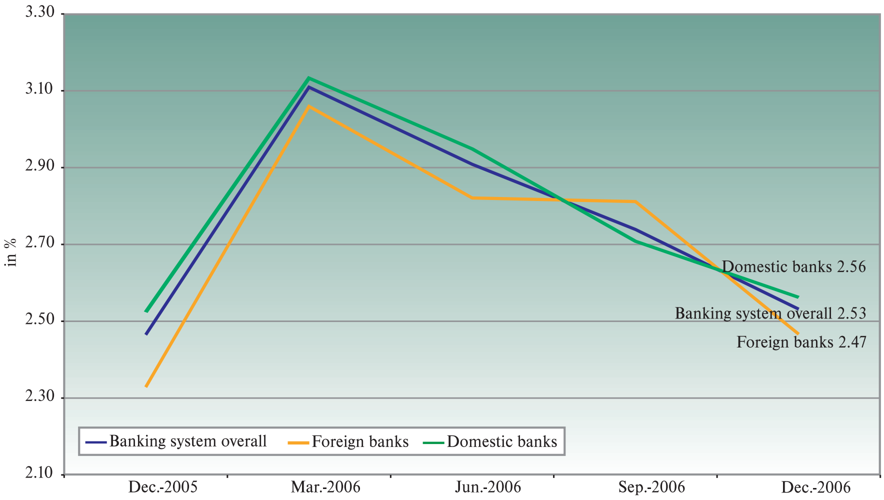


Source: Bank of Slovenia

The average risk of claims declined

Both groups of banks are showing a decline in the average risk of claims,[16] partly as a result of the changeover to the IFRS. Banks created impairments and provisions of 3.91% overall under the IFRS in 2006. The impairments and provisions created by the domestic banks (4.22%) under the IFRS were 1 percentage point higher than those created by the banks under majority foreign ownership (3.25%). The level of coverage of rated claims by provisions stood at 4.64% for the banking system overall at the end of 2005 (5.04% at the domestic banks, and 3.7% at the banks under majority foreign ownership).

Figure 24: **Proportion of D- and E-rated claims, by groups of banks and for banking system**



Source: Bank of Slovenia

Slight adverse movement in non-performing claims

The proportion of non-performing claims in the banking system was only a fraction higher (0.07 percentage points) at the end of 2006 than a year earlier. A comparison between the two groups of banks shows that this proportion increased slightly more at the banks under majority foreign ownership (0.14 percentage points compared with 0.04 percentage points) to stand at 2.47%, just 0.1 percentage points less than at the domestic banks. Alongside the effect of changes in methodology, this is also a consequence of above-average growth in lending activity at the banks under majority foreign ownership.

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16 The average risk of claims is equal to the level of coverage, calculated as the ratio of total impairments and provisions to rated claims.

Table 24: **Breakdown of rated claims by institutional sector, and average credit rating of sectors**

	31-Dec.-05		30-Jun.-06		30-Aug.-06		31-Dec.-06	
	Proportion in %	Average risk (in %)	Proportion in %	Average risk (in %)	Proportion in %	Average risk (in %)	Proportion in %	Average risk (in %)
A. Industry	**20.6**	**5.8**	**20.3**	**5.7**	**21.0**	**5.6**	**20.9**	**5.5**
- metals and machinery	4.2	4.1	4.0	4.1	4.1	4.0	4.0	4.2
- chemicals	2.5	5.2	2.6	6.2	2.5	6.2	2.5	6.1
- food and beverages	2.1	5.9	2.3	5.2	2.3	5.1	2.2	5.6
- construction	5.6	4.3	5.7	3.9	6.1	3.6	6.3	3.4
- energy supply	1.0	2.4	0.9	1.3	0.9	1.2	0.9	1.2
B. Services	**54.1**	**4.1**	**53.0**	**3.2**	**51.5**	**3.3**	**50.5**	**3.0**
- trade, motor vehicle repair	10.1	5.9	10.1	5.5	10.0	5.5	9.9	5.3
- transport, warehousing	3.2	3.4	3.1	2.7	3.1	2.8	3.1	2.8
- financial intermediation	19.8	2.0	18.9	0.8	17.3	0.9	15.9	0.8
- Bank of Slovenia	12.7		11.1		9.8		8.0	
- real estate, leasing	8.9	4.3	9.5	4.0	9.7	4.0	10.4	3.5
- public administration, defence social security	9.8	1.5	8.8	0.2	9.0	0.2	8.4	0.4
- government securities	7.9		7.2		7.3		6.7	
C. Households	**13.0**	**3.7**	**13.5**	**4.7**	**13.3**	**4.9**	**14.1**	**4.4**
D. Non-residents	**12.4**	**4.2**	**13.2**	**3.3**	**14.2**	**3.1**	**14.5**	**3.2**
Total	**100.0**	**4.5**	**100.0**	**4.1**	**100.0**	**4.1**	**100.0**	**3.9**

Source: Bank of Slovenia

Decline in the proportion accounted for by clients from the service sector at banks

As at 31 December 2006 banks were most exposed to clients in the service sector, their proportion declining 3.6 percentage points from the end of 2005 to 50.5%. The main factors in the decline were the decline in the proportion accounted for by Bank of Slovenia securities (down 4.8 percentage points), and to a lesser extent the proportion accounted for by Slovenian government securities (down 1.1 percentage points), while there was an increase in exposure to the real estate sector (up 1.5 percentage points). The level of risk in the service sector declined by 1.1 percentage points, primarily as a result of lower risk in the sectors of financial intermediation (down 1.2 percentage points), public administration (down 1.1 percentage points), real estate (down 0.9 percentage points), trade and motor vehicle repair (down 0.6 percentage points) and transport and warehousing (down 0.5 percentage points).

The proportion of debt accounted for by the highest-risk sectors in industry and its risk level are increasing

The proportion of debt accounted for by the highest-risk sectors of industry had reached 20.9% by the end of the year (up 0.3 percentage points), primarily on account of the construction sector (up 0.6 percentage points), and, to a lesser extent, food and beverages (up 0.1 percentage points). The largest increase in the level of risk was recorded by the chemicals industry (up 0.9 percentage points), while there were significant declines in other sectors, notably energy supply (down 1.2 percentage points), construction (down 0.9 percentage points) and food and beverages (down 0.3 percentage points). Exposure to households also increased slightly (by 1.2 percentage points), its level of risk rising by 0.7 percentage points, while exposure to non-residents increased (by 2.1 percentage points) in the context of a decline of 1 percentage point in risk.

Table 25: **Exposure to particular groups of countries**

in SIT million, %	31-Dec.-2003		31-Dec.-2004		31-Dec.-2005		31-Dec.-2006	
	Amount	Propor.	Amount	Propor.	Amount	Propor.	Amount	Propor.
EU	350,114	67.6	448,386	69.3	648,781	63.5	832,252	59.1
EFTA	30,927	6.0	28,149	4.3	56,469	5.5	67,400	4.8
Former Yugoslav republics	65,930	12.7	99,516	15.4	195,679	19.2	317,942	22.6
CEFTA	12,292	2.4	4,214	0.7	11,253	1.1	19,856	1.4
Other	58,872	11.4	66,898	10.3	109,527	10.7	170,963	12.1
Total	**518,135**	**100.0**	**647,163**	**100.0**	**1,021,709**	**100.0**	**1,408,413**	**100.0**
Proportion of rated claims accounted for by non-residents	10.6%		9.6%		12.4%		14.5%	

Source: Bank of Slovenia

The proportion of exposure to the former Yugoslav republics is increasing

The trend of increasing exposure to the former Yugoslav republics continued, the proportion of the total that they account for reaching 22.6 by the end of the year (up 3.4 percentage points), primarily at the expense of the proportion accounted for by EU member-states (down 4.4 percentage points). The latter prevail in the breakdown of exposure to particular groups of countries, accounting for 59.1% of the total (63.9% together with the EFTA countries), but this proportion is irrevocably declining. The proportion of exposure to other countries increased, the major countries within that group being the USA (47.8%) and Russia (23.1%).

3.6 Capital and capital adequacy

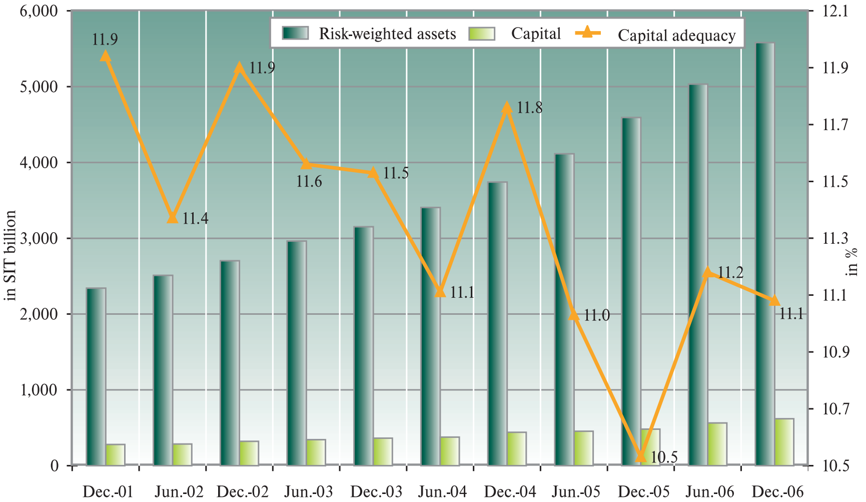
Capital adequacy improved in 2006

Capital adequacy fluctuated between 11% and 12% after 2001, finally reaching a new low of 10.5% at the end of 2005. The ratio improved significantly in 2006, but the increase in capital adequacy was the result of the changeover to the IFRS, owing to which banks saw significant increases in capital from retained earnings as a result of the abolition of certain types of provisions. A lesser factor in the rise in capital adequacy was the decline in currency-risk-weighted assets. The capital adequacy of the Slovenian banking system stood at 11.1% as at 31 December 2006. Growth in capital (28.0%) exceeded growth in risk-weighted assets (21.6%) by 6.4 percentage points.

Original capital accounted for most of the increase in the banking system's capital

The banking system's capital stood at SIT 618.6 billion at the end of December 2006, up SIT 135.2 billion on a year earlier. It was original capital that contributed most to the increase, namely SIT 115.3 billion. As examined above, capital increased on account of the increase in retained earnings as a result of the changeover to the IFRS (SIT 71.0 billion) when banks switched to the IFRS on 1 January 2006. Another factor in the increase in original capital was the increase of SIT 29.4 billion in share capital, with five banks undergoing capital injections in 2006 (worth SIT 7.3 billion), while one of the branches converted into a bank (SIT 22.2 billion). There was a significantly lower increase in additional capital (SIT 14.2 billion), and a decline in capital investments (capital deduction items) of SIT 5.6 billion. The main increases within additional capital were recorded by hybrid instruments (SIT 31.4 billion) and subordinated debt (SIT 15.9 billion), while other items (revaluation adjustments to non-current assets) declined by SIT 37.4 billion.

Figure 25: **Risk-weighted assets, capital and capital adequacy in the banking system**



Source: Bank of Slovenia

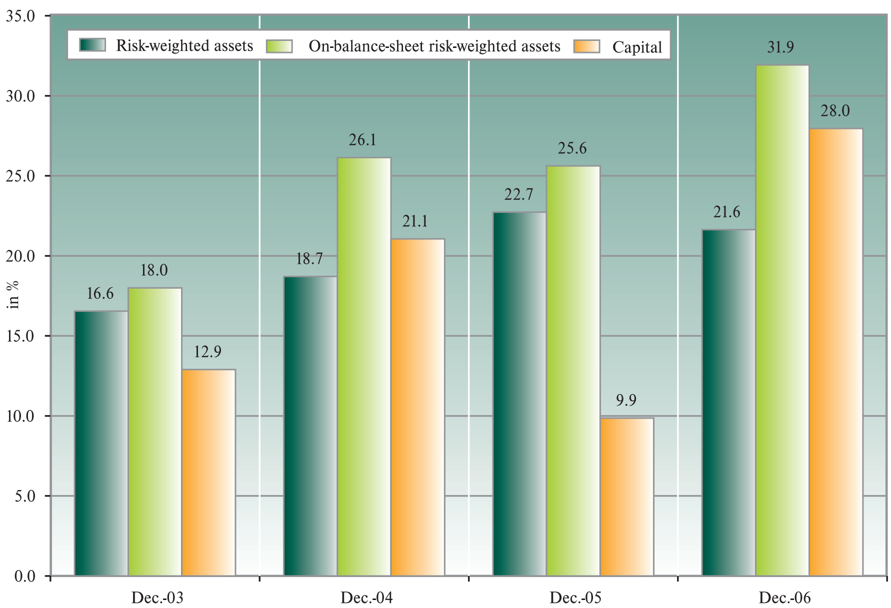
The ratio of original capital to additional capital increased

The ratio of original capital to additional capital shifted towards original capital in 2006, to stand at 72.5% to 27.5% at the end of December (compared with 68.8% to 31.2% a year earlier).

Risk-weighted assets increased

Total risk-weighted assets stood at SIT 5,582.1 billion at the end of 2006, up SIT 989.7 billion or 21.6% from the end of 2005. Credit-risk-weighted assets alone accounted for this, increasing by SIT 1,240.6 billion (31.1%). Currency-risk-weighted assets declined by SIT 243.8 billion (85.4%), while market-risk-weighted assets declined by SIT 2.8 billion (0.9%). The decline in currency-risk-weighted assets was a consequence of the amendment of the capital adequacy regulation, which stipulates that items in euros in the overall net position should no longer be taken into consideration for the purposes of calculating capital requirements. Within the credit-risk-weighted assets there was a sharp increase in on-balance-sheet risk-weighted assets of SIT 1,145.5 billion or 31.9%. Off-balance-sheet risk-weighted assets also increased, by SIT 93.7 billion or 23.8%.

Figure 26: **Year-on-year change in risk-weighted assets and bank capital**



Source: Bank of Slovenia

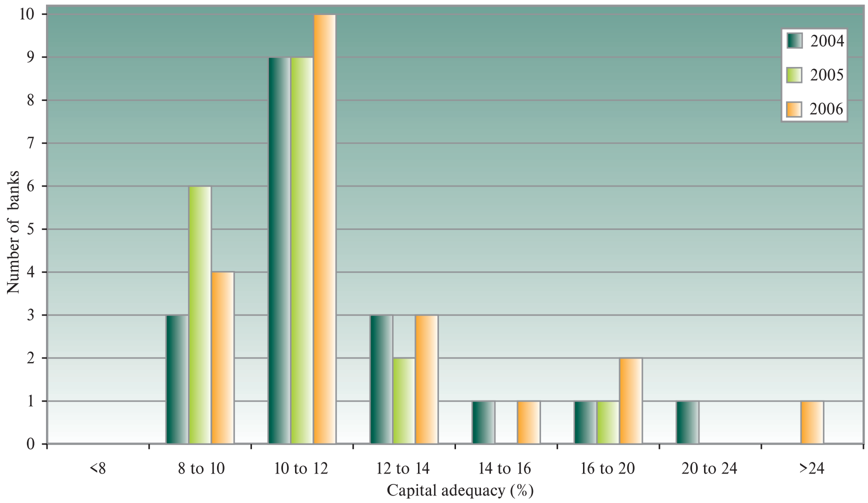
The market risk capital requirements were met by 14 of the 20 banks as at the end of December 2006. The proportion of turnover accounted for by trading was 16.2% in 2006 (compared with 15.3% in 2005). Transactions in equities and debt securities accounted for 25.9% of trading items, while transactions in derivatives and other financial instruments accounted for 74.1%.

14 of the 20 banks met the market risk capital requirements

Banks were using 73.7% of their capital to cover their capital requirements as at the end of December 2006, down 7.9 percentage points from a year earlier. Two banks needed less than 50% of their capital to cover their capital requirements, while two needed more than 90%.

Less capital was used to cover capital requirements in 2006 than in 2005

Figure 27: **Distribution of capital adequacy**



Source: Bank of Slovenia

All the banks met the minimum capital adequacy requirement as at 31 December 2006. There was a notable shift towards the higher capital adequacy intervals in comparison with 2005. The number of banks in the lowest capital adequacy interval of 8% to 10% fell from six to four, while there are no longer any banks in the highest capital adequacy intervals. Half of all the banks are now in the interval of 10% to 12%.

Shift towards higher capital adequacy intervals

3.7 Banking supervision

In its examinations of banks and savings banks in 2006 the Banking Supervision Department continued with its practice of conducting examinations according to the new risk-focused methodology that the department has been introducing into its work for more than a year. Examinations of specific areas were prevalent among the examinations conducted, practice having shown that shorter but more frequent and deeper examinations of specific areas are more significant and more needed than comprehensive examinations. There were also more follow-ups of the implementation of requirements in orders and recommendations, as it was not always clear from the documentation submitted whether the banks had rectified the irregularities.

Examinations of banks and savings banks were shorter, but more frequent and deeper

In 2006 examiners from the Banking Supervision Department focused most attention during their on-site examinations of banks and savings banks to overseeing the latter's activities and readiness for the introduction of the euro. The activities began in 2005, their final goal being to ensure that banks and all their systems were ready to a sufficient degree and on time for the introduction of the

Particular attention was focused on preparations for the introduction of the euro

new currency, and continued in 2006 with two two-monthly cycles of examinations at all banks and savings banks in the spring and the autumn, and a range of shorter interim examinations.

Areas of examinations

In addition to the aforementioned activities, all the standard areas were subject to examination: credit risk, market risks, with the emphasis on interest-rate risk and liquidity risk (only one approval to a bank for an internal approach to measuring interest-rate risk was issued), maintenance of sufficient capital (capital adequacy), prevention of money laundering, IT, etc. In connection with the adaptation to the new currency banks were given particular warning of the restructuring of the Bank of Slovenia's portfolio of instruments owing to the changeover to the euro. Mention should also be made of the comprehensive examinations to determine the risk profiles of banks and savings banks, in relation to the new methodology for risk monitoring at banks and savings banks.

Examinations in 2006

In 2006 there were 77 ordinary examinations based on authorisations by the Governor of the Bank of Slovenia, among which were 51 examinations of adaptations to the euro, several follow-ups of the implementation of requirements from orders or recommendations, and a range of one-day examinations or monitoring of operations in a specific area. On the basis of the examinations, as a result of breaches being identified the Bank of Slovenia issued four orders to rectify breaches, one order to rectify breaches with an additional measure, one ruling setting a higher capital adequacy than legally prescribed, several rulings and resolutions rejecting appeals, extending deadlines in orders and terminating proceedings against banks, and several letters to bank supervisory boards and management boards. As the misdemeanours authority the Bank of Slovenia issued one misdemeanours ruling, in the form of a caution. All the aforementioned material was discussed and approved by the Governing Board of the Bank of Slovenia.

Maintenance of regular contacts with senior management at banks and savings banks

In line with the Core Principles for Effective Banking Supervision, the Bank of Slovenia's Banking Supervision Department maintains regular contact with the management of banks and savings banks, through channels including regular annual meetings held at the completion of examinations or separately. These meetings are primarily devoted to assessing the operating results and position of the bank or savings bank in question and learning about its strategy for future development. The exchange of views and information between supervisors and the management of banking institutions is also a prerequisite for timely and appropriate action in the event of operating difficulties. Under the Banking Act, supervisors are obliged to safeguard confidential data and to uphold commercial confidentiality as a prerequisite for the exchange of information.

Supervision of third parties in the case of suspected provision of banking services without a Bank of Slovenia authorisation

The Bank of Slovenia's supervisory powers extend to other entities in the case of suspected provision of banking services without authorisation from the Bank of Slovenia. In 2006 Bank of Slovenia examiners visited one company suspected of issuing electronic money without a Bank of Slovenia authorisation. Several investigations were conducted at banks as a result of reports and complaints by members of the public and corporate clients.

Examinations of financial institutions in the rest of the world owned by Slovenian banks

Examiners at the Banking Supervision Department continued to examine banks and other financial institutions in the rest of the world that are owned by Slovenian banks in 2006. On the basis of memorandum of understanding (the Bank of Slovenia has a total of 11 memorandum of understanding with foreign supervisory institutions), Bank of Slovenia examiners participated in examinations of the operations of banks in the rest of the world under the majority ownership of NLB (three such examinations were conducted in conjunction with the host supervisors).

There were also three annual dialogues conducted with foreign supervisors at the Bank of Slovenia or at the registered offices of foreign supervisory institutions (the Federation Banking Agency in Bosnia-Herzegovina, the Banking and Payments Authority of Kosovo, and the FMA and National Bank in Austria).

The Bank of Slovenia continued to work with the two other supervisory institutions

Cooperation with the other two Slovenian supervisory institutions (the Securities Market Agency and the Insurance Supervision Agency) took the form of an exchange of information between the institutions. Given the different approach and examination methods used by each institution, there is little joint action by supervisors in the field. The rules on mutual cooperation between supervisory institutions regulate the cooperation between the Bank of Slovenia, the Securities Market Agency and the Insurance Supervision Agency. MoUs have been signed between the Bank of Slovenia and the two agencies, in line with these rules. Supervisory institutions are required to inform the relevant supervisory institution if they identify any infringements that fall under the auspices of other institutions.

3.7.1 Bank of Slovenia supervision of banks for operations in euros

Monitoring of bank preparations for the introduction of the euro

The Bank of Slovenia began monitoring banks' preparations for the introduction of the euro back in 2005. The method used to monitor preparations allowed for current monitoring and analysis of information from banks and savings banks, an appropriate level of information flow, and prompt, effective execution of the tasks. An internal methodology was drawn up before direct controls of banks were introduced.

Monitoring of bank preparations for the introduction of the euro

Three packages of direct monitoring of the entire banking system

In addition to the monthly monitoring of progress reports at individual banks, the Banking Supervision Department planned the execution of three packages of direct controls for the entire banking system. In the first package, which was carried out in 2005, the aim was to motivate banks, to explain the legal and regulatory requirements, and to issue the necessary recommendations in planning and monitoring the projected activities for the introduction of the euro.

Verification of implementation

In March and April 2006 the Banking Supervision Department examined the thoroughness of activities outlined in banks' internal planning, and the implementation of the recommendations made. Priority in examinations was given to delays in activities in progress (the adaptation of IT), which mostly arose as a result of the implementation of the IFRS, increased dependence on outside suppliers, and changing environmental requirements. During the examinations banks were given recommendations for improving the adaptation of information systems, guidelines for preparing for the direct changeover (the preparation and simulation of direct changeover) and requirements for drawing up alternative plans in the event of major operational interruptions.

Preparations for the introduction of the euro were completed in December 2006

A reassessment of the activities that had been due for completion by that time was made in September and October 2006. It was found that the majority of the adaptations had been successfully concluded. Banks participated successfully in testing the exchange of data with the banking environment, and continued with additional integrated testing. Any omissions were primarily the result of dependence on outside suppliers or temporary over-burdening of (human or technical) resources, but banks managed these to a satisfactory degree. In other areas too (legal and operational adaptations, logistics, employee training, PR), implementation was within the framework of banks' planning. It should be emphasised that the Banking Supervision Department's recommendations and guidelines were digested and implemented promptly. On the basis of monthly figures for exposure to critical business processes, the assessment at the beginning of October 2006 was that the banking sector was ready for the changeover. With the exclusion of the potential systemic risk that could be caused by major outside contractors and suppliers, the preparations of the introduction of the euro were practically complete by the beginning of December 2006.

Control of activities in the direct changeover to the euro

Successful implementation of the direct changeover to the euro

During the period of direct changeover (29 December 2006 to 3 January 2007), 24-hour verification of the current status of implementation at banks was organised to provide active monitoring and information about progress. Banks completed the changeover in line with their internal planning, which confirms that the preparations for introduction were well-founded, and the organisation and management of the direct changeover were successfully carried out.

Active monitoring of banking operations will continue with checks on the functioning of bank information systems under the new conditions (monthly processing) in 2007.

3.7.2 Prevention of money laundering

The prevention of money laundering is becoming an international challenge

Financial crime in connection with attempts to launder money is currently a major issue, while the risk of various forms of financial terrorism has been rising in recent years. An effective fight to prevent money laundering and other forms of financial abuses transgresses national boundaries, and facing up to this problem is increasingly a wider international challenge.

A systematic review of bank compliance with money laundering legislation

In line with this, the Bank of Slovenia continued with a systematic review of bank compliance with legislation in 2006, with the aim of discovering the situation in the Slovenian banking industry with regard to the ability of banks to manage risks in this specific field.

In general banks have established the systems to implement the legislation

On the basis of the reviews it can be stated that in general banks have established the legally required system to implement the legislation. The area where the most irregularities were still identified was the opening and closing of accounts for non-resident legal entities that do not trade or produce in the country in which they are registered, such as Delaware in the USA, the British Virgin Isles, and Nevis, while various irregularities were also identified in the treatment of non-resident individuals. In such cases the Bank of Slovenia took appropriate action.

The Bank of Slovenia feels that there is insufficient awareness of money laundering in Slovenia

However, banks still treat the issue of money laundering more as a legal obligation, with too little recognition of it as a form of operational risk. Bank of Slovenia assessments indicate that the Slovenian banking industry still displays a lack of awareness and an erroneous belief that there is little likelihood of money laundering occurring at banks in Slovenia, something that applies to both employees and senior management. In most cases the money laundering prevention system still only covers cash transactions, while the higher-risk area of transactions with foreign banks and other foreign legal entities still warrants insufficient attention.

The Bank of Slovenia actively participated in the review of the new Money Laundering Prevention Act, which should enter into force in 2007.

3.7.3 Information technology

Examinations in IT

Bank of Slovenia examiners made several thematic examinations of information technology at individual banks in 2006. The examinations concerned information systems, including banks' ability to manage the risks inherent in information systems, and the ability to manage the risks arising from weaknesses in their information systems. These risks may be credit or market risks from the failure to deal with clients in an integral manner, liquidity risk from poor monitoring of cashflows, and, not least, inaccurate reporting to the Bank of Slovenia.

The intensity of the risk is usually proportionate to the inconsistencies in the information system

Most banks face these risks, with their seriousness usually being related to the number of inconsistencies in the bank's information system, and the extent to which it is operated correctly and properly supervised. Examinations by Bank of Slovenia inspectors indicated that most banks in Slovenia were exposed to risks of this kind.

Information security

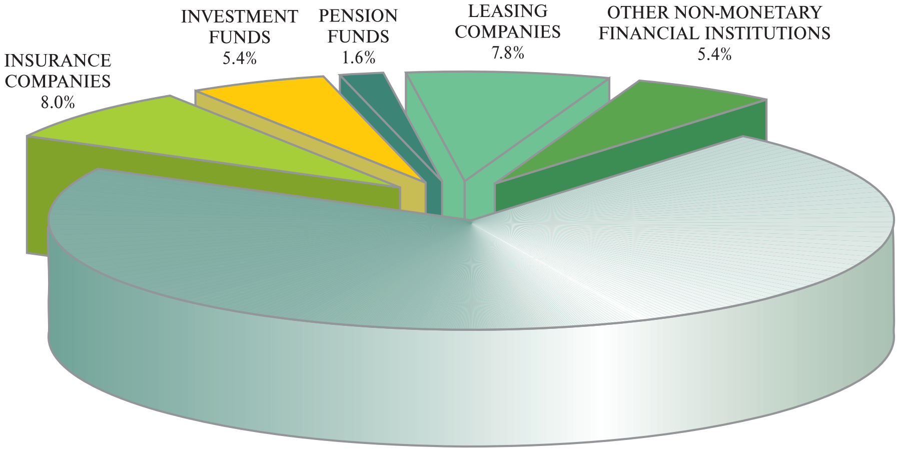
Another important field of information technology is data security. During examinations carried out in 2006, Bank of Slovenia examiners found that in practice no bank had yet fully established an information security system in line with the ISO 17799 standard. The projects are in progress, but a sufficient level of security has not yet been reached. The Bank of Slovenia feels that senior managers at banks should devote more attention to this issue. Computerisation of transactions means that banks are increasingly exposed to various attempts at fraud and other unauthorised uses or changes of data and information. The Bank of Slovenia will focus much attention on data security in the future.

4 FINANCIAL MARKETS

Monetary financial institutions dominate the Slovenian financial market

The Slovenian financial market is dominated by monetary financial institutions, which account for 71% of total assets. At the end of 2006, the non-monetary financial institutions comprised seven investment companies, 99 mutual funds, and 15 insurers (13 insurance companies and two reinsurance companies). At the end of 2006 the pension providers comprised seven mutual pension funds, four pension companies and two insurance companies. There were 12 investment firms and 18 banks among the licensed securities market participants.

Figure 28: **Financial intermediaries by total assets**



* Figures for the end of 2005.

Sources: Bank of Slovenia, Insurance Supervision Agency, Association of Management Companies, Securities Market Agency, Agency for Public Legal Records and Related Services

Investment companies' total assets were higher at the end of 2006

The total assets of investments companies stood at SIT 219.5 billion at the end of 2006, up 10% on a year earlier. One investment company converted into a mutual fund during the year. The total asset value of the mutual funds stood at SIT 462.2 billion at the end of 2006, up 39% on a year earlier.

Table 26: **Composition of Slovenia's financial system**

	2003		2004		2005	
Total assets	in mio SIT	in %	in mio SIT	in %	in mio SIT	in %
Monetary financial institutions	**5,122,664**	**72.8**	**5,711,052**	**70.7**	**7,017,970**	**71.7**
Non-monetary financial intermediaries	**1,909,862**	**27.2**	**2,369,229**	**29.3**	**2,769,961**	**28.3**
Insurance companies	588,753	8.4	684,426	8.5	782,750	8.0
Pension funds	78,384	1.1	113,979	1.4	160,614	1.6
Investment funds	439,181	6.2	499,966	6.2	532,027	5.4
Leasing companies	488,030	6.9	642,406	8.0	763,145	7.8
Others	315,514	4.5	428,453	5.3	531,424	5.4
Total	**7,032,526**	**100.0**	**8,080,281**	**100.0**	**9,787,930**	**100.0**

Source: Bank of Slovenia

Insurance companies are prevalent among non-monetary financial institutions

Insurance companies form the largest group among non-monetary financial institutions. The insurance companies' gross premiums written totalled SIT 429.5 billion in 2006, while their gross claims totalled SIT 246.1 billion. The claims ratio was thus 0.57. The insurance companies held SIT 731.4 billion of investments in the financial market as at the end of 2006. Investments in government securities and other debt securities were prevalent.

493,000 people covered by voluntary supplementary pension insurance

There were 493,000 persons covered by voluntary supplementary pension insurance as at the end of 2006 (52% of these via mutual pension funds). The mutual pension funds, pension companies and insurance companies collected a total of SIT 48.8 billion in premiums from voluntary supplementary pension insurance in 2006, 11% more than in the same period the previous year. The total value of investments held by pension providers at the end of 2006 was SIT 232.2 billion. The majority of their assets were invested in government securities and in other securities, with other debt securities prevalent among these.

The value of investments in the securities market increased

The importance of licensed securities market participants to the Slovenian financial market is evident in the value of the investments that come via these institutions. The total value of these investments as at the end of the first half of 2006 stood at SIT 2547.8 billion, an increase of 5% on the end of 2005.

At the end of December 2006, a total of 1,026 securities from 810 issuers were registered at the Central Securities Clearing Corporation (CSCC)

At the end of December 2006, a total of 1,026 securities from 810 issuers were registered at the Central Securities Clearing Corporation (CSCC), of which 899 were shares, 115 were bonds and 12 were bills. The market or book value of shares registered at the Central Securities Clearing Corporation at the end of 2006 was SIT 5,836 billion (83% of GDP). By far the most prominent share issuers were non-financial companies (79% of the total value), followed by banks (11%), other financial intermediaries (5%) and insurance companies (4%). The largest group of shareholders were non-financial companies (28%), followed by the government (18%), the general public (17%), non-residents (13%), other financial intermediaries (8%), banks (4%) and insurance companies (3%). The value of bonds registered at the Central Securities Clearing Corporation, by market or nominal value, stood at SIT 1,772 billion at the end of 2006 (25% of GDP). The most important bond issuer was the government (80% of the total value), followed by banks (13%), non-financial companies (6%) and insurance companies (1%). The main holders of bonds were banks (43%), then insurance companies (26%), non-residents (12%), the general public (6%), the government (4%), non-financial companies (4%), and other financial intermediaries (3%).

Total market capitalisation increased by 41%

At the end of December 2006, there were 215 securities from 129 issuers being traded on the Ljubljana Stock Exchange, of which 112 were shares, 93 were bonds and 10 were bills. Total market capitalisation rose by 41% in 2006 to SIT 4,514 billion, equivalent to 64% of GDP. Trading volume during 2006 was SIT 434 billion, down 2% on 2005. Just under half of the volume was in block trades. The largest volume was in shares (80%), followed by bonds (10%) and investment companies (9%). The most heavily traded shares during 2006 were Krka, Petrol, Mercator, Merkur and Gorenje. The SBI20, Slovenia's stock market index, rose by 38% over the year, while the investment fund index (the PIX) rose by 28%.

An increase in residents' investments in securities issued in the rest of the world

At the end of 2006 residents held SIT 1,329 billion in investments in securities issued abroad by non-residents (54% in bonds), up SIT 603 billion from a year earlier, and SIT 43 billion in investments in securities issued abroad by residents (80% in Slovenian government eurobonds). Residents held SIT 427 billion of debt securities issued on foreign markets, SIT 337 billion being held by the government.

A net inflow of investments by non-residents into securities

Investments by non-residents in Slovenian securities totalled SIT 194 billion in 2006, but taking the maturity of treasury bills into consideration the net inflow was just SIT 173 billion.

5 SLOVENIA'S ENTRY INTO THE EURO AREA

5.1 Meeting the conditions for entering the euro area

Slovenia meets conditions for the introduction of the euro

The ECB[17] and European Commission[18] convergence reports, which were published on 16 May 2006, confirmed that Slovenia met the conditions for the introduction of the euro. The European Council, consisting of heads of government and heads of state, agreed on 16 June, on the basis of these reports and the opinion of the European Parliament, that Slovenia should introduce the euro and join the euro area on 1 January 2007.

On 11 July 2006 the tolar-euro conversion rate was set at EUR 1 = SIT 239.640

On this basis, on 11 July 2006 the Council of Economic and Finance Ministers adopted a decision on the abrogation of the derogation as of 1 January 2007 and, at the proposal of the European Commission, supported by the opinion of the ECB, a decision on the irrevocable conversion rate between the tolar and the euro. This rate was equal to the central conversion rate, set upon Slovenia's entry into the ERM II on 28 June 2004 at SIT 239.640 to the euro. The setting of the final conversion rate and the decision on the abrogation of the derogation marked the beginning of the last stage of preparations for the introduction of the euro in Slovenia.

Slovenia's entry into the euro area a landmark for both Slovenia and the euro area

The decision to expand the euro area is a significant milestone both for Slovenia and for the euro area. Slovenia will be the first of the ten new EU member-states to join the euro area. For Slovenia, being in the euro area eliminates exchange rate risks within the euro area, increases the transparency of prices and costs, reduces transaction and information costs, and increases resistance to economic and financial shocks. For Slovenia the euro area thus represents a more stable environment, with a credible monetary policy, price stability and low interest rates. Given that after joining the euro area Slovenia is no longer able to pursue an independent monetary policy or exchange rate policy to achieve its economic objectives makes the effective pursuit of other economic policies all the more important, particularly in the areas of fiscal policy, structural reforms and competitiveness. Slovenia can make the most of the advantages afforded by the large currency area if it becomes fully integrated with it. Hence the importance of the ECB's calls to Slovenia to eliminate the remaining restrictions on the free flow of labour for workers from Slovenia into the countries of the Eurosystem. Open, competitive and flexible labour markets are particularly important to the functioning of the euro area and to the effective pursuit of a single monetary policy.

Fulfilment of the convergence criteria

Compatibility of the processes of nominal and real convergence

The economic trends in Slovenia in the last two years have combined good economic growth with the maintenance of the main macroeconomic equilibria. Thus the year-on-year harmonised index of consumer prices (HICP) had already dropped to 2.5% by the end of 2005, successfully concluding the transition disinflation process. It was more pronounced after the year 2000, and is the consequence of adjustments in economic policy, including the introduction of a new monetary policy framework,[19] the objective of which was to ensure a gradual

[17] Convergence Report , ECB, May 2006.
http://www.ecb.int/pub/pdf/conrep/cr2006sl.pdf
[18] Report from the Commission, Convergence Report 2006 on Slovenia, May 2006.
http://www.evro.si/en/slo-and-euro/documents/conv-report-comission-2006.pdf
[19] Monetary Policy Guidelines, Bank of Slovenia, November 2001.
http://www.bsi.si/publikacije-in-raziskave.asp?MapaId=284

yet sustained fall in inflation. The permanence and sustainability of the low inflation are the result of the compatibility of the processes of nominal and real convergence on the product, labour and capital markets with the maintenance of two key macroeconomic balances: the balance of payments and the fiscal balance. These processes were significantly affected by monetary policy by creating and maintaining interest rates at levels to curb inflationary expectations. The Bank of Slovenia conducted the process of nominal convergence of interest rates so as to complete it for the most part by the time of Slovenia's entry into the ERM II. It was thus able to maintain the stability of the exchange rate, required by the criteria for the introduction of the euro, after entry into the ERM II without any particular pressure.

Meeting the inflation criterion and possible risks in the future

The lasting fulfilment of the inflation criterion means that the Slovenian economy within the euro area and under the conditions of a single monetary policy is capable of keeping pace with the development of the euro area without becoming less competitive. There are still some risks on that path, stemming from the process of deepening financial intermediation and the variety of financial supply in the funding of development needs. In accordance with instructions from the ECB in the convergence report of May 2006, the risks are associated with relatively strong domestic demand, especially taking into consideration the rapid growth in lending and further convergence in interest rates. They are combined with risks related to the structural adjustments of administered prices and the secondary effects of the rise in energy prices on the potential rise in wages.

Meeting the fiscal convergence criteria…

Fiscal policy supported the process of real and nominal convergence. The general government deficit has been gradually declining in recent years, reaching 1.4% of GDP in 2006. Public debt has ranged from 28% to 29% of GDP in recent years.

…and the risks

The counter-cyclical pitch of fiscal policy will continue to be one of the key factors that can help maintain the macroeconomic balances, the competitiveness of the economy, and price stability. Under the Slovenian government's Stability Programme[20] of December 2006, a reduction in the structural government deficit is expected in 2009. In its assessment[21] of the Stability Programme, the European Commission stated the need to elaborate the measures required for reducing the deficit to the level of 1% GDP in 2009 more precisely. In the opinion of the Commission, this especially applies to the measures on the expenditure side that should compensate for the expected fall in revenue after the tax reform of 2007 and 2008, to the measures that the government intends to take in order to reduce general government expenditure by 2 GDP percentage points in 2009, and to the achievement of the medium-term target of reducing the government deficit by 0.25 GDP percentage points per year in the period from 2006 to 2009. In its assessment of the programme, the Commission also establishes the unsustainability of the public finance position in the long term, with Slovenia having been listed among the countries with the highest risk of an ageing population and the associated public finance consequences.

Trends in long-term interest rates

Meeting the Maastricht criterion for long-term interest rates is an indicator of confidence in the credible monetary and exchange rate policy of the Bank of Slovenia, and the general economic and fiscal trends in Slovenia. The ECB's Convergence Report states that the sustained convergence of Slovenia's long-term interest rates with the interest rates in the euro area, particularly in the

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20 Stability Programme, December 2006.
http://www.gov.si/mf/slov/tekgib/program_stabilnosti_2006.pdf

21 European Commission, January 2007.
http://ec.europa.eu/economy_finance/about/activities/sgp/country/commrc/sl/cr_si20062007.pdf

long term, is a major gain for the Slovenian economy, as it ensures relatively low real interest rates at low inflation. The main factors affecting this trend were the easing of economic and financial uncertainty as a result of sound public finances and monetary policy, and the narrowing of the inflation gap between Slovenia and the euro area. The narrowing of the spread in long-term interest rates was also favourably affected by the market expectations of the planned early entry of Slovenia into the ERM II and the relatively stable tolar-euro exchange rate after this. The convergence of interest rates was additionally boosted by expectations concerning the introduction of the euro.

ERM II entry exchange rate became the withdrawl rate for adoption of the euro

By the time Slovenia joined the ERM II, the convergence of interest rates had largely been completed. This made it possible to abandon the support of exchange rate policy for the process of convergence in tolar interest rates. The management of changes in the exchange rate in the period leading up to Slovenia's entry into the ERM II was aimed at covering part of the uncovered interest rate parity in order to maintain tolar interest rates at levels meeting the requirements of the disinflation trend. Slovenia entered the ERM II with an exchange rate of 239.640 to the euro, which was equal to the market exchange rate at the time that it joined this mechanism. A standard fluctuation band of +/-15% around the central rate was set. During its time in the ERM II Slovenia made no change to its central rate, and the market exchange rates between the tolar and the euro formed in its vicinity, with the exception of small deviations. The deviation of the market exchange rates from the central rate during the Slovenia's time in the ERM II exceeded 0.05% only exceptionally.

Legal convergence

Amendment of the Bank of Slovenia Act

On 30 March 2006 the National Assembly passed the Act Amending the Bank of Slovenia Act in order to meet the requirements of the Treaty and the Statute with regard to its integration into the Eurosystem. The main amendments concerned the independence of the central bank in managing foreign exchange reserves, the personal autonomy of the members of the Governing Board in accordance with the Statute of the ECB, the subordinate status of the secondary objectives of central banking as opposed to the primary objective of price stability, the ECB's approval for joint international action after the entry into the Eurosystem, and the definition of the operational conditions of the functioning of the Bank of Slovenia in the Eurosystem. The amendment also provided for the standard inscription of the name of the euro in legal documents.

In being harmonised with the Statute of the ECB for the purpose of Slovenia's full integration into the Eurosystem, the amended act also streamlined the management of the Bank of Slovenia. The organs of the Bank of Slovenia are the Governor and the Governing Board. The amendments reduced the number of Governing Board members from nine to five. At present, the members of the Governing Board are the Governor and four vice-governors. Under the act, the transition from nine to five members will be effected by not renewing the terms of the members when they end, until the number of members reaches five. The position of Governor is the only exception to that rule. All members are appointed by the National Assembly at the nomination of the president for a term of six years with the possibility of reappointment. The Governing Board decides by an absolute majority of all its members on all matters that are within its jurisdiction under the Bank of Slovenia Act and other legislation.

5.2 Conversion of tolar cash to euros and the conversion of accounts

Frontloading of euro banknotes and euro coins

Simultaneous introduction of euro deposit money and euro cash

Slovenia introduced euro deposit money and euro cash at the same time. It was the first country to introduce the euro under the “big bang” scenario. During the preparations for the introduction of euro cash, the Eurosystem provide the Bank of Slovenia from its own supplies with 94.5 million euro coins with a total value of EUR 2,175 million. For geographic and logistical reasons, the supplies were physically provided by Oesterreichische Nationalbank on behalf of the Eurosystem. The Finnish Mint, which had been selected through a bidding process, manufactured 296.3 million euro coins, with a value of EUR 104 million, for Slovenia.

The frontloading of eurocash for the banks began on 1 September…

The frontloading of euro coins for the banks began on 1 September 2006, and the frontloading of euro banknotes began on 11 December 2006, and they proceeded entirely in accordance with the timetables outlined in the amendments to the Euro Adoption Plan. By the end of December 2006, the Bank of Slovenia had frontloaded EUR 772.0 million in euro banknotes and EUR 83.2 million in euro coins into bank vaults. These amounts represented 41.5 million euro banknotes and 250.9 million euro coins, with €10 (35% of the total) and €20 (33% of the total) being the most common. The number of banknotes of the highest denomination (€500) was negligible compared with the total quantity of frontloaded banknotes. The most common coins were the 1-cent pieces (16% of the total number), while €2 pieces accounted for the highest proportion in value terms (39%).

… and for retailers on 1 December

Banks began supplying retailers with euro coins on 1 December and with euro banknotes on 11 December 2006. As part of the frontloading process, retailers received euro coin starter kits with an appropriate range of coins for the initial cash operations. Each kit had coins worth EUR 201. In this way, EUR 10.1 million in euro banknotes, EUR 8.8 million in euro coins and EUR 7.2 million in business starter kits were supplied from the vaults of banks and savings banks to the safes of various businesses. It was mainly large companies that signed agreements with banks and savings banks, while small companies, sole traders in particular, opted to purchase business starter kits for frontloading purposes. Starter kits went on sale to the public on 15 December 2006, each kit containing coins worth EUR 12.52. A total of 85% of the 450,000 supplied household starter kits and 46,725 starter kits prepared by the banks themselves had been sold by the end of December 2006, along with 82% of the collector’s sets.

ATMs

The cash changeover and the operation of ATMs went as planned

The main channel for the cash changeover in the first hours of the new year was provided by ATMs, from which clients were able to withdraw the desired amount of euro banknotes. Tolar banknotes could be withdrawn from ATMs until 9 pm on 31 December 2006, while a few minutes after midnight on 1 January 2007 it was possible to initially withdraw sums in euros in €10 and €20 notes. The operation of ATMs was suspended for more than three hours, from 9 pm on 31 December 2006 until several minutes after midnight on 1 January 2007. The reconnecting of ATMs to the network proceeded in accordance with the plans, and was even somewhat ahead of schedule. By 4 am on 1 January, about 72% of ATMs were dispensing euros, and by 3 pm about 92% were. During the morning banks opened designated branches where clients were able to convert tolars into euros. The cash changeover and the preparation of ATMs for the withdrawal of cash in euro banknotes were done primarily at the locations that are always available. The list of ATMs with the timetable for dispensing euro cash was announced in advance, and was published on the website of the Bank Association of Slovenia. On 1 and 2 January the cash changeover was also conducted by the designated bank branches. The Bank of Slovenia briefed the ECB about the progress of the cash changeover at regular intervals, and the ECB informed the public about developments. During the cash changeover, the European Commission also made progress assessments on the basis of an independent survey, making its findings public in press releases.

Banks had EUR 790 million in euro cash at their disposal immediately after the introduction of the euro, and EUR 687 million on 14 January. The value of the euro cash in circulation (without cash at banks) increased from the initial EUR 112 million to EUR 237 million during the same period.

Dual circulation

Period of dual circulation

During the period of dual circulation, between 1 and 14 January 2007, it was possible to make payments with both tolar cash and euro cash. Two weeks after the introduction of euro banknotes and euro coins, on 15 January 2007, the cash changeover was successfully completed in Slovenia as planned, and as of that date the euro entirely replaced the tolar as the sole legal tender. It remained possible to convert tolar banknotes and coins into euros at banks and savings banks at the conversion rate, free of charge, until 1 March 2007. Since 2 March, it has still been possible to change tolar banknotes at the Bank of Slovenia and some commercial banks free of charge, while coins can be changed until 31 December 2016.

Conversion of accounts

The end of the final business day with transactions in tolars (29 December 2006) marked the beginning of the planned closure of balances, conversion of accounts and changeover to payments in euros, which was completed as planned on the afternoon of 2 January 2007.

The Bank of Slovenia successfully transferred to the ECB the corresponding share of foreign exchange reserves and paid in the remaining amount of capital

After the end of business on 29 December, the Bank of Slovenia transferred to the corresponding share of dollar foreign exchange reserves to the ECB on 2 January, and the corresponding share of gold reserves on 3 January. On 30 December it converted all client accounts and security balances used as collateral for securing loans to ESCB banks. On 2 January it subscribed the remaining capital at the ECB and successfully tested the use of cross-border collateral for loans within the ESCB's correspondence central bank model.

The conversion of accounts at banks went without any problems

The closure of balance sheets for the 2006 financial year, the compilation of opening balances, the conversion of accounts and the changeover to payments in euros proceeded entirely as planned. By as early as 2 January all tolar balances had been correctly converted in all client accounts, and integration into payments proceeded without any problems. With volume very high, electronic channels were functioning somewhat more slowly, although without technical difficulties.

The transition to transactions in euros in capital markets went as planned

Upon the conclusion of their operations, the Central Securities Clearing Corporation (CSCC) and the Stock Exchange successfully converted files into euros, allowed members to check the conversion in line with their plans, and activated the offer of public services for transactions in euros. A successful changeover was also made by all investment firms, management companies and operations of mutual pension funds, which are supervised by the Securities Market Agency (SMA). Their redenomination of public-sector and private-issuer securities proceeded without complications.

5.3 Assessment of Slovenia's transition to the euro area

Event marking the end of dual circulation

At the end of the dual circulation period, on 15 January, the Slovenia government and the Bank of Slovenia held an event entitled The Tolar is Leaving, the Euro is Coming at the Cankarjev Dom Cultural and Exhibition Centre, which featured an exhibition entitled From Bronze to the Euro – A Brief History of Money in Slovenia. Mr Jean-Claude Trichet, president of the ECB, Mr Joaquin Almunia, European Commissioner for Economic and Monetary Affairs, Mr Jean-Claude Juncker, President of the Eurogroup, all the prime ministers and finance ministers of the Eurogroup countries, and the EU27 governors were among those invited to the celebrations. On the same day the Bank of Slovenia and the ECB held the Euro Conference Slovenia 2007 at the Union Hall, which was attended by Mr Trichet, Mr Almunia, Mr Juncker and the governors of the national banks of the ESCB.

Successful cash changeover

The euro cash changeover in Slovenia can be described as highly successful, an assessment confirmed by the ECB and European Commission.[22] All the activities were carried out as planned and without major difficulties. Specific disruptions that came to light and that did not substantially affect the changeover were immediately rectified wherever they occurred. The changeover also went smoothly at the banks, and the Introduction of the Euro Act was implemented without complications. The preparations, together with the supply of euro banknotes and euro coins, were carried out sufficiently early to prevent any shortages of euro cash. Neither was it necessary to modify the cash changeover scenario, which confirms that all the participants planned their activities in great detail, and that the Bank of Slovenia and the Slovenian government coordinated them effectively. This all confirms that the preparations for the introduction of the euro were fundamentally sound, the breakdown of business processes, which required adjustments, was precise, and the organisation of changeover management was effective.

Business and the public adjusted quickly to the new currency

The speedy changeover was also helped by the involvement of businesses and the general public, who responded favourably to the new currency and accepted it quickly. The number of cash withdrawals from ATMs also returned to the normal level in the first week of 2007, which means that transactions were conducted as usual. The speed of the changeover is also clear from the fact that as early as the end of the first day the value of euro banknotes in circulation was greater than the value of tolar banknotes.

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22 http://www.ecb.int/press/pr/date/2007/html/pr070116.en.html

6 OTHER ACTIVITIES

6.1 Management of international monetary reserves

The international reserves of the Bank of Slovenia are defined as:

- cash in foreign currency and foreign exchange holdings abroad
- gilt-edged securities from foreign issuers
- monetary gold
- holdings of SDRs and the reserve tranche at the IMF

Decline in the Bank of Slovenia's international monetary reserves

The international monetary reserves of the Bank of Slovenia fell from EUR 6,894.6 million to 5,420.0 million in 2006. The portion of the foreign exchange reserves for which the Bank of Slovenia has liabilities towards the domestic sector on the basis of subscribed foreign currency bills and foreign currency accounts held by banks and the government at the Bank of Slovenia fell by EUR 1,101.2 million in 2006, from EUR 1,689.6 million to EUR 588.4 million. The situation is similar with the other portion of the reserves, the net assets without foreign currency liabilities, which fell from EUR 5,205.0 million to EUR 4,831.6 million in 2006. These falls are mainly due to the decline in the stock of subscribed foreign currency bills, and the stock of foreign exchange swaps, which was zero at the end of 2006.

Table 27: **International monetary reserves and foreign exchange reserves of the banking system**

	BANK OF SLOVENIA							BANKS
	International monetary reserves					Including counter value of liabilities in foreign currency to residents*	Other external claims	Foreign exchange reserves
in EUR million	Gold	SDRs	Reserve position at IMF	Foreign exchange reserves	Total			
1994	0.1	0.1	15.3	1,206.5	1,222.0	708.0	84.2	1,046.0
1995	0.1	0.0	14.9	1,405.9	1,420.9	982.6	132.8	1,297.6
1996	0.1	0.1	14.9	1,837.9	1,853.0	1,032.4	27.2	1,488.4
1997	0.1	0.1	15.7	2,987.3	3,003.1	1,612.1	37.4	978.2
1998	0.1	0.2	55.8	3,048.5	3,104.6	1,580.3	40.0	1,031.2
1999	0.1	1.6	107.3	3,050.3	3,159.3	1,694.4	51.8	1,053.5
2000	0.1	4.0	88.5	3,343.3	3,435.9	1,862.8	62.4	1,361.2
2001	76.2	5.7	91.3	4,810.5	4,983.7	2,212.9	86.2	1,703.0
2002	79.9	6.7	115.9	6,578.9	6,781.4	2,523.8	81.3	1,263.2
2003	80.9	7.3	115.7	6,675.0	6,879.0	2,502.5	69.8	1,024.8
2004	77.8	8.2	87.9	6,367.9	6,541.8	2,351.5	74.2	1,116.4
2005	70.4	9.8	43.6	6,770.7	6,894.6	1,689.6	83.4	2,062.1
2006	78.4	9.3	27.8	5,304.5	5,420.0	588.4	77.6	2,700.4

* Subscribed foreign currency bills and foreign currency accounts of banks and government at the Bank of Slovenia.
Source: Bank of Slovenia

Management of the international monetary reserves of the Bank of Slovenia

The Governing Board lays down the basic rules for managing the international monetary reserves of the Bank of Slovenia on a quarterly basis, separately for each type of risk. Under the current criteria for managing credit risk, foreign exchange reserves may be invested in financial instruments with supranational, sovereign and banking risks, for which there exists a list of partner banks with allowable banking risk and limits on individual banks with regard to their credit ratings. The criterion for managing exchange-rate risk specifies that all the Bank of Slovenia's foreign currency liabilities must be entirely covered by claims in the same currencies. The currency structure and the limits on allowed fluctuations are precisely laid down for that portion of the reserves that does not have foreign currency counter-items on the liabilities side (net reserves). The criterion for managing interest-rate risk specifies the average modified duration of foreign exchange reserves and lays down the maximum allowable modified duration of an individual financial instrument. The criterion for managing liquidity risk specifies the minimum amount of liquid assets. The basic rules for managing international monetary reserves also set out the terms for lending bonds and other activities.

The management of international monetary reserves and changes in investment structure took place within these rules and with respect to the events and expectations of international financial markets. More detailed information on the structure of the international foreign exchange reserves .

6.2 Payments of Bank of Slovenia clients

6.2.1 Transactions for the government sector

Administration of budget user accounts

The Bank of Slovenia manages the treasury accounts of the government and municipalities

The Bank of Slovenia administers the government's single treasury account and 192 standard municipal treasury accounts, open in a number of currencies. The accounts of direct and indirect users of the national and municipal budgets, the Health Insurance Institute and the Pension and Disability Insurance Institute (included in the single treasury account system as set out in the Public Finances Act), were opened as sub-accounts of the government or municipal treasury accounts. The sub-accounts are managed by the Public Payments Administration, to which direct and indirect users of the national and municipal budgets present payment instructions and from which they receive the full set of return information about payments transacted.

In the second half of 2006, SIT 5,117.1 billion in inflows and the same in outflows were conducted through the government single treasury account and SIT 5,820.7 billion in inflows and SIT 5,822.1 billion in outflows through the municipal treasury accounts.

Special foreign currency accounts

In addition to the single treasury accounts, the Bank of Slovenia also manages 89 special foreign currency accounts for the government and other budget users.

International payments

The Bank of Slovenia conducts payments and other transactions for the state on the basis of the Payments Act.

The Bank of Slovenia sold EUR 126.6 million net of foreign currency to budget users

In 2006 the Bank of Slovenia transacted EUR 468.8 million in payments to the rest of the world, and paid out EUR 7.6 million in cash. EUR 513.1 million worth of remittances were made from the rest of the world, and EUR 0.9 million in foreign currency cash was repaid. A total of EUR 173.5 million in foreign currency was sold to budget users, and EUR 46.9 million in foreign currency was purchased from them. Analysis of the currency composition of inflows and outflows shows that 84.3% of inflows were in euros, 2.2% were in dollars, 13.4% in tolars, and a mere 0.1% in other currencies, while 70.5% of outflows were in euros, 7.7% were in dollars, 17.6% in tolars, and 4.2% were in other currencies.

Administration of accounts for foreign financial institutions and EU institutions

The Bank of Slovenia also administers foreign currency accounts for foreign financial institutions and EU institutions, via which foreign currency worth EUR 287.0 million was sold in 2006, with inflows of EUR 756.9 million and outflows of EUR 749.9 million.

Accounts of foreign financial institutions and EU institutions

Fiscal stamps, securities and cash

The Bank of Slovenia organised the issue, distribution and storage of general circulation and commemorative coins.

The Bank of Slovenia released into circulation 100,000 new bimetallic circulation-standard commemorative SIT 500 coins to mark the 250th anniversary of the birth of playwright Anton Tomaž Linhart. Between 1993 and the end of 2006, a total of 532.7 million coins were released into circulation (515.2 million by the end of 2005), worth a total of SIT 3.6 billion (SIT 3.5 billion by the end of 2005). The amount of coins in circulation rose by 3.4% in 2006. The proportion of the total value of cash in circulation accounted for by coins rose to reach 2.4% (compared with 1.6% in 2005).

New commemorative 500-tolar coin to mark the 250th anniversary of the birth of playwright Anton Tomaž Linhart

In 2006 commemorative coins were also issued to mark the 150th anniversary of the birth of Slovenian poet Anton Aškerc (a gold coin and a silver coin), and the 250th anniversary of the birth of playwright Anton Tomaž Linhart (a gold coin, a silver coin and a general circulation). In total 23,155 commemorative coins were issued at the Bank of Slovenia treasury and via commissioners (banks) last year (6,648 coins in 2005), comprising 5,692 gold coins (2,150 in 2005) and 17,463 silver coins (4,498 in 2005).

23,155 commemorative coins sold

The original Slovenian banknotes (the vouchers that preceded the tolar) are exchangeable at the Bank of Slovenia treasury without any time limit. The amount exchanged fell by 25.7% in 2006 (compared with a rise of 46.6% in 2005).

Original Slovenian banknotes are exchangeable at the Bank of Slovenia

A total of 5,844 treasury receipts and outlays of tolar cash and 23,473 incoming and outgoing payments of foreign currency for travel expenses and other needs of government bodies were made (compared with 5,139 treasury receipts and outlays of tolar cash and 20,983 incoming and outgoing payments of foreign currency in 2005).

6.2.2 Administration of accounts for the CSCC and CSCC members

The Bank of Slovenia administers a guarantee fund cash account and a fiduciary account for custodian services for the Central Securities Clearing Corporation. In addition, the Bank of Slovenia also administers the accounts of CSCC members through which cash settlements are made for securities transactions. At the end of 2006 there were 24 CSCC members, 12 commercial banks and 12 investment firms, with open transaction accounts for customer assets and clearing accounts at the Bank of Slovenia.

Guarantee fund cash account and fiduciary account

In 2006 SIT 1,296.2 billion in inflows and SIT 1,293.8 billion in outflows were conducted through the CSCC account and CSCC member accounts.

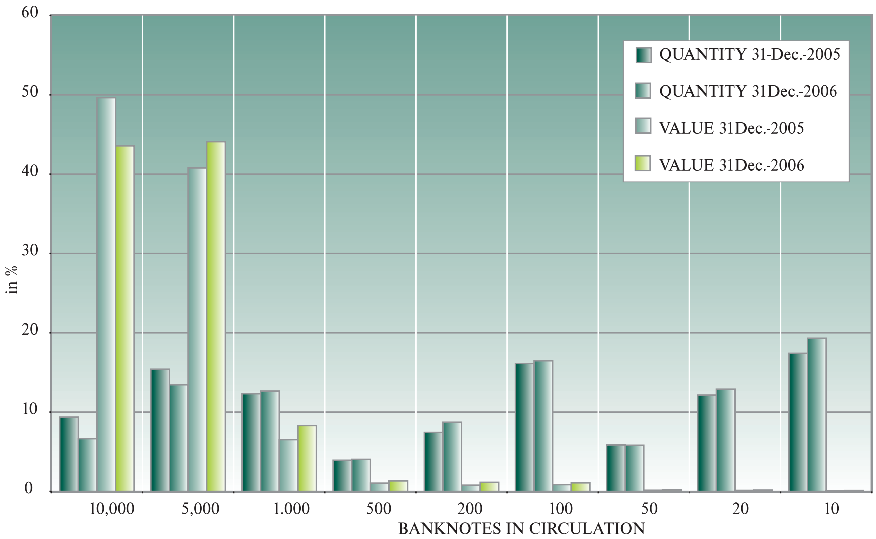
6.3 Cash Operations

In line with its legal powers, the Bank of Slovenia ensured a smooth supply of tolar banknotes to government.

Huge decline in the value of banknotes in circulation

As at 31 December 2006 there were 97.9 million banknotes in circulation with a total value of SIT 149.2 billion (including cash at banks). The value of banknotes in circulation was down 30.2% on 2005, while the quantity of banknotes in circulation was down 13.5%. The main reason for the decline in banknotes in circulation is that Slovenia joined the euro on 1 January 2007. At the end of 2006 banknotes accounted for 97.6% of the value and 15.5% of the quantity of cash in circulation. In terms of value, the most important denomination was the 5,000-tolar note, although the value of these banknotes in circulation had declined. The 10,000-tolar note accounted for 43.6% of the value of banknotes in circulation in 2006, compared with 49.6% in 2005. The value of the 5,000-tolar notes had also declined to account for 44.1% of the value of banknotes in circulation, compared with 40.8% in 2005. These two banknotes were the system's main denominations in cash transactions. The 1,000-tolar note accounted for 8.3% of the value of banknotes in circulation, compared with 6.5% in 2005. The average value and number of 10-, 20- and 50-tolar notes also fell, primarily as a result of the replacement of these banknotes with coins of equal value.

Figure 29: **Banknotes in circulation by volume and denomination**



Source: Bank of Slovenia

62.6 million banknotes and coins counted by the money counting unit

The Bank of Slovenia money counting unit counted 62.6 million banknotes and coins (69.2 million in 2005), comprising 56.0 million banknotes and 6.6 million coins (62.6 million banknotes and 6.6 million coins in 2005). A total of 54.8 million banknotes (compared with 13.1 million in 2005), of which the largest group was 5.9 million 5000-tolar notes, were taken out of circulation and destroyed in order to maintain the quality of the banknotes in use.

Supply of government with tolar cash

Tolar cash was supplied to government through the Bank of Slovenia's banknote depots at five commercial banks, for which the Bank of Slovenia set a quarterly treasury maximum and checked their operations on a daily basis. All these depots operated in accordance with the rules, and no irregularities in their operations were identified last year.

Given the planned introduction of the euro in Slovenia on 1 January 2007, the Bank of Slovenia did not print any new banknotes in 2006.

2,932 counterfeit tolar banknotes, 2,629 counterfeit foreign banknotes and 999 counterfeit foreign coins examined

The Bank of Slovenia examined 2,932 counterfeit tolar banknotes discovered and seized in Slovenia in 2006 (compared with 652 in 2005, an index of 349.7). The value of the counterfeit tolars in 2006 was 0.161 ‰ of the cash in circulation (SIT 24.1 million, compared with SIT 2.4 million in 2005). Most of the counterfeit notes, in terms of both volume and value, were in the three major denominations (10,000, 5,000 and 1,000 tolars). The Bank of Slovenia's work against counterfeiting included cooperation with the Ministry of the Interior (National Analysis Centre – NAC and the Coin National Analysis Centre – CNAC) as well as the ECB, the EU, Interpol and Europol. In 2006, according to figures from the Forensic Investigation Centre at the Ministry of the Interior, 2,692 counterfeit euro banknotes (1,058 in 2005 – index 248.5) and 999 counterfeit euro coins (568 in 2005 – index 175.9) with a total value of EUR 652,449.50 (index 675.1) were found in Slovenia in 2006. The most frequently counterfeited notes were the €500 and €100.

In the Eurosystem there were 49.78 counterfeits per million genuine banknotes in circulation in 2006

The counterfeiting of tolar banknotes is not a major problem in Slovenia. (There were 7.5 counterfeit banknotes per million banknotes in circulation in 2006, compared with 4.9 counterfeit banknotes in 2005, while in the Eurosystem there were 49.8 counterfeit banknotes per million euro banknotes in circulation in 2006, compared with 56.2 counterfeit banknotes in 2005.)

Table 28: **Cash in circulation**

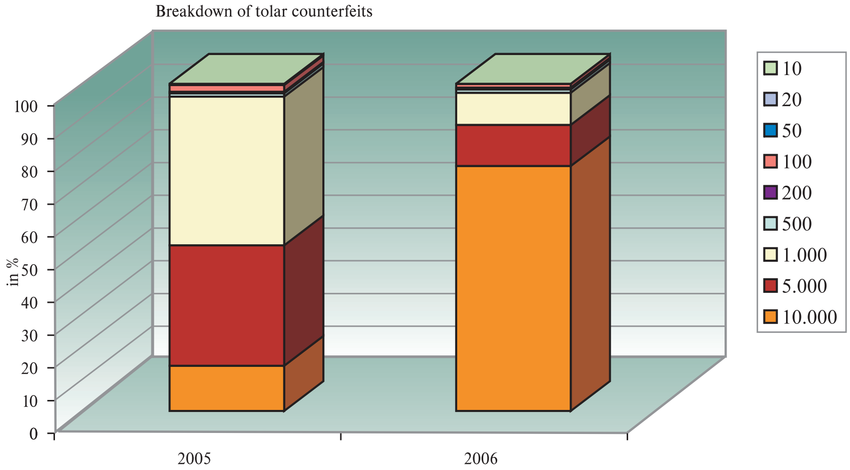
in SIT billion	Banknotes in circulation	Coins in circulation	Total cash in circulation
1996	71.4	0.4	71.9
1997	85.7	0.5	86.1
1998	104.7	0.6	105.2
1999	142.5	0.6	143.1
2000	139.6	0.8	140.4
2001	165.8	1.0	166.8
2002	172.1	1.4	173.4
2003	186.0	1.9	187.5
2004	195.4	2.8	198.1
2005	214.2	3.5	217.7
2006	149.6	3.6	153.2

Note: Figures as at 31 December.
Source: Bank of Slovenia

The value of confiscated counterfeit money is rising

Compared with 2005, 2006 saw a considerable rise in the amount of counterfeit domestic cash (up 349.7%), a significant rise in the number of counterfeit euro banknotes (up 148.5%) and an increase in the number of counterfeit euro coins (up 75.9%). The Ministry of the Interior sent the Bank of Slovenia the following counterfeits for examination: 2,194 10,000-tolar notes, 370 5,000-tolar notes, 287 1,000-tolar notes and 81 other denominations.

Figure 30: **Comparison of examined counterfeit banknotes in 2005 and 2006**



Source: Bank of Slovenia

Most counterfeit banknotes lack a watermark, coloured security fibres...

Compared with the previous year, the number of counterfeit 10,000-tolar notes rose by 2,337.8% (in 2005 it fell by 76.2%), and the number of counterfeit 5,000-tolar notes rose by 54.2% (in 2005 it fell by 57.5%), while the number of counterfeit 1,000-tolar notes fell by 3.0% (in 2005 it rose by 26.5%).

The quality of tolar counterfeits in 2006 was not significantly different from those in 2005. They are primarily counterfeit attempts with the aid of computer technology (scanners, computers and printers). The counterfeits are printed on commercial paper, and in most cases have no security features (e.g. watermark, coloured security fibres, security strips, fluorescent features).[23] Only the foreign counterfeits confiscated showed any discernible improvements in quality.

Cash supply

Banknotes are supplied to government through the Bank of Slovenia's five banknote depots at five commercial depositary banks, while coins are supplied through coin depots.

The banknote depots are mostly supplied with cash from the regular cash operations of banks and savings banks that use their services.

The immediate depot users have entered into agreements with depositaries for the use of the services of the banknote depots, while other banks meet their needs for banknotes through purchases and sales at depositaries (the banknote retail market).

After the accounts of legal entities are transferred to banks, banks collect and pay out all cash to legal entities. Banks receive cash from clients, and the supply of banknotes at the distribution points of the central bank (the banknote depots) thus performs the function of servicing surpluses or deficits of operating cash.

[23] A comparison of examined counterfeit tolar banknotes in 2005 and 2006 is shown in Figure 30.

6.4 Payment systems

6.4.1 Preparations for the introduction of the euro for payment and settlement systems

TARGET

Activities linked to participation in TARGET

The Bank of Slovenia joined TARGET through remote participation in German real-time gross settlement system as early as 2004, while 16 Slovenian banks and one savings bank joined this system in 2005. However, this mode of participation (although adequate for the settlement of payments in euros), which the TARGET Guideline allow, did not fully meet the requirements for the introduction of the euro, which necessitated a number of activities in this area. The activities in 2006 linked to the Bank of Slovenia's participation in TARGET primarily involved the preparation of in-house procedures associated with the full participation of the Bank of Slovenia as a Eurosystem central bank in TARGET, the preparations by four other Slovenian participants (one bank, two savings banks and the CSCC) for participation in the system, and cooperation with the ECB in adjusting the legal basis of the system to the selected method of participation. All the banks and savings banks also had to prepare for settling domestic payments within the system as of 1 January 2007, the real-time gross settlement (RTGS) system for tolars ceasing to operate as of that day.

TARGET2 will replace TARGET

Based on the options offered by the ECB, and a decision by the Governing Board, the Bank of Slovenia did not establish its own real-time gross settlement system to be linked to TARGET, the Bank of Slovenia and the Slovenian banks instead joining TARGET through a foreign (German) real-time gross settlement system integrated into TARGET. This decision had an economic rationale as the Bank of Slovenia's own system of this type would be in operation for less than one year, from the entry into the Eurosystem until the changeover to TARGET2, which will replace the current system.

Harmonisation of the securities settlement system

Preparations for the adoption of the euro were also made with regard to the securities settlement systems, with the continuing assessment of the eligibility of the CSCC system. In accordance with the Statute of the ESCB, all ESCB credit operations must be secured with eligible collateral, including securities booked in the register of eligible securities settlement systems. For this reason securities settlement systems that are used in Eurosystem credit operations must be harmonised with the requirements of the ECB standards for the use of securities settlement systems in ESCB credit operations.

CSCC securities settlement system

Compliance assessment of the CSCC securities settlement system

Accordingly, a formal assessment of the compliance of the CSCC securities settlement system for use in ESCB credit operations began as early as September 2005. By the end of 2005, the Bank of Slovenia, in its role as primary assessor, had prepared its own formal assessment of the CSCC system for the ECB, using the CSCC's self-assessment as the basis. In the first half of 2006 a formal compliance assessment of the CSCC was also prepared by the ECB, and the final assessment report was confirmed by the ECB's Governing Council in October 2006. Based on this, the CSCC was included in the list of systems eligible for use in Eurosystem credit operations, which means that eligible securities entered in the CSCC register can be used as collateral for liabilities to the Eurosystem by any Eurosystem counterparty.

Correspondent central banking model (CCBM)

Providing technological support for the CCBM

In 2006, as part of the project for establishing a new collateral system, the Bank of Slovenia also continued working on establishing technological support for the correspondent central banking model (CCBM), which had to be done when Slovenia joined the Eurosystem. The CCBM makes the cross-border use of financial assets as collateral possible for credit institutions within the ESCB, which is in keeping with the requirement that all eligible collateral for Eurosystem credit operations be available to borrowing credit institutions, irrespective of where in the euro area the collateral is located.

Upgrading the CCBM

Technological support for the CCBM was thus established in the first half of the year, which facilitated the cross-border use of marketable financial assets (securities). All the required testing was also done within this framework, including the mandatory tests with foreign central banks, on the basis of which the ECB confirmed the readiness of the Bank of Slovenia to adopt the euro. In the second half of the year the technological support for the CCBM was upgraded with the support for the use of cross-border non-marketable financial assets (credit claims) as collateral. The project was carried out simultaneously at all the central banks of the ESCB and, after renewed testing among the central banks, was completed by the end of 2006.

Final establishment of the CCBM

The support established for the CCBM allows Slovenian credit institutions to use foreign financial assets as collateral, while allowing foreign financial institutions to use Slovenian financial assets as collateral at their own central bank.

Monitoring preparations for the introduction of the euro in the banking sector

In 2006, in addition to the activities it was responsible for, the Bank of Slovenia also monitored preparations for the introduction of the euro in the banking sector, particularly in i) the operation of ATMs, ii) the processing of card payments, iii) the introduction of new standards for payment instruments (a special payment order, a special paper-based debit order and a credit order), and iv) the testing of the procedures and business processes of banks and state institutions through payment systems. The Bank of Slovenia provided for constant supervision, the monitoring of preparations, and active mediation through regular monthly reporting by participants in these preparations, i.e. the card and ATM processing centres, the Bank Association of Slovenia, banks and savings banks, and government institutions. Particular attention was focused on the preparation of ATMs for issuing cash in the new currency, and on processing of card payments in tolars until 31 December 2006 and in euros from 1 January 2007.

6.4.2 ESCB Projects

Preparations for participation in TARGET2

Participation in the establishment of the TARGET2 system

In 2006, the Bank of Slovenia, as part of its participation in the working bodies of the ESCB, participated in the definition of a new trans-European payment system, TARGET2, which will replace the current TARGET system. The changeover to the new system will be made gradually, according to pre-defined groups of countries, and will last from November 2007 until May 2008. The Bank of Slovenia and Slovenian banks will join the new TARGET2 system at the time of its establishment, i.e. on 19 November 2007.

Advantages of the TARGET2 system

In contrast to the current TARGET system, TARGET2 will be technologically centralised, thereby eliminating the shortcomings of the current system, primarily the high costs of management and uneven standards, i.e. the functionality of individual systems. Centralisation will eliminate these deficiencies. In addition, TARGET2 will provide users with modern mechanisms for effective liquidity management.

Technological centralisation of the TARGET2 system

Centralisation in the TARGET2 system is of a purely technological nature as business relationships between the central bank and commercial banks will remain at the national level even under TARGET2. As part of the TARGET2 project, central banks have the duty to ensure that banks are ready to join TARGET2.

Preparations for TARGET2

The activities of the Bank of Slovenia related to its participation in TARGET2 in 2006 mainly concerned the preparations of the banking sector for joining TARGET2 in the form of workshops, as the Bank of Slovenia is responsible to the Eurosystem for ensuring that Slovenian banks are ready on schedule. A business model for the operation of the Bank of Slovenia as a central bank through the TARGET2 system was also defined.

TARGET2 – Securities

Decision on introducing TARGET2-Securities

In July 2006, the ECB's Governing Council decided to explore, together with other European central clearing houses and market participants, the possibilities of creating a new, centralised European securities settlement infrastructure under the name TARGET2-Securities (T2-S). On the basis of preliminary talks and consultations between the parties concerned (the meetings organised by the ECB were also attended by the CSCC and a representative of Slovenian banks, in addition to the Bank of Slovenia), the Governing Council decided in October that by the end of February 2007 the Eurosystem should prepare a feasibility study for the T2-S project, which the Governing Council will use as the basis for making decisions on the future of the project.

Operating functions of T2-S

TS-2 entails a unified technical platform for the settlement of transactions involving securities through simultaneous security and cash settlements in euros in central bank money. This effectively means that it takes over the settlement function from the central securities depositories, and centralises it on a unified platform. By establishing T2-S, the Eurosystem intends to promote the integration of securities settlement infrastructures in the EU (which makes possible the integration of securities markets as the final goal), and to bring about an increase in the effectiveness of securities settlements (especially between countries or different central securities depositories) and thus a reduction in existing costs and risks. A final decision regarding the establishment of T2-S is scheduled for the summer of 2007.

Beginning of activities related to T2-S in July 2006

The Bank of Slovenia embarked on activities related to the T2-S project in July 2006, and since October has actively participated in the Eurosystem working group in charge of the preparation of the project feasibility study. As part of its activities at the national level, the Bank of Slovenia briefed the Slovenian banking sector and the CSCC on the project back in September, and subsequently the Ministry of Finance.

Single Euro Payments Area (SEPA)

Harmonisation of non-cash payments within the euro area

The introduction of the euro made cash payments within the euro area uniform, but there are still considerable differences between individual countries with regard to non-cash payment transactions both in the area of tariffs and in business practices as such. The concept of the Single Euro Payments Area (SEPA), was created as part of adaptation to the requirements of EC Regulation 2560/2001 concerning cross-border payments in euros, which set the requirement for equalising tariffs for payments of the same type within a country and cross-border payments in euros at an individual provider of payment services, and it comprises not only a unification of tariffs but, in particular, harmonisation in the area of business practices among individual countries, which should promote competition and a consolidation of the existing payments infrastructure.

Purpose of the introduction of SEPA

The ultimate goal of the SEPA is to eliminate the difference between payments in euros within a country and cross-border payments in euros, which means that consumers and companies within the euro area will be able to make non-cash payments from a single account and by using a single set of payment instruments as simply, effectively and safely as they can make payments within their national borders today. At the beginning, the establishment of the SEPA was planned within the euro area, while in the final stage it should cover the entire EU and four more countries (Switzerland, Iceland, Liechtenstein and Norway). The deadline for achieving a critical mass of new SEPA instruments is the end of 2010, and as early as 1 January 2008 clients and companies should also be able to use SEPA instruments for making domestic payments. The next step is the gradual migration from existing payment instruments to SEPA instruments, and a critical mass of clients and companies are expected to use them by the end of 2010. This process will also bring about a consolidation of the existing infrastructure for the processing of payment instruments in the sense of its gradual abandonment and a transition to a SEPA-compatible payment infrastructure.

Formulation of solutions for eliminating operational and technical barriers

Under a plan drawn up at the level of the European Payments Council (EPC), the ECB and the European Commission, the conclusion of the formulation of the solutions and of preparations for their implementation was planned for 2006. Within this framework, the EPC, which represents the European banking sector, finalised the formulation of schemes for SEPA credit payments and direct debits, which will form the basis for the development of payment products and services at banks, and a SEPA card framework and a framework for the clearing and settlement mechanisms, together with a definition of standards. Along with these activities, which were aimed at eliminating the operational and technical barriers that today separate national markets from each other, for the elimination of legal barriers the European Commission also drafted a proposal for a directive on payment services in the internal market.

Establishment of working groups for SEPA

The Bank Association of Slovenia became a member of the EPC in 2004, and in 2005 BAS representatives were also able to participate in EPC working and support groups. In 2006, in accordance with the need for more activity in the SEPA area, an organisational structure was established for supporting SEPA programmes at the domestic level: working groups for SEPA instruments and cash and a support group for SEPA standards were set up within the BAS, in accordance with the organisation of the EPC. Members of the groups are representatives of commercial banks, and Bank of Slovenia representatives also participate as observers.

SEPA national plan

The work within these BAS working groups was mainly aimed at preparing the SEPA national plan, the purpose of which is to define the activities by which Slovenia will join the SEPA in greater detail. By the end of the year the draft of the plan had been prepared, comprising, in addition to the aforementioned organisation for achieving SEPA objectives, the plan for adapting the existing payment schemes and infrastructure to SEPA requirements. Approval of the SEPA national plan by the BAS's supervisory board was planned for the beginning of 2007.

Draft directive on payment services in the internal market

Directive on payment services on the internal market

In December 2005, the European Commission submitted a draft directive on payment services in the internal market to the EU Council and the European Parliament for adoption, and to the European Economic and Social Council (ECOSOC) for formal consultation. The directive should provide an integral legal basis for regulating relationships between providers and users of payment services, and should ensure uniform conditions for the provision of payment services in the EU. With regard to the internal market, the proposal sets market entry requirements for non-bank providers of payment services, thus establishing the right of payment institutions to offer payment services to the public, and introduces clear and detailed information requirements to be met by all providers of payment services, at the same time defining the rights and obligations of users and providers of payment services. This should ensure the harmonisation of national regulations with regard to the conditions for providing payment services, and thus the provision of payment services in the entire EU area under the same conditions.

Coordination of views on the draft directive

The initial goal was to complete the process of final harmonisation in the working bodies of the Council and Parliament and the consultation process in 2006, and to adopt the directive before the end of 2006. Member-states would thus have enough time (18 months according to the latest proposals) for passing the laws and secondary legislation required for harmonising national legislation with the provisions of the directive even before the end of 2008. That is the time scheduled for the beginning of the implementation of the first stage of the SEPA project, to which the directive is closely linked, as it provides a harmonised legal basis for payment services. This timetable was not realised, as in 2006, in addition to debate about opinions received from the ECB, ECOSOC and the numerous parties concerned, member-states were also coordinating their differing views on numerous questions regulated by the draft directive (the Bank of Slovenia was involved in debate about the text of the directive, along with the Ministry of Finance), including the establishment and regulation of a payment institution as a non-banking entity to provide payment services throughout the EU, under the aegis of the freedom to provide services and the freedom of establishment. At the end of November 2006, ECOFIN called on the incumbent and subsequent presiding members of the EU to advocate the quickest possible reaching of a consensus that would enable the Council and Parliament to adopt the directive in the first reading.

6.4.3 Oversight of payment systems

Responsibility of the Bank of Slovenia for oversight of payment systems

Under the Bank of Slovenia Act and the Payment Transactions Act, the Bank of Slovenia is responsible for the oversight of payment systems. The objective of this oversight is to protect the financial system from possible systemic consequences if one or more payment system participants has financial difficulties, and to ensure the operational safety and efficiency of payment systems.

Formalisation of payment system oversight

The Bank of Slovenia formalised the oversight of payment systems through internal bylaws, proceeding from the requirements of the legal framework, the Core Principles for Sistemically Important Payment Systems, which were issued by the Bank for International Settlements in 2001 and were approved by the Governing Board of the Bank of Slovenia as the basis for oversight, and the ESCB guidelines in this area. Particular emphasis was given to properly separating the functions of payment system operations and payment system oversight. An oversight methodology was also drawn up based on the ECB methodology for oversight of the TARGET system.

Oversight of payment systems

In 2006 the Bank of Slovenia, in accordance with its responsibilities, oversaw payment systems on the basis of regular and extraordinary reports by operators of payment systems in Slovenia, who have a duty to submit such reports to the Bank of Slovenia. The operators' reports concern the regular operation of the systems and any planned or unplanned deviations, as well as changes in the concept of the functioning of payments systems. The Bank of Slovenia also followed up the implementation of recommendations made to payment system operators on the basis of previous on-site examinations for adapting payment systems to the requirements of the legal framework and the guidelines of the Core Principles, on the basis of regular quarterly reports from system operators in connection with the implementation of the recommendations.

6.4.4 Payment systems statistics

Managing the RTGS and Giro Clearing systems

In 2006 the Bank of Slovenia operated the RTGS and Giro Clearing systems, and through the single entry point it also granted banks access to the STEP2 pan-European payment system, which makes it possible to process cross-border low-value payments in euros.

The number and value of transactions increases through RTGS

In 2006 a total of 1,567,213 transactions were settled through the RTGS system, with a total value of SIT 76,107.59 billion, a rise of 11.63% in the number of transactions and 21.40% in the value of transactions compared with 2005. On average, 6,294 transactions were settled daily, the average value of which was SIT 48.56 million. On 31 December 2006 the RTGS system was discontinued as a result of the introduction of the euro as the national currency and the resulting full participation of the Bank of Slovenia in the TARGET system.

Increase in the threshold for low-value payments in the STEP2 system

The Giro Clearing net settlement system, the second most important inter-bank payment system, processed 52,108,939 transactions in 2006, with a total value of SIT 5,493.42 billion, a 5.44% increase in the number and 9.28% increase in the value of transactions compared with 2005. The net settlement value of these payments via the RTGS system was SIT 1,078.40 billion, or 19.63% of the gross value of transactions, meaning a netting ratio of 80.37%. On average 209,273 transactions were processed daily, with an average value of SIT 105,421.75.

Increase in the threshold for low-value payments in the STEP2 system

As of 1 January 2006, the threshold for small-value payments was raised from EUR 12,500 to EUR 50,000 in the STEP2 system, which resulted in a significant increase in the number and even more in the value of processed inflow and outflow transactions submitted by banks to the single entry point of the Bank of Slovenia. In 2006, a total of 502,108 outflow transactions and 350,195 inflow transactions were processed via the single entry point. The value of outflows was EUR 3,215.52 million, and the value of inflows EUR 1,441.53 million.

6.5 Statistical system

Basis for statistical functions

The Bank of Slovenia provides statistical functions as a member (of the ESCB) on the basis of the Statute of the ESCB and ECB as one of the authorised producers of national statistics, implementing the Slovenian statistical research programme under the national statistics act, and on the basis of other authorisations.

Main areas in monetary, financial and balance-of-payments statistics

The Bank of Slovenia's main statistics work covers wide areas of monetary, financial and balance-of-payments statistics. It is also increasingly involved in statistical processes in the field of public finances and general economic statistics.

Purpose of the statistical activities of the BS

The statistical activities of the Bank of Slovenia in 2006 served the purpose of informing the domestic and foreign public about financial and macroeconomic trends in Slovenia, data support for the monetary policy of the Bank of Slovenia and national economic policy, and statistical cooperation with international organisations and institutions, primarily the IMF, the ECB and Eurostat (the European statistical office within the European Commission).

Completion of statistical preparations for integration into the euro area

By the performance of regular statistical tasks in cooperation with the ECB and Eurostat, the establishment of regular statistical production and extended time series for integration into the aggregates of the EU and the EMU was gradually completed in 2006. The statistical obligations of the Bank of Slovenia for joining the EMU were fulfilled in a timely manner to a sufficient degree.

Memorandum of understanding in the area of macroeconomic and financial statistics with the MoF and the SORS

The fulfilment of statistical requirements for memberships in the EU and the EMU has in recent years been significantly supported by successful cooperation with the Ministry of Finance and the Statistical Office of the Republic of Slovenia on the basis of the Memorandum of understanding in the field of macroeconomic and financial statistics, signed in 2004. The conclusion of a MoU based on and following the example between the ECB and Eurostat was needed for the purpose of coordinating competences and responsibilities due to the increasing burden of statistical requirements and interdependence among individual statistics. The memorandum set out the responsibilities of individual signatories and the way of cooperation between them in submitting Slovenian macroeconomic and financial statistics to the European Commission, Eurostat and the ECB. The subject of the memorandum includes cooperation in maintaining standard classifications of institutional sectors as a particularly important feature in the provision of macroeconomic and financial statistics. The official sector classification is managed by the Agency for Public Legal Records and Related Services (the APLRRS) as part of the Business Register of Slovenia.

Statistical data basis

The Bank of Slovenia is responsible for producing a complex set of financial accounts and monetary and balance-of-payments statistics. These statistics are mainly based on figures from direct and indirect reports by banks and companies and from balance of payments figures compiled by the Statistical Office of the Republic of Slovenia (SORS), in cooperation with the Customs Administration of the Republic of Slovenia (CARS). The Bank of Slovenia also collects, compiles and publishes statistics on modern payment instruments, financial markets etc.

Direct reporting of data for financial accounts proceeds through the APLRRS

The direct reporting of quarterly data for financial accounts through the APLRRS continues with great success. Based on figures submitted to the Bank of Slovenia through the APLRRS, financial accounts were prepared in 2006 for the last quarter of 2005 and for the first, second and third quarters of 2006.

First submission of quarterly financial account data to the ECB

In May 2006 quarterly financial account data were submitted to the ECB for the first time in accordance with ECB regulations (Guideline of the ECB amending Guideline ECB/2002/7 on the statistical reporting requirements of the ECB in the field of quarterly financial accounts (ECB/2005/13). Also in 2006, quarterly data for the financial accounts of the general government sector were submitted to Eurostat and the ECB for the first time (Regulation of the European Parliament and Council (EC) No. 501/2004).

Audit of financial accounts for the 2001 to 2006 Q3 period for the purpose of ensuring consistency with other statistics

The audit of financial accounts data for the period from 2001 until the third quarter of 2006 began in 2006. The main reasons for the audit were the changes in the methodology and concept of composition of financial accounts, and changes in other statistics (balance of payments / IIP, general government statistics, non-financial accounts). The purpose of the audit is to ensure quality data and consistency with other statistics.

Adjustment to the introduction of IFRS and the transition from national to coordinated monetary statistics

In the statistics of financial (including monetary) institutions and markets, reporting by other monetary financial institutions was in accordance with Regulations ECB/2001/13 and ECB/2001/18 adjusted to the introduction of the IFRS in the spring of 2006. After the changeover to the IFRS, only the time series of harmonised monetary statistics (including harmonised monetary aggregates) were still kept, which are compiled simultaneously with national monetary statistics from the end of 2004. This also resulted in changes in the corresponding set of tables in the bulletin and on the Bank of Slovenia website.

Fluctuations in the quality of data received in 2006

At the beginning of 2006, superfluous individual reports, both statistical ones and those concerning the supervision of banking operations, were discontinued on the basis of a common single report on interest rates for different purposes. A great deal of attention in 2006 was paid to the elimination of fluctuations in the quality of data received from reporting agents due to the introduction of the IFRS and preparations for the introduction of the euro.

Establishment of new reports of financial institutions and markets for the ECB

Moreover, in the statistics of financial institutions and markets, on the basis of existing data by the so-called short-term ECB approach in compliance with Guideline ECB/2003/2, the new reports on securities and non-monetary financial intermediaries were accomplished in the autumn of 2006 due to Slovenia's integration into the euro area.

Intensive preparations for membership of the euro area

After the passing of the decision on integration into the euro area, alongside the normal production of data for the ECB with the status of a country before the entry, there was a significant increase in the simultaneous submission of test data, adapted – technically and in terms of content – to the criteria for membership of the euro area. The submitted time series are the subject of thorough quality control by the ECB.

Maintenance of indirect balance-of-payment reporting until integration into the euro area

In the area of balance-of-payments statistics, the Bank of Slovenia preserved the reporting of data on clients' international transactions in the ERM II period prior to the introduction of the euro on the basis of an agreement with banks. Under Regulation of the European Parliament and Council (EC) No. 2560/2001 on cross-border payments in euros, so-called indirect data reporting would have to be limited to amounts above the value of EUR 12,500.

Preparation of the basis for direct reporting

In accordance with the concept of the transition from indirect to direct reporting, the guidelines were prepared in 2006 for the beginning of direct reporting on transactions in debt securities, credit operations, services, current and capital transfers and, partly, on commodities, all with non-residents, in 2007. The new reporting on credit operations, including deposits, thus constitutes a transition from documentary individual reporting to simpler aggregate reporting. In addition to the guidlines, new software was prepared in 2006, as well as the corresponding sampling methods for the potential reporting population, which will reduce the burden of reporting.

Seeking alternative sources for travel data

Owing to the changeover to direct data reporting, possibilities of alternative sources of data for reporting tourism services were sought in 2006 because direct reporting is not possible. Alternative sources are additional targeted surveys in cooperation with the SORS and information on roaming by mobile telephone users on networks run by operators in other countries.

Fisher's ideal index

The Bank of Slovenia must also submit to the ECB certain other information, especially in the areas of general government and general economic statistics, which, in addition to information about the Maastricht economic criteria, i.e. information about long-term interest rates and the general government balance, public debt and the harmonised consumer price index, also includes other information from national account statistics, labour statistics, information about procedures with regard to an excessive government deficit, etc. This information is compiled by the SORS and/or the Ministry of Finance in accordance with an agreement between institutions. In 2005 and 2006, the Bank of Slovenia developed a calculation for the real estate price index that had not previously existed in Slovenia, in the form of Fisher's ideal index.

Standards for publishing statistical data

The Bank of Slovenia also successfully concluded the technological inclusion in the ESCB statistical information system. The overall exchange of statistical data with the ECB takes place on the basis of the GESMES/TS technical standards.

The Bank of Slovenia releases data on its website in accordance with the IMF's Special Statistical Data Dissemination Standards for Slovenia, prepared together with the SORS and the Ministry of Finance. The standards require the regular publication of methodologically sound key macroeconomic figures according to an advance release calendar. Slovenia fully meets the requirements of the IMF's special data publication standards.

Key financial and economic information for Slovenia are published in a monthly bulletin and in annual publications on direct investments and financial accounts. All publications, along with information on the extended time series of data from the bulletin and certain other important data, are also published on the Bank of Slovenia website. The more important recipients of the statistical data are the ECB, Eurostat, the SORS, the IMF and the BIS.

Participation in the Committee on Monetary, Financial and Balance of Payments Statistics

In addition to regular meetings of the working groups and in the seminars of the Eurostat and the ECB the representatives of the Bank of Slovenia also participate in the regular plenary meetings of the Committee on Monetary, Financial and Balance of Payments Statistics, CMFB, as a main body for coordination of the strategic questions of the European financial statistics.

6.6 International co-operation

International Monetary Fund

Slovenia's quota at the IMF remains unchanged

Slovenia's quota at the IMF was unchanged at SDR 231.7 million, which translates to 0.12% of the voting power of all IMF members.

In 2006 Slovenia received a proportion of returned IMF loans under the FTP plan

Since 1998 Slovenia has been among the IMF member-states that finance loans under the Financial Transactions Plan (FTP). Slovenia did not participate in FTP payments in 2006, but did receive a proportion of returned IMF loans from previous years from Uruguay, Pakistan and Sri Lanka worth a total of SDR 11.8 billion. At the end of December 2006 Slovenia's reserve position at the IMF stood at SDR 24.4 million.

Report on consultations with Slovenia pursuant to Article 4 of the IMF Statute

In March IMF representatives held regular annual consultations with Slovenia pursuant to Article 4 of the IMF Statute. The Board of Executive Directors addressed the report from the IMF Commission in early July. The report was published on 10 July 2006.

The European Central Bank and the European System of Central Banks

The Bank of Slovenia is a member of the ESCB

When Slovenia joined the European Union on 1 May 2004, the Bank of Slovenia became a member of the European System of Central Banks, which comprises the ECB and all the national central banks of the EU member-states. The Governor of the Bank of Slovenia attended the sessions of the General Council of the ECB as a member in 2006, and also from July the sessions of the Governing Council of the ECB as an observer.

In 2006 Bank of Slovenia experts attended sessions of committees and their working groups whenever they met as part of the ESCB, i.e. with all the EU national central banks, and after 11 July 2006 they also attended, as observers, the sessions of Eurosystem committees and working groups.

The key for ECB capital subscription is 0.3345%

The key for ECB capital subscription for the Bank of Slovenia was 0.3345% at the end of 2006. In line with the Statute of the ESCB and ECB, the national central banks' percentage shares in the key for subscription to the ECB are weighted relative to the relevant member-state's proportion of overall EU population and GDP. The national central banks are the sole subscribers to and holders of the capital of the ECB. The NCBs of the member-states that have introduced the euro have paid up their entire shares of the ECB's capital. The NCBs of EU member states that have not yet introduced the euro have not paid up their entire share, but only 7% of the amount that they will have to pay up when they introduce the euro. The total amount of paid-up subscribed ECB capital from all central banks was EUR 4,089.3 million at the end of 2006. When Slovenia joined the EU, the Bank of Slovenia paid the minimum percentage of subscribed ECB capital in the amount of EUR 1.3 million.

European Union

Oversight of compliance of Slovenian laws with the acquis communautaire

The Bank of Slovenia continued its collaboration in monitoring regulations and inspecting the compliance of Slovenian laws with the acquis communautaire in the areas of economic and monetary union, freedom to provide services and the free movement of capital.

Membership of the Bank of Slovenia in the EFC, CEBS and CMFB

In 2006 Bank of Slovenia experts attended sessions of committees, working groups and other bodies that are active within the institutions of the EU with a focus on financial and monetary matters. Thus Bank of Slovenia experts attended several sessions of the Economic and Financial Committee (EFC) and its subcommittees, meetings of the Committee of European Banking Supervisors (CEBS) and its working groups, meetings of the Committee on Monetary, Financial and Balance of Payments statistics (CMFB) and other working groups from the relevant area which that are active within the European Commission and the EU Council.

Other areas

Collaboration in resolving succession issues

In 2006 the Bank of Slovenia continued to collaborate in the process of resolving succession issues related to the former Socialist Federal Republic of Yugoslavia, primarily the implementation of the Agreement on Succession Issues, ratified in July 2004.

7 APPENDICES

7.1 Five-year income statement and balance sheet

Table 29: **Five-year income statement for 1 January to 31 December**

	2002	2003	2004	2005	2006
Operating income					
Interest and similar income	60,228	74,512	60,376	58,101	56,105
Interest and similar expenses	-42,321	-67,841	-44,975	-37,593	-37,261
Net interest income	**17,907**	**6,671**	**15,401**	**20,508**	**18,843**
Net foreign exchange gain/loss	-8,588	-16,593	-5,312	27,564	-18,130
Gain (loss) from price revaluation of securities	10,814	-8,530	-122	-11,040	-14,403
Gain (loss) from gold revaluation	1,550	740	-498	6,653	1,915
Net investment income	**21,684**	**-17,712**	**9,469**	**43,685**	**-11,775**
Fee and commission income	1,793	1,660	1,682	2,036	2,146
Fee and commission expenses	-406	-426	-486	-457	-358
Net fees and commissions	**1,387**	**1,234**	**1,196**	**1,579**	**1,787**
Other operating income	382	322	367	325	986
Total operating income (expenditure)	**23,452**	**-16,156**	**11,032**	**45,589**	**-9,001**
Operating expenses	-4,396	-4,971	-5,524	-5,916	-10,851
Provisions and write-downs	-498	-704	-398	-1,070	-590
Operating surplus (deficit) available for appropriation	**18,558**	**-21,830**	**5,110**	**38,603**	**-20,442**
Appropriations:					
Transfer to /Release of special reserves for foreign exchange differences	-8,588	-16,593	-5,312	27,564	-18,130
Transfer to /Release of special reserves – price risk (securities)	9,365	-8,995	-409	-7,497	-
Release of general reserves – price risk (securities)	-	-	-	-3,557	-14,202
Transfer to/Release of special reserves – price risk (gold)	1,550	740	-498	6,653	1,915
Financial results after the appropriation of net foreign exchange differences and income (expenses) from unrealised price revaluation	16,231	3,018	11,329	15,440	9,975
Transfer to general reserves	12,173	2,264	8,497	11,580	7,481
Total transfer to reserves	**14,500**	**-22,584**	**2,278**	**34,743**	**-22,936**
Provision for transfer of surplus to the budget of RS	4,058	755	2,832	3,860	2,494
Total appropriations	**18,558**	**-21,830**	**5,110**	**38,603**	**-20,442**

Source: Bank of Slovenia

Table 30: **Five-year balance sheet as at 31 December**

	2002	2003	2004	2005	2006
Assets					
Financial assets					
Foreign currency assets	**1,588,462**	**1,669,475**	**1,612,953**	**1,689,882**	**1,337,692**
Gold and gold receivables	18,403	19,143	18,646	16,873	18,793
Cash and deposits	592,862	400,209	178,046	321,635	236,941
Derivative financial instruments	328	48	39	35	-
Financial assets at fair value through P/L	927,375	1,190,216	1,359,684	1,304,626	1,042,377
Receivables from the Republic of Slovenia	7,668	7,175	6,963	7,395	9,137
International Monetary Fund	28,221	29,130	23,033	12,803	8,919
Accrued interest and other assets	13,605	23,554	26,543	26,515	21,527
Domestic currency assets	**3,255**	**1,263**	**808**	**748**	**986**
Due from banks	18	9	-	-	-
Reverse – repo agreements	1,148	-	-	-	-
Accrued interest and other assets	2,089	1,254	808	748	986
Fixed assets	3,094	3,106	3,554	3,643	3,928
Total assets	**1,594,812**	**1,673,844**	**1,617,315**	**1,694,273**	**1,342,606**
Liabilities and reserves					
Serviced liabilities					
Foreign currency liabilities	**591,278**	**604,758**	**573,638**	**417,148**	**154,595**
Current accounts and deposits to governmental institutions	30,545	41,059	63,156	82,466	109,293
Derivative financial instruments	-	-	0	1	-
Bank of Slovenia bills	552,952	555,260	500,757	323,938	32,449
IMF and other international financial organisations	7	5	1,389	1,789	3,475
SDR allocation	7,643	7,156	6,937	7,358	6,956
Accrued interest and other liabilities	131	1,278	1,399	1,596	2,422
Domestic currency liabilities	**627,508**	**704,963**	**665,619**	**844,401**	**844,207**
Current accounts	89,804	100,818	104,108	104,286	100,994
Commercial banks' deposits	-	-	156,730	203,490	230,360
Overnight deposits	18,360	8,170	4,800	1,500	95,159
Bank of Slovenia bills	375,636	472,330	266,588	525,184	402,381
Republic of Slovenia deposits	134,793	109,674	127,477	2,682	1,296
International financial organisations	-	-	264	271	263
Accrued interest and other liabilities	8,915	13,971	5,651	6,988	13,754
Banknotes in circulation	172,056	186,042	195,352	214,248	149,631
Provision for transfer of surplus to the budget of RS	4,058	755	2,832	3,860	2,494
Total liabilities	**1,394,900**	**1,496,517**	**1,437,442**	**1,479,657**	**1,150,926**
Capital and Reserves	199,912	177,327	179,873	214,616	191,680
Total liabilities and reserves	**1,594,812**	**1,673,844**	**1,617,315**	**1,694,273**	**1,342,606**

Source: Bank of Slovenia

7.2 Major measures in 2006

7.2.1 Monetary policy measures

February

The Bank of Slovenia offered banks the outright purchase of EUR 500 million from the stock of 7-day foreign exchange swaps.

The Bank of Slovenia cut its interest rates: from 5.00% to 4.75% for the lombard loan, from 4.00% to 3.75% for 60-day tolar bills, from 4.10% to 3.75% for the temporary purchase of securities, from 1.50% to 1.25% for the 7-day foreign exchange swap, and from 1.0% to 0.75% for the 7-day reverse foreign exchange swap.

The cut of 0.25 percentage point in the foreign exchange swap rate meant that the Bank of Slovenia's refinancing rate was lowered from 3.75% to 3.50%.

March

The Bank of Slovenia cut its interest rates: from 4.75% to 4.50% for the lombard loan, from 3.75% to 3.50% for 60-day tolar bills, and consequently from 3.95% to 3.70% for the long-term deposit (effective from 1 April 2006), from 3.75% to 3.50% for the temporary purchase of securities, from 1.25% to 0.75% for the 7-day foreign exchange swap, and from 0.75% to 0.25% for the 7-day reverse foreign exchange swap.

The rise of 0.25 percentage point in the ECB's main refinancing rate to 2.50% and the cut of 0.50 percentage point in the Bank of Slovenia's foreign exchange swap rate meant that the Bank of Slovenia's refinancing rate was lowered from 3.50% to 3.25%.

June

The Bank of Slovenia abolished subscription to US dollar-denominated foreign currency bills.

The Bank of Slovenia cut the interest rate on 60-day tolar bills from 3.50% to 3.25%, as a result of which the interest rate on the long-term deposit is lowered from 3.70% to 3.45%, effective from 1 August 2006.

The rise of 0.25 percentage point in the ECB's main refinancing rate to 2.75% meant that the Bank of Slovenia's refinancing rate was raised from 3.25% to 3.50%.

The Bank of Slovenia offered banks the outright purchase of EUR 300 million from the stock of 7-day foreign exchange swaps.

August

The Bank of Slovenia raised its interest rates: from 4.50% to 4.75% for the lombard loan, from 3.50% to 3.75% for the temporary purchase of securities, from 3.25% to 3.50% for 60-day tolar bills, and consequently from 3.45% to 3.70% for the long-term deposit (effective from 1 October 2006), and from 2.25% to 2.50% for the overnight deposit.

The rise of 0.25 percentage point in the ECB's main refinancing rate to 3.00% meant that the Bank of Slovenia's refinancing rate was raised from 3.50% to 3.75%.

The Bank of Slovenia abolished subscription to foreign currency bills maturing in 120 days.

September

The Bank of Slovenia offered banks the outright purchase of EUR 140 million from the stock of 7-day foreign exchange swaps, and the outright sale of EUR 3 million from the stock of 7-day reverse foreign exchange swaps.

The Bank of Slovenia terminated the agreement on cooperation with commercial banks on interventions on the foreign exchange markets owing to the changeover to the euro. The agreement ceased to be in force after the three-month period of notice elapsed on 21 December 2006.

The Bank of Slovenia notified the signatories of the agreement on cooperation that they will receive an offer for the outright purchase/sale of foreign exchange from the stock of 7-day foreign and reverse foreign exchange swaps on the first Friday of the month for the remainder of the agreement's period in force.

The Bank of Slovenia abolished subscription to foreign currency bills maturing in 90 days.

For its October maintenance period (beginning 27 September), the Bank of Slovenia modified the system of the reserve requirement, viz.:

- the reserve requirements are now calculated from the standing as at the final day of the month,
- the Bank of Slovenia calculates the requirements on the basis of figures from statistical reporting,
- liabilities are allocated to maturity categories with regard to original maturity, while liabilities are reallocated with regard to period of notice only upon notice actually being given,
- a standard allowance of SIT 23.964 million deduction is introduced,
- in the current monitoring of the ownership of issued debt securities, the amount of such securities held by other institutions subject to the reserve requirements is excluded from the basis for calculating the reserve requirement; if there is no current monitoring of the ownership of such securities, the entire amount of the securities is included in basis for calculating the reserve requirement,
- the maintenance period is adjusted to the calendar for the Eurosystem's reserve requirements,
- during the transitional maintenance period from 13 to 31 December 2006, liabilities to institutions subject to the Eurosystem's reserve requirements are to be excluded from the reserve base in addition to liabilities to institutions subject to the reserve requirements in Slovenia.

October

The Bank of Slovenia cut the 7-day foreign exchange swap rate from 0.75% to 0.50% and the 7-day reverse foreign exchange swap rate from 0.25% to 0%.

The rise of 0.25 percentage point in the ECB's main refinancing rate to 3.25% and the cut of 0.25 percentage point in the Bank of Slovenia's foreign exchange swap rate meant that the Bank of Slovenia's refinancing rate remained at 3.75%.

The Bank of Slovenia offered banks the outright purchase of EUR 140 million from the stock of 7-day foreign exchange swaps, and the outright sale of EUR 13.5 million from the stock of 7-day reverse foreign exchange swaps.

November

The Bank of Slovenia offered banks and savings banks the option to subscribe to tolar bills maturing in 120 days. The other terms of subscription were the same as those for 60-day tolar bills. Until the end of 2006 two offers were made to banks and savings banks each week, 60-day and 120-day bills alternating. A total of seven offers with a maturity of 120 days were made to banks and savings banks. The final bill will be repaid on 30 April 2007.

The Bank of Slovenia offered banks and savings banks without sufficient eligible collateral for an interest-free loan for the frontloaded euro cash the chance to subscribe to a short-term deposit at the Bank of Slovenia. The banks and savings banks were only able to subscribe to the short-term deposit on 22 November 2006 with maturity on 1 February 2007 and/or 30 March 2007 at a fixed nominal interest rate of 3.50% p.a.

The Bank of Slovenia abolished subscription to foreign currency bills maturing in 60 days.

December

The Bank of Slovenia offered banks the outright purchase of EUR 70 million from the stock of 7-day foreign exchange swaps.

The Bank of Slovenia cut the interest rate on the lombard loan from 4.75% to 4.50% and the 7-day foreign exchange swap rate from 0.50% to 0.25%.

In accordance with the termination of the agreement on cooperation with commercial banks on interventions on the foreign exchange markets (see 21 September 2006), the Bank of Slovenia canceled the offer of 7-day foreign and reverse foreign exchange swaps. Banks that held a stock of foreign exchange swaps had two possibilities:

- repurchasing or reselling the swapped foreign exchange under the terms applying to the mandatory repurchase/resale, or
- deeming the swapped foreign exchange to have been purchased/sold outright, without the obligation of repurchase/resale.

The Bank of Slovenia abolished the offer of the temporary purchase of securities, and with effect on 1 January 2007 canceled the standing facilities of the overnight deposit, the lombard loan and intraday credit.

7.2.2 Secondary legislation affecting banking supervision

The majority of the secondary legislation affecting banking supervision in 2006 had to be issued or amended owing to the adoption of the Mortgage Bond and Municipal Bond Act (Official Gazette of the Republic of Slovenia, No. 17/06), the new Companies Act (Official Gazette of the Republic of Slovenia, No. 42/06), the new Banking Act (Official Gazette of the Republic of Slovenia, No. 131/06), and the introduction of the euro.

The biggest innovation in 2006 were the regulations governing the issue of mortgage bonds and municipal bonds, issued in July 2006 pursuant to the Mortgage Bond and Municipal Bond Act (Official Gazette of the Republic of Slovenia, No. 17/06). The **regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds** regulates in detail how it is determined for banks whether the conditions for acquiring an authorisation to issue mortgage bonds or municipal bonds have been met.

The **regulation on the calculation of the net present value of cover assets** sets out the detailed rules for matching the cover assets and the liabilities from issued mortgage bonds and municipal bonds based on the net present value principle, and other rules for matching the maturities, remuneration and currency exposure of the cover assets with the liabilities from issued mortgage bonds and municipal bonds.

The **regulation on the inclusion of derivatives in cover assets** sets out the maximum level of inclusion of derivatives in cover assets, the type and credit ratings of the parties conducting such transactions, and other detailed instructions for the use of derivatives.

The **regulation on the custodian of the cover register** regulates in detail how it is determined that the conditions for appointing the custodian of a cover register and for acquiring a Bank of Slovenia authorisation to act as the custodian of a cover register have been met.

October 2006 also saw the issue of the **regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks**, which sets out the content, the form and the method for calculating and reporting liquidity ratios and for daily planning of liquidity flows to ensure an adequate liquidity position.

Until its entry into force, the liquidity of banks and savings banks had been regulated separately by the regulation on the daily planning of tolar liquidity, the regulation on the tolar liquidity ladder at savings banks, and the regulation on the minimum level of liquidity to be maintained by banks. The last of these was amended several times last year as a result of the gradual relaxation of the foreign currency liquidity minimum and the adaptation to the conditions of business in the Eurosystem, the amendments primarily relating to the gradual reduction of the foreign currency minimum to complete abolition, and to the criteria for consideration and inclusion of financial assets.

The regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks combines the content of all three of the aforementioned regulations. Major new features in this regulation include the addition of investments that meet the Eurosystem's eligible criteria to the array of financial assets, the abolition of the necessity of meeting the ratio in the second category, the exclusion from the calculation of the financial assets that a bank holds in order to provide the liquid assets necessary for the payment of deposits covered by the guarantee scheme, a significant reduction in the weights of sight deposits by households and non-financial companies, liquidity flow planning aggregated in domestic and foreign currency, and the introduction of qualitative measurement of liquidity risk (the possibility of using an internal methodology for sight deposits by households and non-financial companies).

The most-demanding part in substantive terms consists of the regulations implementing the international standards for risk management (Basel II) adopted in December 2006 pursuant to the new Banking Act (Official Gazette of the Republic of Slovenia, No. 131/06).

January	Average effective interest rates on consumer loans by banks and savings banks Guidelines for implementing the regulation on reporting by monetary financial institutions N-1 Regulation on the cessation of validity of the regulation on the reporting of effective interest rates
February	Regulation amending the regulation on the daily planning of tolar liquidity and monitoring of concentration of depositors Regulation amending the regulation on the tolar liquidity ladder at savings banks Regulation amending the regulation on the reporting by branches of banks of member-states

Regulation on the minimum scope and content of audits and auditors' reports Regulation amending the regulation on the compliance of the operations of Slovenska izvozna družba, d.d., Ljubljana with regulations governing bank operations Regulation amending the regulation on the minimum level of liquidity to be maintained by banks	**March**
Regulation amending the regulation on submission of bank and savings bank information Regulation amending the regulation on the conditions to be met by banks and savings banks in order to provide banking services and other financial services Regulation amending the regulation on the minimum level of liquidity to be maintained by banks Amendments to the instructions for compiling the report on inter-bank deposits Regulation amending the regulation on the financial reports and accounts of banks and savings banks Guidelines for implementing the regulation on the financial reports and accounts of banks and savings banks (methodology for calculating indicators) Guidelines amending the guidelines for implementing the regulation on the financial reports and accounts of banks and savings banks (methodology for compiling balance sheets and income statements) Guidelines amending the guidelines for implementing the regulation on the assessment of credit risk losses by banks and savings banks	**April**
Regulation amending the regulation on the minimum level of liquidity to be maintained by banks	**May**
Regulation amending the regulation on the tolar liquidity ladder at savings banks Regulation amending the regulation on the deposit guarantee scheme Instructions amending the instructions for compiling the report on the tolar liquidity ladder ratios at savings banks Guidelines amending the guidelines for implementing the regulation on the financial reports and accounts of banks and savings banks (methodology for calculating indicators)	**June**
Average effective interest rates on consumer loans by banks and savings banks Guidelines amending the guidelines for implementing the regulation on the assessment of credit risk losses by banks and savings banks Regulation amending the regulation on the capital adequacy of banks and savings banks Regulation amending the regulation on the minimum level of liquidity to be maintained by banks	**July**

	Regulation on the conditions for acquiring an authorisation to issue mortgage bonds and municipal bonds Regulation on the calculation of the net present value of cover assets Regulation on the inclusion of derivatives in cover assets Regulation on the custodian of the cover register
September	Instructions for compiling monthly reports of account balances
October	Regulation on the reporting of inter-bank deposits Regulation on the publication of the summary of the audited annual report and other information for branches of banks of member-states Instructions on the content and method for reporting inter-bank deposits Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks
November	Regulation amending the regulation on the granting of special liquidity loans with the participation of the Bank of Slovenia Regulation amending the regulation on the assessment of credit risk losses by banks and savings banks.
December	Regulation amending the regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks Guidelines for implementing the regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks Regulation on the calculation of the capital of banks and savings banks Regulation on the calculation of the capital requirements for credit risk using a standardised approach for banks and savings banks Regulation on the calculation of the capital requirements for credit risk using a internal ratings-based approach for banks and savings banks Regulation on the calculation of the capital requirements for credit risk in securitisation Regulation on credit protection Regulation on the recognition of external credit assessment institutions Regulation on the calculation of capital requirements for market risk for banks and savings banks Regulation on the calculation of capital requirements for operational risk for banks and savings banks Regulation on the reporting of capital and capital requirements of banks and savings banks

Regulation on risk management and implementation of the process of assessing internal capital adequacy for banks and savings banks

Regulation on the supervision of banks and savings banks on a consolidated basis

Regulation on disclosures by banks and savings banks

Regulation on the investments of banks and savings banks in qualifying holdings in entities in the non-financial sector

Regulation on large exposures of banks and savings banks

Guidelines amending the guidelines for implementing the regulation on the assessment of credit risk losses by banks and savings banks

7.2.3 Procedure pursuant to the Misdemeanours Act

The Bank of Slovenia issued one caution in 2006 as part of its supervision of the implementation of laws defining misdemeanours, in line with its new role as a misdemeanours authority pursuant to the Misdemeanours Act, which entered into force on 1 January 2005.

7.3 Governance and organisation

7.3.1 Governing Board of the Bank of Slovenia as at 31 December 2006

President of the Governing Board

Mitja Gaspari
(Governor of the Bank of Slovenia)

Other members of the Governing Board

Samo Nučič
(Deputy-Governor)

Darko Bohnec
(Vice-Governor)

Janez Košak
(Vice-Governor)

Andrej Rant
(Vice-Governor)

Božo Jašovič
(member of the Governing Board)

Boštjan Jazbec, Ph.D.
(member of the Governing Board)

Ivan Ribnikar, Ph.D.
(member of the Governing Board)

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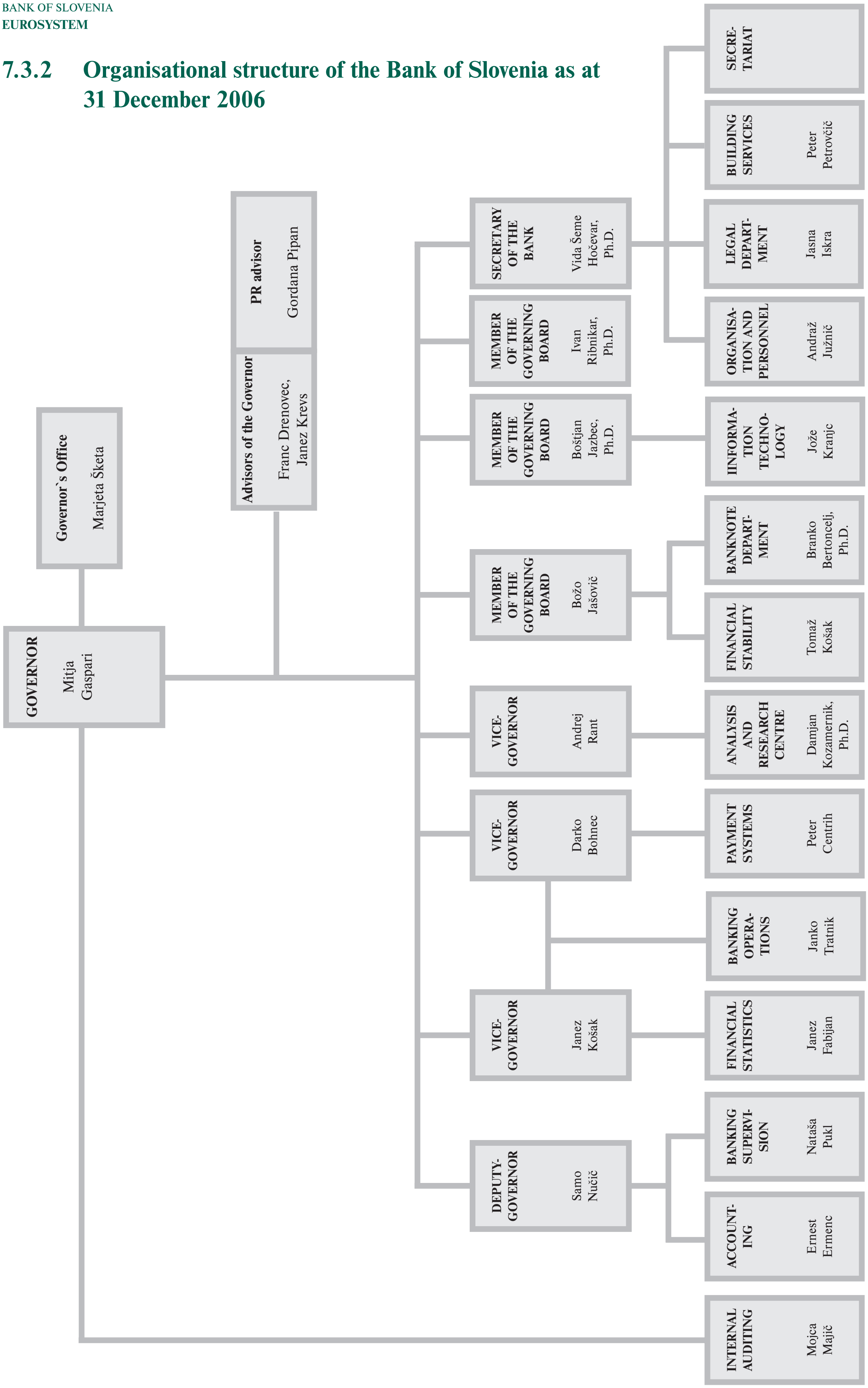
EUROSYSTEM

7.3.2 Organisational structure of the Bank of Slovenia as at 31 December 2006



7.3.3 Commissions and committees of the Governing Board in 2006

- Monetary and Exchange Rate Policy Committee (president: Darko Bohnec)
- Commission of the Governing Board of the Bank of Slovenia for the Preparation of Opinions in Connection with Procedures for Ruling on the Issue of Authorisations to Provide Banking Services, Authorisations to Acquire a Qualifying Holding and Other Authorisations, Approvals and Opinions Pursuant to the Banking Act (president: Samo Nučič)
- Commission of the Governing Board of the Bank of Slovenia for the Preparation of Opinions for the Issue of Authorisations to Hold Office as a Member of a Bank's Management Board (president: Ivan Ribnikar, Ph.D.)
- Research Commission (president: Ivan Ribnikar, Ph.D.)
- Audit Committee
  (president: Boštjan Jazbec, Ph.D. until 12 September 2006,
  Dušan Zbašnik, Ph.D. since 13 September 2006)

7.4 Publications and website

Title and basic information	Content
Monthly Bulletin • monthly • in Slovene • English translation	Macroeconomic statistics with an emphasis on monetary statistics, exchange rates and economic relations with the rest of the world. Review of current developments in charts; methodological appendix; review of Slovenian banks, calendar of data releases.
Annual Report • annual (released in spring) • in Slovene • English translation	Report by the Bank of Slovenia to the National Assembly of the Republic of Slovenia. Description of economic developments, monetary policy, operations of banks and the Bank of Slovenia, and other activity of the Bank of Slovenia.
Report on Supervision of Banking Operations • annual (released in autumn) • English translation	Report by the Banking Supervision Department to the National Assembly on the operations of banks, the development of legal foundations for supervision, and banking supervision.
Neposredne naložbe / Direct Investment • annual • bilingual release in Slovene and English	Statistical review of direct and portfolio investment vis-a-vis Slovenia, both inward and outward (on an annual basis).
Surveys and Analyses • quarterly • in Slovene	Analytical and methodological presentations in monetary field, balance of payments and related area.
Financial Markets • quarterly • in Slovene	Statistical review of non-monetary financial intermediaries, the securities market and interest rates.
Monetary Review • monthly • in Slovene	Current macroeconomic analysis with detailed itemisation of monetary and balance of payments movements.
Monetary Policy Implementation Report • half-yearly • in Slovene and English	Current and envisaged monetary policy actions, outline of inflation trends and projections of key macroeconomic indicators for Slovenia for the next two years.
ARC Working Papers	Collection of articles on all topics of professional and operational relevance to central banking. Content of articles may be analytical or merely informative.
Financial Stability Report • annual • English translation	Analytical monitoring of developments in the banking sector, and articles by experts on maintaining financial stability.
website • index of Slovenian pages http://www.bsi.si/... .../html/kazalo.html • index of English pages http://www.bsi.si/... .../eng/index.htm	Website of the Bank of Slovenia with information about the institution, Slovenian banknotes and coins, laws and regulations governing the work of the central bank, and other useful information. Current data on exchange rates, interest rates and Bank of Slovenia securities, and major publications available for download in electronic form.

7.5 Glossary of selected terms

Base money – Cash in circulation, bank reserves and book money (sight deposits) at the Bank of Slovenia.

Capital (in accounting sense) – Subscribed capital, capital surplus, profit reserves, retained earnings and net losses from previous years, capital revaluation adjustment, net profit not yet distributed, net loss not yet covered and security deposit.

Capital adequacy – The ratio of capital to total risk-weighted assets and other risk-weighted items.

Capital (in regulatory sense) – An amount calculated on the basis of original and additional capital that banks can use to cover their capital requirements in accordance with the regulation on the capital adequacy of banks and savings banks (Official Gazette of the Republic of Slovenia, Nos. 24/02 and 85/02).

ESCB – The European System of Central Banks.

Financial institutions – In the official sector classification based on ESA95, the financial institutions sector is divided into five sub-sectors: the central bank, other monetary financial institutions, other financial intermediaries except insurance companies and pension funds, ancillary financial institutions, and insurance companies and pension funds. Monetary financial institutions include the central bank and other monetary financial institutions engaged in financial intermediation. Non-monetary financial institutions comprise other financial intermediaries excluding insurance companies and pension funds, ancillary financial institutions, and insurance companies and pension funds.

Foreign currency bills – Short-term securities issued by the Bank of Slovenia, subscribed for and paid in foreign currency (euros or dollars).

Foreign exchange intervention:

- **Direct foreign exchange intervention** – The direct purchase or sale of foreign currency by the Bank of Slovenia on the inter-bank foreign exchange market.
- **Indirect foreign exchange intervention** – The setting of the exchange rate on foreign exchange markets facilitated for the Bank of Slovenia by the agreement on cooperation with commercial banks on interventions on the foreign exchange markets.

Foreign currency minimum – The minimum permitted amount of foreign currency assets of a bank.

Interest margin (net) – The ratio of net interest (interest income less interest expenses) to average gross interest-bearing assets.

Interest spread (nominal) – The difference between the average nominal interest rate that the bank earns on its investments and the average nominal interest rate that the bank pays on its liabilities of the same maturity.

Large exposure – An exposure of a bank to a counterparty equalling or exceeding 10% of the bank's capital.

Liquidity ladder – An instrument that sets out the necessary ratio of financial assets to capital and liabilities for particular maturities. Banks calculate the liquidity position using the liquidity ratio.

Liquidity ratio – The ratio of the sum of financial assets in domestic and foreign currency to capital and liabilities in domestic and foreign currency with regard to residual maturity. Banks must allocate financial assets and capital and liabilities according to residual maturity into two categories, one with a residual maturity of up to 30 days, and one with a residual maturity of up to 180 days. In accordance with latest regulations the liquidity ratio in the first category must be at least 1, while that in the second category is of an informative nature.

Monetary aggregates (M1, M2 and M3) – Measures of the national money supply of differing liquidity. The most liquid measure, M1, includes cash in circulation and tolar sight deposits at banks and the Bank of Slovenia. M2 comprises M1 plus savings and time deposits at banks and the Bank of Slovenia. M3 consists of M2 plus household foreign currency deposits at banks and, since September 1999, foreign currency deposits by all non-monetary sectors at banks.

Monetary sector – The monetary sector comprises the Bank of Slovenia and the commercial banks. Savings banks and savings and loan undertakings, which together account for 1.5% of the total assets of monetary financial institutions (as defined by the ECB), are not included. This practice is consistent with ECB rules, which permit minor institutions representing less than 5% of the total assets of national monetary financial institutions to be excluded from the definition of the monetary sector.

Money market – The market on which participants gather and invest short-term assets and trade them via instruments with an original maturity of up to one year.

Monetisation – Conversion of assets purchased by the central bank and commercial banks into money. It involves the purchase of (financial) assets, i.e. claims, or the granting of loans, using newly created or issued money.

Net provisions – The difference between write-offs of loans and claims deemed unrecoverable, expenses for long-term provisioning, expenses for specific provisioning and expenses for provisions for general banking risks, and income from loans and claims previously written off, income from eliminated long-term provisions and income from eliminated provisions for general banking risks from the income statement.

Non-interest margin – The ratio of net non-interest income to average assets.

Nominal interest rate – The total interest rate, comprising the part that compensates the lender or investor for inflation and the real part.

Open (foreign exchange) position – Unequalised foreign currency items on the balance sheet of a bank. Either claims or liabilities may be in excess.

Operating costs – Labour costs, costs of materials and services, depreciation, amortisation and revaluation operating expenses on intangible fixed assets and tangible assets, taxes, and subscriptions and membership fees.

Other assets – Investments in the equity of entities in the same group (subsidiaries, associates and joint ventures) and other customers, intangible non-current assets, tangible assets, treasury stock, uncalled capital, deferred expenses and accrued income, and other assets such as cheques, inventories and claims arising from interest, fees and commissions.

Other liabilities – Liabilities arising from interest and fees and commissions, accrued expenses and deferred income, long-term provisions for liabilities and costs, provisions for general banking risk, and other liabilities.

Other risk-weighted items – Equal to the sum of the capital requirements for currency and market risk, multiplied by conversion factors corresponding to the required minimum capital adequacy ratio (e.g. 12.5 for a capital adequacy ratio of 8%).

Persons in a special relationship with a bank – Major shareholders in a bank and members of a bank's bodies, and parties related to them.

Provisions – These comprise general provisions against unknown losses and specific provisions for potential losses arising from on-balance-sheet items and off-balance-sheet items, for country risk and for other known risks.

Rating of assets – Banks and savings banks grade assets into ratings A to E based on the estimated ability of the debtor to meet the liabilities to the bank when they fall due.

The A-rating comprises:
- claims on the Bank of Slovenia and the Republic of Slovenia, claims on the European Communities, governments and central banks of EEA countries and comparable OECD countries
- claims on debtors who are expected to be able to pay their liabilities without difficulties and who pay their liabilities when they fall due or exceptionally up to 15 days in arrears
- claims secured with gilt-edged collateral;

The B-rating comprises:
- claims on debtors whose cashflows are estimated to be sufficient for the regular settlement of due liabilities, but whose financial position is currently weak, and where there are no grounds to believe that it will deteriorate significantly in the future
- claims on debtors who frequently pay their liabilities up to 30 days in arrears and occasionally 31 to 90 days in arrears;

The C-rating comprises:
- claims on debtors whose cashflows are estimated to be insufficient for the regular settlement of due liabilities
- claims on debtors who are substantially undercapitalised
- claims on debtors who lack sufficient long-term resources to finance long-term investments
- claims on debtors who do not currently provide the bank with satisfactory information or appropriate documentation regarding claims, guarantees and resources for the repayment of claims
- claims on debtors who frequently pay their liabilities 31 to 90 days in arrears, and occasionally 91 to 180 days in arrears;

The D-rating comprises:
- claims on debtors for whom there exists a high probability of loss
- claims on debtors who are insolvent or have no liquidity
- claims on debtors in respect of whom a motion for the initiation of composition or bankruptcy proceedings has been filed with a competent court

- claims on debtors who are subject to rehabilitation or composition proceedings;
- claims on debtors who are in bankruptcy
- claims on debtors who frequently pay their liabilities 91 to 180 days in arrears, and occasionally 181 do 365 days in arrears but a reasonable expectation still exists that the claims will partly be covered;

The E-rating comprises:
- claims on debtors that are not expected to be repaid
- claims whose legal status is in dispute.

Repo – The sale (or purchase) of securities and their simultaneous purchase (or sale) on a specified date in the future or on demand. In repos between the Bank of Slovenia and banks, the securities are retained by the seller (the bank), but the buyer (the Bank of Slovenia) acquires a lien on them.

Reserve requirement – The minimum prescribed amount of assets, commonly computed as a percentage of the deposits and other liabilities of institutions subject to the requirement, that such institutions (banks, savings banks and savings and loan undertakings) are obliged to maintain in their settlement accounts or special reserve requirement accounts at the Bank of Slovenia.

Secondary liquidity – Investments in financial instruments that are highly liquid and can be sold quickly.

Sionia – Interest rate for overnight deposits on the inter-bank market.

Sterilisation – Generally, the sale of short-term government securities by the central bank intended to offset the effect of its purchases of foreign exchange on base money. In Slovenia sterilisation means the sale of tolar bills by the Bank of Slovenia intended to offset the effect of its purchases of foreign exchange on base money.

Swap – The spot purchase (or sale) of another currency and its simultaneous forward sale (or purchase). In a swap transaction the foreign currency is transferred from the seller's account to the buyer's account.

TARGET – The Trans-European Automated Real-Time Gross Settlement Express Transfer system has been operating since 1999 with the aim of providing support for the implementation of Eurosystem monetary policy and the secure, reliable and efficient settlement of domestic and cross-border payments. The system consists of the interconnected national real-time gross settlement systems of the euro area, the UK, Denmark, Sweden (until 31 December 2006), Poland and Estonia.

Tolar bills – Short-term tolar-denominated Bank of Slovenia debt securities.

Tolar indexation clause (Slovenian abbreviation: TOM) – The officially determined indexation rate for claims and liabilities computed as average monthly inflation (since January 1998, the retail price index, previously the cost of living index) for the most recent month or the most recent period (currently 12 months).

Total assets – The sum of all asset or liability items on the balance sheet (of a bank).

8 FINANCIAL STATEMENTS

Statement of responsibilities of the Governing Board

The Law on the Bank of Slovenia (the Bank) and the Statutes of the Bank require the Governing Board to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Bank and the surplus or deficit of the Bank for that period. In preparing those financial statements the Governing Board is required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed; and
- Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The Governing Board has a general responsibility for taking such steps as are reasonably open to it to safeguard the assets of the Bank.

Deloitte

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INDEPENDENT AUDITOR'S REPORT

To the Governing Board of the Bank of Slovenia

Report on the Financial Statements

We have audited the accompanying financial statements of Bank of Slovenia (the 'Bank'), which comprise the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Responsibility for the Financial Statements
The Governing Board is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Bank of Slovenia as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by EU.

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DELOITTE REVIZIJA D.O.O.
Ljubljana, Slovenija 1

Andreja Bajuk Mušič
Certified Auditor

Andreja Bajuk Mušič

Ljubljana, March 2nd, 2007

Yuri Sidorovich
President of the Board

Statement of income and expenditure
for the year ended 31 December (in million of tolars)

	Notes	2006	2005
Operating income:			
Interest and similar income	4	**56,105**	58,101
Interest expense and similar charges	5	**-37,261**	-37,593
Net interest income (expenditure)		**18,843**	20,508
Net foreign exchange gain/loss		**-18,130**	27,564
Gain (loss) from price revaluation of securities		**-14,403**	-11,040
Gain (loss) from gold revaluation		**1,915**	6,654
Net investment income		**-11,775**	43,685
Fee and commission income		**2,146**	2,036
Fee and commission expense		**-358**	-457
Net fee and commission income		**1,787**	1,579
Other operating income		**986**	325
Total operating income (expenditure)		**-9,001**	45,589
Operating expenses	6	**-10,851**	-5,916
Provisions and write-offs	7	**-590**	-1,070
Operating surplus (deficit) available for appropriation		**-20,442**	38,603
Appropriations:			
Transfer/Release to special reserves for foreign exchange differences		**-18,130**	27,564
Release from special reserves – price risk (securities)		**0**	-7,497
Release from general reserves – price risk (securities)		**-14,202**	-3,557
Transfer/Release to special reserves – price risk (gold)		**1,915**	6,654
Financial results after the appropriation of net foreign exchange gain/loss and gain/loss from unrealized price revaluation		**9,975**	15,440
Transfer to general reserves		**7,481**	11,580
Total transfer to reserves	14	**-22,936**	34,743
Provision for transfer of surplus to the budget of RS		**2,494**	3,860
Total appropriations		**-20,442**	38,603

The notes on pages 9 to 24 form an integral part of the financial statements.

Balance sheet

at 31 December (in million of tolars)

	Notes	**31.12.2006**	31.12.2005
Assets			
Financial assets			
Foreign currency assets			
Gold and gold receivables	8	**18,793**	16,873
Cash and deposits		**236,941**	321,635
Derivative financial instruments	9	**0**	35
Financial assets at fair value through P/L		**1,042,377**	1,304,626
Receivables from the Republic of Slovenia		**9,137**	7,395
International Monetary Fund		**8,919**	12,803
Accrued interest and other assets	10	**21,527**	26,515
Total		**1,337,692**	1,689,882
Domestic currency assets			
Accrued interest and other assets		**986**	748
Total		**986**	748
Fixed assets	11	**3,928**	3,643
Total assets		**1,342,606**	1,694,273
Liabilities and reserves			
Serviced liabilities			
Foreign currency liabilities			
Current accounts and deposits to governmental institutions		**109,293**	82,466
Derivative financial instruments		**0**	1
Bank of Slovenia bills		**32,449**	323,938
IMF and other international financial organisations		**3,475**	1,789
SDR allocation	12	**6,956**	7,358
Accrued interest and other liabilities		**2,422**	1,597
Total		**154,595**	417,148
Domestic currency liabilities			
Current accounts		**100,994**	104,286
Commercial banks' deposits		**230,360**	203,490
Overnight deposits		**95,159**	1,500
Bank of Slovenia bills		**402,381**	525,184
Republic of Slovenia deposits		**1,296**	2,682
International financial organisations		**263**	271
Accrued interest and other liabilities		**13,754**	6,988
Total		**844,207**	844,401
Banknotes in circulation	13	**149,631**	214,248
Provision for transfer of surplus to the budget of RS		**2,494**	3,860
Total liabilities		**1,150,926**	1,479,657
Capital and Reserves	14	**191,680**	214,616
Total liabilities and reserves		**1,342,606**	1,694,273

The notes on pages 9 to 24 form an integral part of the financial statements.

Statement of changes in equity

for the year ended 31 December (in million of tolars)

	Capital of the BoS	General reserve	Special Reserve	Operating surplus/ Deficit	Total equity
Balance at 31 December 2004	**2,000**	**66,911**	**110,962**	**-**	**179,873**
Operating surplus	-	-	-	38,603	38,603
FX gains/losses	-	-	27,564	-27,564	-
Transfer/Release to special reserves -price risk (securities)	-	-	-7,497	7,497	-
Transfer /Release to general reserves - price risk (securities)	-	-3,557		3,557	
Transfer/Release to special reserves -price risk			6,654	-6,654	
Operating surplus retained in general reserve	-	11,580	-	-11,580	-
Provisions for transfer to RS	-	-	-	-3,860	-3,860
Total movement	0	8,024	26,720	-	34,743
Balance at 31 December 2005	**2,000**	**74,934**	**137,682**	**-**	**214,616**
Arising in the period					
Operating deficit	-	-	-	-20,442	-20,442
FX gains/losses	-	-	-18,130	18,130	-
Transfer /Release to general reserves - price risk (securities)	-	-14,202		14,202	-
Transfer/Release to special reserves -price risk (gold)			1,915	-1,915	
Operating surplus retained in general reserve	-	7,481	-	-7,481	-
Provisions for transfer to RS	-	-	-	-2,494	-2,494
Total movement	-	**-6,721**	**-16,215**	-	**-22,936**
Balance at 31 December 2006	**2,000**	**68,213**	**121,467**	**-**	**191,680**

An analysis of the movements in each category within 'Reserves' is presented in Note 14.

The notes on pages 9 to 24 form an integral part of the financial statements.

Statement of cash flows

for the year ended 31 December (in million of tolars)

	Notes	**2006**	2005
Cash flows from operating activities			
Interest received		**61,933**	58,450
Interest paid		**-38,009**	-37,646
Other		**-4,889**	-3,360
Net cash flow from operating activities		**19,034**	17,443
Cash flows from investing activities			
Purchase of securities		**-4,023,797**	-692,796
Proceeds from sale of securities		**4,255,639**	763,332
Purchase of time deposits		**-16,918,064**	-12,665,193
Proceeds from redemption of time deposits		**16,996,515**	12,556,317
Loans and reverse repo to domestic banks		**-8,578,436**	-52,377
Repayment from domestic banks		**8,578,436**	52,377
Purchase of fixed assets		**-672**	-603
Proceeds from sale of fixed assets		**3**	4
Net cash flow from investing activities		**309,624**	-38,939
Cash flows from financing activities			
Issue of banknotes in circulation		**-64,618**	18,896
Issue of Bank of Slovenia bills	18	**4,944,411**	6,216,849
Repayment of Bank of Slovenia bills	18	**-5,329,385**	-6,093,662
Republic of Slovenia deposit		**38,086**	-111,283
Other, net		**-1,927**	-3,623
Net cash flow from financing activities		**-413,433**	27,177
Exchange rate effect		**193**	-463
Net cash flow from all activities		**-84,582**	5,218
Cash and cash equivalents at beginning of year		**-132,098**	-137,316
Cash and cash equivalents at end of year	19	**-216,680**	-132,098
Increase (decrease) in cash and cash equivalents		**-84,582**	5,218

The notes on pages 9 to 24 form an integral part of the financial statements.

The unaudited financial statements were approved by the Governing Board on 21. February 2007 and these audited financial statements were approved by the Governing Board on 21. March, 2007 and were signed on its behalf by:

Mitja Gaspari
President of the Governing Board and
Governor of the Bank of Slovenia

In accordance with Article 49 of the Bank of Slovenia Act. The Bank of Slovenia shall inform the National Assembly of the Republic of Slovenia of these annual financial statements.

Notes to the financial statements

1. Constitution

The Bank of Slovenia (the Bank) is the central bank of the Republic of Slovenia. It was constituted by the Law on the Bank of Slovenia dated 25 June 1991. In 2002 and in 2006 the Bank of Slovenia Act (Official Gazette of the Republic of Slovenia No. 58/02, and No. 72/06) was adopted. The Bank is a legal person, governed by public law, which independently disposes of its own property. The Bank is wholly owned by the state and is autonomous as regards its finances and administration. The Bank is supervised by Parliament. The Bank shall take care of the stability of domestic prices and of general liquidity of the financial system.

2. Accounting standards and conventions

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), adopted by the EU. as promulgated by the International Accounting Standards Board under the historical cost convention as modified by the revaluation of gold, financial assets designated at fair value through profit and loss, and all derivative contracts. These were adopted by the Governing Board at the 90th meeting on 9 May 1995.

3. Specific accounting policies

Foreign currencies

Foreign currency financial assets and liabilities have been translated into Tolars (SIT) using the middle exchange rates of the Bank of Slovenia applying at the balance sheet date. Transactions in foreign currencies have been translated into SIT using exchange rates applying on the settlement dates of those transactions.

Income and expense recognition

Interest income and expense is recognised in the statement of income and expenditure for all interest bearing instruments using the effective interest method.

Fees and commissions receivable mainly arise from payment and settlement services, supervisory and regulatory functions and the distribution of fiscal stamps on behalf of the state. Fee and commission income is recognised in the statement of income and expenditure on an accrual basis.

Financial assets and liabilities

All financial assets are initially recognised at cost in the balance sheet on a settlement date basis. The settlement date is the date that an asset is delivered to or by an enterprise. Financial liabilities are recognised in the balance sheet when the Bank becomes a party to the contractual provisions of the instrument.

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Gold and gold receivables

The Bank's gold holdings are valued on the basis of the dollar market price per fine ounce of gold. The revaluation gain or loss due to movements in the price per fine ounce and the dollar exchange rate is reported in the income statement as a gain (loss) from gold revaluation. The net unrealised gain or loss is taken to special reserves according to a decision of the Governing Board.

Financial assets at fair value through profit or loss

The bank decided, due to the amendment to IAS 39 (December 2003) that revoked the option to account for fair value changes of financial instruments classified as available for sale in the income statement, to designate its portfolio of securities as at fair value through profit and loss for the reason the existing accounting treatment would not had changed materially. In June 2005 the IASB published an amendment to the fair value option (IAS 39, Financial instruments: Recognition and Measurement) that set the conditions that are required to be met for designation of financial instruments to be measured at fair value, with value changes recognised in profit and loss (IAS 39, paragraph 9). As the Bank continually manages and evaluates performance of its securities portfolio on a fair value basis, which is reflected in the internal reports for key management and the external available financial information and meets the condition of the amendment, the bank decided to preserve the existing accounting treatment of measurement of financial assets at fair value through profit and loss.

This assets category comprises of fixed and floating rate interest bearing instruments and is designated by management. Gains and losses arising from changes in the fair value of the financial assets are included in the income statement in the period in which they arise. The fair values of quoted investments in active markets are based on current last prices. The effect of securities price changes appears in the Statement of Income and Expenditure under the item Gain (loss) from price revaluation of securities.

Derivative financial instruments

The bank does not use derivative financial instruments except foreign exchange swap arrangements with domestic banks for the purposes of implementing monetary policy and managing loans to banks. Both are recognised on the balance sheet at their fair value. Gains are accrued over the life of the swap and reported in the Income Statement as swap gains. The market value is derived from the difference between the forward price and the market price of the underlying item.

Hedging

The Bank did not designate any transactions as hedges during the year.

Impairment of financial assets

If there is objective evidence that an impairment loss on loan and receivables carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, including amounts recoverable from guarantees and collateral discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the income statement.

Current accounts and deposits

Borrowings are recognised initially at cost. Subsequently, borrowings are stated at amortised cost.

Bank of Slovenia bills

Bank of Slovenia bills comprise bills in domestic currency and bills in either EUR or USD. Tolar bills are issued with maturities of sixty and two hundred and seventy days. Foreign currency bills are issued with maturities from two to four months. Both kinds of Bank of Slovenia bills are carried at amortized cost.

Fixed assets

Investment properties located in Austria and not used by the Bank itself are carried at fair value and are not depreciated. The Bank's policy is to obtain an independent appraisal by an external certificated valuer and to revalue these properties once every 5 years. The property's fair value is determined by the avarage of market values of land and buildings and theirs net present values of rental income. The last revaluation was performed in 2004. Property revaluations are taken to reserves. All other fixed assets are stated at cost and net of depreciation except for land, which is not depreciated.

Depreciation is provided on a straight line basis so as to write off the cost of the assets over their estimated useful lives at the following annual percentage rates:

Buildings	1.3 – 1.8 %
Computers	20 – 33 %
Other equipment	10 – 25 %

Gains and losses on disposal of fixed assets are determined as the difference between net disposal proceeds and the carrying amount of the asset and are recognised as income or expense in the statement of income and expenditure.

Banknotes in circulation

Banknotes issued by the Bank represent a charge on the Bank in favour of the holder and are recognised as a liability at face value.

Cash flows

Cash and cash equivalents are defined as net freely transferable cash in convertible currency and demand deposits.

Cash flows from investing activities comprise cash movements in Bank portfolios, arising from the performance of the functions of the central bank. Also included are cash flows arising from movements in IMF Special Drawing Rights and fixed assets. Cash flows from financing activities are those arising from the issue of currency, the issue of Bank of Slovenia bills and movements in Republic of Slovenia deposits. Operating activities include income and expenditure cash flows not included as investing or financing activities.

Cash movements in portfolios have been presented on a gross basis.

Provisions

Provisions for legal claims are recognised when the bank has a present legal or constructive obligation as a result of past events; it is more likely than not than an outflow of resources will be required to settle the obligation: and the amount has been reliably estimated.

Taxation

The Bank is not subject to Slovenian profit taxes.

Appropriations

In accordance with the Bank of Slovenia Act, net profit is allocated to special reserves, general reserves and the budget of the Republic of Slovenia. Unrealized income deriving from exchange rate and price changes is allocated in its entirety to special reserves. Realized gains or losses represent the difference between the selling price and last revaluation price. Revaluations are prepared on a monthly basis.

The special reserves may only be used to cover a shortfall deriving from unrealized losses deriving from exchange rate and price changes. After the allocation of funds to special reserves, 25% of net income is allocated to the budget of the Republic of Slovenia, while the rest is allocated to general reserves.
A net loss of the Bank of Slovenia is covered from general reserves. Any net loss which cannot be covered from general reserves is covered by the budget of the Republic of Slovenia.

Events after the Balance sheet date

Republic of Slovenia introduced the euro as a new legal tender on the 1st of January 2007. The Bank became part of the Eurosystem and took over joint responsibility for monetary policy and for exercising the common strategic goals of the ESCB.

In accordance with Article 49.1 of the Statute of the ESCB and the legal acts adopted by the Governing Council of the ECB, the Bank paid up as at 1 January 2007 a remaining 93% of its capital subscription amounted to EUR 17.1 million. The total amount of paid-up capital, considering the changed capital key 0.3194% (changes upon the accession of Bulgaria and Romania) is EUR 18.4 million. In accordance with Article 30.1 of the Statute of the ESCB, on 2 and 3 January 2007 the Bank transferred also a part of foreign reserve assets to the ECB with a total value equivalent to EUR 192 million.

According to the Bank of Slovenia Act and according to the Statute of the ESCB and ECB the Governing Board of the Bank has adopted at the 343rd meeting on 20 December 2006 the Decision of the alteration of the legal basis for accounting and for annual accounts. New legal basis, with effect from 1 January 2007 onward represents Guideline of the European Central Bank on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16).

4. Interest Income

	2006	2005
	SIT million	SIT million
Interest income from foreign currency		
Income on gold assets	**7**	14
Interest on deposits	**9,931**	5,402
Income on financial assets at fair value through P/L	**44,983**	48,867
Interest on International Monetary Fund deposits	**258**	445
Total	**55,178**	54,728
Interest income from domestic currency		
Interest on loans to banks	**15**	15
Interests from Reverse – repo agreements	**19**	39
Swap gains	**892**	3,319
Total	**926**	3,373
Total interest income	**56,105**	58,101

Income on financial assets at fair value throught P/L consists of the following:

	2006	20045
	SIT million	SIT million
Interest income	**44,983**	48,867
Gains less losses from financial assets at fair value through P/L	**-14,403**	-11,040
Total investment income on marketable securities, net	**30,580**	37,827

5. Interest expenses

	2006 SIT million	2005 SIT million
Interest expenses on foreign currency		
Interest on current accounts and deposits to governmental institutions	**2,135**	889
Interest on Bank of Slovenia bills	**5,598**	9,728
Total	**7,733**	10,618
Interest expenses on domestic currency		
Interest on current accounts	**815**	828
Interest on commercial banks' deposits	**7,906**	8,201
Interest on overnight deposits	**69**	23
Interest on Republic of Slovenia deposits	**19**	2,288
Interest on Bank of Slovenia bills	**20,703**	15,621
Other interest	**16**	15
Total	**29,529**	26,975
Total interest expenses	**37,261**	37,593

6. Operating expenses

	2006 SIT million	2005 SIT million
Staff costs	**3,986**	3,594
Administration costs	**2,451**	2,017
Banknote production costs	**4,286**	160
Other	**128**	143
Total operating expenses	**10,851**	5,916

The Bank employed 435 employees as at 31 December 2006 (2005: 414 employees).

In accordance with the contract between the Bank and the Trade union from March 2002 Bank employees have been included into Voluntary supplementary pension insurance, which is defined as a contribution plan. Staff costs include contribution of the Bank for Voluntary supplementary pension insurance of SIT 85 million (2005: SIT 75 million).

In 2006 the remuneration of the Governing board members of the Bank was of SIT 209 million (2005: SIT 201 million).

Banknote production costs for the year 2006 includes accrued costs of eurobanknote production for banknotes that were borrowed from the Eurosystem for frontloading and changeover purpose.

7. Provisions and write-offs

	2006 SIT million	2005 SIT million
Contingent liabilities	**95**	1,070
Other provisions	**496**	-
Total provisions and write-offs	**590**	1,070

Other provisions include provisions for post-employment benefits and are calculated in accordance with IAS 19 – Employee benefits on the basis of actuarial assumptions as at 31.12.2006. The latter consider the stipulations of the Bank collective agreement, expected future salary increase and a rate of 4.7% used to discount the future obligations, determined by reference to 10-years high quality corporate bonds in the euro area.

8. Gold and gold receivables

	2006	2005
	SIT million	SIT million
Gold	**9,309**	32
Gold deposits	**9,484**	16,841
Total gold and gold receivables	**18,793**	16,873

9. Derivative financial instruments

Foreign exchange swaps and currency forwards

The Bank entered into certain foreign exchange swap agreements in 2005 and in 2006 which require the Bank to buy EUR for SIT and/or to sell EUR for SIT. The value of derivative instruments and currency forwards are as follows at 31 December:

	2006		2005	
	Fair value	**Notional amount**	Fair value	Notional amount
	SIT million	**SIT million**	SIT million	SIT million
Foreign exchange swaps				
- to be received forward against EUR	-	-	35	164,780
- to be given forward against EUR	-	-	1	4,792
Total derivative financial instruments				169,572

The notional amounts of certain types of financial instruments provide a basis for comparison with instruments recognised on the balance sheet but do not necessarily indicate the amounts of future cash flows involved or the current fair value of the instruments and therefore do not indicate the Bank's exposure to credit or price risks. The derivative instruments become favourable (assets) or unfavourable (liabilities) as a result of fluctuations in market interest rates or foreign exchange rates relative to their terms.

10. Accrued interest and other assets

	2006	2005
	SIT million	SIT million
Paid-up capital of the ECB	**312**	312
Capital investments in other non-residents	**5,030**	5,199
Accrued interest	**14,985**	21,003
Other assets	**1,199**	1
Total	**21,527**	26,515

Capital investments in other non-residents represents BIS shares of SIT 5,009 million (2005: SIT 5,178 million) and SWIFT shares of SIT 21 million (2005: SIT 21 million), carried at cost value.

On 1 May 2004 Slovenia joined the European Union and consequently the Bank became a member of the Europea System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the ECB the Ban became the subscriber of the capital of the ECB. Sub-item Accrued interest and other assets represents the Bank participating interest in the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 c the ESCB Statute and which must be adjusted every five years. The share of the Bank in the ECB's capital i 0.3345% and was calculated in accordance with Article 29 of the Statute of the ESCB, on the basis of populatio and GDP data provided by the European Commission. As Slovenia does not participate in the euro area, th transitional provisons of Article 48 of the Statute apply. Consequently, the Bank was required to pay-up a minim contribution of 7% of its subscribed capital to the ECB upon entry to the ESCB on 1 May 2004 amounting to EU 1,302,967 (SIT 312 million).

Keys for subscriptions of the ECB's capital and amounts of paid-up capital are as follows:

Central bank	**Capital key until 30 April 2004**	**Subscribed capital until 30 April 2004**	**Paid-up capital until 30 April 2004**	**Capital key from 1 May 2004**	**Subscribed capital from 1 May 2004**	**Paid-up capital from 1 May 2004**
	%	**EUR**	**EUR**	**%**	**EUR**	**EUR**
Nationale Bank van België/Banque Nationale de Belgique	2.8297	141,485,000	141,485,000	2.5502	141,910,195	141,910,195
Deutsche Bundesbank	23.4040	1,170,200,000	1,170,200,000	21.1364	1,176,170,751	1,176,170,751
Bank of Greece	2.1614	108,070,000	108,070,000	1.8974	105,584,034	105,584,034
Banco de España	8.7801	439,005,000	439,005,000	7.7758	432,697,551	432,697,551
Banque de France	16.5175	825,875,000	825,875,000	14.8712	827,533,093	827,533,093
Central Bank and Financial Services Authority of Ireland	1.0254	51,270,000	51,270,000	0.9219	51,300,686	51,300,686
Banca d'Italia	14.5726	728,630,000	728,630,000	13.0516	726,278,371	726,278,371
Banque centrale du Luxembourg	0.1708	8,540,000	8,540,000	0.1568	8,725,401	8,725,401
De Nederlandsche Bank	4.4323	221,615,000	221,615,000	3.9955	222,336,360	222,336,360
Oesterreichische Nationalbank	2.3019	115,095,000	115,095,000	2.0800	115,745,120	115,745,120
Banco de Portugal	2.0129	100,645,000	100,645,000	1.7653	98,233,106	98,233,106
Suomen Pankki-Finlands Bank	1.4298	71,490,000	71,490,000	1.2887	71,711,893	71,711,893
Total euro-area NCBs	***79.6384***	*3,981,920,000*	*3,981,920,000*	***71.4908***	*3,978,226,562*	*3,978,226,562*
Česká národní banka	-	-	-	1.4584	81,155,136	5,680,860
Danmarks Nationalbank	1.7216	86,080,000	4,304,000	1.5663	87,159,414	6,101,159
Eesti Pank	-	-	-	0.1784	9,927,370	694,916
Central Bank of Cyprus	-	-	-	0.1300	7,234,070	506,385
Latvijas Banka	-	-	-	0.2978	16,571,585	1,160,011
Lietuvos bankas	-	-	-	0.4425	24,623,661	1,723,656
Magyar Nemzeti Bank	-	-	-	1.3884	77,259,868	5,408,191
Central Bank of Malta/Bank Ċentrali ta' Malta	-	-	-	0.0647	3,600,341	252,024
Narodowy Bank Polski	-	-	-	5.1380	285,912,706	20,013,889
Banka Slovenije	-	-	-	0.3345	18,613,819	1,302,967
Národná banka Slovenska	-	-	-	0.7147	39,770,691	2,783,948
Sveriges Riksbank	2.6636	133,180,000	6,659,000	2.4133	134,292,163	9,400,451
Bank of England	15.9764	798,820,000	39,941,000	14.3822	800,321,860	56,022,530
Total non-euro area NCBs	***20.3616***	*1,018,080,000*	*50,904,000*	***28.5092***	*1,586,442,685*	*111,050,988*
Total euro area and non-euro area NCBs	**100.0000**	**5,000,000,000**	**4,032,824,000**	**100.0000**	**5,564,669,247**	**4,089,277,550**

11. Fixed assets

	Land and buildings SIT million	Computers & equipment SIT million	Total SIT million
Cost or valuation			
At 1 January 2005	3,213	3,304	6,517
Additions	13	556	568
Disposals	-	-205	-205
At 1 January 2006	3,226	3,654	6,880
Additions	235	537	772
Disposals	-	-142	-142
At 31 December 2006	**3,461**	**4,048**	**7,509**
Depreciation			
At 1 January 2005	663	2,300	2,963
Disposals	-	-205	-205
Charge for the year	23	455	479
At 1 January 2006	686	2,551	3,237
Disposals	-	-141	-141
Charge for the year	24	461	485
At 31 December 2006	**711**	**2,870**	**3,581**
Net book value			
At 31 December 2006	**2,750**	**1,178**	**3,928**
At 31 December 2005	2,540	1,103	3,643

At 31 December 2006 an amount of SIT 1,383 million relating to investment properties in Austria (2005: SIT 1,383 million) is included in land and buildings.

12. SDR allocation

	2006 SIT million	2005 SIT million
SDR allocation	**6,956**	7,358
Total SDR allocation	**6,956**	7,358

The SDR allocation liability has an interest rate of 4.07% at 31 December 2006 (2005: 3.03%). Interest paid by the Bank is recharged directly to the Republic of Slovenia, thereby giving a nil effective interest.

Receivables from the Republic of Slovenia have a carrying value equal to principal and are mostly funded by Special Drawing Rights allocations.

13. Banknotes in circulation

Value of banknotes in circulation by denomination:

		2006	2005
		SIT million	SIT million
SIT	10	**189**	197
SIT	20	**252**	275
SIT	50	**285**	331
SIT	100	**1,612**	1,825
SIT	200	**1,707**	1,683
SIT	500	**1,977**	2,223
SIT	1,000	**12,385**	13,946
SIT	5,000	**65,801**	87,214
SIT	10,000	**65,019**	106,149
Total		**149,226**	213,844
Tolar coupons		**404**	404
Total		**149,631**	214,248

14. Capital and reserves

	2006	2005
	SIT million	SIT million
Balance at 1 January	**214,616**	179,873
Transfer/Release to special reserve for foreign exchange differences	**-18,130**	27,564
Release from special reserve – price risk (securities)	**0**	-7,497
Release from general reserves - price risk (securities)	**-14,202**	-3,557
Transfer/Release to special reserve – price risk (gold)	**1,915**	6,654
Transfer to general reserve	**7,481**	11,580
Balance at 31 December	**191,680**	214,616
Represented by		
Initial capital of the Bank of Slovenia	**2,000**	2,000
Special reserve for foreign exchange differences	**111,106**	129,236
Special reserve – price risk (securities)	**0**	-
Special reserve – price risk (gold)	**10,361**	8,446
General reserve	**66,830**	73,551
Investment properties revaluation	**1,383**	1,383
Total reserves	**191,680**	214,616

The reserves of the Bank of Slovenia are composed of general reserves and special reserves. General reserves serve to cover general risks associated with the operations of the Bank of Slovenia. Special reserves serve to cover exchange rate and price risks. Special reserves are equal to the amount of unrealized income deriving from exchange rate and price changes.

15. Commitments and off-balance sheet instruments

Foreign exchange swaps and currency forwards

The Bank entered into certain foreign exchange swap agreements in 2005 and in 2006 which require the Bank to buy EUR for SIT and to sell EUR for SIT. The notional amounts of these instruments are shown in Note 9.

Litigation and other provisions

There are certain legal claims pending or threatened involving the Bank, which have not yet been settled. The Governing Board believes that sufficient provision has been made in the accounts for any expected loss from future settlement. Detailed information in accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" has not been given as this is considered by the Governing Board to be prejudicial to the Bank of Slovenia's position in these cases.

16. Fair value of financial assets and liabilities

The following table summarises carrying amounts and fair values of those financial assets and liabilities not presented on the Bank of Slovenia balance sheet at their fair value. The estimated fair values of fixed interest bearing deposits and of Bank of Slovenia bills are based on discounted cash flows using prevailing money market interest rates for debts with similar credit risk and remaining maturity.

	Carrying value		Fair value	
	2006	2005	**2006**	2005
	SIT million	SIT million	**SIT million**	SIT million
Assets				
Cash and deposits	**236,941**	321,635	**237,023**	321,939
Liabilities				
Current accounts and deposits to banks	**109,293**	82,466	**109,619**	82,669
Bank of Slovenia bills in foreign currency	**32,449**	323,938	**32,598**	324,820
Commercial banks' deposits	**230,630**	203,490	**231,104**	205,925
Overnight deposits	**95,159**	1,500	**95,159**	1,500
Bank of Slovenia bills in domestic currency	**402,381**	525,184	**403,736**	527,016
Republic of Slovenia deposits	**1,296**	2,682	**1,296**	2,682

The fair values of deposits approximate their carrying amounts as they are payable on demand or of very short maturity.

Due to the specific role of IMF holdings and the SDR allocation, fair values of both do not differ from their carrying amounts.

The fair value of currency in circulation is considered to be its face value.

17. Risk Management

Credit Risk

All marketable securities are interest bearing bonds. All marketable securities and deposits are held with foreign banks. Financial asset with the IMF consists of SDR account, Republic of Slovenia Quota, Security Account and No.1 Account with the IMF. Item is shown on a net basis according to the reserve trance position role as of Bank's own reserves (IMF Articles of Agreement).

All foreign banks in which the Bank places funds have a credit rating of at least A-. Credit rating represents the average of credit ratings graded by Fitch, Moody's and Standard & Poor's. The maximum credit risk exposure at 31 December 2006 in the event that other parties fail to perform their obligations is the amount recorded in the financial statements as financial assets. Sovereign issuers' exposure consists of OECD countries, new EU member states and the Republic of Slovenia. The Governing Board believes that there is no significant concentration of credit risk.

Concentrations of securities by currency and type of counterparty ae as follows at 31 December 2006:

	EUR	USD	Other	Total
	%	%	%	%
Sovereign bonds	**42.30**	**7.83**	**2.18**	**52.31**
Supranational securities	**2.04**	**1.02**	**0.48**	**3.55**
Foreign banks securities	**33.93**	**3.48**	**6.74**	**44.15**
December 31, 2006	**78.27**	**12.34**	**9.40**	**100.00**
Sovereign bonds	38.71	9.82	3.30	51.83
Supranational securities	2.12	1.61	1.33	5.06
Foreign banks securities	35.72	3.24	4.14	43.11
December 31, 2005	76.55	14.67	8.77	100.00

Interest rate risk

Average effective interest rates:

	Repricing period				
	3 months or less	3 months to 1 year	Over 1 year	2006 Total	2005 Total
	%	%	%	%	%
Assets					
Foreign currency assets					
Gold and gold receivables	**0.01**	-	-	**0.01**	0.06
Cash and deposits	**4.37**	-	-	**4.37**	2.86
Derivative financial instruments	-	-	-	-	1.50
Financial assets at fair value through P/L	**4.15**	**4.35**	**4.23**	**4.24**	3.28
International Monetary Fund	**3.02**	-	-	**3.02**	2.46
Liabilities					
Foreign currency liabilities					
Current accounts and deposits to governmental institutions	**3.43**	**5.15**	-	**3.64**	2.81
Derivative financial instruments	-	-	-	-	1.00
Bank of Slovenia bills	**3.40**	-	-	**3.40**	2.45
Domestic currency liabilities					
Current accounts	**0.75**	-	-	**0.75**	0.75
Commercial banks' deposits	**3.68**	-	-	**3.68**	4.20
Overnight deposits	**2.50**	-	-	**2.50**	2.25
Bank of Slovenia bills	**3.50**	**3.50**	-	**3.50**	4.00
Republic of Slovenia deposits	**1.00**	-	-	**1.00**	1.00

The effective interest rates shown represent average interest at the end of the reporting period.

Interest sensitivity of assets and liabilities

(SIT million)

	Repricing period			
	3 months or less	3 months to 1 year	Over 1 year	2006 Total
Assets				
Foreign currency assets				
Gold and gold receivables	18,793	-	-	**18,793**
Cash and deposits	236,941	-	-	**236,941**
Financial assets at fair value through P/L	146,783	180,504	715,090	**1,042,377**
Receivables from the RS	2,182	-	6,956	**9,137**
International Monetary Fund	8,919	-	-	**8,919**
Total assets	**413,617**	**180,504**	**722,045**	**1,316,166**
Liabilities				
Foreign currency liabilities				
Current accounts and deposits to governmental institutions	95,913	13,380	-	**109,293**
Bank of Slovenia bills	32,449	-	-	**32,449**
IMF and other IFO	3,467	-	8	**3,475**
SDR allocation	-	-	6,956	**6,956**
Domestic currency liabilities				
Current accounts	100,994	-	-	**100,994**
Commercial banks' deposits	230,360	-	-	**230,360**
Overnight deposits	95,159	-	-	**95,159**
Bank of Slovenia bills	365,179	37,201	-	**402,381**
Republic of Slovenia deposits	1,296	-	-	**1,296**
International fiancial organisations	263	-	-	**263**
Total liabilities	**925,080**	**50,582**	**6,964**	**982,626**
Net interest sensitivity gap	**-511,464**	**129,922**	**715,082**	**333,540**
December 31, 2005				
Total assets	417,105	262,853	983,409	1,663,367
Total liabilities	984,580	57,534	210,850	1,252,964
Net interest sensitivity gap	-567,475	205,320	772,558	410,403

Currency risk

The nature and manner in which the Bank conducts its operations, principally in relation to monetary policy management and foreign currency reserve management, give rise to currency concentrations in the financial assets. This primarily arises from country and counterparty concentration of exposures.

Basic guidelines for the management of the Bank's international reserves are set by the Governing Board of the Bank and revised on a quarterly basis; the guidelines prescribe the currency structure, average term of deposits and of investments in foreign securities, as well as selection of foreign banks.

These concentrations of risk by currency and type of counterparty are as follows at 31 December 2006:

	SIT	EUR	USD	Other	Total
	SIT million	SIT million	SIT million	SIT million	SIT million
Assets					
Foreign currency assets					
Gold and gold receivables	-	-	-	18,793	**18,793**
Cash and deposits	-	113,785	59,949	63,206	**236,941**
Financial assets at fair value through P/L	-	815,842	128,583	97,952	**1,042,377**
Receivables from the RS	-	-	-	9,137	**9,137**
International Monetary Fund	-	-	-	8,919	**8,919**
Accrued interest and other assets	-	13,872	1,593	6,062	**21,527**
Domestic currency assets	986	-	-	-	**986**
Total assets	**986**	**943,498**	**190,125**	**204,070**	**1,338,679**
Liabilities					
Foreign currency liabilities					
Current accounts and deposits to governmental institutions	-	79,594	29,445	254	**109,293**
Bank of Slovenia bills	-	32,449	-	-	**32,449**
IMF and other IFO	-	3,467	-	8	**3,475**
SDR allocation	-	-	-	6,956	**6,956**
Accrued interest and other liabilities		2,180	193	48	**2,422**
Domestic currency liabilities	844,207	-	-	-	**844,207**
Total liabilities	**844,207**	**117,691**	**29,639**	**7,265**	**998,802**
Net balance sheet position	**-843,221**	**825,807**	**160,486**	**196,805**	**339,877**
Off-balance sheet net position	-	-	-	-	-
December 31, 2005					
Total assets	748	1,252,656	239,314	197,912	1,690,630
Total liabilities	844,401	341,947	67,464	7,737	1,261,549
Net balance sheet position	-843,652	910,709	171,850	190,175	429,082
Off-balance sheet net position	-	-169,572	-	-	-169,572

Maturities of assets and liabilities

(SIT million)

	Remaining period to the contractual maturity date			
	3 months or less	3 months to 1 year	Over 1 year	2006 Total
Assets				
Foreign currency assets				
Gold and gold receivables	-	-	18,793	**18,793**
Cash and deposits	236,941	-	-	**236,941**
Financial assets at fair value through P/L	146,783	180,504	715,090	**1,042,377**
Receivables from the RS	2,182	-	6,956	**9,137**
International Monetary Fund	2,257	-	6,662	**8,919**
Accrued interest and other assets	11,002	5,494	5,030	**21,527**
Domestic currency assets				
Accrued interest and other assets	723	69	194	**986**
Total assets	**399,887**	**186,067**	**752,725**	**1,338,679**
Liabilities				
Foreign currency liabilities				
Current accounts and deposits to governmental institutions	108,909	383		**109,293**
Bank of Slovenia bills	32,449	-	-	**32,449**
IMF and other IFO	3,467	-	8	**3,475**
SDR allocation	-	-	6,956	**6,956**
Accrued interest and other liabilities	2,250	172	-	**2,422**
Domestic currency liabilities				
Current accounts	100,994	-	-	**100,994**
Commercial banks' deposits	230,360	-	-	**230,360**
Overnight deposits	95,159	-	-	**95,159**
Bank of Slovenia bills	365,179	37,201	-	**402,381**
Republic of Slovenia deposits	1,296	-	-	**1,296**
International financial organisations	263	-	-	**263**
Accrued interest and other liabilities	12,936	39	779	**13,754**
Total liabilities	**953,264**	**37,795**	**7,743**	**998,802**
Maturity gap	**-553,377**	**148,271**	**744,982**	**339,877**
December 31, 2005				
Total assets	419,747	271,571	999,313	1,690,630
Total liabilities	992,601	58,097	210,850	1,261,549
Maturity gap	-572,855	213,474	788,462	429,082

Liquidity risk is the risk that a company will face inability in raising funds at short notice to meet its immediate liabilities associated with financial instruments. Liquidity risk is also the risk of selling a financial asset quickly at significantly lower value than its fair value.

The matching and controlled mismatching of the maturities is a key criterion in determining and managing the Bank's foreign currency assets and liabilities. This is reflected in appropriate maturities of foreign assets additionally taking into account potential needs for intervention. The Bank has set controls that encounter different liquidity ratios for different instruments. These limits as well as currency and credit risk exposures are monitored daily. Additionally, the Bank has standby credit facility arrangements.

One of the Bank's primary task is to ensure liquidity of payments within the country. The nature of these activities is such that the Bank is not subject to the liquidity constraints that impact on other entities.

18. Supplemental cash flow information: cash flows from Bank of Slovenia bills

	2006	2005
	SIT million	SIT million
Source		
Banks deposits	**26,870**	46,760
Tolar bills	**-**	258,596
Total	**26,870**	305,356
Disbursement		
Foreign currency bills	**-289,042**	-182,169
Tolar bills	**-122,803**	-
Total	**-411,845**	-182,169
Total net source/disbursement	**-384,975**	123,187

19. Supplemental cash flow information: cash and cash equivalents

	2006	2005
	SIT million	SIT million
Foreign currency assets		
Cash	**10,067**	11,893
Total assets	**10,067**	11,893
Foreign currency liabilities		
Demand deposits	**-29,355**	-35,399
Domestic currency liabilities		
Commercial banks' demand deposits	**-92,266**	-97,664
Overnight deposits	**-95,159**	-1,500
Non-bank deposits	**-9,967**	-9,428
Total liabilities	**-226,747**	-143,991
Cash and cash equivalents	**-216,680**	-132,098

Foreign currency cash assets include IMF balances of SIT 2,257 million (2005: SIT 2,354 million) and do not include time deposits of SIT 214,071 million (2005: SIT 294,828 million) or other assets of SIT 13,261 million (2005: SIT 14,459 million).

Foreign currency demand deposits do not include restricted deposits of SIT 79,938 million (2005: SIT 47,067 million).

Domestic currency liabilities include overnight deposits of SIT 95,159 million (2005: SIT 1,500 million), Republic of Slovenia deposits of SIT 1,294 million (2005: SIT 2,680 million) and tolar accounts of central banks and of the European Commission of SIT 263 million (2005: SIT 271 million). They do not include liabilities to KDD of SIT 318 million (2005: SIT 145 million).