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Abbreviations used in Macroeconomic Developments and Projections*

BRIC	Brazil, Russia, India, China
CB	central bank
CPI	consumer price index
EC	European Commission
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
Eonia	Euro OverNight Index Average
ESCB	European System of Central Banks
ESM	European Stability Mechanism
ESR95	European System of Accounts (1995)
EU	European Union
EUR	Euro
Euribor	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
Fed	Federal Reserve
FRED	Federal Reserve Economic Data
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
LTD ratio	loan to deposit ratio
LTRO	longer-term refinancing operation
MoF	Ministry of finance
MRO	main refinancing operation
NACE	standard classification of economic activities
NFCs	non-financial corporations
NLB	Nova Ljubljanska Banka d.d.
NPISH	non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
PMI	purchasing managers' index
PPI	producer price index
Q	quarter
ROW	rest of the world
SURS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar
VAT	value added tax
WEO	World Economic Outlook
ZDR	Employment Relationship Act
ZPIZ-2	Pension and Disability Insurance Act
ZUJF	Fiscal Balance Act
ZUTD	Labour market regulation act

* The Macroeconomic Developments and Projections report is the successor to the Price Stability Report.

Executive Summary

Economic activity has been declining since the second half of 2011 as a result of a significant drop in domestic demand and the stagnation of foreign demand. Uncertainty, rising unemployment, a decline in consumer confidence, constraints on financing and the fall in purchasing power have contributed to a large decline in private sector demand. In the second half of last year, additional fiscal consolidation measures were another major factor in the decline in domestic demand. Medium-term consolidation of the public finances and the restructuring of bank and corporate balance sheets remains vital. This limits the room for mitigating the consequences of the crisis. In such circumstances, economic activity is expected to decline by almost 2% this year. The economy is not expected to grow until 2014. A sharp decline in employment is also expected. By contrast, the situation in industry is relatively favourable, including exports. The decline in imports in line with domestic demand and the gradual increase in exports could widen the current account surplus to more than 4% of GDP. Inflation increased at the end of last year as a result of one-off effects and growth in energy prices, while core inflation remained low due to the deteriorating macroeconomic situation. Projections indicate a fall in inflation to below 2% in the second half of this year. In recent months, two key structural reforms were unanimously adopted , the pension reform, which will contribute to the sustainability of public finances, and the labour market reform, which is expected to reduce inflexibility on the labour market and encourage employment.

* * *

The recession in the euro area deepened in the second half of 2012. After the difficulties in certain euro area periphery countries, the decline in activity spread to the majority of euro area countries. The situation outside the euro area has been more favourable, particularly in emerging Asian economies. The global economic activity slowed in the second half of last year, which spurred certain central banks to introduce additional measures to stimulate economic growth. Greater central bank activity helped to somewhat reduce uncertainty on the financial markets. Accordingly, confidence indicators in the euro area increased, as did prices of oil and other commodities.

In addition to the deterioration in the international environment, the Slovenian economy suffered a further decline in domestic demand in 2012. GDP fell by 2.3% as the situation deteriorated, primarily from the second quarter on, when comprehensive government austerity measures brought a decline in government consumption, and a particularly sharp decline in consumer confidence. The decline in household consumption increased the pace of the cost adjustment of the economy, which further reduced consumer purchasing power. In particular, low domestic demand strongly impacted service activities. Investment also continued to contract as a result of harsher corporate financing conditions. This was reflected in a further decline in construction activity. The contribution made to GDP growth by manufacturing, which was the basis for the otherwise weak economic recovery in 2010 and 2011, turned negative last year, but was still relatively favourable in the given circumstances. Alongside construction, employment fell in private sector services and in industry in 2012. In the second half of the year, public sector started reducing jobs as well.. The year-on-year fall in employment exceeded 2% at the end of the year. Unemployment therefore rose sharply in the final quarter, as the ILO unemployment rate approached 10%.

After balanced position in 2011, the current account recorded a surplus of 2.3% of GDP, primarily as a result of a significant narrowing in the merchandise trade deficit. Nominal growth in exports of merchandise and services was low due to weak foreign demand, while imports fell sharply as a result of the decline in domestic demand. The cost competitiveness of the economy is displaying an improving trend, even though it was hindered in 2012 by a decline in productivity. The latter resulted in moderate growth in nominal unit labour costs, but at a lower rate than in the euro area average. This allowed the continued narrowing of the gap in cost competitiveness that arose in 2008 and 2009.

Loans received from domestic banks declined again last year, while financing from the rest of the world and, partly, internal financing increased. In the second half of last year, loans to households declined for the first time. Alongside a decline in consumer loans, this was the result of negligible growth in housing loans. The banks still have constraints in replacing maturing financial liabilities, but are gradually improving the LTD ratio on their balance sheets. The quality of the loan portfolio has continued to deteriorate, as a result of which impairment and provisioning costs are rising. This is being reflected in the stock of loans granted and in interest rates for corporates, which are significantly above the euro area average. High funding costs are also a factor in the high bank lending rates. Interest rates on loans to households are comparable to average interest rates for such loans in the euro area.

Growth in the harmonised index of consumer prices rose to 2.8% in 2012. Core inflation remains low, at 1%. Demand-side pressures on prices are very weak, while the supply-side impact on inflation is also limited. The main factors in the rise of 0.7 percentage points in inflation relative to 2011 were rises in prices of public services, higher levies associated with fiscal consolidation, and euro prices of certain commodities. Fiscal factors, which accounted for more than half of the overall rise in prices, have continued to have a profound impact on inflation in the early part of this year.

GDP is expected to decline by around 2% in 2013, and then to resume very slow growth in 2014. The downward revision of the projection is a reflection of the factors that caused the recession last year remaining unfavourable. Foreign demand remains weak, and access to financing is often limited. At the same time, additional fiscal consolidation measures are necessary, and indicators of uncertainty and economic sentiment remain unfavourable. Weak domestic demand will be reflected not only in low investment, but in a decline in household and government consumption. Growth in exports will also be low, but will lead to a surplus in net trade as imports decline. The current account surplus is expected to widen to 4.0% of GDP this year, and to around 4.5% of GDP by the end of the projection horizon. Inflation is expected to fall to 2.3% this year, and to below 2% in the next two years. Core inflation will remain low due to adverse macroeconomic situation.

The risks to the GDP growth projection remain high, with risks concentrated on a downside. The risk of lower foreign demand continues as a result of the lack of growth and persistent uncertainty in the euro area, and the uncertainty surrounding the situation in certain major economies. The uncertainty surrounding domestic factors also remains high, in particular additional fiscal consolidation measures and measures to improve the situation of the financial system. The situation on the labour market is deteriorating very rapidly, and could remain unfavourable over the longer term. The financing situation also remains uncertain, particularly in connection with access to foreign financing. This could be further constrained by downgradings of Slovenia's sovereign debt. The risks surrounding inflation remain balanced, and similar to those in previous projections. The risks of higher inflation are related primarily to additional fiscal consolidation measures, price rises in sectors less exposed to competition, and higher energy and food prices. A larger decline in domestic demand and sharper cost adjustment in the economy could result in lower core inflation.

* * *

The provisions and commitments of the Stability and Growth Pact dictate a reduction in the general government deficit. Fiscal consolidation is also a prerequisite for preventing further sovereign downgrades and facilitating normal access to financing for *the public and private sectors in the financial markets. A major factor in the constraints on financing is the lack of clarity in programmes of the restructuring of the banking system and the of corporate sector. However, in December 2012 the National Assembly unanimously passed a reform of the pension system aimed at improving the sustainability of public finances. In Reporting of Government Deficit and Debt Levels, the general government deficit in 2013 was estimated at 4.2% of GDP, including funding for strengthening bank capital in the amount of 1.2% of GDP. Excluding the funding for strengthening bank capital, the foreseen deficit stands at 3.0% of GDP. The Stability Programme of April 2012 planned the gradual elimination of the structural deficit by 2015, for which additional measures will be required. Given the limited possibilities of economic growth in the medium term, high unemployment and a lack of confidence in the economy and among consumers, it would be advisable to make greater use of measures with a smaller adverse impact on demand and economic growth. During this process, concern should also be given to the proper level of social security. This entails greater use of measures on the revenue side of the budget, at least temporarily, and less reduction in expenditures on goods and services, investment and public sector employment. Nevertheless, reducing the deficit should also be based on the continued adjustment of public sector wages and social transfers, where the situation so permits.*

In its guidance of activities to strengthen bank capital and in its supervision of the banks, the Bank of Slovenia is attending to the gradual strengthening of the banking system, in line with the guidelines of the European Banking Authority. The ability to roll over or obtain new funding in the rest of the world depends on the capital adequacy of banks, the sovereign credit rating, and the restructuring of the over-leveraged real sector. Strengthening the banking system must also rely more on the effective addressing of non-performing loans on bank balance sheets. Financing the economy predominantly with foreign debt via bank lending, that prevailed before the crisis, is now no longer feasible. The economy needs financial restructuring and deleveraging. It is vital to address over-leveraged corporates, partly by means of debt-to-equity conversions, which would also reduce the need for additional impairments at the banks. The aforementioned factors are partly hindering the functioning of the monetary policy transmission mechanism, and contribute to higher interest rates on corporate loans in comparison to the euro area average. The Bank of Slovenia therefore supports the use of a variety of measures to stabilise banks in difficulty as envisaged in the Government Measures to Strengthen the Stability of Banks Act. The Bank of Slovenia also warned that it is vital to speed up the adoption of amendments to the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act.

Rising unemployment is becoming an important problem. The increased uncertainty surrounding employment is also a major factor in the low level of domestic consumption, as unemployment is the largest risk to household income. Holding wage growth below productivity growth will be essential to reducing unemployment. Here it is necessary for individuals' wages to better reflect their contribution to the performance of corporates and public sector institutions. Increased cost and innovation competitiveness would also allow corporates to reinforce their capital adequacy, to generate their own resources of financing, and to gain easier access to external financial resources. Because the structure of investment was unfavourable in 2012, technological level of production has to be strengthened to enable acceleration in export growth during the anticipated recovery in foreign demand. Active labour market policy should ensure the appropriate level of training and retraining for the unemployed to increase their employment opportunities and to switch the labour force from sectors in difficulty to sectors with good prospects.

With the adoption of reforms of the labour market and the pension system, progress has been made in the field of structural reforms. Appropriately pitched, the latter have a long-term impact on economic growth and labour productivity, thereby contributing to medium-term fiscal consolidation. Encouraging effective corporate and public sector governance, the development of human capital, market competition, particularly in the service sector, and innovation remain of key importance. These factors widen the scope of business opportunities, increase the attractiveness of the economic environment for new investment, and thus promote economic development and facilitate the transition from cost competitiveness to competitiveness via innovation.

								Projections					
								2013		2014		2015	
	2006	2007	2008	2009	2010	2011	2012	**Apr.**	Δ	**Apr.**	Δ	**Apr.**	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	5.8	7.0	3.4	-7.8	1.2	0.6	-2.3	**-1.9**	-1.2	**0.5**	-0.3	**1.4**	…
Employment	1.6	3.3	2.6	-1.8	-2.2	-1.6	-1.3	**-2.4**	-0.9	**-0.9**	-0.3	**-0.1**	…
Compensation per employee	5.4	6.2	7.2	1.8	3.9	1.6	-0.4	**-0.5**	-0.8	**0.6**	0.0	**0.6**	…
Productivity	4.2	3.5	0.8	-6.1	3.5	2.2	-1.0	**0.5**	-0.3	**1.4**	0.0	**1.5**	…
ULC (nominal)	1.1	2.6	6.4	8.5	0.4	-0.6	0.7	**-1.0**	-0.5	**-0.8**	0.0	**-0.8**	…
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	5.0	7.0	4.1	-6.1	-2.1	-1.4	-3.7	**-3.0**	-1.3	**-1.3**	-0.9	**0.3**	…
Net exports	0.2	-2.0	0.1	2.4	1.5	1.3	3.3	**1.5**	-0.3	**1.1**	-0.4	**1.0**	…
Changes in inventories	0.7	2.0	-0.9	-4.1	1.9	0.7	-1.9	**-0.5**	0.2	**0.8**	1.0	**0.0**	…
Domestic demand	*real growth rates, %*												
Domestic demand	5.6	9.0	3.2	-10.0	-0.2	-0.7	-5.7	**-3.7**	-1.9	**-0.6**	-0.1	**0.4**	…
Private consumption	2.8	6.3	2.3	0.1	1.3	0.9	-2.9	**-3.1**	-1.4	**-1.2**	-1.6	**0.2**	…
Government spending	4.0	0.6	5.9	2.5	1.5	-1.2	-1.6	**-2.3**	-0.3	**-0.5**	1.1	**-0.4**	…
Gross fixed capital formation	10.4	13.3	7.1	-23.2	-13.8	-8.1	-9.3	**-4.9**	-1.6	**-3.0**	-1.2	**1.6**	…
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	12.5	13.7	4.0	-16.7	10.1	7.0	0.3	**0.4**	-2.0	**2.6**	-1.7	**4.5**	…
Imports of merchandise and services	12.2	16.7	3.7	-19.5	7.9	5.2	-4.3	**-1.7**	-1.8	**1.5**	-1.4	**3.8**	…
Current account: EUR billion	-0.8	-1.6	-2.3	-0.2	-0.2	0.0	0.8	**1.4**	0.2	**1.5**	-0.1	**1.6**	…
as % GDP	-2.5	-4.8	-6.2	-0.7	-0.6	0.0	2.3	**4.0**	0.7	**4.3**	0.0	**4.6**	…
Terms of trade*	-0.5	0.9	-1.5	3.8	-3.9	-1.6	-0.9	**-0.6**	-0.5	**-1.0**	-1.0	**-1.0**	…
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	2.5	3.8	5.5	0.9	2.1	2.1	2.8	**2.3**	0.0	**1.4**	0.1	**1.6**	…
HICP excluding energy	1.7	3.8	4.9	1.7	0.3	1.0	1.8	**2.0**	0.1	**1.5**	0.0	**1.7**	…
HICP energy	8.5	3.4	9.4	-4.5	13.9	8.8	9.0	**4.3**	0.0	**0.9**	0.3	**0.8**	…
International environment	*growth rates, % (if not specified otherwise)*							Assumptions					
Foreign demand**	11.6	11.3	5.9	-14.2	11.3	7.5	1.4	**1.6**	-0.9	**3.2**	-0.8	**4.5**	…
Oil (USD per barrel)	65	73	98	62	80	111	112	**115**	5.0	**115**	5.0	**115**	…
Non-oil commodities	29.1	17.4	10.1	-23.0	37.1	18.0	-7.2	**1.2**	-0.4	**2.0**	-3.1	**5.0**	…
EMU inflation	2.2	2.1	3.3	0.3	1.6	2.7	2.5	**1.8**	0.1	**1.8**	-0.2	**2.0**	…
PPI Germany	5.4	1.3	5.4	-4.0	1.5	5.6	2.0	**1.7**	-0.1	**2.4**	1.0	**2.2**	…

* Based on national accounts deflators.

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

Δ: Difference between current projections and projections in October 2012 Price Stability Report.

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

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1 International Environment

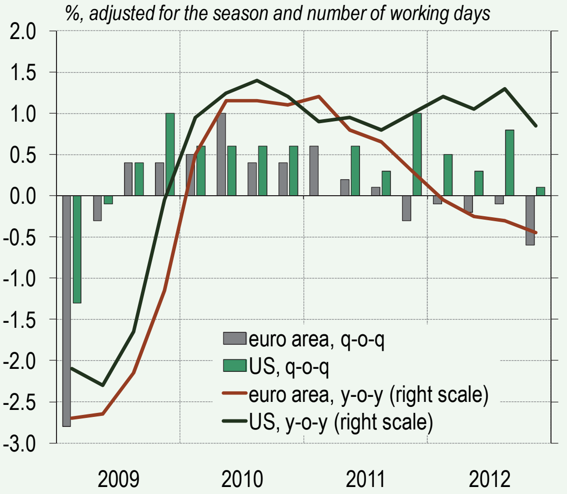
The recession in the euro area deepened in the second half of 2012. It spread to the majority of euro area countries, but the situation outside the euro area remained more favourable, particularly in emerging Asian economies. The global economic climate also slowed during the second half of the year. Stronger central bank activity helped to slightly reduce uncertainty on the financial markets, and confidence indicators in the euro area increased accordingly, as did prices of oil and other commodities.

Economic developments

Global economic growth slowed in the second half of 2012, as growth in international trade weakened. Economic growth in most of the BRIC countries remained high compared with developed countries, and ranged from 1.4% in Brazil to 7.9% in China year-on-year in the final quarter. Growth in the US stalled at the end of the year as a result of the negative contribution made by government consumption and a contraction in exports. The end of the fiscal stimulus also brought increased uncertainty, which resulted in a decline in the consumer confidence indicators.

Figure 1.1: GDP growth in the euro area and the US

%, adjusted for the season and number of working days



Sources: Eurostat, FRED.

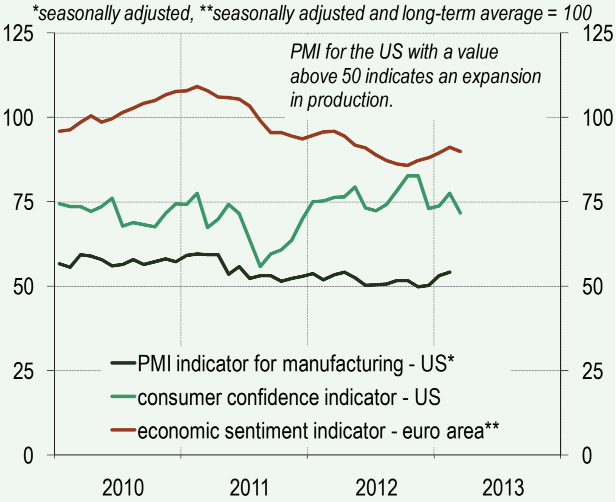
The economic contraction in the periphery countries spread to other major euro area countries in the final quarter of 2012. There was a sharp decline in investment, while international trade was also down on a quarterly basis. Household consumption also declined, as a result of record high unemployment, which had risen to 11.9% by January 2013, and low consumer confidence. The rise in the economic sentiment indicator in the euro area ended in March.

The economic situation in Slovenia's largest trading partners deteriorated in the final quarter of 2012. GDP in the final quarter was down 0.6% in quarterly terms in Germany, 0.2% in Austria, 0.3% in France and by 0.9% in Italy. All of these economies also recorded a decline in gross investment and international trade. Activity in the

Figure 1.2: International comparison of unemployment rates

Sources: Eurostat, FRED.

Figure 1.3: Economic sentiment indicators for the euro area and the US



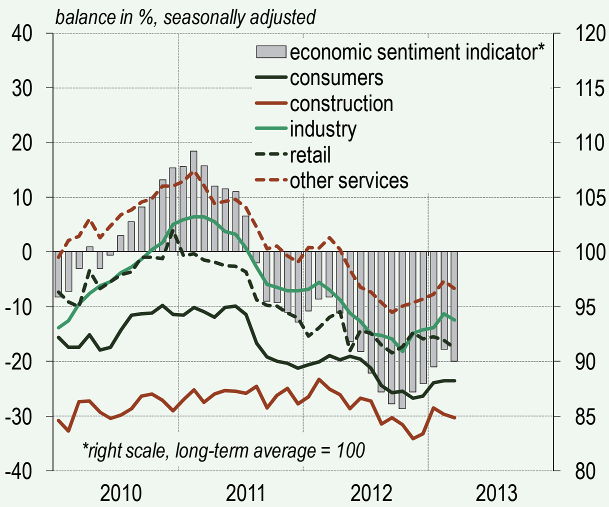
Sources: Eurostat, FRED.

final quarter also declined in the majority of the trading partners outside the euro area, except in Russia, where it slowed. GDP was down 2.3% in year-on-year terms in Croatia, and by 1.5% in Serbia.

Financial markets and commodity prices

The major central banks continued to use additional non-standard measures in early 2013. The ECB cut its key interest rate to 0.75% in July and announced its OMT operation in September. Having raised its inflation target to 2% in January, the Bank of Japan also intends to expand its use of non-standard monetary policy measures in 2013. In December the Fed also announced a new cycle of government securities purchases and swaps. The Fed will continue to use non-standard measures and to hold down interest rates until unemployment falls below 6.5%, assuming price growth to remain slow and inflation expectations stable. The Fed's key interest rate has been in the interval between 0.00% and 0.25% since December 2008. The Bank of England's key interest rate has remained unchanged since March 2009, lately signalling that it is willing to look through the inflation higher than its target over the temporary, albeit protracted, period.

Figure 1.4: Confidence indicators in the euro area



Source: European Commission.

The euro has mostly risen against the US dollar since the middle of last year, but began falling in February of this year. The main factors in the euro / US dollar exchange rate at the end of 2012 were the actions by the Fed and a moderate reduction in uncertainty surrounding the fiscal crisis in the euro area periphery countries. The euro began to slide as a result of the deepening recession in the euro area in the final quarter of last year. It averaged USD 1.296 in March, down 1.8% on March 2012. In March the euro was up 3.0% in year-on-year

Box 1.1: Macroeconomic trends in Slovenia's major trading partners in the Balkans in 2013-2015

Given the contraction in economic activity in the EU in 2012 and the anticipated stagnation in 2013, the forecasts for this year's macroeconomic developments in the Balkan countries have also been revised downwards. This is also worsening the outlook for growth in Slovenia's exports, as the Balkan countries account for around 16% of total exports. The largest shares are those of Croatia (6.5%), Serbia (3%), Bosnia and Herzegovina (2.7%) and Romania (1.5%), which are included in this analysis.

Alongside the adverse economic situation in the international environment, weak domestic consumption is another factor worsening the economic outlook for the Balkan countries in 2013-2015. GDP growth in the Balkan countries that are Slovenia's largest trading partners is forecast to be very low this year, at an average of less than 1%. Given the expected gradual improvement in the global economic situation, GDP could grow faster in the next two years, but the risks are on the down side, primarily because of the risks to foreign demand. Domestic corporates and households that borrowed

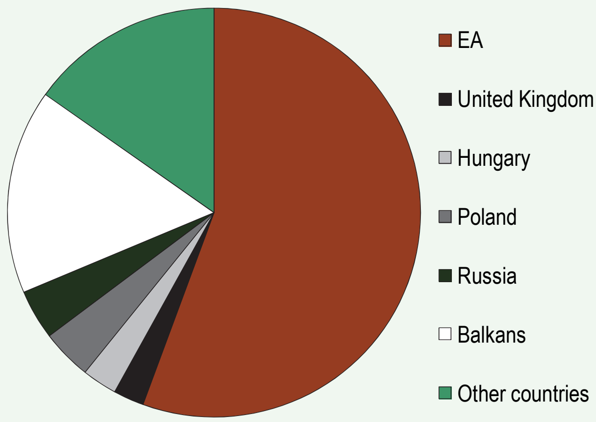
Figure 1: GDP forecasts for Slovenia's main trade partners in the Balkans in 2013

Source: Consensus Economics.

Figure 2: GDP forecasts for Slovenia's main trade partners in the Balkans in 2014

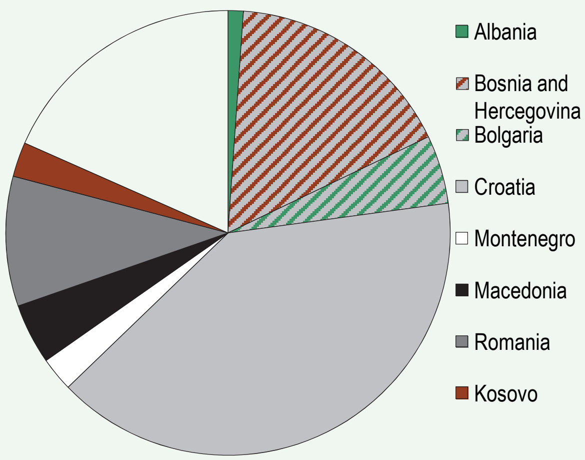
Source: Consensus Economics.

Figure 3: Average share of trade exports from Slovenia to selected groups of countries, 2010-2012



Source: Statistical Office of the Republic of Slovenia.

Figure 4: Average share of trade exports from Slovenia to the Balkans, 2010–2012



Source: Statistical Office of the Republic of Slovenia.

heavily during the global boom are now deleveraging. This is hindering investment and curbing private consumption, both of which are being constrained by fiscal consolidation. Private consumption has also been constrained by a stagnation and falls in wages and by high inflation. Unemployment reached record levels at the end of 2012. In December the rate stood at 21.1% in Croatia, 22.4% in Serbia, and more than 40% in Bosnia and Herzegovina. Unemployment will remain high between 2013 and 2015.

Some internal and external imbalances have diminished since the outbreak of the crisis in 2008, but the macroeconomic situation has deteriorated, which has increased the financing needs of the economy. Public debt and the Balkan countries' external debt have risen since the outbreak of the crisis in 2008, while corporate lending has declined. Growth in loans to the non-financial sector over the last few years has been much lower than during the pre-crisis period, albeit it remained positive. As a result of downgradings, costlier borrowing and low FDI, the manoeuvring room for economic policy to ease the financing conditions has shrunk further. The poor availability of financing is slightly alleviated by EU funds.

The current account deficit is narrowing in most Balkan countries. It averaged significantly more than 10% of GDP at the outbreak of the crisis in 2008, but this had more than halved by 2012. The smaller current account deficit was primarily the result of the decline in domestic demand. Of the countries analysed, this year's largest current account deficits are forecast for Serbia and for Bosnia and Herzegovina, at around 9% of GDP, while Croatia is forecast to have the smallest deficit, at around 1% of GDP.

Despite the narrowing trade deficit, external debt has increased. Although the governments are taking consolidation measures, the public finance situation is worsening. Gross external debt is forecast to remain high between 2013 and 2015. It averaged 75% of GDP in the Balkan countries in 2012. The highest figure was in Croatia, where it stood at more than 100% of GDP. The lowest external debt last year was recorded in Bosnia and Herzegovina, at around 52% of GDP, while there was a sharp rise in Serbia's gross external debt, from 67% of GDP in 2008 to more than 80% of GDP in 2012. The external debt was the product not only of high private sector debt, but also of the increased government sector borrowing caused by rising general government deficits. The individual countries of the Balkans attempted to reduce their general government deficits by raising VAT (Croatia), by taking administrative measures to improve tax collection efficiency (Romania), by improving controls of government expenditure (Bosnia and Herzegovina), and by other measures. The deterioration in the macroeconomic situation nevertheless necessitated new borrowing, which led to a rise in public debt.

Domestic factors are having a major impact on inflation in the Balkan countries. These primarily relate to rises in administered prices (mainly gas and electricity), the situation on the food market (weather conditions, market development) and fiscal measures. The main factors in inflation in the Balkan countries between 2010 and 2012 were high food prices (most notably in Serbia), energy prices (all countries) and one-off factors (taxes, administrative duties, etc.). The IMF is forecasting that Bosnia and Herzegovina will have the lowest inflation rate in 2013 at 2.0%, while Serbia will have the highest at 7.5%, having recorded very high inflation in 2012 (12.2% in December) despite the measures taken by the central bank.

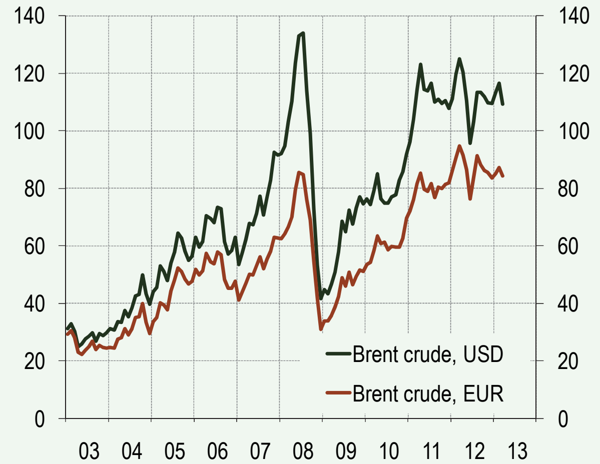
terms against the pound sterling, 1.7% against the Swiss franc, and 13.0% against the Japanese yen under the influence of the strong economic stimulus by the Japanese central bank.

After rising briefly in early 2013, the price of Brent crude fell in March to its level of the second half of 2012, when it was fairly stable. The price of Brent crude did not change significantly in the second half of the year, and stood at around USD 110 per barrel. The reduced uncertainty surrounding the fiscal crisis in the euro area and the economic stimulus by major central banks increased the price to almost USD 120 per barrel in early 2013. In March the oil price again dipped below USD 110, as a result of heightened uncertainty on the financial markets. The euro price of Brent crude was thus down more than 10% in year-on-year terms in March. US dollar commodity prices were down 2.6% in year-on-year terms in February.

Figure 1.5: Euro / US dollar exchange rate and central bank interest rates

Sources: ECB, Federal Reserve.

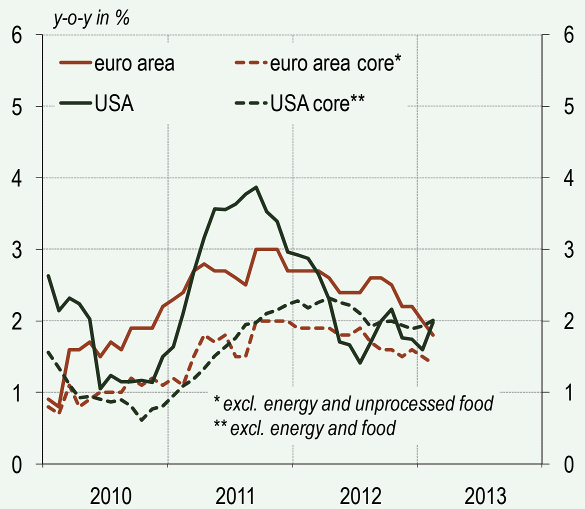
Figure 1.6: Oil prices per barrel



Sources: Bloomberg, ECB, Bank of Slovenia calculations.

The situation on the financial markets had temporarily eased since mid-2012 under the influence of central bank actions, but the uncertainty increased again in March as a result of the Cypriot crisis. In Ireland, where assessments of fiscal consolidation and the stabilisation of the financial system are mostly encouraging, the spreads over lowest-risk securities are already allowing the country to finance itself on the international financial markets. In other periphery countries financing risk recorded a renewed slight increase in March, which is worsening financing conditions and hindering economic recovery.

Figure 1.7: Inflation in the euro area and the US



Sources: Eurostat, U.S. Department of Labor.

2 Economic Trends and the Labour Market

In addition to the deterioration in the international environment, the Slovenian economy was hit by another domestic demand shock in 2012. GDP in Slovenia declined by 2.3%, comparable to the falls in Italy and Portugal. The situation deteriorated notably from the second quarter, when tougher fiscal tightening brought a further decline in government consumption, and a particularly sharp decline in consumer confidence. The decline in household consumption was exacerbated by the cost adjustment of the private sector through reduction in the wage bill, which further undermined consumer purchasing power. Low domestic demand had a major impact on the service sector in particular. The ongoing contraction in investment was reflected in a further decline in construction activity. The contribution made to GDP growth by manufacturing, which was the basis for the weak economic recovery in 2010 and 2011, turned moderately negative last year.

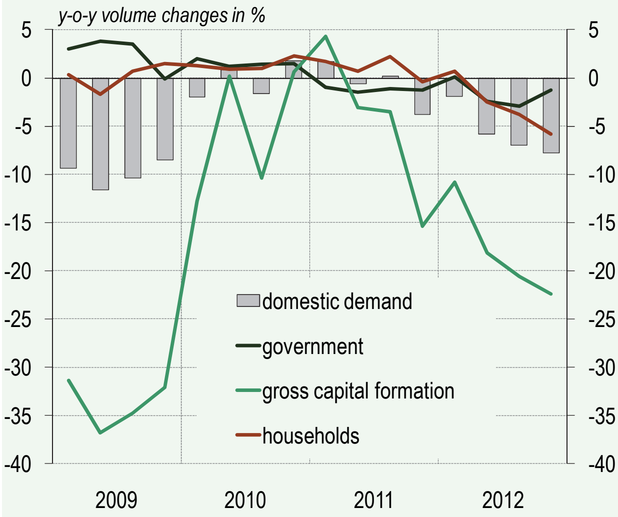
Due to deteriorated macroeconomic situation, employment ended the year down more than 2% in year-on-year terms. Alongside construction, employment fell in private sector services and in industry in 2012. In the second half of the year, it fell in the public sector as well. Unemployment therefore rose sharply in the final quarter, as the surveyed unemployment rate approached 10%.

Aggregate demand

The largest factor in the decline in domestic demand in 2012 was a sharp decline in final household consumption and in inventories. In the final quarter, household consumption was down almost 6% in year-on-year terms, having increased by 1% in 2011. The deterioration was the result of certain government austerity measures, and the wage adjustment in the private sector, which reduced the real wage bill by 4%. The decline in final government consumption increased to 1.6% as a result of a quarterly decline of almost 3% in the second quarter when the ZUJF measures entered into force. The contraction in gross investment increased from less than 5% in 2011 to just under a fifth, primarily as a result of a sharp adjustment in inventories. The contribution of inventories to the change in GDP was negative in the amount of almost 2 percentage points, having been positive in the previous year. Gross fixed capital formation declined by more than 9%. This was not significantly larger than in 2011, but the structure did change. The fall in construction investment was only slightly smaller at almost 16%, while investment in machinery and equipment declined by more than 3%, having recorded high growth in 2011.

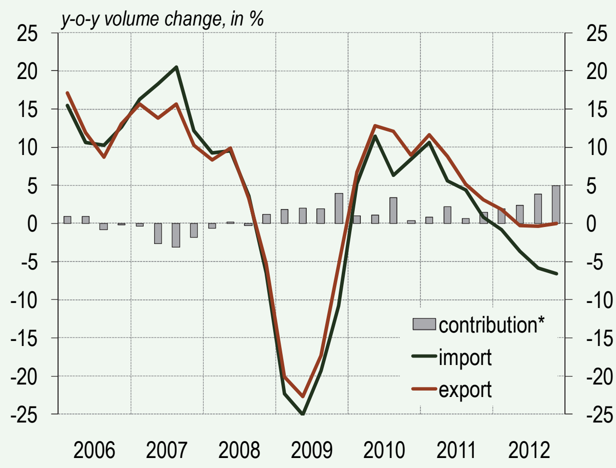
With exports recording moderate growth, the sharp decline in imports meant that net foreign trade made a strong contribution to aggregate demand. Its posi-

Figure 2.1: Components of domestic demand



Source: SORS, Bank of Slovenia calculations.

Figure 2.2: Exports and imports of goods and services



Source: SORS.
*Note: *Contribution of net trade to y-o-y BDP change in p.p.*

tive contribution to the change in GDP in 2012 was 3.3 percentage points. It increased during the year, reaching almost 5 percentage points in the final quarter, the highest level to date. This large contribution was primarily the result of an increase in the year-on-year contraction in imports, which stood at just under 7% in the final quarter of last year and is a reflection of the sharp decline in domestic demand. Export growth stood at 0.3%, thanks to relatively favourable growth in exports of services. Merchandise exports were unchanged overall during the year, but only as a result of the relatively high growth in the first quarter.

Gross domestic product

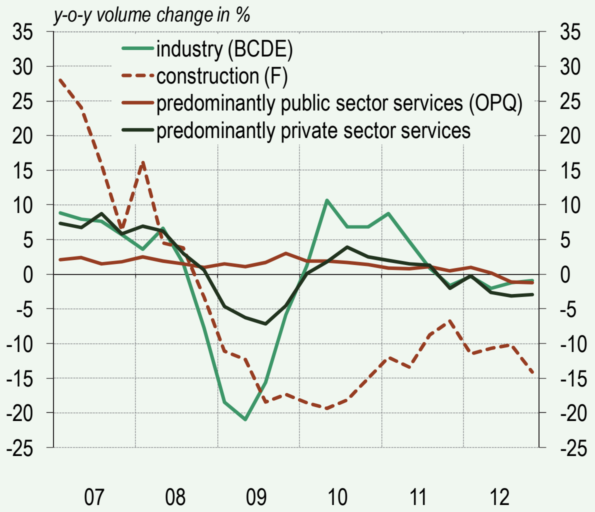
The fall in GDP in 2012 was one of the largest in the euro area. GDP fell by 2.3%, which was similar to the fall in certain other countries undergoing pronounced fiscal consolidation. The gap by which it trailed the euro area average widened during the year. At the end of the year, quarterly GDP growth has been lower than the euro area average for six consecutive quarters. The main factor in the gap remains the pronounced decline in activity in the construction sector, but the situation in all service segments was also comparatively worse last year. The decline in value-added in industry alone was smaller, which is coinciding with the stagnation in merchandise exports.

The contribution made to GDP growth by industry turned moderately negative in 2012. Value-added was down just over 1%. Larger decline was prevented by the manufacturing sector refocusing on markets outside the EU. Activity in industry declined in the second half of the year, when the situation in the euro area also deteriorated more sharply. Of the major segments of manufacturing, the only increases in output last year were recorded by

Figure 2.3: GDP and employment

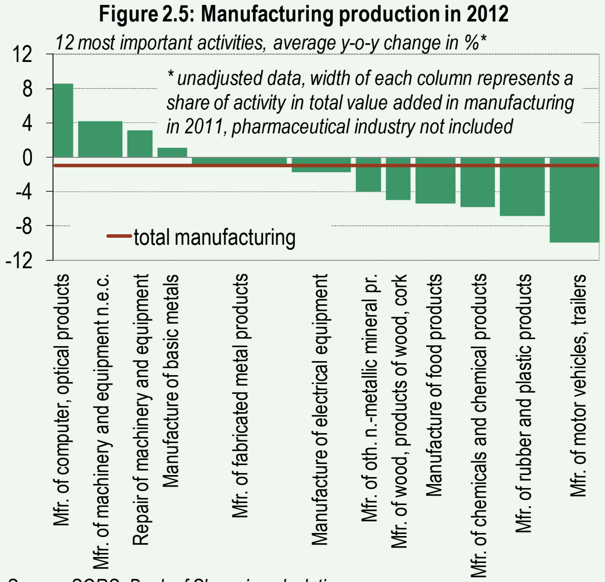
Source: Eurostat – national accounts, seasonally and working days adjusted data.

Figure 2.4: Value added by activity



Source: SORS, Bank of Slovenia calculations.

Figure 2.5: Manufacturing production in 2012



Source: SORS, Bank of Slovenia calculations.

firms involved in the manufacture of computers, electronic and optical equipment, the manufacture of machinery and equipment not elsewhere classified, the repair and installation of machinery and equipment and, according to strong growth in exports, the manufacture of pharmaceuticals. The manufacture of motor vehicles recorded the largest decline, in line with the crisis on the European car market. Industry accounted for 0.3 percentage points of the year-on-year decline in GDP.

As a result of low domestic demand, the situation in the service sector deteriorated sharply in 2012. Services accounted for just under 1 percentage point of the decline in GDP. After recording weak growth in 2011, total value-added in private-sector services declined by more than 2%, all groups of services recording a decline. Quarterly growth in value-added turned negative in the second quarter, which coincided with a larger contraction in domestic demand. The largest deteriorations were recorded by the trade and repair of motor vehicles, transportation and storage, and accommodation and food service activities, where value-added fell on average by just under 3% last year after increasing by almost 2% in 2011. According to turnover figures, the largest factor in overall decline in this group of services was worsening situation in total retail trade, including trade and repair of motor vehicles and motorcycles. For the first time since the outbreak of the crisis, there was also a decline in value-added in public services, as a result of a decline of 1.2% in the second half of the year.

The quarterly movements in value-added do not yet indicate any easing of the crisis in the construction sector. The decline increased to almost 5% towards the end of the year. Value-added in construction was down just over a tenth in 2012. All types of construction recorded a sharp decline in activity. This is a reflection of the fall in the number of transactions on the real estate market and the absence of major infrastructure projects. The share of construction's value-added in the GDP fell to 5.5%, which is below the euro area average. Despite this fall, construction still made the largest contribution of all sectors to the decline in GDP in 2012, at 0.6 percentage points.

Labour market

The deterioration in the economic situation in the second quarter of 2012 accelerated the year-on-year decrease in employment.[1] Total employment fell by just

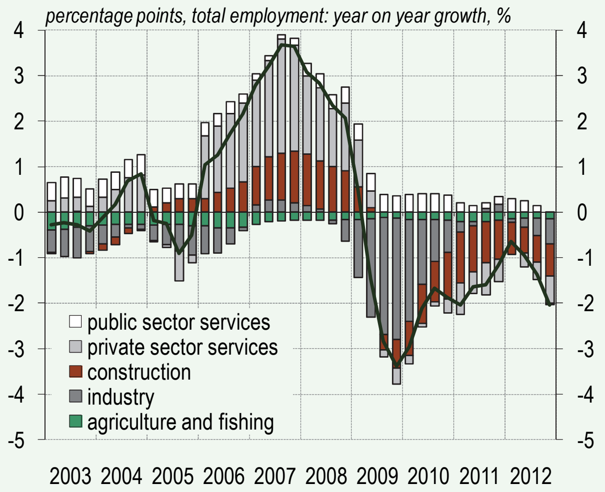
[1] The employment analysis uses national accounts figures.

over 1% in 2012, less than in the previous three years, although the rate of decrease accelerated rapidly over the course of the year. The year-on-year decrease in employment amounted to less than 1% in the early part of the year, but had reached 2% by the end of the year, the number of employees falling to 926,200 in the final quarter. The last time employment was so low was in the middle of 2005.

Employment decreased in the majority of private sector activities. The largest fall was again recorded in construction, where the year-on-year fall accelerated further in the second half of the year to reach 9.5% by the final quarter of 2012. A cause for concern is the fall in employment in industry, which stood at 2.4% in the final quarter. The decrease in employment in industry was significantly smaller than in the crisis year of 2009.

Employment in public services increased by just under 1% in 2012, but the year-on-year rate of growth had turned negative by the final quarter.[2] The decrease in employment marked the beginning of government's plans to reduce employment in the public sector. Monthly figures from the SORS, which are not fully com-

Figure 2.6: Contribution of sectors to changes in total employment



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

Figure 2.7: Structural indicators of the labour market

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

Table 2.1: Employment

	2008	2009	2010	2011	2012	4Q11	1Q12	2Q12	3Q12	4Q12
	average annual growth in %					*y-o-y growth in %*				
A Agriculture, forestry and fishing	-2.1	-1.7	-2.0	-2.5	-1.7	-2.2	-1.8	-1.6	-1.7	-1.8
BCDE Industry	-0.3	-8.7	-5.7	-0.1	-1.3	0.7	-0.4	-0.9	-1.7	-2.4
F Construction	12.1	-0.9	-9.4	-11.4	-8.3	-10.4	-8.8	-7.3	-7.6	-9.5
GHI Trade, accommodation, transport	3.9	0.1	-2.4	-2.4	-1.4	-1.5	-0.6	-1.2	-1.6	-2.1
J Information and communication	5.8	4.0	0.8	0.3	1.6	-0.4	1.2	1.6	2.0	1.6
K Financial and insurance activities	4.5	1.8	-0.7	-1.0	-2.8	-2.4	-2.8	-2.8	-2.0	-3.6
L Real estate activities	11.8	4.3	0.0	-3.7	-2.9	-5.6	-3.8	-5.7	0.0	-2.0
MN Professional, technical and other business activities	2.5	-0.5	2.6	0.3	0.3	0.0	1.8	0.3	-0.1	-0.6
OPQ Public administration and defence; education, health	1.9	2.2	2.3	0.9	0.9	1.0	1.6	1.4	0.7	-0.2
RSTU Other activities	4.3	3.1	1.7	-1.9	-0.4	-1.8	-0.3	0.0	-0.6	-0.6
TOTAL	2.6	-1.8	-2.2	-1.6	-1.3	-1.2	-0.6	-1.0	-1.4	-2.0

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

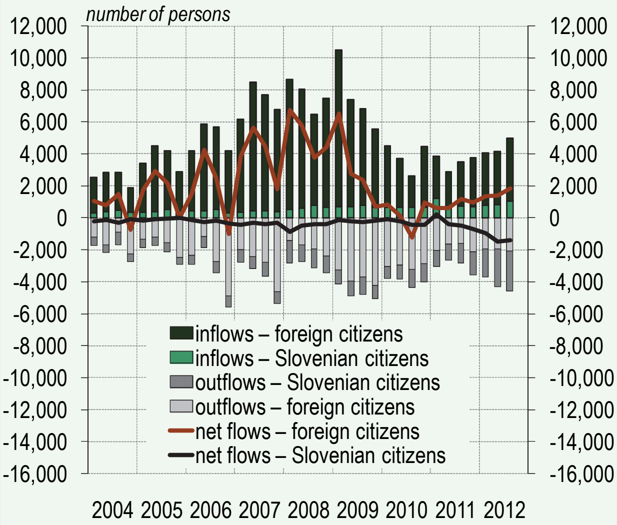
[2] The public sector comprises the sectors of public administration and defence, compulsory social security, education, and health.

Box 2.1: Immigration and emigration in Slovenia

Immigration and emigration can have a significant impact on total population and on the workforce, and can therefore be an important factor in economic trends. From a long-term perspective, migration can mitigate or exacerbate other demographic trends. Most notably, emigration of those with good qualifications reduces potential human capital, and investment of public funds in education is not recovered through higher tax inflows. Short-term emigration of the unemployed reduces fiscal expenditure and imbalances on the labour market, which is particularly significant during times of economic crisis. Transfers from the rest of the world also increase. By contrast, immigration can expand the workforce in segments of the labour market with excess demand for labour.

Current levels of migration according to official records in Slovenia are not yet a cause for concern, but the trends are not favourable. The period of rapid economic growth in Slovenia before the crisis saw a sharp influx of construction workers, but this was cyclical in nature and reversed after the outbreak of the crisis. Since the outbreak of the crisis in 2008 the collapse in construction-related immigration has significantly reduced the number of foreign residents in Slovenia, while the number of Slovenian nationals emigrating has been rising since the second half of 2011. Lower wages, temporary employment, low number of vacancies and the rise in the number of unemployed with higher qualifications suggest that this is largely the result of emigration by the young and well-educated.

Figure: Migrations in Slovenia



Source: SORS.

The size and structure of migratory flows in Slovenia are generally comparable to other euro area periphery countries. Emigration by Slovenian nationals has nevertheless already exceeded emigration from certain euro area periphery countries in relative terms. There was a net emigration of around 4,000 Slovenian nationals during the first three quarters of 2012, equal to total emigration between mid-2008 and the end of 2011, and emigration by Slovenian nationals has exceeded emigration by foreign nationals since the second quarter of 2012. Statistics for the level of qualifications of emigrants are not available over the longer term,[1] but surveys (the most recent was conducted for 2004-2009) suggest an increase in emigration by highly-qualified workers, and a greater inclination to potential emigration during times of crisis. Experience from the rest of the world has shown that after the outbreak of a crisis the first wave of emigration usually consists of foreign, low-skilled workers, while the second wave consists of highly-qualified domestic workers.

The main factors in the overall effect of emigration are the likelihood of returning after the crisis period and the quality of the work (and other) experience acquired abroad. It is therefore necessary to put in place conditions that encourage highly-qualified emigrants to return after the end of the crisis, i.e. after a certain period of living abroad.

[1] The only data available is for 2011, when those with tertiary qualifications accounted for approximately a quarter of emigration by Slovenian nationals, and for approximately just a tenth of total emigration from Slovenia.

parable with national accounts figures, indicate that employment in public administration and defence decreased for the second consecutive year, but the fall was significantly larger in the second half of 2012. Employment in the education and health sectors rose by 1.2% and 2.4% respectively in 2012, but by the end of the year the rate of employment growth had reached zero in the education sector and had slowed sharply in the health sector.

Box 2.2: Major labour market reforms adopted on 5 March 2013

The Employment Relationship Act (ZDR) adopted by the National Assembly on 5 March 2013 introduces changes aimed to increase labour market flexibility, although certain measures may actually have the opposite effect. In addition to the simplification of administrative procedures related to hiring and firing, the ZDR contains two major packages of economically significant changes. The first package relates to shorter notice periods and reductions in severance payments, while the second relates to curbs on temporary employment.

Under the ZDR, notice periods have mostly been shortened to 60 days, with a maximum period of 80 days. Severance payments have also been reduced, to one-fifth of the base for employment of one to 10 years, one-quarter of the base for employment of 10 to 20 years and one-third of the base for employment of more than 20 years.[1] The entitlement to retirement benefits is now linked to the years of service with the employer. Lay-off procedures mostly remain unchanged in substantive terms, but the formal simplification means that the administrative burden has been reduced. At the same time the retention of the retirement benefit is still reducing the employability of older workers, as is the retention of the bonus for years of service. Furthermore, the age of employees enjoying special protection will be gradually raised to 58. From the point of view of the employability of older unemployed workers, it is positive that protection from termination is no longer guaranteed to older workers who already meet the conditions for protection against termination when the new employment contract is signed.

The ZDR has several measures to curb the use of temporary contracts, the aim being to reduce the duality of the labour market and the gaps between temporary and permanent employees. The measures 1) limit the chaining of contracts for the same job to a maximum of two years, 2) introduce severance payments in the event of termination of temporary employment at a level comparable to severance payments for permanent employment, and 3) impose a five-fold increase on employers' contributions to unemployment insurance on temporary contracts, while exempting the employer from paying the contribution for the first two years after hiring an employee permanently.

The use of temporary contracts will probably be curbed most by the introduction of severance payments for temporary employment. This measure is reducing the flexibility of the labour market, as the currently flexible part of the labour market will become more rigid, while the flexibility of the even more significant rigid segment of the labour market will not increase. It will still be possible to chain temporary contracts by formally reassigning employees to other work. The change in the employer's contribution to unemployment insurance on temporary contracts is a reasonable measure in economic terms, but because the contribution is small (0.06% of wages), it probably will not have a significant effect. From an employer's point of view, a further constraint on flexibility is the quota for employees hired via an agency, who may not account for more than 25% of the headcount. Another constraint on employer flexibility, or an enhancement of employee security, is the protection afforded to economic dependents, i.e. sole proprietors who generate more than 80% of their revenue with a single client. The amended ZDR allows them to demand limited employment protection rights from the client.

Under the amendments to the Labour Market Regulation Act (ZUTD), only pensioners are allowed to engage in temporary occasional work. This type of work is limited by monthly and annual quotas. The limits apply to both workers and employers, in the form of a minimum hourly rate and maximum number of hours per month and per year. The measure will most likely encourage pensioners to undertake temporary work, and in this respect will have positive effects.

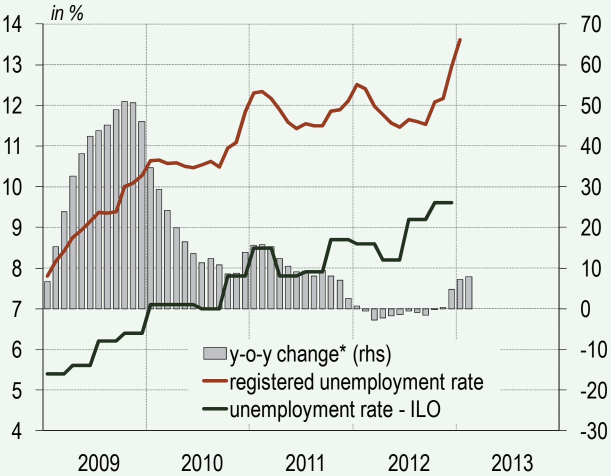
[1] The base is the employee's average monthly wage in the last three months for full-time work, or during the period of work before the termination of the temporary employment contract.

The adverse situation on the labour market is being reflected in a decrease in the number of vacancies and new hires. The number of vacancies decreased by 13% in 2012. There were two large falls, in the second quarter and the final quarter. The number of new hires in 2012 fell accordingly, by 6.5%. The fall was sharpest towards the end of the year, partly as a result of the large number of new hires for temporary employment at the end of 2011 that were not re-engaged. New hires in December were down almost a half in year-on-year terms, partly as a result of a base effect. Last year also saw a decrease in the number of vacancies per unemployed person, which is a measure of labour market tightness. This implies a reduced probability of an unemployed person finding a job. The number of new hires was nevertheless even lower than suggested by this indicator, which signals an increasing mismatch between the structure of vacancies and the structure of unemployment. Another indication is the larger proportion of the rise in registered unemployment accounted for by the young and by those with higher qualifications. The vast majority of vacancies and new hires in 2012 were for temporary employment.

The registered unemployment rate reached 13% at the very beginning of 2013, while the survey unemployment rate approached 10%. The number of registered unemployed rose from just over 105,000 in September 2012 to more than 124,000 in February 2013, while the registered unemployment rate rose by 2.1 percentage points between September 2012 and January 2103 to 13.6%. The number of unemployed increased most in the final quarter of 2012 and January 2013 as a result of seasonal factors. The number of persons registering with the Employment Service in October because their student status expired was larger than in the previous two years. In late 2012 and early 2013 there was a higher inflow into unemployment as a result of the expiry of temporary employment contracts. This was higher than in previous years, partly as a result of the increase in temporary employment at the end of 2011. The survey unemployment rate rose from 9.2% in the third quarter to 9.6% in the final quarter, the highest figure to date.[3]

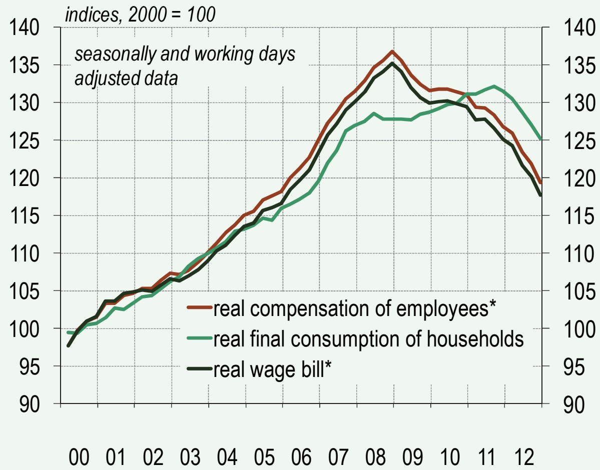
Of the reasons cited for registering as unemployed in 2012, the loss of temporary employment recorded the

Figure 2.8: Unemployment rate



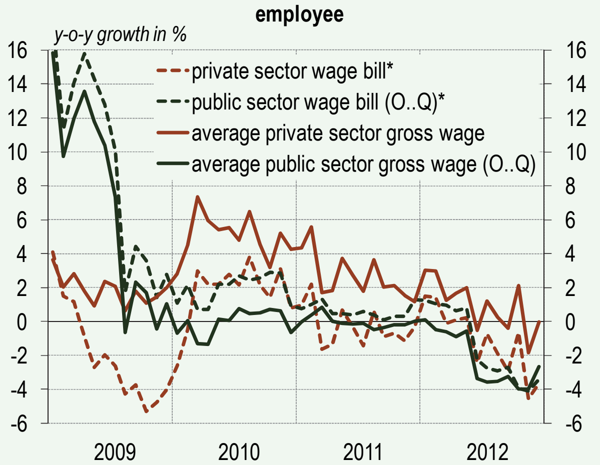
*Note: * y-o-y change in the number of registered unemployed persons, in %*
Sources: Employment Office of the Republic of Slovenia, SORS, calculations Bank of Slovenia.

Figure 2.9: Wage bill, compensation of employees and final consumption of households



Sources: SORS - national accounts, ECB, Bank of Slovenia calculations.
*Note: *Deflated by seasonally adjusted HICP index.*

Figure 2.10: Total wage bill and average monthly gross wage per employee



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

[3] Surveys have been conducted since 1992.

Table 2.2: Labour cost indicators

	2008	2009	2010	2011	2012	Q411	Q112	Q212	Q312	Q412
	nominal y-o-y growth, %									
Gross wage	8.3	3.5	3.9	2.0	0.1	1.1	1.6	0.3	-0.7	-1.0
Gross wage in the private sector	7.8	1.9	5.0	2.6	0.9	1.6	2.4	1.0	0.4	0.0
Gross wage in the public sector[1]	10.1	6.8	-0.1	0.0	-2.2	-0.1	-0.3	-1.6	-3.5	-3.5
Gross wage in manufacturing	7.6	0.9	8.9	3.9	2.5	3.1	3.4	2.5	2.0	2.3
Labour costs per hour worked[2]	9.2	3.7	1.1	2.0	-0.3	1.2	-1.5	2.6	-0.6	-1.7
Labour costs per hour worked in manufacturing[2]	10.6	5.7	3.2	1.9	2.9	2.6	-2.0	9.1	2.9	1.8
Gross wage per unit of output[3]	7.5	10.2	0.4	-0.3	1.2	2.4	0.9	2.7	1.0	0.0
Gross wage per unit in manufacturing[3]	6.9	10.3	-4.9	0.2	1.9	5.8	2.5	3.4	0.9	0.5
Unit labour costs[3, 4]	6.4	8.5	0.4	-0.6	0.7	1.8	0.9	0.8	1.1	-0.1
Compensation per employee[4]	7.2	1.9	3.9	1.6	-0.4	0.5	1.6	-1.5	-0.6	-1.0
Output per employee	0.8	-6.1	3.5	2.2	-1.1	-1.3	0.7	-2.3	-1.7	-1.0
Output per employee (manufacturing)	0.7	-8.5	14.4	3.7	0.7	-2.5	0.9	-0.8	1.1	1.8
HICP	5.5	0.9	2.1	2.1	2.8	2.6	2.5	2.5	3.2	3.0
GDP deflator	4.1	3.6	-1.1	1.0	0.4	1.9	0.9	0.1	0.5	0.2

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

largest increase in its proportion of the total. The number of such registrations at the Employment Service was up 13%. The number of those citing redundancy was up just under a quarter on 2011. Their inflow increased in particular towards the end of the year. The number deregistering as unemployed was almost 8,500 per month on average during 2012. Alongside those finding employment, deregistrations for reasons other than employment also made a significant contribution. The proportion of deregistrations accounted for by retirements has been high since 2010 and in 2012 was up just under 10% on 2011. The proportion of long-term unemployed declined in the final months of 2012, but only as a result of the large inflow of newly registered unemployed. The proportion of long-term unemployed nevertheless remained above 50% in 2012.

Wage developments were marked by the necessity for a cost adjustment trend in the economy to the adverse macroeconomic situation. The average nominal gross wage per employee in the total economy increased slightly as a result of growth in the early part of the year. Austerity measures began to take effect in the second half of the year, which was reflected in a decline in the average wage in the public sector. It was down by 3.5% in year-on-year terms in the second half, and by more than 2% over the year as a whole. This also had a demonstration effect on wages in the private sector. Year-on-year growth in private sector wages practically ceased between June and the end of the year, having stood at just over 2% previously. Towards the end of the year the private sector responded to the decline in economic activity by cutting wages for the first time during the crisis.

3 Current Account and Competitiveness Indicators

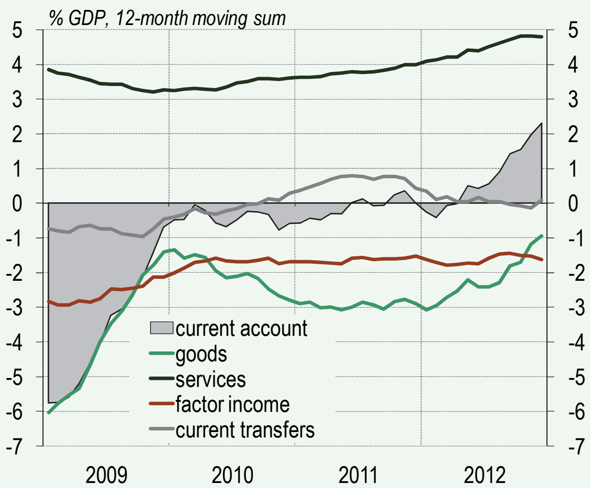
After its balanced position in 2011, the current account recorded a surplus of 2.3% of GDP in 2012, primarily as a result of a significant narrowing in the goods trade deficit. The largest increase in the surplus was in the final quarter, when it amounted to between 3% and 4% of GDP in seasonally adjusted terms. Foreign demand was weak last year, and domestic demand fell sharply. This meant that nominal growth in exports of goods and services was weak, while imports fell sharply. The deficit in factor income remained unchanged as the surplus in labour income widened and the deficit in capital income widened. The surplus in current transfers narrowed.

Improvements in cost competitiveness were hindered last year by the decline in productivity, but unit labour costs measured by value-added rose by just 0.5% as the economy underwent faster cost adjustment than during the first wave of the crisis. This was less than average rise in the euro area, which allowed Slovenia to further close the gap in cost competitiveness. The rise in the euro and the inflation above the euro area average have led Slovenia's price competitiveness to deteriorate in recent months.

Current account

The current account surplus widened in the second half of 2012 as a result of declining imports. After being in balance in 2011, the current account recorded a surplus of 2.3% of GDP last year. The surplus is occurring in an environment of deteriorating international business conditions and a worsening internal economic situation. Austerity measures and the adverse labour market situation brought a contraction in domestic consumption, which together with the slowdown in export growth contributed to a sharp decline in import demand. The main factors in the widening current account surplus were a narrowing of the goods trade deficit by 2 percentage points to 0.9% of GDP and an increase of 0.7 percentage points in the surplus of trade in services to 4.7% of GDP.

Figure 3.1: Components of the current account

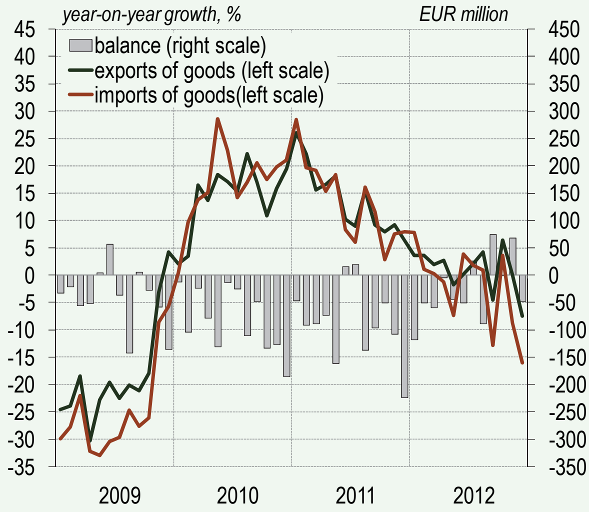


Sources: Bank of Slovenia, SORS.

Goods trade

The goods trade deficit narrowed particularly sharply in the second half of last year. Growth in nominal exports began to slow in the second half of 2011 as economic growth in the main EU trading partners waned. Having recorded year-on-year growth of 2.9% in the first quarter, exports were stagnating by the final quarter. The sharper decline in domestic consumption meant that the changes were even larger on the import side, the year-on -year rate slowing sharply from 1.6% in the first quarter to -5.1% in the final quarter. Imports of goods were down 2.3% in year-on-year terms in 2012, while exports were up 0.9%. The goods trade deficit thus narrowed to 0.9% of GDP. Coverage of goods imports by exports increased by more than 2 percentage points last year to more than

Figure 3.2: Trade in goods



Source: Bank of Slovenia.

Table 3.1: Components of the current account

	2005	2006	2007	2008	2009	2010	2011	2012
				v mio EUR				
Current account balance	-498	-771	-1,646	-2,295	-246	-209	2	818
1. Goods	-1,026	-1,151	-1,666	-2,385	-498	-997	-1,043	-335
2. Services	920	993	1,047	1,424	1,165	1,285	1,443	1,701
2.1. Transport	398	456	525	561	437	496	585	618
2.2. Tourism	743	783	834	904	891	1,002	1,135	1,291
- of which, exports	1,451	1,555	1,665	1,827	1,804	1,925	1,952	2,006
2.3. Other	-221	-247	-312	-42	-163	-213	-277	-208
3. Factor income	-295	-440	-789	-1,030	-754	-599	-550	-578
3.1. Labour income	128	107	50	8	81	143	218	338
3.2. Capital income	-424	-547	-839	-1,038	-835	-743	-768	-916
4. Current transfers	-97	-173	-239	-303	-159	102	153	29
				as % GDP				
Current account balance	-1.7	-2.5	-4.8	-6.2	-0.7	-0.6	0.0	2.2
1. Goods	-3.6	-3.7	-4.8	-6.4	-1.4	-2.8	-2.9	-0.9
2. Services	3.2	3.2	3.0	3.8	3.3	3.6	4.0	4.7
2.1. Transport	1.4	1.5	1.5	1.5	1.2	1.4	1.6	1.7
2.2. Tourism	2.6	2.5	2.4	2.4	2.5	2.8	3.1	3.5
- of which, exports	5.1	5.0	4.8	4.9	5.1	5.4	5.4	5.5
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.5	-0.6	-0.8	-0.6
3. Factor income	-1.0	-1.4	-2.3	-2.8	-2.1	-1.7	-1.5	-1.6
3.1. Labour income	0.4	0.3	0.1	0.0	0.2	0.4	0.6	0.9
3.2. Capital income	-1.5	-1.8	-2.4	-2.8	-2.3	-2.1	-2.1	-2.5
4. Current transfers	-0.3	-0.6	-0.7	-0.8	-0.4	0.3	0.4	0.1

Sources: SORS, Bank of Slovenia.

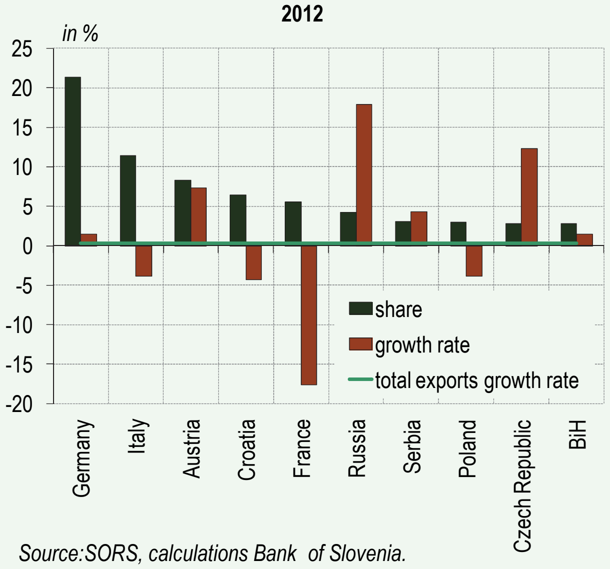
95%. The widening surplus with non-EU countries accounted for 55% of the narrowing of the goods trade deficit, and the diminishing deficit with EU Member States for the remainder.

The terms of trade were unfavourable last year, but less so than in 2011. Year-on-year growth in import prices calculated on the basis of national accounts stood at 3.1% in the first quarter, primarily as a result of higher energy prices and the euro's depreciation against the US dollar. By the final quarter growth in import prices had declined to 1.3%. The largest factor was the decline in year-on-year growth in euro oil prices from 18% in the first quarter to 5% in the final quarter, as a result of the sharp slowdown in the euro's year-on-year depreciation against the dollar. Import prices rose by 2.2% overall last year, and export prices by just over 1%. The terms of trade thus deteriorated by 1.2%, 0.6 percentage points less than in 2011. Their contribution to the goods trade deficit declined to 0.7% of GDP.

Low consumption in the EU and Slovenia has coincided with a decline in trade in consumer goods. Of total exports of goods, only exports of consumer goods recorded a decline in 2012, by 1.8% as a result of a decline of almost 6% in exports to EU Member States. Overall growth in exports of intermediate goods and capital goods was positive, as a result of an increase of more than 6% in exports to non-EU countries. Imports began to decline after the announcement of stricter austerity measures in the second quarter. Imports of consumer goods declined by almost 4%: after recording year-on-year growth of 2.7% in the first quarter they then declined by more than 9% in the second and third quarter. After high growth in imports of capital goods in 2011 in line with the growth in investment in machinery and equipment, last year the year-on-year contraction increased from 1% in the first quarter to just under 9% in the final quarter. As a result of the rapid decline in growth in exports of goods and the sale of industrial goods on the domestic market, imports of intermediate goods declined by just under 0.5% last year, and by almost 4% in the final quarter.

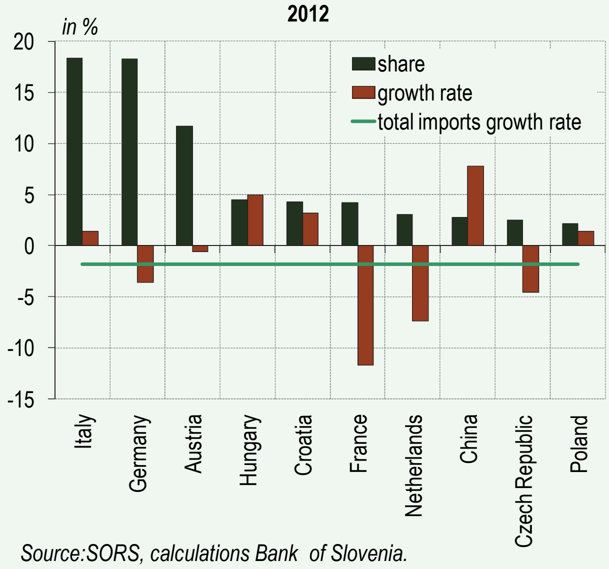
Slovenian firms compensated for the decline in demand from the euro area by increasing exports to the countries of central and southern Europe and the former Soviet Union. According to SORS figures, exports of goods to EU Member States fell by 2.2% in 2012, while exports to non-EU countries increased by 6.4%. Of the major euro area trading partners, exports to Austria and Germany recorded the largest increase. Exports to Italy fell, while a decline in demand for cars brought an even larger fall in exports to France. Of other EU Member

Figure 3.3: Share in exports and the growth rate of exports in 2012



Source:SORS, calculations Bank of Slovenia.

Figure 3.4: Share in imports and the growth rate of imports in 2012



Source:SORS, calculations Bank of Slovenia.

States, there was a significant increase in exports to the Czech Republic and Slovakia, while outside the EU exports to Russia were up almost a fifth. Croatia was the only former Yugoslav republic where Slovenia's exports were down last year. The share of total exports of goods accounted for by non-EU countries thus increased to 31%. This was mainly due to the increase in exports of goods to the countries of the former Soviet Union. Imports from EU Member States fell by 3.1%, while imports from non-EU countries increased by 2.3%.

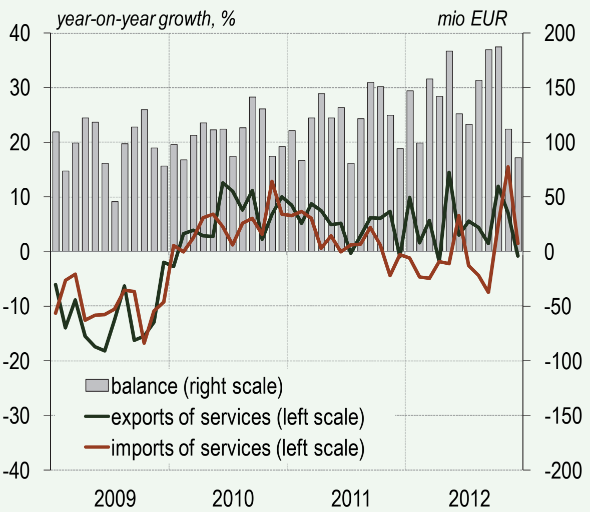
Trade in services

The surplus of trade in services widened significantly last year, as exports of services increased by more than 5%, despite weak foreign demand. Imports remained unchanged. The surplus of trade in services increased to EUR 1.7 billion or 4.7% of GDP, the highest figure to date. Exports of travel services increased by almost 3%, which given the rise of just under 6% in the number of visits and overnight stays by foreign visitors indicates a decline in their average spending. Imports of travel services declined by 12.5% as household disposable income fell in real terms. The surplus of trade in travel services thereby widened to a record EUR 1.3 billion. Growth in trade in transport services declined sharply last year, in line with the decline in exports of goods. Exports of transport services were up by just 1.6%, while imports fell by just under 2%, primarily as a result of a sharp year-on-year decline in the first quarter. The surplus of trade in transport services widened to more than EUR 600 million. The deficit in trade in other services (services other than travel and transport) also narrowed significantly last year. The surpluses in foreign trade intermediation services and construction services increased. The deficit in intellectual property services (patents, licences, copyrights) has continued to widen rapidly.

Factor income and transfers

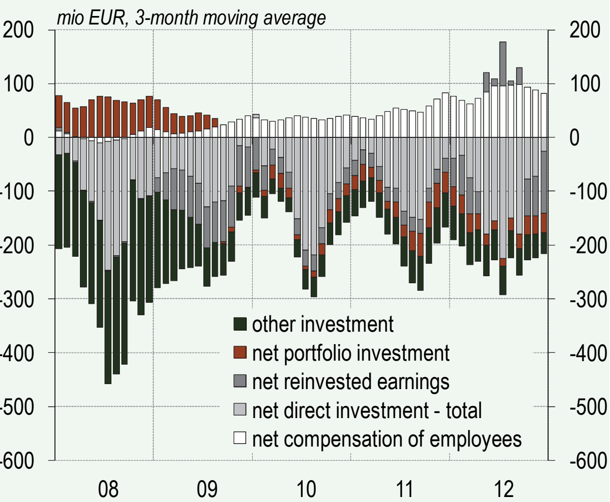
The deficit in net factor income was unchanged in 2012, and stood at 1.6% of GDP. The surplus in labour income has been widening rapidly, increasingly as a result of a rise in the number of residents working abroad. The deficit in capital income continued to widen last year, by EUR 148 million to just over EUR 900 million. Outflows of capital income declined by more than 7%, while inflows were down two-fifths.

Figure 3.5: Trade in services



Source: Bank of Slovenia.

Figure 3.6: Net factor income



Source: Bank of Slovenia.

Net FDI accounted for more than two-thirds of the deficit in factor income. The deficit in income from FDI widened by EUR 156 million in 2012 to EUR 574 million. The largest factor was divestment by Slovenian corporates in the rest of the world, reinvested earnings declining by EUR 275 million last year. Slovenian corporates' reinvested earnings in the rest of the world have declined by a total of EUR 1.1 billion since the outbreak of the crisis, while non-residents' reinvested earnings in Slovenia have declined by EUR 0.5 billion. The loss of reinvested earnings has been compensated for by an increase in equity. Slovenian corporates' stock of outward FDI has thus declined by just EUR 0.5 billion since 2008, while non-residents' stock of inward FDI in Slovenia has actually increased by EUR 0.6 billion over the same period.

As a result of low interest rates and the net decline in private sector debt, net payments of other capital income have also been declining since 2008. As the stock of loans to the rest of the world remained unchanged, the largest decline during this period was recorded by liabilities for loans raised in the rest of the world, at EUR 5 billion. As a result, net interest payments to the rest of the world declined by more than a tenth to EUR 203 million. The decline in loan liabilities was compensated for by issues of debt securities. The stock of debt securities held by non-residents amounted to EUR 4.6 billion in 2008, but had increased to EUR 10.1 billion by the third quarter of last year. The stock of residents' investments in foreign securities increased from EUR 10.6 billion to EUR 11.6 billion over the same period. As a result of the increased cost of borrowing during the crisis, income from investments in debt securities has been in deficit since 2010. Outflows of this income declined slightly last year, by EUR 13 million to EUR 116 million.

Current transfers were in surplus last year, as a result of high inflows of European funds in December. The surplus amounted to EUR 110 million in December, but just EUR 29 million over the whole of 2012, barely a sixth of that in 2011. The largest contribution to last year's decline in the surplus in current transfers was the widening of EUR 94 million in the deficit in private transfers to EUR 184 million as a result of an increase in payments of compensation and non-life insurance, property tax and social contributions. The net surplus in government transfers declined by EUR 33 million to EUR 210 million. Net funding from the EU budget increased by just over a tenth last year to EUR 451 million, while other government transfers declined.

Selected competitiveness indicators

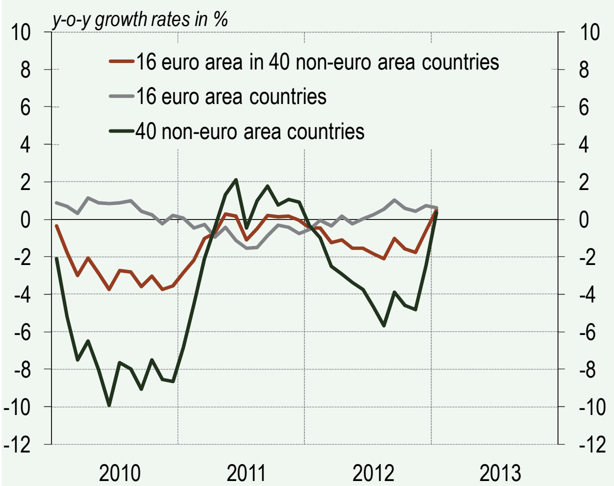
The fall in the euro in 2012 improved Slovenia's competitiveness as measured by the nominal effective exchange rate. The nominal effective exchange rate appreciated at the end of last year and in the early part of this year. The euro's falls against the US dollar, Chinese yuan, Japanese yen and pound sterling last year reduced Slovenia's nominal harmonised price competitiveness indicator, but by an average of almost 2 percentage points less than the indicator for the euro area. The smaller depreciation was the result of the euro's rise against the currencies of countries that have a higher weight in Slovenia's indicator. Slovenia trades less with the US, China and Japan than does the euro area overall, and more with Croatia, Poland and Hungary. The euro appreciated by 3.5% against the Hungarian forint overall

Figure 3.7: Nominal harmonised competitiveness indicator

y-o-y growth rates in %, relative to 40 non-euro area countries

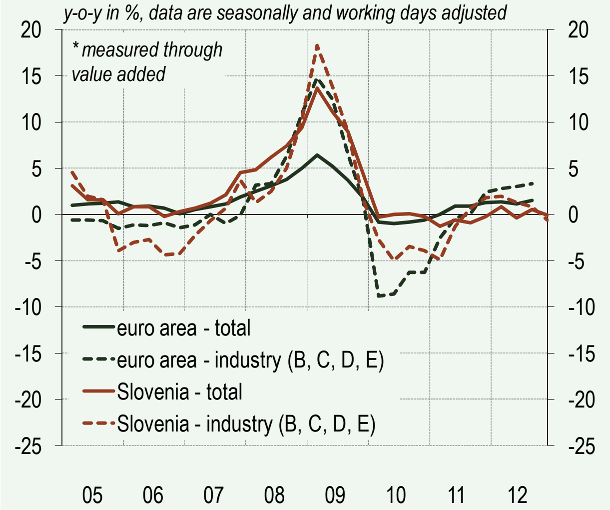
Source: ECB.

Figure 3.8: Harmonised price competitiveness indicator (HICP / CPI deflator)



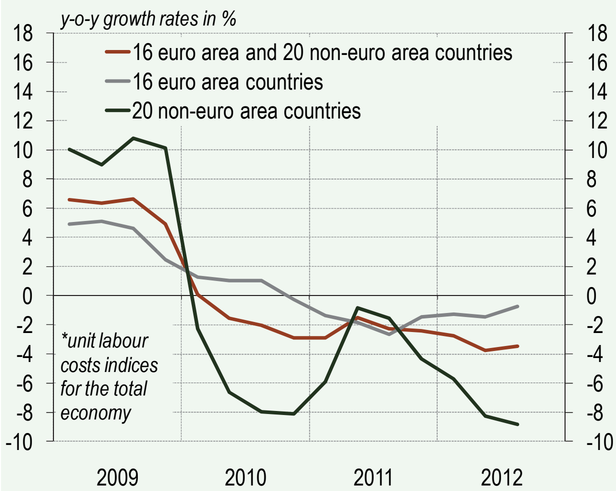
Source: ECB.

Figure 3.10: Nominal unit labour costs*



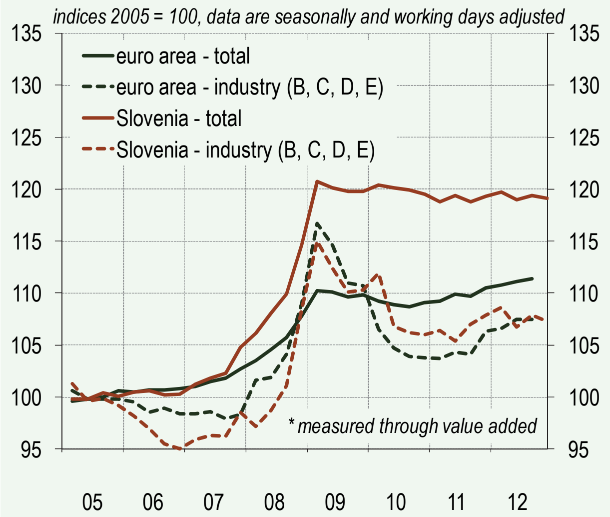
Source: Eurostat, Bank of Slovenia calculations.

Figure 3.9: Harmonised competitiveness indicator* (based on ULC)



Source: ECB.

Figure 3.11: Nominal unit labour costs*



Source: Eurostat, Bank of Slovenia calculations.

in 2012, by 1.6% against the Polish zloty and by just over 1% against the Croatian kuna. As the euro continued to strengthen against most major currencies, the year-on-year appreciation in Slovenia's nominal effective exchange rate had increased to 1.7% by February. The average euro area appreciation was slightly stronger, largely as a result of the larger impact of the sharp depreciation of the yen.

Slovenia's price competitiveness against countries outside the euro area improved last year, while its competitiveness against euro area countries deteriorated. In the early part of this year Slovenia's price competitiveness has deteriorated against both groups of countries. Slovenia's price competitiveness against countries outside the euro area improved by more than 3% on average in 2012. Alongside the growth in the nominal indicator at the end of last year and in the early part of this year, another factor in the deterioration in Slovenia's price competitiveness against countries outside the euro area was higher inflation. Slovenia's price competitiveness against these countries deteriorated by 1.1% in year-on-year terms in February. Higher inflation meant that the deterioration in price competitiveness against euro area countries continued in the early part of this year.

Since deteriorating significantly in 2008 and 2009, the cost competitiveness indicator has been slowly improving. ULCs of the total economy as measured by value-added were up just 0.5% in 2012, one percentage point less than in the euro area overall. The lower growth in Slovenia was the result of a decline in nominal wages in the majority of the private sector, and the government measures in relation to public sector wages. ULCs in the total economy nevertheless remained higher than in the euro area overall. The adjustment of nominal wages and labour costs in the total economy is still lagging the adjustment in the productivity. The exception is industry, where during the crisis labour costs have adjusted more to changes in orders and output. As a result of increased exposure to international competition, the changes in ULCs in industry have been similar to those in the euro area.

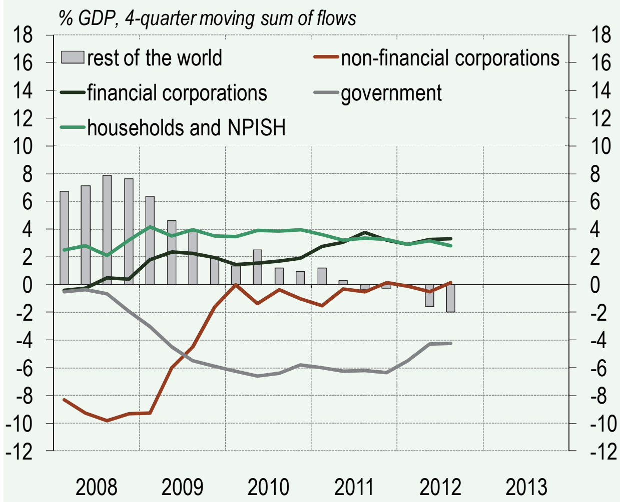
4 Financing

Financing has a significant impact on economic activity. The funding conditions in the banking system are reflected in the structure of corporate financing, where the stock of loans from domestic banks declined again last year, while there was an increase in financing from the rest of the world and, partly, in internal financing. Rising unemployment and the decline in household disposable income have also reduced household financial investments and liabilities. Total loans to households declined for the first time in the second half of last year. In addition to a fall in consumer loans, growth in housing loans was extremely low. The banks continue to face constraints in replacing funding. Given the economic situation the quality of the loan portfolio has continued to deteriorate, for which reason impairment and provisioning costs are rising. This is having an adverse effect on the amount of bank lending and on the level of interest rates. Interest rates on corporate loans are significantly higher than the euro area average, while interest rates on loans to households are still at a comparable level.

Savings-investment gap by sector

The ongoing decline in investment by non-financial corporations and the government has contributed to a significant increase in the surplus[4] of domestic savings over domestic investments. The surplus, which is evidenced as a financial surplus against the rest of the world, had reached 2% of GDP by the third quarter of 2012. As a result of the ongoing decline in investment and deleveraging, the one-year financial balance of non-financial corporations[5] (hereinafter: corporates) was close to zero last year. Financial corporations' financial surplus during the first three quarters remained at around 3.3% of GDP. The government again reduced its one-year financial deficit a bit in the second and third quarters of 2012, as a result of the decline in net government investment caused by fiscal consolidation. The government sector's one-year financial deficit in the third quarter stood at 4.2% of GDP, down more than 2 percentage points on

Figure 4.1: Savings-investment gap



Sources: Bank of Slovenia - consolidated financial accounts, SORS.

[4] The savings-investment gap is defined as the surplus of financial assets (savings) over financial liabilities (investments).
[5] According to the ESA 95 definition, non-financial corporations (corporates) are legal entities that are market producers of goods and non-financial services.

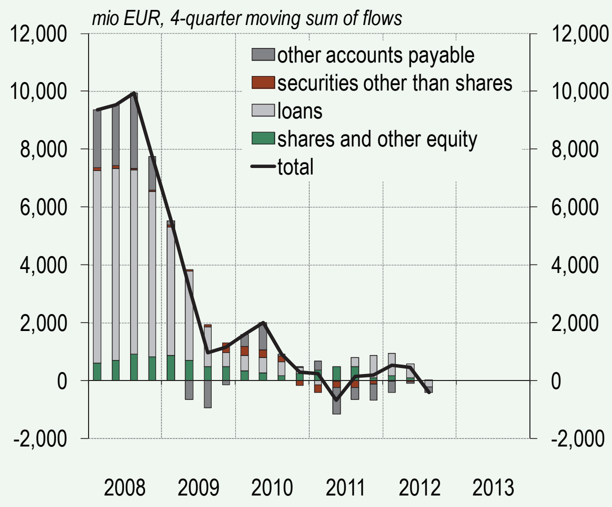
2011. The household sector's financial surplus declined again as a result of falling household purchasing power, to stand at 2.8% of GDP in the third quarter, down almost 0.5 percentage points on the previous year.

Financing and financial assets of corporate sector

The corporate deleveraging process was reflected in a decline of EUR 893 million in their liabilities during the first three quarters of 2012, primarily on account of loans. Corporate loans declined by EUR 505 million. These primarily comprised loans from domestic lenders, banks in particular, while loans from the rest of the world increased by EUR 270 million. Shares and other equity, which remains the most important source of corporate financing, were down EUR 38 million on the end of 2011. Financing via debt securities remained at the same level as at the end of 2011. The stock of trade credits and advances declined by EUR 283 million in the first three quarters, primarily as a result of a decline in credits between domestic corporates. Financing via trade credits and advances from the rest of the world increased by EUR 97 million during the first three quarters. Corporates' total financial liabilities amounted to EUR 86.6 billion in the third quarter of 2012.

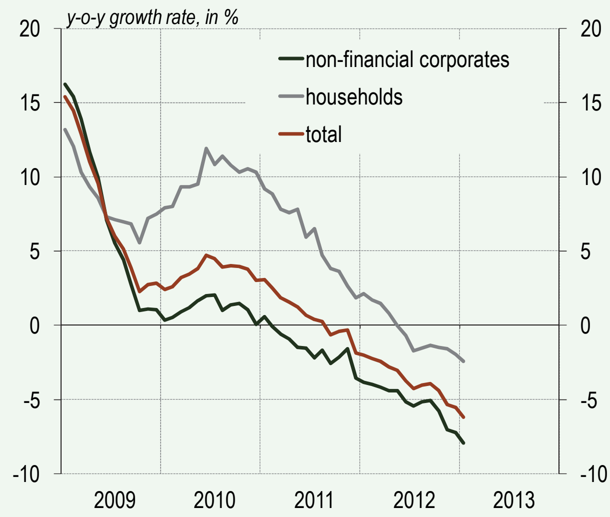
The decline in corporate loans is partly related to the decline in investment, but the supply of loans is also diminishing. The stock of loans[6] to corporates contracted by 5.1% last year, loans of all maturities declining. Another factor in the decline in corporate loans remains the weak demand for loans caused by the decline in investment opportunities and the financial restructuring process being dictated for corporate balance sheets by deleveraging needs. At the same time weaker corporate performance in the adverse macroeconomic situation and the resulting inability to settle liabilities are causing a deterioration in banks' loan portfolios, which is feeding back

Figure 4.2: Financial liabilities of NFCs (S.11), by instruments



Source: Bank of Slovenia, unconsolidated data.

Figure 4.3: Loans to households and non-financial corporates



Source: Bank of Slovenia

into their lending capacity and their caution in approving new corporate loans. The banks are also being constrained in lending by the tightened conditions for renewing foreign funding. The deterioration in the quality of the banking system's loan portfolio is also being reflected in bank downgradings, which is further limiting access to foreign funding.

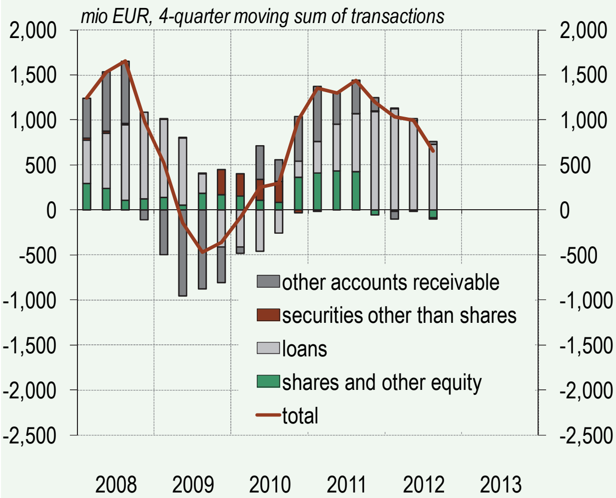
Last year corporates sought to compensate for the decline in bank financing primarily by means of for-

6 Gross loans (excluding impairments) of other monetary financial institutions. In addition to banks, this sector also includes savings banks and money-market funds.

eign financing, and partly by means of internal resources. Given the constraints in the domestic banking sector, corporates increasingly looked to financing in the rest of the world, via both trade credits and loans. FDI increased by EUR 112 million last year, primarily as a result of an increase in foreign owners' equity. Corporates received EUR 110 million from the rest of the world, primarily via repayments of loans previously made to non-residents. Financing via trade credits also increased last year, by EUR 330 million. This was a particularly important resource for export-oriented corporates, which were able to finance their operations in this way. Some indicators suggest that corporates that have the option are also making internal adjustments, as financing via retained earnings is increasing.

Corporate financial assets declined by EUR 591 million over the first three quarters of 2012, primarily as a result of a decline in loans granted and a decline in trade credits and advances. The stock of loans granted declined by EUR 486 million in the first three quarters. Loans to the rest of the world and loans to other corporates both declined. Trade credits and advances granted also declined, by EUR 207 million. This was primarily the result of a decline in corporate financing via trade credits and advances inside the corporate sector. Trade credits and advances to the rest of the world increased in line with growth in nominal exports. The stock of investments in shares and other equity increased by EUR 90 million after the end of 2011, primarily as a result of investments in shares in domestic companies. Investments in currency and deposits and investments in debt securities declined by EUR 114 million during the first three quarters of 2012. Corporates' total financial assets amounted to EUR 44 billion in the third quarter of 2012.

Figure 4.4: Financial liabilities of NFCs (S.11) against ROW, by instruments



Source: Bank of Slovenia, non-consolidated data.

Household financing and savings[7]

Household financial liabilities amounted to EUR 12.2 billion at the end of the third quarter of 2012, down EUR 154 million on the end of 2011. Liabilities from loans declined by EUR 260 million during the first three quarters of 2012, primarily as a result of the decline in consumer purchasing power. Consumer loans have been declining since mid-2010, while there was also a sharp slowdown in growth in housing loans last year. The latter declined despite a fall in real estate prices, which is an indication of households postponing the purchase of real estate in the current situation of high uncertainty. Growth in housing loans[8] averaged 3.8% last year, down more than 10 percentage points on 2011. The stock of consumer loans fell by 6.5%.

The largest factor in the decline in household financial assets was a decline in bank deposits, which amounted to almost EUR 400 million during the first three quarters of 2012. The decline in household financial assets is in line with the partial mitigation of the decline in real consumption as purchasing power declines sharply. Investments in currency and deposits, which account for half of all household assets, also declined.[9] The decline was most evident in other deposits at domestic banks and at banks in the rest of the world. House-

[7] Includes non-profit institutions serving households (S.15), in addition to households (S.14).
[8] Gross loans (excluding impairments) of other monetary financial institutions. In addition to banks, this sector also includes savings banks and money-market funds.
[9] In part, this is likely to be the response to government measures in connection with social transfers. Savings at banks reduce the scope of social transfers and eligibility to receive them (Stability of the Slovenian Banking System, December 2012).

Box 4.1: Implementation of monetary policy between September 2012 and mid-March 2013

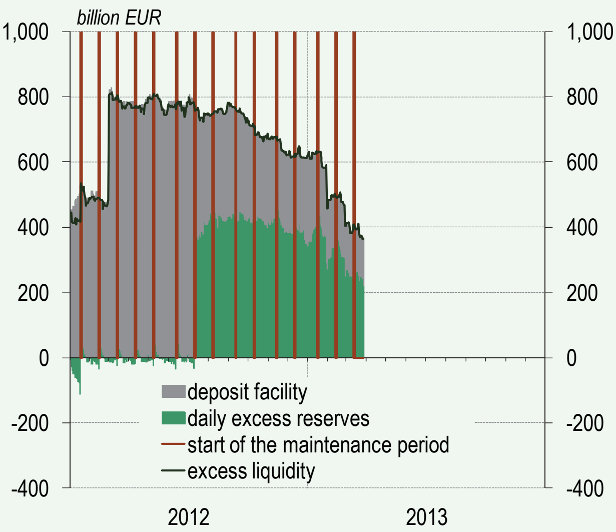
The main factors that stabilised the situation in the euro area between September 2012 and March 2013 were: (i) the second 3-year LTRO in early March 2012, (ii) a cut in the key ECB interest rates by 25 basis points on 11 July 2012[1], and (iii) the announcement of Outright Monetary Transactions (see Box 4.1 in the October 2012 Price Stability Report) in August 2012. The commitment by the Governing Council of the ECB that the Eurosystem will intervene with purchases to maintain government bond yields at acceptable levels restored the confidence in the sovereign debt of countries with fiscal imbalances and in banks from these countries. The latter started issuing securities in the covered and uncovered bank bond markets again towards the end of 2012. Having obtained long-term funding has allowed the banks to begin with early repayments of a part of the allotted amounts of both 3-year LTROs in early 2013.

High participation in the two 3-year LTROs (see Box 4.2 in the April 2012 Price Stability Report) provided the banks with liquidity for a period of three years with the possibility of partial or full early repayment from the end of January or February 2013 onwards, weekly on the day that coincides with the settlement of main refinancing operations (MROs). On 6 December 2012, the Governing Council of the ECB extended the conduction of MROs and LTROs as fixed rate tender procedures with full allotment at least until 9 July 2013. Therefore, alongside the ongoing MROs and the 1-month and 3-month LTROs, both 3-year LTROs substantially increased excess liquidity in the euro money market.[2] It increased from an average of EUR 230 billion in November 2011 to more than EUR 800 billion in early March 2012. The excess liquidity began declining in September as a result of the gradual reduction in MROs and LTROs of shorter maturities. The decline accelerated at the end of January and February 2013 with the first early repayments of both 3-year LTROs. Excess liquidity thus fell to below EUR 400 billion in March 2013 (Figure 1).

On 30 January, the banks repaid EUR 137 billion at the first early repayment of the first 3-year LTRO. By 14 March they had repaid a total of EUR 157 billion or 32% of this operation. The first early repayment of the second 3-year LTRO in the amount of EUR 61 billion followed on 27 February 2013, with a total of EUR 72 billion or 14% of this operation being repaid by 14 March. The early repayments substantially decreased the outstanding amount of LTROs, which fell by an average of EUR 191 billion in February 2013 to EUR 878 billion as compared with September 2012. The outstanding amount of MROs was almost unchanged at the average of EUR 129 billion in February 2013 as compared with September 2012. It temporarily decreased to an average of EUR 79 billion between October 2012 and January 2013.

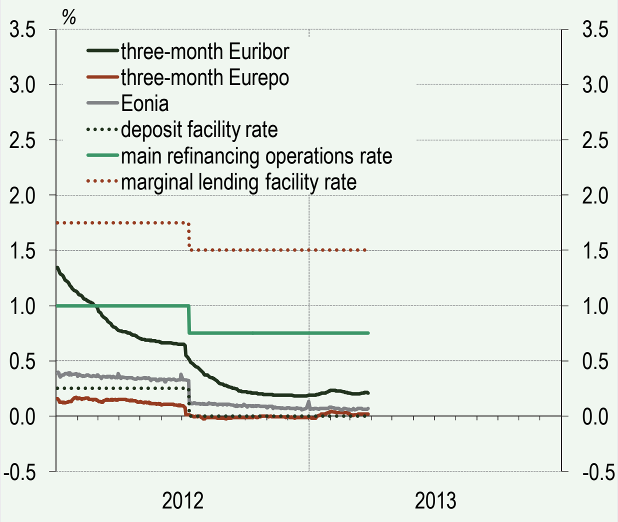
The size of the first early repayment of the first 3-year LTRO exceeded the market participants' expectations, which had fluctuated around EUR 100 billion. By contrast, the first early

Figure 1: Excess liquidity in the euro area



Source: ECB.

Figure 2: ECB and money market interest rates



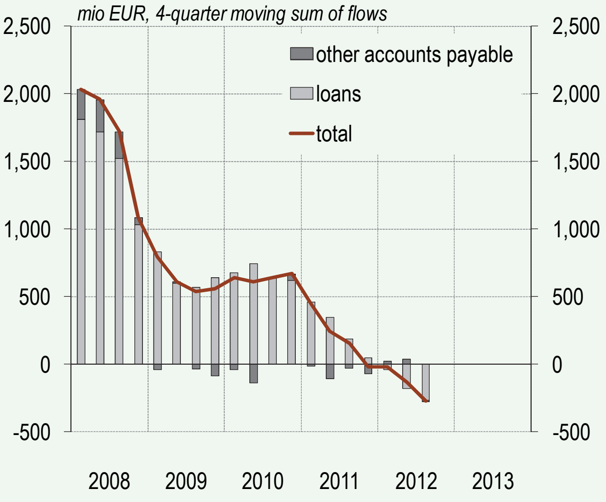
Source: Bloomberg, ECB.

repayment of the second operation was considerably lower than the expectations, which had fluctuated around EUR 130 billion. Due to the substantially lower early repayments of the first 3-year LTRO in the following weeks (the largest has reached EUR 5 billion), the market participants' confidence in the maintenance of substantial excess liquidity in the euro area strengthened. This confidence was reinforced by the statement of ECB president Mr Draghi at the press conference after the meeting of the ECB Governing Council of 7 February 2013 that the early repayments reflect improvements in financial market confidence and that the ECB will maintain accomodative monetary policy stance. Having fallen since the end of 2011 as a result of high excess liquidity, interest rates on the interbank money market decreased further (see Figure 2).

The outstanding amounts of MROs and LTROs for Slovenian banks increased between September and December 2012 and reached its highest level to date, at EUR 3,988 million. In 2013, the demand for MROs and LTROs declined and averaged EUR 3,915 million in February 2013. By 14 March Slovenian banks had not participated in any early repayments of the 3-year LTROs, as they were having difficulties refinancing their liabilities on the financial markets.

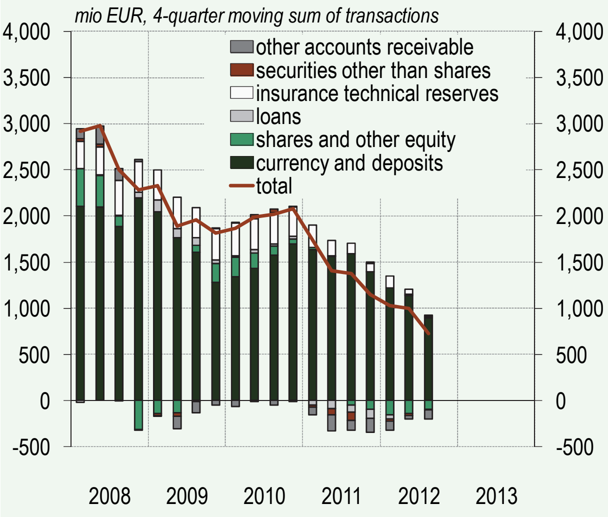
[1] Interest rate on the main refinancing operations fell to 0.75%, interest rate on the deposit facility to 0.00% and interest rate on the marginal lending facility to 1.50%.
[2] Excess liquidity is defined as the difference between the liquidity that the banks obtain from the Eurosystem and the bank's liquidity needs.

Figure 4.5: Financial liabilities of households and NPISH (S.14 & S.15), by instruments



Source: Bank of Slovenia, consolidated data.

Figure 4.6: Financial assets of households (S.14 in S.15)



Source: Bank of Slovenia, consolidated data.

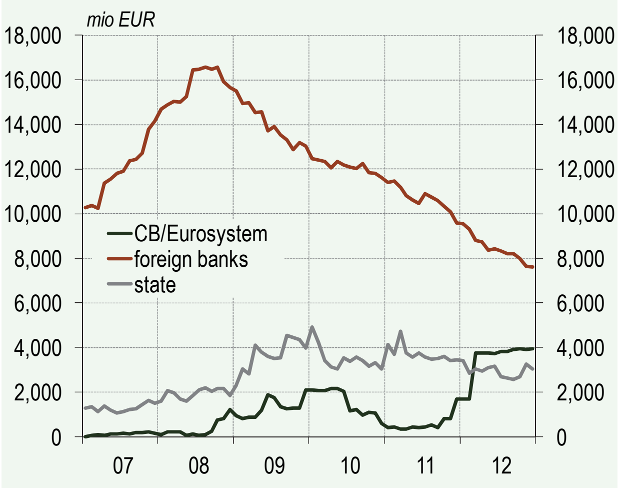
holds simultaneously increased their sight deposits, which can be used for consumption purposes. Investment in shares and other equity, which account for just over a quarter of total household assets, increased by EUR 60 million during the first three quarters of 2012. This was primarily the result of positive revaluations. Investments in insurance technical reserves, which account for 12% of total household assets, increased by EUR 99 million. The total stock of households' assets thus stood at EUR 37.5 billion at the end of the third quarter of 2012.

Bank funding and interest rates

The change in the structure of bank funding has been dictated by the stricter conditions for accessing foreign funding, and the LTD ratio on bank balance sheets has also been gradually adjusting. Liabilities to all sectors have declined, other than liabilities to the Eurosystem.[10] The banks made net debt repayments to foreign banks of EUR 2,214 million last year. The majority of the repaid loans were of longer maturity. Liabilities from debt securities also declined, by almost EUR 1,550 mil-

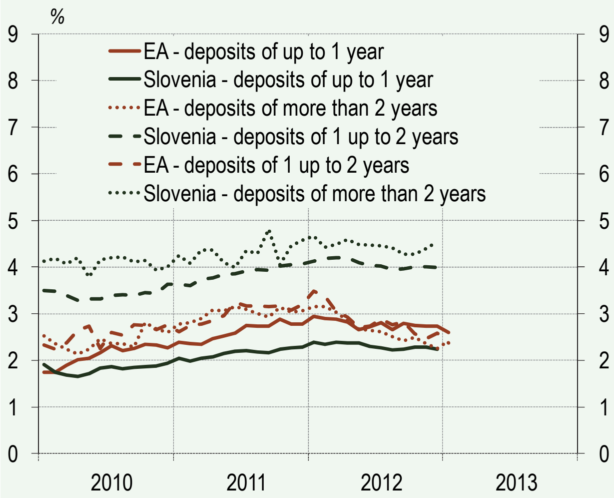
[10] A large portion of the funding obtained from the Eurosystem was earmarked for the repayment of foreign bank loans.

Figure 4.7: Selected liabilities of domestic banks



Source: Bank of Slovenia.

Figure 4.8: Interest rates on household deposits, by maturity

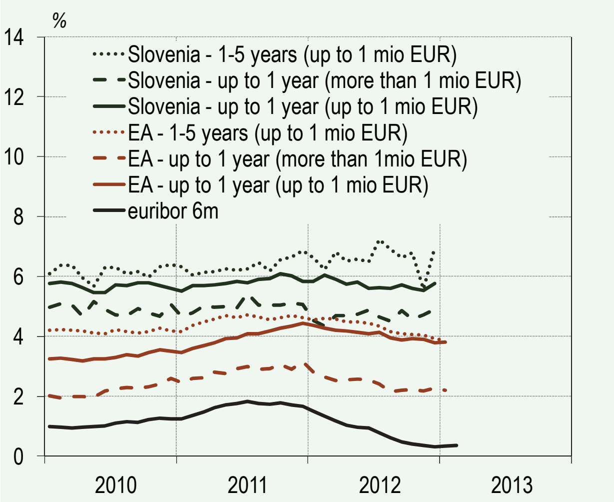


Source: ECB, Bank of Slovenia.

lion, as a result of prepayments of the banks' own bonds. The government sector reduced its deposits by EUR 410 million, for the needs of current operations and the repayment of maturing debt. Deposits by the private sector declined by EUR 481 million, with corporates and other financial institutions to the fore. Households also reduced their deposits at banks last year, primarily as a result of a reduction in short-term deposits. Long-term household deposits, which are more desirable from the point of view of bank funding, again increased slightly last year. One factor was the interest rates on such deposits, which are significantly above the euro area average. The banks partly compensated for the loss of funding via cheaper funding from the Eurosystem, primarily 3-year LTROs. The corresponding liabilities increased by over EUR 2,250 million last year, and have helped to reduce the banks' short-term and medium-term refinancing risk. Domestic banks' liabilities to foreign banks have declined by more than a half since 2008, or just over EUR 8 billion. The LTD ratio also fell from 160% in 2008 to 137% in 2012.

The increased difficulty in accessing funding for banks, its higher cost, and the desire to maintain net interest income are being reflected in higher interest rates on loans, in particular to corporates. Interest

Figure 4.9: Interest rates on loans to NFCs

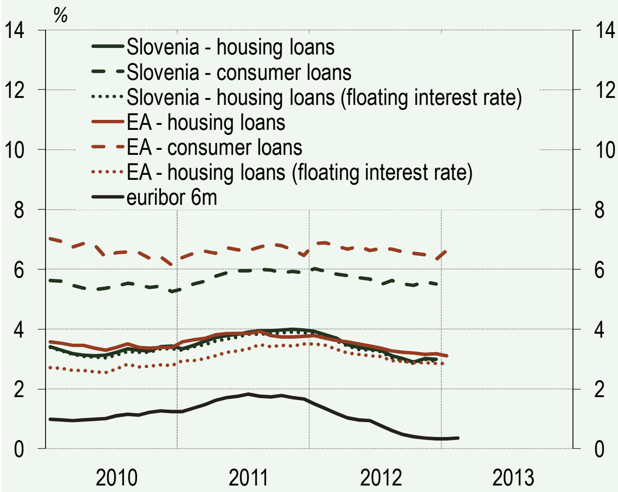


Source: ECB, Bank of Slovenia.

rates on new loans to corporates were again significantly higher than average euro area interest rates last year. There are several reasons: (1) the higher cost of bank funding, (2) rising indebtedness and thus increased risk on the part of Slovenian corporates compared with the euro area average and (3) the need to maintain the banking system's net interest income, in part to cover impairment costs. Interest rates on corporate loans have thus remained more than 2 percentage points higher than the euro area average, which is placing a further burden on corporates and is hindering already weak economic activity.

Interest rates on new loans to households are similar to the euro area average, and are largely being adjusted to interbank interest rates. Interest rates on consumer loans and housing loans fell last year in line with the fall in the EURIBOR. Interest rates on consumer loans in Slovenia remain lower than the euro area average, although the spread is narrowing. Last year there was also a decline in the spread in interest rates on housing loans, and the rates were at a similar level at the end of the year. The mark-up over the 6-month EURIBOR for housing loans increased slightly last year, which could be a reflection of slightly greater caution on the part of the banks in approving such loans given the adverse labour market situation.

Figure 4.10: Interest rates on loans to households



Source: ECB, Bank of Slovenia.

5 Public Finances

The general government deficit narrowed in 2012, reaching 3.7% of GDP according to SORS estimates. The main factors were the measures introduced by the Fiscal Balance Act, and certain additional government austerity measures. The structural deficit stood at 3.1% of GDP according to European Commission estimates. The largest contribution to the continuing rise in government debt to 54.1% of GDP in 2012 was the difference between the implicit interest rate on the debt and the decline in nominal GDP. The enactment of the pension reform in the early part of this year has improved the long-term sustainability of Slovenia's public finances.

In the report on the general government deficit and debt, general government deficit is estimated at 3.0% of GDP this year excluding the already taken measures for strengthening bank capital, or 4.2% of GDP when these measures are included. There are risks in meeting the target. These derive from the potential deterioration in the macroeconomic situation, and the action to resolve banks' bad assets. Further fiscal consolidation is vital to stabilise government debt, and with it access to financing. As much as possible, consolidation measures should be designed to put minimum constraints on economic activity.

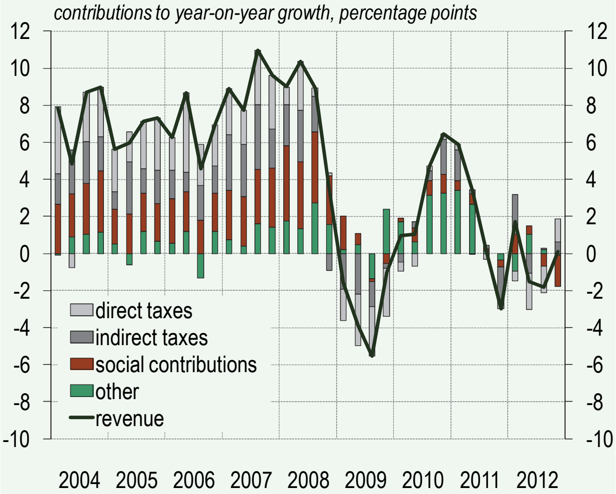
General government deficit

The general government deficit narrowed significantly in 2012, while the general government debt increased again. The general government deficit amounted to 3.7% of GDP in 2012, 2.7 percentage points less than in the previous year. This was slightly higher than the 3.5% of GDP planned in the Stability Programme and predicted by the European Commission in its forecasts for the euro area. The deficit remains primarily of a structural nature. At the end of the year, general government debt stood at 54.1% of GDP, and remained below the average euro area debt, which was estimated at 93.1% of GDP last year.

General government revenues fell by 0.4% in 2012, primarily as a result of the decline in economic activity, but also as a result of government measures. The largest decline was in corporate income tax. The tax rate was cut from 20% to 18% in 2012, while the allowances for investment and for research and development were increased. While the proposed changes were being drawn up, it was estimated that the tax liability from corporate income tax for 2012 would fall by EUR 170 million, or 1.1% of general government revenues (0.5% of GDP). There was an increase in indirect taxes, despite the decline in household consumption. VAT revenues were down on the previous year, while revenues from excise duties were higher. The level of excise duty on all products subject to excise duty rose. In 2012 excise duties on

Figure 5.1: General government revenue

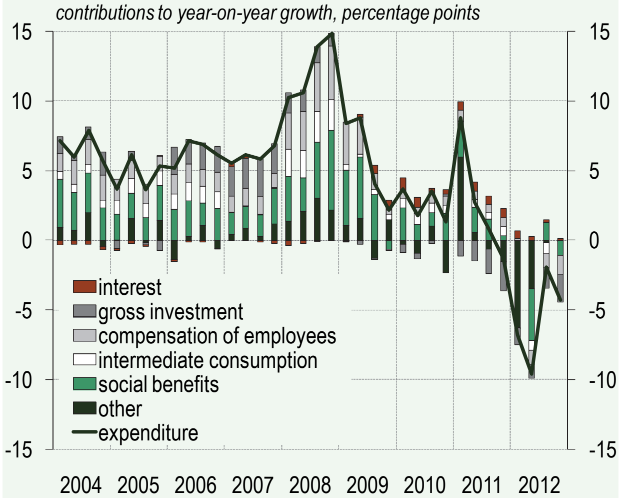
contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations.

Figure 5.2: General government expenditure

contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations.

mineral oils were raised several times, excise duties on tobacco were raised three times, excise duties on alcohol were raised, and in the middle of the year a tax for the pollution of the air with emissions of carbon dioxide was introduced for motor fuels. The adverse situation on the labour market had an impact on revenues dependent on the total wage bill. Social contributions were down, while personal income tax revenues were up 0.6%. Despite the absolute decline in general government revenues, the larger decline in economic activity meant that they rose as a proportion of GDP.

There was a significant reduction in general government expenditure in 2012, which covered all major expenditure categories. Only expenditure on interest recorded a significant increase. General government expenditure fell by 5.7% last year. The key factors were the measures introduced by the ZUJF, and the constraints on expenditure under the government's discretionary powers. Employee compensation and social benefits both declined last year, for the first time during the period for which data is available. Despite the rise in the unemployment rate, the largest declines in social benefits were recorded by unemployment benefits and social security transfers. Expenditure on family benefits and parental compensations also declined. The measures restricting expenditure on pensions included non-

Table 5.1: General government deficit and debt in Slovenia, 2008-2015

	SORS					Stability Programme					EC		
as % GDP	2008	2009	2010	2011	2012	2011	2012	2013	2014	2015	2012	2013	2014
Revenue	42.4	43.1	44.5	44.4	45.1	44.5	44.7	44.1	43.8	43.7	44.4	45.6	44.8
Expenditure	44.3	49.1	50.3	50.8	48.8	50.9	48.2	46.7	45.3	44.1	48.8	50.7	49.5
of which: interest	1.1	1.3	1.6	1.9	2.1	2.0	2.5	2.6	2.5	2.5	2.4	2.8	3.0
Net lending (+) / borrowing (-)	-1.9	-6.0	-5.7	-6.4	-3.7	-6.4	-3.5	-2.5	-1.5	-0.4	-4.4	-5.1	-4.7
Structural balance	…	…	…	…	…	-3.8	-1.8	-1.1	-0.7	-0.1	-3.1	-2.3	-3.1
Debt	22.0	35.0	38.6	46.9	54.1	47.6	51.9	53.1	52.6	50.9	53.7	59.5	63.4
Real GDP *(growth, %)*	3.4	-7.8	1.2	0.6	-2.3	-0.2	-0.9	1.2	2.2	2.2	-2.0	-2.0	0.7

Soures: SORS (realisation), Ministry of Finance (April 2012), European Commission (EC, February 2013).

Box 5.1: Review of structural reforms in Slovenia since the outbreak of the crisis

The structural reforms relate to measures to ensure sustainable long-term economic growth. There is usually a substantial lag in their effects, which is a significant obstacle to determining the impact of an individual reform on macroeconomic aggregates. Here the choice of structural reforms is extremely important, as research indicates that certain labour market reforms have the fastest impact on economic growth. Other extremely important factors in the impact of structural reforms are the credibility of economic policymakers, the institutional environment and the phase of the business cycle in which the economy finds itself. Carrying out structural reforms at a time of crisis is an important support to other reforms, but individual structural reforms may also have an adverse impact on economic growth, employment and other aggregates in the short term.

International institutions (IMF, OECD, ECB, European Commission) have often stressed the importance of structural reforms to promoting economic growth in Slovenia.[1] Slovenia's failure to carry out such reforms was repeatedly stated to be one of the main reasons for the decline in its long-term economic potential, competitiveness and fiscal sustainability.[2] It is also suggested that this is one of the reasons why Slovenia is ranked relatively low in terms of competitiveness. Among the most problematic areas are the inefficiency of government bureaucracy and restrictive labour market legislation.[3]

The government has recently carried out some reforms. Of the reforms affecting the labour market, the pension reform is the most important, having been approved unanimously on 4 December 2012 when the National Assembly adopted the ZPIZ-2. In addition to the short-term effects, the most important of which is the reduction in the budget deficit, the reform is expected to have long-term effects primarily by ensuring greater participation in the labour market and stabilisation of the public debt. Under the Fiscal Balance Act (ZUJF), which was adopted by the National Assembly on 11 May 2012, certain incentives were introduced to increase participation in the labour market by students and older persons. The labour market reform is also expected to contribute significantly to greater participation by various groups and to greater flexibility. The reform should above all help to reduce the dual nature of the labour market. In Slovenia during the crisis this has been reflected primarily in differences in trends in temporary and permanent employment, and thereby between younger and older participants, the latter having better protection on the labour market.

The second package of reforms is aimed at promoting competitiveness and entrepreneurship, and improving the business environment. The government committed itself to action in these areas in the Programme for the Promotion of Entrepreneurship and Competitiveness 2007-2013, in the Programme of Measures Aimed at Boosting the Economy I-III, and in the Action Programme for Eliminating Administrative Barriers and Reducing the Regulatory Burden 2012-2013.[4] Certain reforms from those programmes had already been adopted. One of them with particular significance is the e-VEM programme, which has shortened company registration

[1] For example: Høj, Galasso, Nicoletti, Dang: An empirical investigation of political economy factors behind structural reforms in OECD countries, OECD Economic Studies No.42, 2006/1;
Duval in Elmeskov: The Effects of EMU on Structural Reforms in Labour and Product Markets, ECB Working Paper No. 596;
http://www.ecb.int/press/key/date/2012/html/sp121214.en.html, ECB;
http://ec.europa.eu/economy_finance/structural_reforms/index_en.htm, European Commission.

[2] For example:
IMF : http://www.imf.org/external/np/sec/pn/2012/pn12134.htm
OECD: http://www.oecd.org/slovenia/sti-outlook-2012-slovenia.pdf;
http://www.oecd.org/slovenia/theneedforstructuralreforms.htm,
http://www.oecd.org/eco/growth/Slovenia.pdf

[3] For more, see for example:
http://www.umar.gov.si/fileadmin/user_upload/publikacije/pr/2012/PoR_2012.pdf

[4] For more, see for example:
http://www.minus25.gov.si/novice/artikel/v-obdobju-od-julija-do-septembra-realiziranih-42-ukrepov-iz-akcijskega-programa-za-odpravo-administr/;
http://www.minus25.gov.si/fileadmin/user_upload/mju/Boljsi_predpisi/Novice/1.porocilo_PAP_Priloga_3.pdf;
http://www.minus25.gov.si/fileadmin/user_upload/mju/Boljsi_predpisi/Program_-25__/AKCIJSKI_PROGRAM_OAO_2012_2013.pdf;
http://www.mgrt.gov.si/fileadmin/mgrt.gov.si/pageuploads/DPK/Dopolnjen_Program_ukrepov___15.10.2009.doc;
http://www.google.si/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CC8QFjAA&url=http%3A%2F%2Fwww.vlada.si%2Ffileadmin%2Fdokumenti%2Fsi%2Fprojekti%2F2012%2F3._program_ukrepov_140912.doc&ei=HUcSUb-4HaKF4gTsu4CIAQ&usg=AFQjCNHXcne5CgJVoDYRhZOnLJ2tNTQNLA&sig2=bGp3TXGc9e79KWVQj_VU0w&bvm=bv.41934586,d.Yms

procedures. Other measures relate to subsidies for the start-up of new, innovative firms, the financing of technological development projects in conjunction with SID banka, the simplification of corporate insolvency and compulsory liquidation proceedings to maintain healthy cores of debtors, financial incentives for investment, particularly in environment-friendly resources, the promotion of employment in development departments, tenders for the promotion of FDI and tenders to encourage the development of new creative cores. The Action Programme for Reducing Administrative Burdens on business by 25% is expected to reduce administrative barriers for firms, thanks in part also to the introduction of flat-rate taxation for small business proprietors and the abolition of compulsory announcement of firms' status arrangements and other arrangements in the Official Gazette of the Republic of Slovenia.

These reforms will help to strengthen Slovenia's competitive position, but it is important that reforms continue. Only in this way can the normal restructuring of the economy away from sectors with low value-added to sectors with higher value-added be ensured. This would also raise employment in the long term.

adjustment of pensions, while some pensions were also reduced. A rise of 2.6% in the number of pensioners nevertheless led to an increase in expenditure on pensions last year, albeit significantly less than in previous years. Expenditure on general government investment fell for the fourth consecutive year, while expenditure on intermediate consumption and subsidies was also down. A further contribution was made to the reduction in expenditure by the decline in one-off transactions. The three largest transactions of a one-off nature raised expenditure in 2011 by 1.1% of GDP, while in 2012 only one major transaction of 0.2% of GDP was disclosed (capital strengthening at NLB). The increase in debt brought higher interest payments, which amounted to 2.1% of GDP. General government expenditure as a proportion of GDP declined to less than 50%.

The central government accounted for the majority of the general government deficit. According to SORS estimates, the central government deficit stood at 3.5% of GDP in 2012, while the social security funds recorded a deficit of 0.3% of GDP. Local government recorded a surplus of 0.1% of GDP.

General government debt and guarantees

The general government debt increased to 54.1% of GDP last year. The government primarily borrowed by issuing long-term bonds. The general government debt stood at EUR 19.189 billion at the end of December. Last year's increase in debt was primarily the result of a snowball effect, i.e. the difference between the implicit interest rate and nominal GDP growth. This effect accounted for 3.0 percentage points of the total increase in debt of 7.2 GDP percentage points. The majority of the borrowing was undertaken in October, when the government issued a 10-year bond on the US dollar financial market with a nominal value of USD 2.25 billion. The government also borrowed by issuing treasury bills and by raising long-term loans at the domestic banks. The Ministry of Finance continued to issue treasury bills in the early part of

Table 5.2: Contributions of components to change in general government debt

% GDP	2008	2009	2010	2011	2012
debt	22.0	35.0	38.6	46.9	54.1
change in debt	**-1.1**	**13.1**	**3.6**	**8.3**	**7.2**
of which: primary balance	0.8	4.6	4.1	4.4	1.6
difference interest rate-growth rate ("snow-ball effect")	-0.5	2.4	1.6	1.3	3.0
deficit debt adjustment	-1.4	6.0	-2.1	2.5	2.6

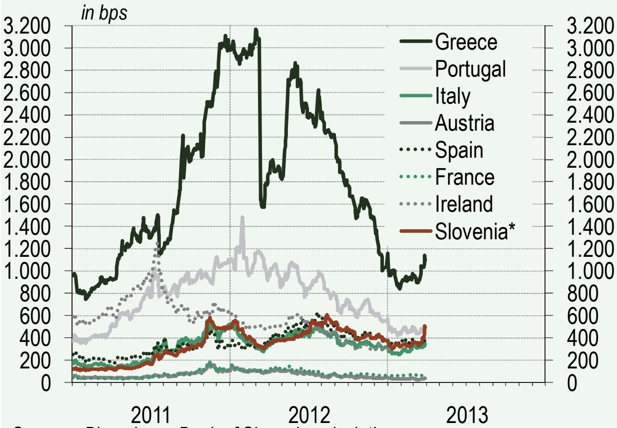
Source: SORS, Bank of Slovenia calculations.

this year. According to data for the consolidated general government position,[11] last year's total borrowing amounted to EUR 3 billion. The money was earmarked for repaying debt in the amount of EUR 1.3 billion, and for financing the budget deficit and the deficit in the lending and repayments account in the amount of EUR 1.6 billion. A small part was earmarked for prefinancing the principal of debt maturing in the future. Under the programme for financing the state budget for 2013, this year's budget borrowing ceiling is EUR 4.6 billion. This amount includes possible borrowing for the repayment of debt principal maturing in the next two years in the amount of EUR 3.1 billion.

The largest decline in government guarantees last year was the result of the maturing of government-guaranteed bank bonds. The stock of guarantees amounted to EUR 6.5 billion or 18.3% of GDP at the end of December. Of this, EUR 2.8 billion comprises guarantees for DARS d.d. The stock of guarantees was down EUR 0.5 billion on the previous year. The largest decline came from the maturing of bank bonds issued with a government guarantee in 2009. The main increase during the year was in guarantees related to international assistance for the euro area countries in financial difficulties via the European Financial Stability Facility (EFSF). According to state budget figures, guarantees in the amount of EUR 24 million were called last year.

The required yield on Slovenian 8-year government bonds fell after last August, and fluctuated close to 5% in the early months of this year. Since last October, when long-term bonds were issued, the spread on Slovenian government bonds over the benchmark German bonds of similar maturity has been relatively stable at close to 400 basis points. The required yields fluctuated around 5.5%. The spread and required yields fell slightly further after the adoption of the pension reform and the austerity budgets for 2013 and 2014, despite February's downgrading of Slovenia's long-term sovereign debt at one of the rating agencies. In early March the spread approached 360 basis points and the required yield was fluctuating around 5%. The required yield then rose to more than 6% towards the end of March. The liquidity of Slovenian bonds remains extremely low, which makes issuance more difficult and raises the required yield. The continuation of fiscal consolidation and structural reforms is the key to reducing required yields. This includes measures to address over-leveraged corporates and thereby banks' bad assets.

Figure 5.3: Spreads on long term government bonds over German bond



Sources: Bloomberg, Bank of Slovenia calculations.
Notes: Spread is calculated as a difference between the yield of long term government bond and the yield of reference German bond on a daily basis and is used as a measure of country's credit risk.
** SLOREP 01/21 is used after 11. January 2011.*

Last year there was a significant increase in Slovenia's assistance to euro area countries facing debt problems. Slovenia is participating in the bailouts for Ireland, Portugal and Greece via the EFSF, while it was additionally involved in the first bailout package for Greece in the form of bilateral loans. Both forms of assistance are raising general government debt. At the end of last year they accounted for EUR 972 million of the debt, equivalent to 2.7% of GDP, having amounted to 0.9% of GDP the previous year. The European Stability Mechanism (ESM), which will eventually replace the EFSF, was established last October. Spain, which needs financial assistance for its financial sector, had received EUR 41.4 billion of assistance from the ESM by the end of this March. The ESM's contribution to the rise in government

[11] The consolidated general government position includes the state budget, local government budgets, the Health Insurance Institute and the Pension and Disability Insurance Institute.

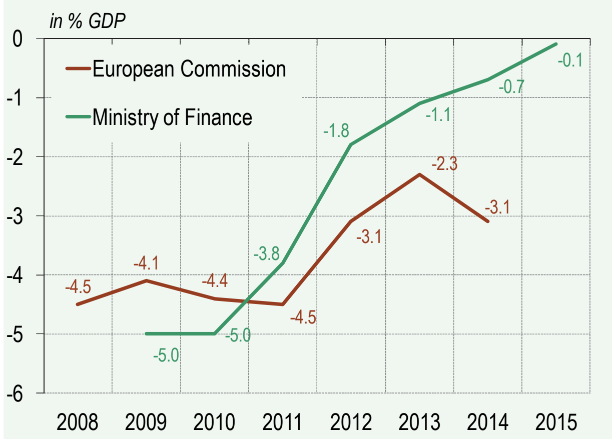
debt in the countries participating in the assistance is the amount of the paid-up capital alone. Financial assistance provided by the ESM to a recipient country does not enlarge government debt. Slovenia's capital contribution to the ESM is EUR 342 million. Last year it paid up EUR 137 million of this, or 0.4% of GDP. The remainder of the capital will be paid up this year and next year.

Planned developments in the general government deficit

The medium-term budgetary strategy is based on the correction of the excessive deficit and the gradual attainment of a balanced structural position. Slovenia has been undergoing the excessive deficit procedure since December 2009. At that time the European Council recommended that Slovenia reduce its structural deficit by an average of 0.75 GDP percentage points a year between 2010 and 2013, and reduce the deficit to below 3% of GDP by 2013. In the updated Stability Programme from April 2012, Slovenia planned the attainment of all these targets, and confirmed its medium-term fiscal target of a balanced structural position. According to these plans, the actual position and the structural position are expected to be almost in balance by 2015.

Attaining the targets is being made more difficult by the macroeconomic conditions being less favourable than expected, and the planned measures in connection with the resolution of banks' bad assets. A deficit of 4.2% of GDP is planned for this year, or 3% of GDP if the already taken measures for strengthening bank capital are excluded. In the period of almost one year since the most recent update to the Stability Programme was drawn up, the macroeconomic precepts have deteriorated significantly, which is making the targets harder to attain. Measures in connection with banks' bad assets

Figure 5.4: Public finance structural balance



Note: Structural balance estimate by the MoF reflects targeted dynamics, while the EC estimate only includes adopted measures.
Sources: EC, Ministry of Finance - Stability Programme, April 2012.

may also have an adverse impact on the public finances.[12] In the report on the general government deficit and debt from April 2013 a general government deficit is estimated at 4.2% of GDP for this year, including 1.2% of GDP for strengthening bank capital. According to European Commission forecasts from February 2012, this year's deficit is expected to amount to 5.1% of GDP, higher than planned. Some 0.9 percentage points of the aforementioned deficit comprises capital strengthening at NLB, i.e. the conversion of contingent convertible bonds paid up by the government last year into equity. A new update of the Stability Programme is expected in April of this year, and will set out the government's fiscal strategy. In the event of satisfactory efforts at fiscal consolidation and the adverse impact of an unexpected fall in economic growth on the public finances, the European Commission may extend the deadline for correcting the excessive deficit (under the reformed pact).

Further fiscal consolidation is necessary for restoring investor confidence and access to foreign financial markets. This will also reduce borrowing costs, not

[12] The Government Measures to Strengthen the Stability of Banks Act entered into force in December 2012. The law provides for the following measures: 1) the purchase or takeover of bank assets in return for consideration and their management at the Bank Asset Management Company, 2) government guarantees, 3) increases in bank share capital and 4) measures to provide the requisite liquidity to banks as a last resort. The total stock of guarantees may not exceed EUR 4 billion (11% of GDP), while measures for strengthening bank capital should not exceed EUR 1 billion (just under 3% of GDP) according to available information.

only for the government, but also for the private sector. It would halt the upward trend in government debt, which remains below the reference value of 60% of GDP, but is quickly approaching it. According to the report on the government deficit and debt from April 2013, the general government debt is expected to reach 59.2% of GDP by the end of this year. The government must first ensure the correction of the excessive deficit through its fiscal consolidation measures. The government must then attain its medium-term target. It is important that the measures are designed to minimise the impact on the already weak economic activity.

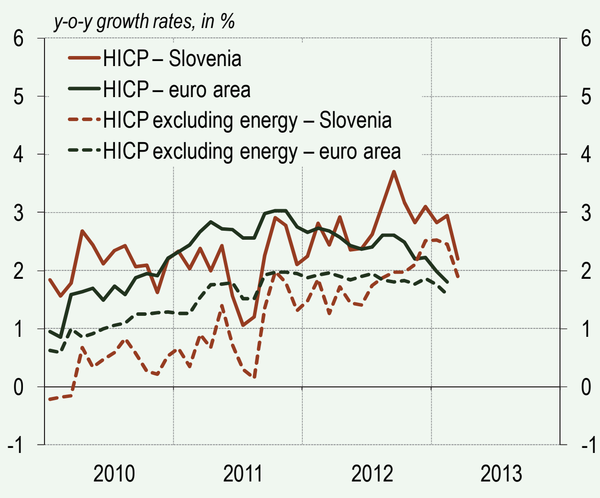
A sustained reduction in the deficit requires measures of a permanent nature and structural reforms. The pension reform introduced at the beginning of this year has partly improved medium- and long-term fiscal sustainability. Some of the measures taken are temporary in nature. They are tied to a specific period or to economic growth. The latter are to apply until the year after the year when GDP growth exceeds 2.5%. The former include the taxation of high-value real estate and a new 50% personal income tax rate to apply in 2013 and 2014, while the latter include a reduction in the annual allowance for pensioners. The pension reform adopted is gradually tightening retirement conditions, while reform of the labour market does not have any significant direct impact on the public finances. Reforms to achieve greater efficiency, which may not impact socially disadvantaged sections of the population, are also required in the fields of healthcare and long-term care.

6 Inflation

Growth in the harmonised index of consumer prices rose to 2.8% in 2012, 0.3 percentage points higher than the euro area average. Core inflation remains low, at around 1%. The uncertainty on the labour market and the decline in household disposable income mean that demand-side pressures on prices are very weak, while at the same time the supply-side impact on inflation is also limited, given the necessary cost adjustment of the firms. The main factors of the 0.7 percentage points increase in inflation relative to 2011 were rises in prices of public services, higher levies associated with fiscal consolidation, and prices of certain commodities. Fiscal factors continued to have an impact in the first three months of this year.

The average annual inflation rate as measured by the HICP stood at 2.8% in 2012, 0.7 percentage points more than in the previous year, and 0.3 percentage points more than the euro area average. The largest contributions to headline inflation last year again came from energy and food prices. The rise in annual inflation primarily occurred in the second half of the year, due to higher growth in prices of unprocessed food and measures related to fiscal consolidation. Inflation fell slightly at the end of last year and at the beginning of this year as a result of slower growth in prices of unprocessed food and euro oil prices and a fall in gas prices. It averaged 2.7% over the first three months of 2013.

Figure 6.1: Inflation



Sources: Eurostat, SORS, calculations Bank of Slovenia.

Macroeconomic factors and core inflation indicators

Core inflation remains low, despite a rise in certain prices related to fiscal consolidation. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged 0.7% in 2012, up 1.1 percentage points on the previous year. The largest factors in the rise in core inflation were changes in the subsidisation of school meals and other fiscal consolidation measures that resulted in rises in the prices of some public services in the second half of the year. Year-on-year growth in

Figure 6.2: Core inflation

Sources: Eurostat, Bank of Slovenia calculations.

prices of other services remained very low in 2012, while the prices of non-energy industrial goods again fell in year-on-year terms. The narrowest core inflation indicator thus remains well below the euro area average. By contrast, the two broader core inflation indicators ended the year above the euro area average. The main factors in this were excise duties on alcohol and tobacco and prices of unprocessed food, which rose significantly faster than in the euro area in the second half of the year. Core inflation as measured by the HICP excluding energy and unprocessed food increased by 0.8 percentage points last year, to 1.5%. The broadest core inflation indicator, the HICP excluding energy, also rose, to 1.8%. The narrowest core inflation indicator averaged 0.7% year-on-year during the first three months of this year, thus remaining below the euro area average.

The low level of core inflation was a result of the decline in private consumption, while the cost pressures on price developments were primarily related to rises in commodity prices as the growth in nominal labour costs remained low. Low nominal wage growth, the decline in social transfers and the price rises associated with fiscal consolidation reduced household disposable income in real terms, which is greatly restricting domestic consumption. The absence of inflationary pressures on the demand side is also in line with the decline in the stock of loans to households in the second half of the year. The decline in wages was outpaced by the decline in productivity for the majority of last year. The

Table 6.1: Breakdown of the HICP and price indicators

	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2013	2008	2009	2010	2011	2012	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13
HICP	*100.0%*	5.5	0.9	2.1	2.1	2.8	2.6	2.5	2.5	3.2	3.0	2.7
Breakdown of HICP:												
Energy	*14.4%*	9.4	-4.5	13.9	8.8	9.0	8.0	8.3	8.7	10.8	8.0	4.8
Food	*23.5%*	8.1	1.8	2.5	4.8	4.7	4.8	3.7	3.8	5.1	6.2	6.5
processed	*16.1%*	9.9	2.7	2.9	5.0	4.7	6.0	4.7	4.4	4.6	5.0	5.2
unprocessed	*7.4%*	4.6	0.0	1.7	4.3	4.5	2.3	1.4	2.1	6.1	8.5	9.5
Other goods	*27.9%*	2.2	0.0	-2.2	-0.9	-0.2	0.0	-0.6	0.2	0.2	-0.7	-0.6
Services	*34.3%*	5.3	3.2	1.2	0.0	1.5	1.1	1.9	1.1	1.1	2.0	1.8
Core inflation indicators												
HICP excl. energy	*85.6%*	4.9	1.7	0.3	1.0	1.8	1.7	1.5	1.5	1.9	2.2	1.5
HICP excl. energy and unprocessed food	*78.2%*	5.0	1.9	0.2	0.7	1.5	1.6	1.5	1.5	1.5	1.6	1.5
HICP excl. energy, food, alcohol and tobacco	*62.2%*	3.8	1.7	-0.4	-0.4	0.7	0.6	0.7	0.7	0.7	0.8	0.7
Other price indicators:												
Industrial producer prices on domestic market		5.6	-0.4	2.0	3.8	1.0	2.9	1.1	0.9	0.9	1.2	...
GDP deflator		4.1	3.6	-1.1	1.0	0.4	1.9	0.9	0.1	0.5	0.2	...
Import prices[1]		2.7	-4.6	6.4	5.9	2.2	4.2	2.9	2.4	2.2	1.4	...

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

trend of gradual corporate cost adjustment nevertheless remains one of the important factors of low core inflation. Prices were to a large extent influenced by the higher input costs associated with euro commodity prices, particularly oil.

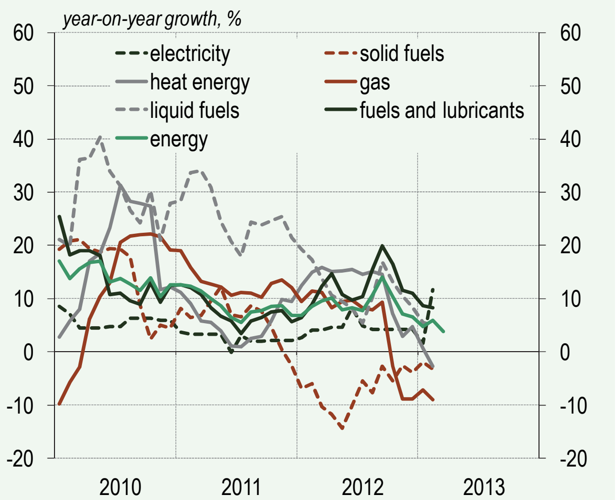
Microeconomic factors and the structure of inflation

The rise in oil prices on the global markets, the fall in the euro and the rise in excise duties led to high growth in energy prices in 2012. Energy prices rose by 9.0% on average during the year, 0.2 percentage points more than in the previous year and 1.4 percentage points more than in the euro area overall. The largest rise was in prices of motor fuels, at an average of 12.3% over the year, compared with a euro area average of 10.7%. Liquid fuels prices rose sharply again in 2012, by an average of 11.8%. The rise in prices of district heating was higher than in the euro area overall, while the rise in prices of electricity, gas and solid fuels was lower. Year-on-year growth in energy prices averaged 4.8% over the first three months of this year. Alongside the growth in oil prices on global markets, other factors contributing to the continuing high growth were the rise in the carbon tax and a rise in the charge for sustainable electricity production.

Figure 6.3: Energy prices

Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia calculations.

The key factors in growth in food prices were the rise in excise duties on tobacco and high year-on-year growth in prices of unprocessed food in the second half of the year. Food price inflation averaged 4.7% last year, 0.1 percentage points lower than the previous year and 1.6 percentage points more than in the euro area overall. Prices of processed food rose by an average of 4.7% in 2012. The main factors were excise duties on tobacco, and rises in prices of milk, dairy products and

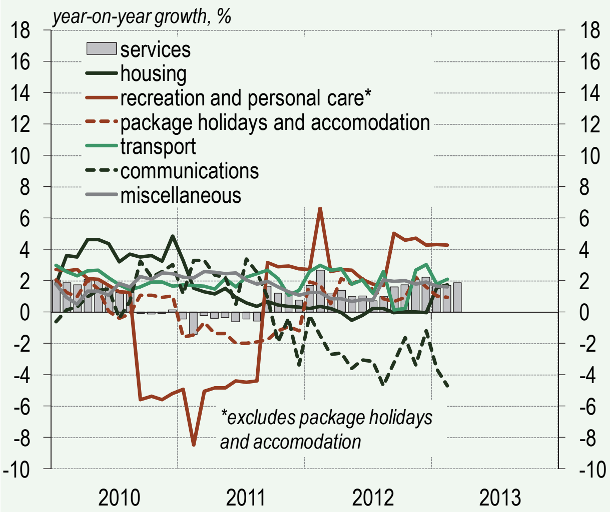
Figure 6.5: Food prices

Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.6: Services prices and prices of non-energy industrial goods

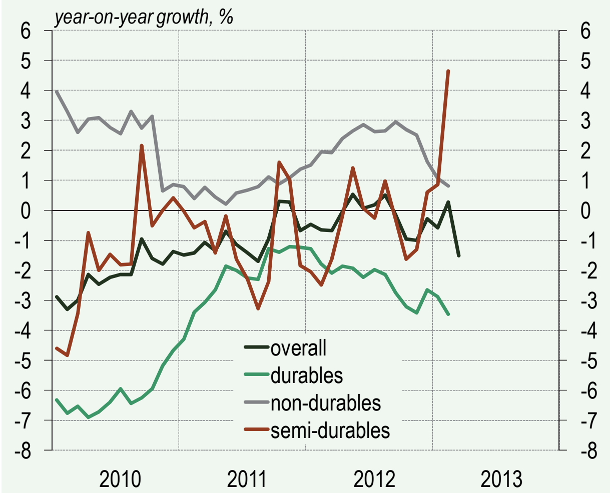
Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations.

eggs, bread and cereals, sugar, and alcoholic beverages. The largest contribution was made by the rise in excise duties on tobacco, at 0.3 percentage points. Prices of unprocessed food rose sharply in the second half of the year, primarily as a result of faster growth in prices of fruit and vegetables. Year-on-year growth in prices of meat also remained high, averaging 4.8%. Year-on-year growth in food prices averaged 6.5% over the first three months of this year.

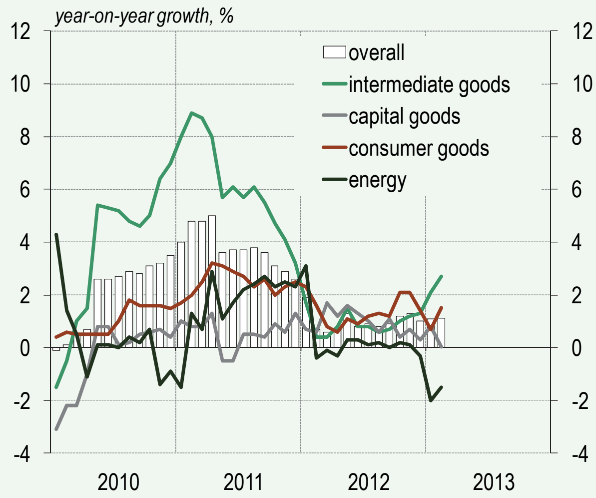
Measures related to fiscal consolidation had an impact on services prices in 2012. After stagnating in 2011, services prices rose by 1.5% on average last year, 0.3 percentage points less than in the euro area average. The rise in services prices was the result of the abolition of subsidies for school meals and a significant rise in prices of public services in the second half of the year. After falling for two years, prices of package holidays rose again last year, by an average of 1.5%. Growth in prices of other services remains very low as a result of the contraction in domestic demand. Prices of telephone and internet services continued to fall in 2012. They were down 2.7% on average over the year. Over the first three months of this year, year-on-year growth in services prices averaged 1.8%, partly as a result of transfering the responsibility for setting prices of municipal services to the local governments, and the introduction of a tax on financial transactions.

In line with the weak economic activity and low consumer purchasing power, prices of non-energy industrial goods fell again in 2012. Prices of industrial goods fell by 0.2% on average in 2012, compared with 0.9% the previous year. The less-pronounced decline was primarily the result of a smaller fall in prices of clothing and footwear and car prices, whose total weight in the basket of prices is more than a tenth. In the euro area, prices of non-energy industrial goods rose by 1.2% on average in 2012. The decline in purchasing power was reflected more strongly in prices of sports equipment, which fell by 11.6% on average in 2012, having risen by 6.4% in the previous year. Over the first three months of this year, prices of non-energy industrial goods fell by 0.6% on average despite unseasonal movements in prices of clothing and footwear.

Industrial producer prices

Industrial producer prices on the domestic market rose by 1.0% on average in 2012, 2.8 percentage points less than in the previous year. Growth remained low at the beginning of this year. Year-on-year growth in all categories of goods other than capital goods was down on the previous year. The largest decline was in year-on-year growth in commodity prices, which was down 5.2 percentage points at 0.9%. This was primarily the result of the year-on-year fall in metals prices on global markets. Year-on-year growth in prices of consumer durables also slowed, to average 2.1% over the year. Year-on-year growth in prices of consumer non-durables averaged 1.2% last year. It was exceptionally low in the first half of the year, before increasing slightly in the second half of the year, when higher prices of food commodities on global markets were reflected in prices of food products at domestic producers. Energy prices were down in year-on-year terms in the early part of the year, then rose slowly in line with the movement of prices in the production of electricity, gas and steam. They rose by 0.3% on average in 2012. Average year-on-year growth in prices of capital goods was up 0.3 percentage points in 2012 at 0.9%, primarily as a result of higher year-on-year growth in the manufacture of computer, electronic and optical equipment. During the first two months of this year, growth in industrial producer prices on the domestic market remained at a level similar to last year.

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations.

Figure 6.10: Industrial producer prices on the domestic market (comparison with euro area)

Sources: Eurostat, Bank of Slovenia calculations.

7 Projections of Economic Trends and Inflation 2013-2015[13]

GDP is expected to decline by around 2% in 2013, and then to resume very slow growth in 2014. The projections of economic growth in this year and next year have thus been revised downwards from the previous projections by a total of 1.5 percentage points. The downward revisions were due to weaker foreign demand, constraints on financing, fiscal consolidation measures, the sharp fall in employment and the resulting high uncertainty in the economy. Weak domestic demand will be reflected not only in low investment, but in a decline in household and government consumption. Export growth will also be low, but as imports fall the contribution made by net trade throughout the projection horizon will remain positive. These developments are reflected in the projection of a current account surplus, which is expected to widen to 4.0% of GDP this year, and to around 4.5% of GDP by the end of the projection horizon. Inflation is expected to fall to 2.3% this year, and to below 2% in the next two years. The adverse macroeconomic situation means that core inflation will remain low.

The risks to the GDP growth projection remain high, with risks concentrated on the downside. There remains a risk of lower foreign demand, as a result of the lack of growth and persistent uncertainty in the euro area, and the uncertainty surrounding the situation in some major economies. The uncertainty surrounding domestic risk factors also remains high, in particular the absence of the fully defined additional fiscal consolidation measures and measures to improve the state of the financial system. The situation on the labour market is deteriorating very rapidly, and could remain weak over the longer term. The funding also remains uncertain, particularly in connection with access to foreign funds. This could be further constrained by additional downgrades of Slovenia's sovereign debt.

The risks surrounding inflation remain balanced, and similar to those in previous projection. The risks of higher inflation are related primarily to additional fiscal consolidation measures, price rises in sectors less exposed to competition, and higher energy prices and food prices. A larger decline in domestic demand and sharper cost adjustment in the economy could result in lower core inflation.

[13] *The projections were made on the basis of current statistical methodologies and data available on 11 March 2013. The projections of macroeconomic factors presented in this report are based on assumptions of the movement in variables from the international environment and certain domestic factors dependent on economic policy decisions. The assumptions of the movement in variables from the international environment are taken from the Consensus Forecasts and Eastern Europe Consensus Forecasts (February 2013), the European Economic Forecasts (European Commission, February 2013), the OECD Economic Outlook (December 2012), and the IMF WEO update (January 2013). The assumptions used in the projections are not the same as those used by the ESCB in its projections. For details of the relationship between the Bank of Slovenia projections and the ESCB projections, see the annex of the April 2008 Price Stability Report.*

International environment and external assumptions

In light of the renewed decline in activity at the end of last year, the outlook for economic growth in Slovenia's most important trading partners is weaker. This is partly a reflection of the situation on the labour market, and the resulting low confidence. The forecast for economic growth in Slovenia's most important trading partners was cut as a result of the decline in international trade and the contraction of domestic demand in euro area countries in the second half of last year. The forecast for 2013 was down by a third compared with previous projection. Foreign demand is anticipated to increase by just 1.6% on average in 2013, and growth is not expected to recover until the middle of the year according to current forecasts by international institutions. Lower carry-over means that average growth is also expected to be lower in 2014, at around 3.2%. The assumption of growth in foreign demand in 2015 is also significantly lower than the long-term average of around 5.5%.

Despite the slowdown in global economic activity, the assumption for US dollar oil prices is higher than in previous projection. Prices of other commodities are expected to track lower global economic growth. Given the maintenance of high liquidity in the global fi-

Figure 7.1: Projections of economic activity for 2013

Sources: Consensus Economics, European Commission.

Figure 7.2: Projections of economic activity for 2014

Sources: Consensus Economics, European Commission.

Table 7.1: Assumptions for the international environment

						Assumptions					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**April**	**Δ**	**April**	**Δ**	**April**	**Δ**
	annual average growth (%) if not stated otherwise										
Foreign demand*	5.9	-14.2	11.3	7.5	1.4	**1.6**	-0.9	**3.2**	-0.8	**4.5**	…
Oil (USD/barrel)	98	62	80	111	112	**115**	5	**115**	5	**115**	…
Non-oil commodities	10.1	-23.0	37.1	18.0	-7.2	**1.2**	-0.4	**2.0**	-3.1	**5.0**	…
EMU inflation	3.3	0.3	1.6	2.7	2.5	**1.8**	0.1	**1.8**	-0.2	**2.0**	…
PPI Germany	5.4	-4.0	1.5	5.6	2.0	**1.7**	-0.1	**2.4**	1.0	**2.2**	…

** Volume of imports from the basket of foreign partners.*
Δ: Difference between current assumptions and assumptions in October 2012 Price Stability Report.
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Economic Outlook.

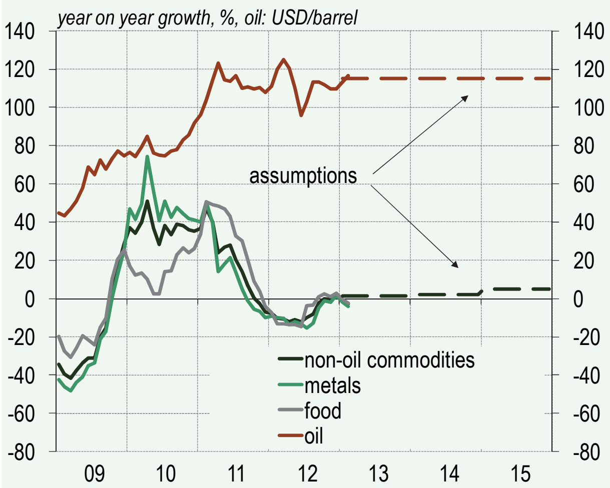
nancial system, and the persistence of certain unfavourable supply factors, oil prices are projected at around USD 115 per barrel. This represents an average rise of around 5% compared with the oil price assumptions from previous projection, although oil prices in euros are around 2% higher than in the previous projection. The rise in the euro means that the change in the assumption of euro denominated oil prices is slightly lower. Slower global economic activity is expected to produce slower growth in primary commodity prices, particularly in 2013, after which they are assumed to rise gradually in line with the anticipated global economic recovery.

Inflation in the euro area is assumed at less than 2%, as a result of weak domestic consumption. Despite the rise in energy and food prices and the consolidation measures in most euro area countries, inflation will be low as a result of the adverse situation on the labour market and limited domestic demand. Given that no significant improvements are expected on the labour market, core inflation will remain low as household consumption remains weak. Growth in producer prices in Germany is assumed to gradually decline as economic activity remains low and input costs rise only slowly.

GDP growth

In 2013 GDP is projected to again decline significantly, by 1.9%. Growth is expected to resume in 2014, and to increase to around 1.5% in 2015. The projection for GDP growth in 2013 is more than 1 percentage point lower than in the previous projection, while the projection for 2014 has also been revised down, by just under 0.5 percentage points. This is a substantial downward revision, larger than in most euro area countries. Alongside the assumption of lower growth in foreign demand, domestic demand is also expected to decline further as a result of fiscal consolidation and the deterioration in the labour market. With the confidence indicators remaining low, the data currently available suggests a probable further decline in aggregate economic activity in the early part of this year. Average economic growth in Slovenia is estimated to trail the euro area average by around 1 percentage point per year. The level of economic activity in 2015 will therefore be almost 10% lower than before the outbreak of the crisis at the end of 2008.

Figure 7.3: Commodity prices

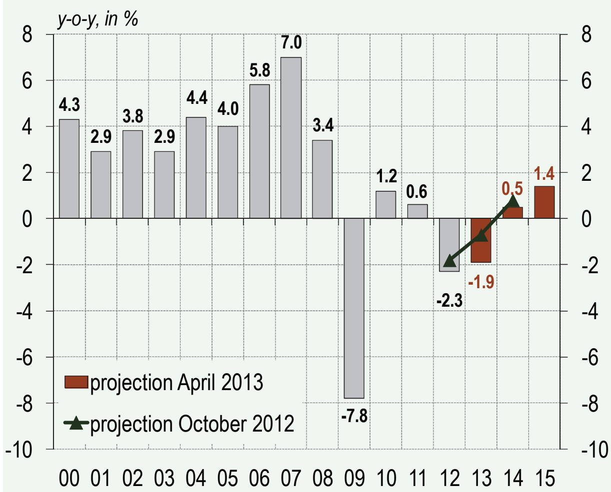


Sources: ECB, Bloomberg, Bank of Slovenia assumptions.

Aggregate demand

Domestic consumption is projected to fall, as investment, household consumption and government con-

Figure 7.4: GDP growth projection



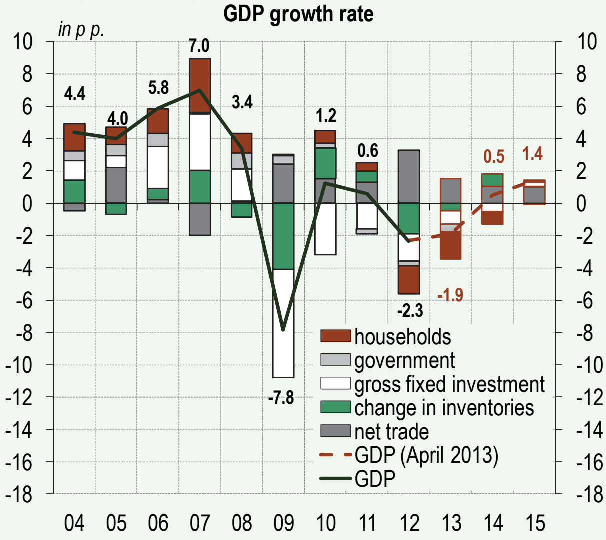
Sources: SORS, projection Bank of Slovenia.

sumption all decline. Household consumption is expected to decline this and next year, primarily as a result of the situation on the labour market and fiscal consolidation measures. The cumulative decline in household consumption over the entire projection horizon is projected at more than 4%. This will be the result of a further decline in real household income caused by further rises in unemployment, the continuing decline in social transfers, and inflation, which will remain relatively high this year. Household consumption is expected to stabilise in 2015, in line with the slowdown in the decline in real disposable income. This could gradually strengthen household confidence.

Government consumption will be constrained by the need for fiscal consolidation. The assumptions for government consumption are taken from the revised budgets for 2013 and 2014, which are based on a significant decline in expenditure. The projections assume a fall in the average nominal wage in the public sector, a fall in employment, and a decline in expenditure on intermediate consumption. This year's reduction in final government consumption is expected to be larger than that of last year. It is also estimated to cumulatively decline by around 1% in 2014 and 2015.

No major construction investment can be expected during the projection horizon, with the exception of certain ongoing projects in the energy sector. Construction investment will also be constrained by financing constraints, high stocks of unsold housing and fiscal consolidation measures. Given the high indebtedness of construction firms and the lack of projects with an appropriate return and adequate security against risks, banks will remain cautious in financing construction. In light of fiscal consolidation, major government investment is not expected. Construction investment is expected to rely primarily on the construction of facilities in the energy sector.

Figure 7.5: Projection of expenditure contributions to GDP growth rate



Sources: SORS, projection Bank of Slovenia.

After the decline in investment in equipment and machinery in 2012, this area is expected to improve very slowly. Evidence of the low need for investment is the stagnation in capacity utilisation in the manufacturing sector below the long-term average. Another factor curbing investment is the deterioration in financing conditions

Table 7.2: Components of domestic demand

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	April	Δ	April	Δ	April	Δ
	real growth rates in v %										
Domestic demand	3.2	-10.0	-0.2	-0.7	-5.7	**-3.7**	-1.9	**-0.6**	-0.1	**0.4**	...
Private consumption	2.3	0.1	1.3	0.9	-2.9	**-3.1**	-1.4	**-1.2**	-1.6	**0.2**	...
Government spending	5.9	2.5	1.5	-1.2	-1.6	**-2.3**	-0.3	**-0.5**	1.1	**-0.4**	...
Gross fixed capital formation	7.1	-23.2	-13.8	-8.1	-9.3	**-4.9**	-1.6	**-3.0**	-1.2	**1.6**	...

Δ: Difference between current projections and projections in October 2012 Price Stability Report.
Source: SORS, Bank of Slovenia.

for corporates that require financial restructuring. Investment in machinery and equipment is also being constrained by lower growth forecasts for the main trading partners and the increasing difficulty of access to funding. Investment in machinery and equipment is expected to increase after the anticipated gradual improvement in foreign demand in the second half of this year. It will only increase overall in 2013 as a result of increased investment in the energy sector, which will have an extremely high import component.

The contribution to GDP growth made by net trade will be high, primarily as a result of the decline in domestic demand and thus imports. The projections for growth in imports and exports are lower, given the deterioration in the international environment and, even more, the decline in domestic demand. The contribution to GDP growth made by net trade will therefore be large, albeit slightly smaller than in previous projections, as a high import component of capital goods is expected. The gap between import growth and export growth will have narrowed by the end of the projection horizon as a result of the gradual stabilisation of domestic demand.

Supply side

As a result of the deterioration in the international environment, activity in export-oriented sectors will decline further in 2013, before increasing only slowly. An even slower recovery is expected in sectors dependent primarily on domestic demand. The situation in the export sector will be worse than previously anticipated, as the refocusing of exports to markets outside the EU has been relatively slow. Value-added in the export sector will decline at least during the first half of the year, as demand indicators remain unfavourable. At the same time there has been a significant increase in the proportion of firms in industry citing the uncertain economic situation among the factors limiting production. Growth in foreign demand is later expected to increase, thereby raising the contribution to GDP growth made by export sectors. Activity in sectors dependent primarily on domestic demand will be low, as a result of the persistent adverse situation on the labour market and government consolidation measures. The situation in wholesale and retail trade in particular is expected to deteriorate, as a result of the continuing decline in consumer purchasing power and low consumer confidence. Value-added in financial and insurance activities will also decline this

Table 7.3: Activity, employment and wages

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**April**	Δ	**April**	Δ	**April**	Δ
	growth rates, %										
GDP (real)	3.4	-7.8	1.2	0.6	-2.3	**-1.9**	-1.2	**0.5**	-0.3	**1.4**	…
Employment	2.6	-1.8	-2.2	-1.6	-1.3	**-2.4**	-0.9	**-0.9**	-0.3	**-0.1**	…
Compensation per employee	7.2	1.8	3.9	1.6	-0.4	**-0.5**	-0.8	**0.6**	0.0	**0.6**	…
Productivity	0.8	-6.1	3.5	2.2	-1.0	**0.5**	-0.3	**1.4**	0.0	**1.5**	…
ULC (nominal)	6.4	8.5	0.4	-0.6	0.7	**-1.0**	-0.5	**-0.8**	0.0	**-0.8**	…
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	4.1	-6.1	-2.1	-1.4	-3.7	**-3.0**	-1.3	**-1.3**	-0.9	**0.3**	…
Net exports	0.1	2.4	1.5	1.3	3.3	**1.5**	-0.3	**1.1**	-0.4	**1.0**	…
Changes in inventories	-0.9	-4.1	1.9	0.7	-1.9	**-0.5**	0.2	**0.8**	1.0	**0.0**	…

Δ: Difference between current projections and projections in October 2012 Price Stability Report.
Source: SORS, Bank of Slovenia.

year at least, as a result of the decline in turnover in the banking system in connection with the decline in domestic demand and economic activity, and the need for structural adjustments in this sector.

Activity in the construction sector is expected to decline this year and next year at least, albeit at a slower pace than in recent years. Although the ratio of value-added in the construction sector to GDP is already very low and below the euro area average, it is difficult to predict an end to the contraction in construction activity. The crisis in this sector is likely to abate gradually, as survey demand indicators remain at a low level. The continuation of existing infrastructure projects is expected to help mitigate the decline in value-added in construction, although it should be noted that imported goods and services will account for a large portion of the value of these projects.

Labour market

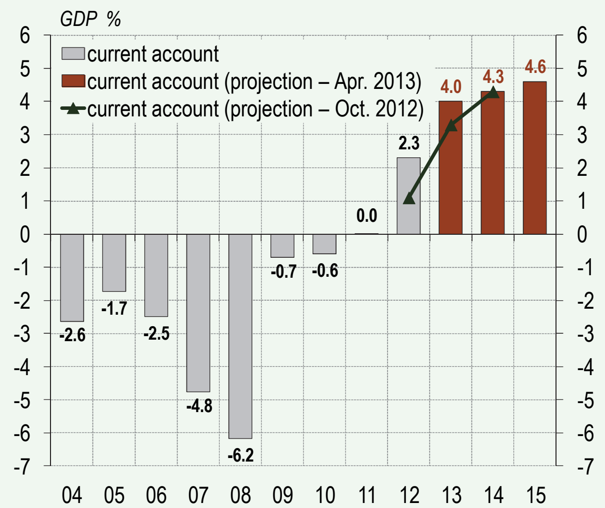
After a significant fall in employment at the end of 2012, employment can be expected to fall even faster this year, and unemployment to rise. Employment is projected to fall by 2.4% this year, and by almost 1% further in 2014. The very gradual recovery in economic activity in 2015 will not result in an immediate rise in employment. Employment will fall in the public sector and in the private sector in 2013. In industry, employment will fall primarily as a result of a lack of foreign demand, while weak domestic demand will continue to prevent a rise in employment in sectors primarily dependent on the domestic market. The number of employees in the construction sector will fall further as investment falls, albeit more slowly than in previous years. As a result of the contraction in activity in sectors with low value-added, structural unemployment is expected to rise, and will be exacerbated by the diminishing employment opportunities for the higher-qualified. In light of the fiscal consolidation measures, the cumulative fall in employment in the public sector this year and the next two years is expected at approximately 3.5%. The surveyed unemployment rate is projected to rise to almost 12% by 2014, even as some of the unemployed continue to leave the active population.

High unemployment will act to curb wages in the private sector, while in the public sector wage growth will depend on the government's austerity measures. The average wage in the private sector is not expected to change significantly over the projection horizon. A fall in the average wage in the private sector could be limited by the statistical effect of the changing structure of the workforce as a result of the anticipated lay-off of relatively low-paid employees. Real wages are expected to fall in all years of the projection, by around 5% cumulatively. Wages in the public sector have stagnated since 2010, and began to fall after the entry into force of the ZUJF in mid-2012. They are expected to fall by around 2.5% this year, and to remain almost unchanged over the next two years.

Foreign trade

Due to major decline in domestic demand, the projection of the current account surplus has been revised significantly upwards. The revision averages approximately 0.5 GDP percentage points each year. This year’s surplus will widen to around 4% of GDP, primarily as a result of a sharp increase in the merchandise trade surplus. The increase in the current account surplus will slow in the coming years, as imports slowly begin to increase alongside the gradual recovery in foreign demand. Unfavourable terms of trade will prevent an even larger increase in the current account surplus.

After widening rapidly in 2013, the goods trade surplus is expected to increase more gradually over the remainder of the projection horizon, while the surplus of trade in services is foreseen to remain unchanged. The surplus of trade in goods and services is expected to increase from around 4% of GDP last year to around 5% of GDP this year, and is anticipated to remain at approxi-



Sources: SORS, projection Bank of Slovenia.

Sources: SORS, Bank of Slovenia projections.

mately this level until 2015. The goods trade position is expected to move from a deficit of around 1% of GDP last year to a surplus of around 0.5% of GDP this year, and to reach a surplus of approximately 1% of GDP by 2015. The surplus of trade in services is estimated at just under 4.5% of GDP over the projection horizon. The surplus of trade in services connected with goods trade, most notably transport services and business and technical services, will gradually increase. Net exports of travel services are expected to remain relatively unchanged, as a result of gradual growth in exports and, above all, a slowdown in the decline in imports.

The deficit in factor income is anticipated to narrow from 1.6% of GDP in 2012 to close to 1% of GDP by 2015, while the surplus in transfers is expected to gradually approach approximately 1% of GDP. A narrower deficit in capital income is expected to be the main factor in the narrowing deficit in factor income. Growth in interest payments to the rest of the world is foreseen to be low, given the assumption of persistently low interest rates. A renewed economic recovery could increase the flow of FDI. This would gradually increase receipts and expenditure from dividends and profit distributions. The deficit in income from investments in securities is expected to widen, primarily as a result of an increase in the

Table 7.4: Current account projections

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**April**	Δ	**April**	Δ	**April**	Δ
Exports of goods and services	4.0	-16.7	10.1	7.0	0.3	**0.4**	-2.0	**2.6**	-1.7	**4.5**	…
Imports of goods and services	3.7	-19.5	7.9	5.2	-4.3	**-1.7**	-1.8	**1.5**	-1.4	**3.8**	…
Current account: EUR billion	-2.3	-0.2	-0.2	0.0	0.8	**1.4**	0.2	**1.5**	-0.1	**1.6**	…
as % GDP	-6.2	-0.7	-0.6	0.0	2.3	**4.0**	0.7	**4.3**	0.0	**4.6**	…
Terms of trade*	-1.5	3.8	-3.9	-1.6	-0.9	**-0.6**	-0.5	**-1.0**	-1.0	**-1.0**	…

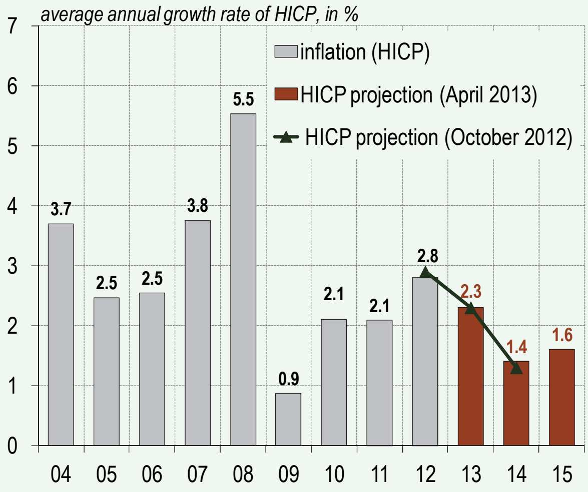
** Based on national accounts deflators.*
Δ: Difference between current projections and projections in October 2012 Price Stability Report.
Sources: SORS, Bank of Slovenia.

stock of securities held in the non-residents' portfolio. As a result of a fall in the employment of foreign workers and increased employment abroad on the part of residents, net inflows of labour income are anticipated to remain at around 1% of GDP. The more effective disbursement of EU funds is expected to be the main factor in the increased surplus in transfers. Private transfers and other official transfers are anticipated to record a deficit.

Inflation

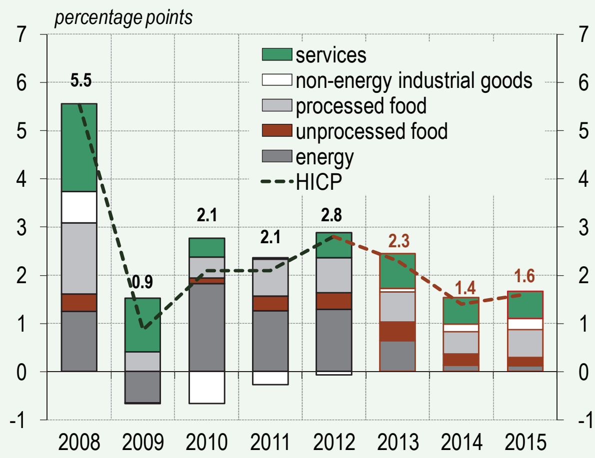
Inflation will again exceed 2% in 2013. It is projected to fall in 2013 and 2014, primarily as a result of lower growth in energy prices. The inflation projection is unchanged from the last round, although there has been a change in its structure. Inflation as measured by the HICP is expected at 2.3% this year, before falling to 1.4% in 2014 and rising to 1.6% in 2015. Fiscal consolidation measures, the decline in real household income and tougher financing conditions will continue to have an impact on inflation. The impact of external factors will be lower than in previous years.

Figure 7.8: Inflation projection



Sources: SORS, projection Bank of Slovenia

Figure 7.9: Projections of contributions to inflation by components



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

Food prices are expected to make the highest contribution to inflation of any category this year, while the contribution by energy prices will also remain high. The contribution made by food prices is expected to be highest because of high commodity prices on global markets, a rise in excise duties and the pass-through of the rapid growth in prices of unprocessed food from last year. Year-on-year growth in food prices is anticipated at 4.4% in 2013, and around 3% in the next two years. Given the assumed movement of the euro against the US dollar, the assumed movement of oil prices on global markets, and unchanged excise duties, energy prices are expected to rise by 4.4% this year. Year-on-year growth in energy prices is foreseen to slow in the next two years. The contribution made by services prices will increase primarily as a result of fiscal needs in the first half of the projection horizon, and in line with the recovery in domestic demand in the second half. This will also have an impact on the contribution made by prices of industrial goods, which will remain low over the projection horizon.

Core inflation will remain low as a result of weak domestic consumption. The persistent adverse situation on the labour market and the decline in real income are reducing household demand. Core inflation is therefore anticipated to remain low. Average growth in the HICP excluding energy, food, alcohol and tobacco is projected at 1.1% this year, and is expected to remain at that level

Box 7.1: Impact of a 2 percentage point rise in VAT on the inflation projection for 2013-2015

In the fiscal consolidation programmes in recent years many countries opted for an increase in general government revenue, often via a rise in VAT. The majority of countries have favoured a rise in the standard VAT rate, while some have raised the reduced rate. The average standard VAT rate in the EU currently stands at 21.2%, and has risen by an average of 1.7 percentage points during the crisis. Among the 27 Member States, only seven, including Slovenia, have not changed the VAT rate. The minimum VAT rate is set by the European Commission at 15%, and is currently only applied in Luxembourg. The maximum rate is not prescribed, but it should not exceed 25%. Hungary has exceeded this ceiling when raising VAT in January 2012 by 2 percentage points to 27%.

A rise in VAT is generally followed by price rises, as firms pass through all or at least some of the tax increase into final consumer prices. In the current economic situation this pass-through is expected to be limited. It is difficult to estimate the size of the pass-through of the rise in VAT into final consumer prices, but experience has shown that it is usually between 60% and 100%. In Hungary, the pass-through of the recent rise in VAT carried out at the beginning of 2012 amounted to 87%.[1] In 2010, Greece raised the standard rate by 4 percentage points to 23%, the reduced rate by 2 percentage points to 11%, and the minimum rate by 1 percentage point. The estimated pass-through in 2010 was 64%.[2] The United Kingdom raised the standard VAT rate by 2.5 percentage points in January 2011 to 20%, and the estimated pass-through stood at around 70%.[3]

The inflation projections presented in Section 7 do not include a rise in VAT. This box therefore illustrates the impact on inflation if the standard VAT rate were to be raised by 2 percentage points. The assumption is that the standard VAT rate is to be increased on 1 July 2013, while the reduced VAT rate remains unchanged. In the event of full pass-through, a rise of 2 percentage points in the VAT rate would raise the prices to which it applies by 1.7% (122/120-1 = 0.017). The calculation of the impact on headline inflation should also take account of the proportion of products in the HICP that are taxed at the standard rate. In the Slovenian basket of goods for 2013 it is slightly more than a half.

In a situation of declining household consumption, a 100% pass-through of the VAT rise into final consumer prices is unlikely. The pass-through also depends on the timing of the introduction; for example, many firms change their prices in

Table 1: Comparison of VAT rates by country before the crisis and today

	before the crisis reduced / standard rate	Jan. 13 reduced / standard rate		before the crisis reduced / standard rate	Jan. 13 reduced / standard rate
Austria	10 / 20	10 / 20	Latvia	5 / 18	12 / 21 (2011: 22)
Belgium	6 and 12 / 21	6 and 12 / 21	Lithuania	5 and 9 / 18	5 and 9 / 21
Bulgaria	7 / 20	9 / 20	Luxembourg	3 and 6 / 15	3 and 6 / 15
Cyprus	5 and 8 / 15	5 and 8 / 18	Malta	5/18	5 and 7 / 18
Czech Republic	9 / 19	15 / 21	Netherlands	6 / 19	6 / 21
Denmark	25	25	Poland	3 and 7 / 22	5 and 8 / 23
Estonia	5 / 18	9 / 20	Portugal	5 and 12 / 21	6 and 13 / 23
Finland	8 and 17 / 22	10 and 14 / 24	Romania	9 / 19	5 and 9 / 24
France	2.1 and 5.5 / 19.6	2.1 . 5.5 and 7 / 19.6	Slovakia	10 / 19	10 / 20
Germany	7 / 19	7 / 19	Slovenia	8.5 / 20	8.5 / 20
Greece	4.5 and 9 / 19	6.5 and 13 / 23	Spain	4 and 7 / 16	4 and 10 / 21
Hungary	5 / 20	5 and 18 / 27	Sweden	6 and 12 / 25	6 and 12 / 25
Ireland	4.8 and 13.5 / 21	4.8 and 9 and 13.5 / 23	UK	5 / 17.5	5 / 20
Italy	4 and 10 / 20	4 and 10 / 21			

Source: VAT Rates Applied in the Member States of the European Union: Situation at 14. January 2013. European Commission.

January, when a rise can more easily be passed through into the final price. In the alternative projections it is envisaged that the pass-through is incomplete, with part of the rise being compensated for by a decline in the producers' or merchants' margin, who will in this way try to prevent an additional fall in sales. A wage-inflation spiral is therefore unlikely to arise in the medium term, as the situation does not allow firms to raise wages, despite higher inflation.

The impact of a potential rise in VAT on inflation as measured by the HICP has been estimated on the basis of three scenarios. Only the direct impact on prices is considered, and not the potential impact of a rise in VAT on other macroeconomic aggregates. The first scenario projects that, given the exceptionally low household demand, a rise in VAT will pass through into final consumer prices to a lesser extent. The exception is energy prices, where low price elasticity and price regulation mean that a higher pass-through is expected. The high pass-through scenario projects the same for prices of processed food. In the processed food category, only tobacco, tobacco products and alcoholic beverages, for which demand is very price inelastic, are taxed at the standard VAT rate. This allows merchants to largely pass rises in excise duties and taxes through to consumers. The high pass-through scenario projects a slightly lower pass-through of a rise in VAT into prices of other goods and services. A third scenario is also presented, and envisages a theoretical 100% pass-through of the rise in VAT into final prices of goods and services.

The initial impact of a rise in VAT is evident in inflation in the first year. In the event of a rise in VAT, given the above assumptions inflation would increase by 0.4 percentage points in the first year under the lower pass-through, and by 0.6 percentage points under the higher pass-through. Assuming a rise in VAT on 1 July 2013, this would entail an increase in average inflation in 2013 and 2014 of between 0.2 and 0.3 percentage points. In the case of full pass-through, aver-

Table 2: Pass-through scenarios

	pass-through in %		
	lower pass-through	**higher pass-through**	**full pass-through**
processed food	45	90	100
energy	80	90	100
other goods	25	50	100
services	30	60	100

Source: Bank of Slovenia assumptions.

Table 3: Alternative projections

	Projection April 2013			*Scenario 1*			*Scenario 2*			*Scenario 3*		
				lower pass-through			**higher pass-through**			**full pass-through**		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Consumer prices (HICP)	2.3	1.4	1.6	2.5	1.6	1.6	2.6	1.7	1.6	2.8	1.9	1.6
food	4.3	2.9	3.1	4.4	2.9	3.1	4.5	3.0	3.1	4.6	3.1	3.1
energy	4.3	0.9	0.8	5.0	1.6	0.8	5.1	1.7	0.8	5.2	1.7	0.8
other goods	0.0	0.3	0.5	0.1	0.5	0.5	0.3	0.6	0.5	0.6	0.9	0.5
services	2.1	1.6	1.7	2.2	1.7	1.7	2.3	1.8	1.7	2.4	1.9	1.7
Core inflation indicators (HICP)												
excluding energy	2.0	1.5	1.7	2.1	1.6	1.7	2.2	1.7	1.7	2.4	1.9	1.7
excl. energy and unprocessed food	1.7	1.4	1.7	1.9	1.5	1.7	2.0	1.7	1.7	2.1	1.8	1.7
excl. energy, food, alc. and tobacco	1.1	1.0	1.2	1.3	1.1	1.2	1.4	1.2	1.2	1.6	1.4	1.2

Note: All scenarios assume a rise in standard VAT rate by 2 percentage points in July 2013.
Sources: SORS, Bank of Slovenia projections.

age annual inflation would be 0.5 percentage points higher in both years. The inflation projections for 2015 remain unchanged in all the scenarios, as the impact of the VAT rise will have dropped out of the year-on-year comparisons by that time, given the assumptions applied.

Analysis by product category reveals that the impact of a VAT rise is strongest in energy prices, where the highest pass-through is assumed, and the entire basket of energy prices is subject to a rise in the standard VAT rate. Around three-quarters of non-energy industrial goods are taxed at the standard VAT rate, compared with only around a third of processed food products and services. The pass-through into the final prices of these components of the index is therefore lower. In prices of non-energy industrial goods and services prices, i.e. in all the main components of core inflation, the pass-through would be very limited because of low consumer purchasing power and the decline in domestic consumption.

[1] Magyar Nemzeti Bank, Quarterly Report on Inflation, March 2012. http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_infrep_en/mnben-inflation-20120329/infl_jelentes_201203_en.pdf.
[2] Bank of Greece. 2011. Monetary Policy 2010-2011. http://www.bankofgreece.gr/BogEkdoseis/NomPol20102011_en.pdf.
[3] Bank of England. 2011. Inflation Report February 2012. http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.

until the end of the projection horizon. The main change compared with 2012, when core inflation stood at 0.7%, will be the rise in services prices caused by fiscal consolidation. The projected developments in commodity prices, which are passed through into final consumer prices via import prices and producer prices, are not expected to give rise to any major price pressures in the production chain. For this reason prices of non-energy industrial goods will remain unchanged this year, and are expected to gradually rise over the next two years in line with the dynamics in domestic demand.

The overall direct impact on inflation from announced government measures is expected to be even higher this year than last year. January's rise in excise duties on tobacco and the carry-over effects of last year's rises in excise duties on tobacco will contribute 0.3 percentage points towards inflation this year. Should the government leave excise duties on refined petroleum products unchanged for the remainder of this year, their contribution to inflation will amount to 0.1 percentage points, as a result of carry-over from last year. The introduction of the tax on financial services in March of this year is expected to contribute 0.1 percentage points to inflation in 2013. The total contribution to this year's inflation made by ad-

Table 7.5: Inflation projections

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**April**	Δ	**April**	Δ	**April**	Δ
						average annual growth, %					
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	**2.3**	0.0	**1.4**	0.1	**1.6**	…
food	8.1	1.8	2.5	4.8	4.7	**4.3**	-0.1	**2.9**	0.2	**3.1**	…
energy	9.4	-4.5	13.9	8.8	9.0	**4.3**	0.0	**0.9**	0.3	**0.8**	…
other goods	2.2	0.0	-2.2	-0.9	-0.2	**0.0**	-0.2	**0.3**	-0.3	**0.5**	…
services	5.3	3.2	1.2	0.0	1.5	**2.1**	0.4	**1.6**	0.2	**1.7**	…
Core inflation indicators (HICP)											
excluding energy	4.9	1.7	0.3	1.0	1.8	**2.0**	0.1	**1.5**	0.0	**1.7**	…
excl. energy and unprocessed food	5.0	1.9	0.2	0.7	1.5	**1.7**	0.0	**1.4**	0.0	**1.7**	…
excl. energy, food, alcohol and tobacco	3.8	1.7	-0.4	-0.4	0.7	**1.1**	0.1	**1.0**	0.0	**1.2**	…

Δ: Difference between current projections and projections in October 2012 Price Stability Report.
Sources: SORS, Bank of Slovenia.

ministered prices and indirect taxes is thus anticipated at 0.5 percentage points. Government measures are expected to contribute around 0.1 percentage points to inflation in 2014 and 2015. The calculation of the impact of government measures on inflation does not take account of a possible rise in VAT rates.

The available monetary indicators and long-term inflation forecasts suggest that there is no expectation of higher price pressures in the medium term. Household loans began declining in the second half of 2012, as the decline in consumer loans increased. The reasons were a decline in demand for bank loans, and stricter financing conditions. This situation does not suggest the possibility of a more substantial reversal in domestic demand. Unit labour costs will decline as a result of adjustments in labour costs in the private and public sectors. Consensus is forecasting average annual inflation of just above 2% in Slovenia between 2013 and 2018.

Risks and uncertainties

Demand from the rest of the world, which in the current situation is the main growth factor in the Slovenian economy, remains uncertain. The fiscal problems in the euro area are only being addressed gradually, which may lead to a renewed loss of confidence in the sustainability of public finances in some countries. This would directly worsen their economic growth prospects, as it would lead to a deterioration in the financing conditions, and in the event of a renewed deterioration in the economic situation it would likely trigger additional austerity measures. Uncertainties also remain because of the lack of a clear timetable and method for addressing the large imbalances in some other major economies, including the fiscal situation in the US. The consequent possibility of smaller growth in demand in advanced economies is also increasing the risk of activity cooling in emerging economies.

The failure to fully define the implementation of additional fiscal consolidation measures and the measures for resolving the constraints on financing and providing stimulus to the economy is becoming an increasingly significant source of risk. This is adversely affecting the credibility of domestic economic policy at home and in the international environment. The resulting uncertainty often hinders or delays proper adjustments and business decision-making by the private sector.

The uncertainty surrounding the availability of financing remains linked to the ability of banks and corporates to increase their capital, and risks of further deteriorations in the quality of bank balance sheets. Bank funding costs and corporate financing costs remain high as a result of the high spreads on government borrowing in the rest of the world. In the event of additional downgrades of Slovenian banks and long-term sovereign

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

	Publication of new/previous forecast	GDP growth rate, %				Inflation annual average, %				Current account % of GDP			
		2013		2014		2013		2014		2013		2014	
		new	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ
Bank of Slovenia	Apr. 13/Oct. 12	**-1.9**	-1.2	**0.5**	-0.3	**2.3**	0.0	**1.4**	0.1	**4.0**	0.7	**4.3**	0.0
EIPF	Mar. 13/Sep. 12	**-0.8**	-2.4	**0.6**	-1.2	**1.6**	0.3	**1.4**	-0.6	**4.6**	2.5	**5.5**	2.9
IMAD	Mar. 13/Sep. 12	**-1.9**	-0.5	**0.2**	-0.7	**2.1**	-0.1	**1.6**	-0.2	**4.4**	0.6	**3.8**	0.6
Consensus Forecasts	Mar. 13/Sep. 12	**-1.2**	-1.7	**0.6**	…	**2.3**	0.0	**2,1**	…	**…**	…	**…**	…
European Commission	Feb. 13/Nov. 12	**-2.0**	-0.4	**0.7**	-0.2	**2.2**	0.0	**1.5**	-0.1	**3.8**	1.1	**3.3**	1.0
OECD	Nov. 12/May 12	**-2.1**	-1.7	**1.1**	…	**2.3**	0.9	**1.8**	…	**5.1**	3.7	**6.4**	…

Δ: Difference between current and previous forecasts.
Sources: Bank of Slovenia, EIPF, IMAD, European Commission, Consensus Economic Forecasts, OECD, Bank of Slovenia calculations.

debt, additional constraints would be placed on bank and government funding. In seeking resources, corporates are, in addition to a lack of suitable projects and the banks' restrictions on the supply of loans, also being constrained by high relative indebtedness, i.e. the debt-to-equity ratio. A downturn in corporate performance caused by deepening economic crisis would be reflected in the banks' balance sheets, and their capital insufficiency could be exacerbated by negative feedback between the financial and real sectors. An increase in capital is therefore vital for corporates and banks alike to improve their financing conditions.

The likelihood of lasting high unemployment is increasing markedly. Unemployment could rise further in the event of a deepening crisis in the international and domestic environment, and could remain high even when the economic situation begins to improve. Weaker global economic growth could hit employment in industry in particular, while weaker domestic demand could hit employment in the majority of the service sector in addition to the construction sector. A further rise in structural unemployment would be particularly problematic. Unemployment would thus become a permanent social problem, with a sharp loss of potential output and the possibility of a renewed increase in political instability and economic uncertainty.

The inflationary risks are balanced. The main factors that could lead to higher-than-expected inflation are possible increases in indirect taxes and administered prices as part of the fiscal consolidation process, rises in prices in sectors where competition is low (such as municipal services, district heating, public transport, electricity companies), rises in energy and other commodity prices and a fall in the euro. A slowdown in economic growth as a result of lower foreign and domestic demand could lead to lower inflation. Lower economic activity would further delay the improvement in the situation on the labour market, thereby curbing labour costs and pressures on prices from the supply side. This would further reduce the possibility of higher corporate input costs passing through into final consumer prices.