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Abbreviations used in Macroeconomic Developments and Projections

AECM	European Mutual Guarantee Association
AT	Austria
BAMC	Bank Assets Management Company
BE	Belgium
bps	Basic point
BRIC	Brazil, Russia, India, China
CB	Central Bank
CIP	Competitiveness and Innovation Programme
COSME	EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises
CPI	Consumer price index
CZ	Czech Republic
DARS	Motorway Company in the Republic of Slovenia
DE	Germany
EA	Euro area
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EE	Estonia
EFSF	European Financial Stability Facility
EIB	European Investment Bank
EIF	European Investment Fund
EMU	Economic and Monetary Union
ES	Spain
ESA	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
EUR	Euro
Euribor	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Communities
FDI	Foreign direct investment
Fed	Federal Reserve
FR	France
FRED	Federal Reserve Economic Data
GBP	British Pound
GDP	Gross domestic product
H	Half-year
HICP	Harmonised Index of Consumer Prices
HR	Human resource
HU	Hungary
IE	Ireland
IEA	International Energy Agency
ILO	International Labour Organization
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund

IT	Italy
LTRO	Longer-term refinancing operation
MDAP	Macroeconomic Developments and Projections
MoF	Ministry of Finance
NEIG	Non-energy industrial goods
NFC	Non-financial corporation
NPISH	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
PL	Poland
p. p.	Percentage point
PPI	Producer price index
PT	Portugal
Q	Quarter
QE	Quantitative Easing
RS	Republic of Slovenia
SEF	Slovene Enterprise Fund
SI	Slovenia
SK	Slovakia
SMEs	Small and medium-sized enterprises
SORS	Statistical Office of the Republic of Slovenia
SU	Soviet Union
TEŠ 6	Block 6 of Šoštanj power station
UK	United Kingdom
ULC	Unit labour costs
US	United States of America
USD	US dollar
VAT	Value added tax
WDN	Wage Dynamics Network
WEO	World Economic Outlook
ZDR	Employment Relationship Act
ZUTD	Labour Market Regulation Act

Executive Summary

The economic recovery has continued in 2014, the pace of economic growth exceeding expectations especially in the second quarter. Foreign demand remained the main engine of economic growth, but it is expected to slow down in the second half of the year. GDP growth is projected to reach 1.6% this year, before decelerating to 1.3% next year. The current account surplus will narrow over the projection horizon to around 4.5% of GDP as a result of weaker export growth, a slight increase in imports and increased interest expenditure. There has been a sharp fall in inflation, as a result of falling commodity prices on global markets, the persistence of relatively weak domestic demand, and last year's fiscal measures dropping out of the inflation calculation. Inflation is expected to remain at around 1%.

* * *

The solid economic growth that began in early 2013 has continued this year. Year-on-year growth in GDP averaged 2.5% in the first half of the year, while quarterly growth stood at 1.0% in the second quarter. Growth has thus significantly outpaced the euro area average. The main factors stimulating this growth alongside favourable exports were growth in investments and the build-up of inventories.

In the early part of the year, exports were supported by solid foreign demand and relatively favourable cost competitiveness, but the pace of growth began to slow down in the middle of the year. This was primarily related to the slowdown of economic activity in most of the major trading partners and to the rising uncertainty surrounding the future development of the Ukraine-Russia crisis. The adverse signals from the international environment have already been reflected in the confidence indicators, whose improvement in the early part of the year stalled and reversed in the middle of the year.

Investments in infrastructure, partly financed by EU funds, remained high in the first half of the year, particularly at the municipal level. High investment growth was thus the result of factors that were mostly temporary in nature. At the same time, investments in machinery and equipment declined in the first half of the year, which is not encouraging in relation to potential output. Final government consumption continued to contract in the first half of the year.

The relatively favourable labour market situation, with rising employment and wages, primarily in the private and export-oriented sector, allowed for a modest recovery in private consumption. In the first half of the year, outflows from registered unemployment increased sharply on account of new hires, while inflows into unemployment due to the expiry of temporary employment contracts declined as a result of last year's labour market reforms. The number of unemployed has fallen by around 15,000 this year to 115,000.

There has been a sharp fall in inflation, as a result of falling commodity prices on global markets, the persistence of rather weak domestic demand, last year's fiscal measures dropping out of the inflation calculation, and other base effects. Inflation averaged 0.6% over the first eight months of this year, almost the same as in the euro area overall.

The current account surplus in the 12 months to June amounted to 5.3% of GDP, down somewhat on the figure of 5.8% of GDP recorded at the end of 2013. The narrowing of the surplus despite solid export growth was the result of a narrower surplus in services and a wider deficit in factor income caused by increased interest payments to the rest of the world.

In a situation of favourable growth in the export sector and deleveraging of the economy, the current account surplus is being reflected in high net savings by the private sector. Corporates have been net savers for two years now, amid weak investment and further reductions in indebtedness. The stock of corporate liabilities from bank loans declined again in the early part of the year. The decline in loans to the private sector despite strengthened economic growth was primarily the result of high corporate indebtedness. Corporates are thus being forced to seek alternative forms of financing, such as loans from the rest of the world *and retained earnings. This year households have maintained their financial surplus at the level of the end of last year, having slightly increased their consumption as income has risen and indebtedness has declined.*

In 2014 confidence to the domestic banking system is gradually being restored. This has been reflected in an increase in deposits by almost all the non-banking sectors. The increased confidence is the result of the successful process of the recovery and the resolution and stabilisation of the banking sector. Nevertheless, this process is not yet complete and will continue to have an impact on bank balance sheet structure in the future. On the funding side, the decline in the banking system's balance sheet was the result of a reduction in the banks' indebtedness to the rest of the world, and a reduction in liabilities on the basis of debt securities. The contraction on the investment side was primarily the result of further reduction of loans to the private sector.

The government is the sole sector to run a financial deficit this year. According to SORS estimates, the one-year general government deficit excluding aid for financial institutions stood at 4.2% of GDP at the end of this March, which is less than at the end of last year. On the other hand, the general government debt had increased to 78.7% of GDP by the end of the first quarter.

The projections suggest only a gradual economic recovery. GDP growth is projected to reach 1.6% this year, before slowing down to 1.3% next year as a result of cooling exports and investments in the second half of this year. Economic growth is expected at just under 2% in 2016. The economic recovery will be based on a positive contribution from net trade, although the domestic demand components will gradually strengthen as well.

In addition to the economic recovery in the first half of the year, another major factor in the economic growth projection for 2014 was the extremely positive carry-over effect from the previous year. The high growth in activity recorded in the first half of the year is expected to slow down in the second half as the global growth decelerates and temporary factors decline in importance. An upward revision in GDP growth compared to the previous projection has therefore been made for this year alone. The GDP growth estimate for 2015 is lower than in the previous projection, in accordance with the slowdown in foreign demand.

Net trade will make a positive contribution to GDP growth over the entire projection period. Investment growth will be limited mainly by persistently high corporate indebtedness and by the uncertain outlook for the recovery of foreign demand. Household consumption will only increase gradually, given the still-uncertain situation on the labour market, while government consumption will be constrained by the need for fiscal consolidation. In comparison to the previous projections, the slight increase in growth in the domestic demand components is the result of high growth in the first half of 2014, and will contribute to higher imports. This will reduce the current account surplus, which is expected to narrow from 5.2% of GDP this year to around 4.5% of GDP by the end of the projection period. In light of the weak domestic demand and the absence of price pressures from the international environment, inflation is expected to remain at around 1% over the projection period.

The risks surrounding the economic growth projections are on the upside for this year, and on the downside for subsequent years. In addition to the carry-over effect and the high realisation in the first half of this year, the potential absence of additional fiscal consolidation measures until the end of the year could make a positive contribution to growth in domestic demand. This would particularly be the case if the positive impacts of the temporary factors that raised growth in the first half of the year continued. Growth over the remainder of the projection period could be lower than expected, as a result of additional cooling of the global growth, renewed tightening of financing conditions on international markets and potential further increase in political and economic tensions between Russia and the EU.

The risks to expected inflation figures over the projection period are balanced. Rises in energy prices caused by deteriorating situation in oil exporters and certain additional fiscal measures on the revenue side could lead to higher growth in prices than currently projected. The main factors likely to lead to lower inflation would be a slowdown in the global growth and a slower recovery in domestic demand.

* * *

In July 2014 the Bank of Slovenia outlined its view of Slovenia's economic policy future strategic challenges.[1] *Economic policy measures should thus focus primarily on cleaning up the balance sheets and strengthening the capital adequacy of the banking*

[1] http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=5849

sector, establishing the foundations for financial stability, corporate deleveraging and restructuring, and on strengthening the long-term sustainability of public finances.

The new government will have to respond quickly and effectively to the economic challenges in domestic and foreign environment. Yet, adopted measures will need to have the minimum possible short-term adverse impact, particularly on exports, but also on domestic demand. At the same time, the measures should also focus on encouraging long-term economic potential and on ensuring sustainable long-term growth. Only thus will the conditions for the gradual elimination of high unemployment be put in place.

								Projections					
								2014		2015		2016	
	2007	2008	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	6.9	3.3	-7.8	1.2	0.6	-2.6	-1.0	**1.6**	1.0	**1.3**	-0.1	**1.8**	0.1
Employment	3.4	2.6	-1.8	-2.2	-1.6	-0.8	-1.5	**0.1**	1.2	**0.2**	0.4	**0.6**	0.0
Compensation per employee	6.2	7.2	1.8	4.0	1.6	-1.2	1.9	**1.2**	0.2	**1.4**	0.1	**1.6**	0.0
Productivity	3.5	0.7	-6.1	3.5	2.3	-1.8	0.5	**1.4**	-0.3	**1.2**	-0.4	**1.5**	0.2
ULC (nominal)	2.6	6.4	8.5	0.5	-0.7	0.6	1.4	**-0.3**	0.3	**0.2**	0.4	**0.1**	-0.2
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	7.0	4.0	-5.7	-2.8	-1.3	-3.7	-2.1	**0.3**	0.8	**0.5**	0.2	**1.2**	0.1
Net exports	-2.0	0.2	1.9	2.1	1.4	2.9	1.0	**0.9**	-0.2	**0.7**	-0.3	**0.5**	-0.1
Changes in inventories	2.0	-0.9	-4.0	1.9	0.6	-1.8	0.1	**0.3**	0.3	**0.0**	0.0	**0.0**	0.0
Domestic demand	*real growth rates, %*												
Domestic consumption	9.0	3.1	-9.5	-0.9	-0.8	-5.6	-2.1	**0.3**	0.9	**0.5**	0.2	**1.2**	0.0
Private consumption	6.3	2.6	0.9	1.0	0.0	-2.9	-4.0	**0.1**	0.8	**0.5**	0.3	**1.0**	-0.2
Government spending	1.9	4.9	2.4	0.1	-1.3	-1.5	-1.1	**-1.7**	-0.4	**-0.4**	0.1	**-0.4**	-0.1
Gross fixed capital formation	12.0	7.0	-22.0	-13.7	-4.6	-8.9	1.9	**3.3**	2.7	**1.8**	0.1	**3.9**	1.0
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	13.6	4.2	-16.6	10.1	7.0	0.3	2.6	**3.8**	1.0	**3.7**	-0.9	**5.0**	-0.1
Imports of merchandise and services	16.8	3.8	-18.8	6.6	5.0	-3.9	1.4	**3.0**	1.5	**3.1**	-0.8	**5.0**	-0.1
Current account: EUR billion	-1.4	-2.0	-0.2	0.0	0.1	1.0	2.1	**1.8**	-0.7	**1.7**	-1.0	**1.7**	-0.9
as % GDP	-4.1	-5.3	-0.5	-0.1	0.4	2.8	5.8	**5.2**	-1.9	**4.8**	-2.6	**4.6**	-2.4
Terms of trade*	0.9	-1.3	3.5	-4.0	-1.4	-1.0	1.0	**0.3**	0.5	**-0.4**	0.2	**0.1**	0.6
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	3.8	5.5	0.9	2.1	2.1	2.8	1.9	**0.5**	0.0	**0.7**	-0.4	**1.2**	-0.1
HICP excluding energy	3.8	4.9	1.7	0.3	1.0	1.8	1.9	**0.8**	0.0	**0.8**	-0.5	**1.4**	-0.1
HICP energy	3.4	9.4	-4.5	13.9	8.8	9.0	1.8	**-0.9**	0.7	**0.0**	-0.5	**0.0**	-0.4
International environment	*growth rates, % (if not specified otherwise)*							**Assumptions**					
Foreign demand**	8.6	2.9	-13.5	9.9	7.0	0.9	0.8	**0.7**	-0.9	**2.4**	-0.9	**3.1**	-0.5
Oil (USD per barrel)	73	98	62	80	111	112	109	**107**	-3	**107**	-3	**107**	-3
Non-oil commodities	17.4	10.1	-23.0	37.1	17.9	-7.2	-5.2	**-4.8**	-2.0	**0.1**	-1.9	**4.4**	-0.4
EMU inflation	2.1	3.3	0.3	1.6	2.7	2.5	1.4	**0.6**	-0.3	**1.1**	-0.2	**1.4**	-0.1
PPI Germany	1.3	5.4	-4.0	1.5	5.1	1.7	0.0	**-0.5**	-1.4	**0.6**	-1.3	**1.6**	-0.7

* Based on national accounts deflators.

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

Δ : Difference between current projections and projections in Macroeconomic Developments and Projections, April 2014.

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

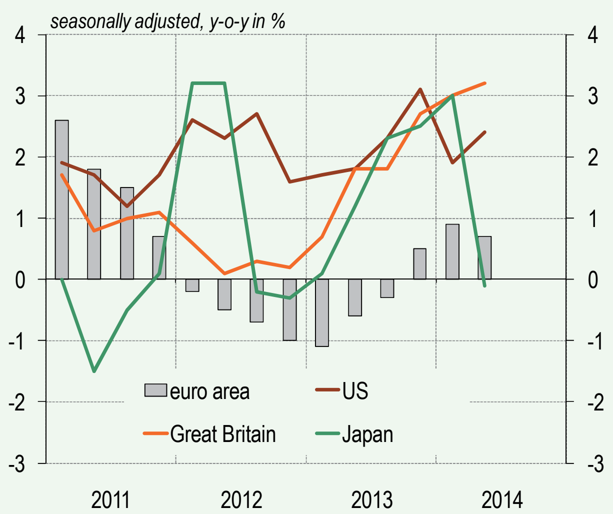
1 International Environment

Global economic growth remained moderate in the first half of the year, but lower than forecast at the beginning of the year. Economic growth slowed in the second quarter in the euro area, but rose sharply in certain developed countries. Economic activity also slowed sharply in certain emerging economies, which also saw their currencies slide sharply. Monetary policy in the majority of developed countries remained expansionary. The ECB loosened monetary policy in the euro area even further in June and September with a combination of standard and non-standard measures. Economic sentiment and consumer confidence in the euro area remained high in the early part of the second half of the year, despite certain adverse signals from the international environment, while the unemployment rate fell slightly. The euro nevertheless fell, while other commodity prices also fell as oil prices fell sharply at the beginning of the third quarter.

Economic developments

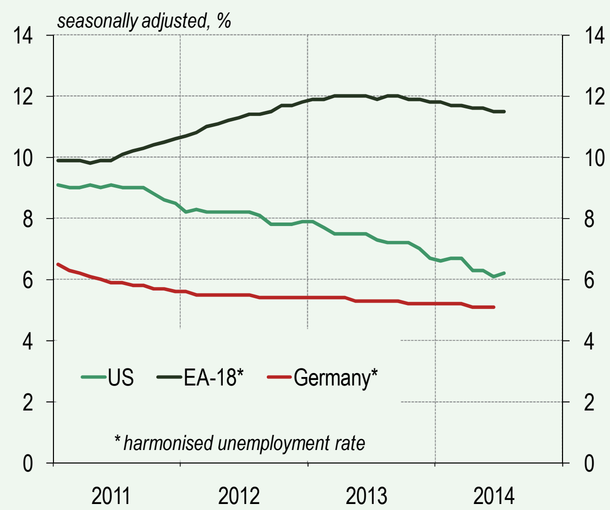
The economic recovery in the euro area seen in the final quarter of last year and the first quarter of this year slowed in the second quarter. The euro area emerged from recession in the second half of last year. The economic sentiment and consumer confidence indicators have remained at a high level, above their long-

Figure 1.1: GDP growth in developed economies



Source: Eurostat.

Figure 1.2: Unemployment rate

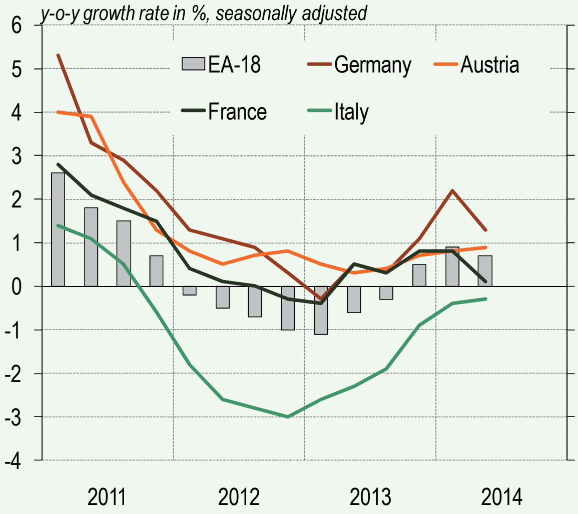


Source: Eurostat, FRED.

term averages, although they began declining in the second half of the year. The unemployment rate fell to 11.5% in the second quarter, its lowest level since September 2012. Nevertheless, in the second quarter real GDP remained at the level of the previous quarter, primarily as a result of a decline in gross investment, while the year-on-year rate of growth slowed to 0.7%. The main factors in the decline were the contractions of 0.2% in economic activity in Germany and Italy, and the stagnation in France. The situation in the euro area periphery countries remained stable or even improved slightly. Of the developed countries outside the euro area, there was a sharp slowdown in economic activity in Japan, where real GDP in the second quarter was down 1.8% in quarterly terms, the largest decline since the 2011 earthquake, and down 0.1% in year-on-year terms. Real GDP increased in the first half of the year in the US and the UK. Activity in the two countries accelerated sharply in the second quarter: year-on-year growth stood at 2.5% in the US and 3.2% in the UK.

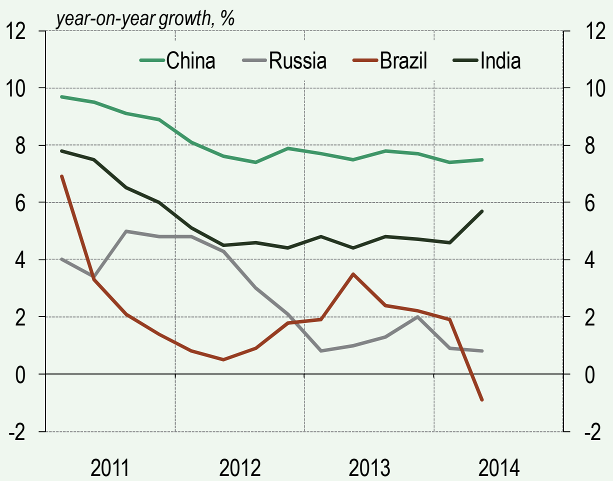
Economic developments in the BRIC countries varied in the first half of this year. Economic growth in the BRIC countries, which remained high after the outbreak of the international financial crisis, was again favourable in the first half of the year, but slowed sharply in Russia and actually declined in Brazil. Year-on-year economic growth in Russia stood at 0.8% in the second quarter, the lowest figure in the last year and a half. Economic activity in Russia is influenced by the fall in prices of oil, which is one of Russia's most important exports, the uncertainty caused by the situation in Ukraine and the international sanctions imposed on Russia. Alongside the shocks on the domestic financial market, all this has contributed to a sharp fall in the ruble. Real GDP growth remained stable and high in China. The year-on-year rate stood at 7.5% in the second quarter of 2014, slightly below its long-term average.

Figure 1.4: GDP growth in main EU trading partners



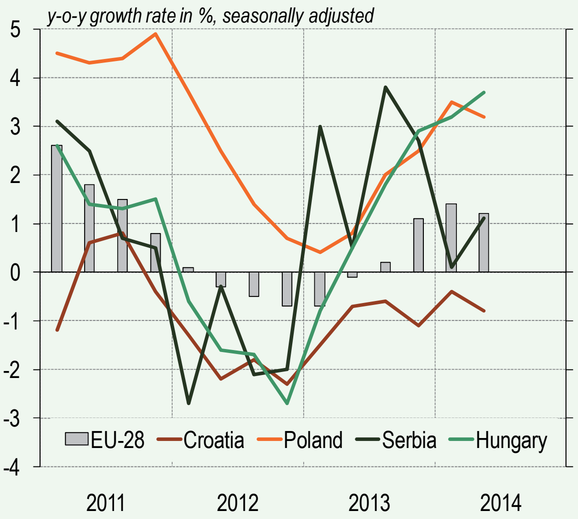
Source: Eurostat.

Figure 1.3: GDP growth in BRIC countries



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

Figure 1.5: GDP growth in countries of Eastern Europe



Source: Eurostat, Trading Economics.

Economic activity also declined in certain other major trading partners of Slovenia. In Croatia, which is in recession for the third consecutive year, real GDP declined again in the first half of the year, the year-on-year contraction deepening to 0.8% in the second quarter. Economic activity in Serbia also slowed sharply in the first half of this year, but remained positive despite the floods in the second quarter.

Financial markets and commodity prices

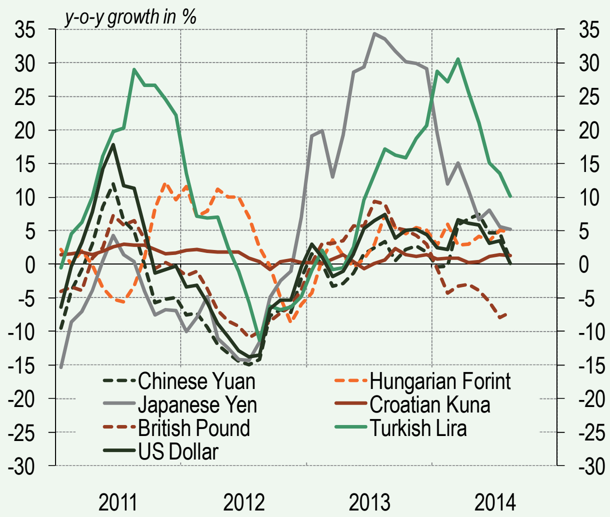
Monetary policy remained expansionary this year at major central banks in developed economies, and became even looser in the euro area. The Fed's tapering of its QE purchases of long-term securities in late 2013 continued this year. Monetary policy in the US remained expansionary, despite the pick-up in economic activity in the second quarter. The key interest rate remained unchanged in the interval between zero and 0.25%. Monetary policy also remained expansionary in the euro area. The ECB made further cuts in its key interest rate to 0.15% in June and 0.05% in September. At the same time the ECB lowered the interest rate on the marginal lending facility and the interest rate on the deposit facility, which became negative, and announced additional monetary policy measures.[2] The ECB adopted a combination of standard and non-standard measures to encourage stronger lending to corporates and households, and thereby a revival of economic activity and inflation. Monetary policy in the UK also remains expansionary, the Bank of England's key interest rate having remained at 0.5% since March 2009, while its non-standard stimulus measures have amounted to GBP 375 billion.

The euro's rise against the majority of global currencies in the second half of last year continued in the early months of this year, but it began to slide in the second quarter. The movement of the exchange rate in the first quarter of 2014 was under the influence of the euro area's favourable macroeconomic figures. The stabilisation in the euro area periphery countries was also a factor in the rise in the euro. The euro stood at around USD 1.39 in mid-March, and remained close to this level until early May. After the release of weaker economic figures in the summer months for some of the euro area core countries, and increased uncertainty surrounding the unrest in Ukraine and the impact of sanctions against Russia on the euro area economy, the euro began falling.

Figure 1.6: Euro / US dollar exchange rate and central bank interest rates

Source: ECB, Federal Reserve.

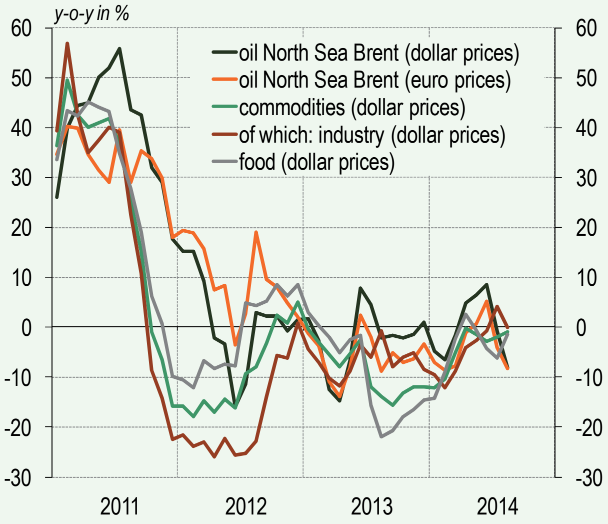
Figure 1.7: Exchange rates



Source: ECB, Bank of Slovenia calculations.

[2] For more on the additional measures, see http://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html and http://www.ecb.europa.eu/press/pr/date/2014/html/pr140904.sl.html.

Figure 1.8: Commodities



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

It averaged just USD 1.30 over the first ten days of September. The euro averaged USD 1.36 over the first eight months of this year, up 3.7% on the same period of 2013. The euro's average value over the first eight months of the year was up 10.4% in year-on-year terms against the Japanese yen, but down 4.5% in year-on-year terms against the pound sterling.

The price of Brent crude rose gradually over the first half of the year, but fell sharply at the beginning of the third quarter. Prices of other commodities also fell. US dollar prices of Brent crude rose from USD 107 per barrel in January to USD 112 per barrel in June. There was then a sharp fall, the price reaching USD 102 per barrel by the end of August. The average US dollar price of Brent crude over the first eight months of the year was down 0.3% on the same period last year. The price was down 8.1% in year-on-year terms in August. The fall in oil prices was largely attributable to the contraction and slowdown in activity in individual developed and emerging countries, and the reduced forecasts for oil demand issued by the International Energy Agency (IEA) in August. At the same time, estimates of oil production and oil reserves in the US were raised, while uncertainties surrounding potential disruptions to supply in the Middle East, Africa and Iraq eased. Average US dollar primary commodity prices over the first eight months of the year were down 4.4% in year-on-year terms, while food prices over the same period were down by the same amount.

Geopolitical tensions and other uncertainties in individual developing countries brought a sharp fall in their currencies. The financial markets were shaken at the end of last year and the early part of this year by the instability in connection with the political situation in Turkey, South Africa and Argentina, the adverse developments on their stock markets and the falls in their currencies. The situation eased temporarily in the early part of this year. The unrest in Ukraine brought sharp falls in the Russian ruble and the Ukrainian hryvnia in April. As unrest deepened in the Middle East, in Libya, in Iraq and Syria and in Ukraine, and new uncertainties arose as a result of the sanctions against Russia and the partial default by Argentina, uncertainties again rose on the financial markets of certain countries in the early summer, and their currencies fell. In August the euro was thus up 9.5% in year-on-year terms against the Russian ruble, 47.9% against the Argentinian peso and 61.9% against the Ukrainian hryvnia.

2 Economic Trends and the Labour Market

Growth in economic activity in the first half of the year exceeded expectations, particularly in the second quarter.[3] Quarterly GDP growth stood at 1.0% in the second quarter. The main factors in this alongside favourable exports were rapid growth in investments and the build-up of inventories. Industry performed well despite the slowdown in foreign demand, as output and exports both increased. Total value-added in private-sector services increased as a result of a rise in domestic consumption. Growth in the construction sector was a significant factor in the increase in economic activity, and was based primarily on public investment in infrastructure. In addition to a build-up of inventories, investment contributed most to the positive developments in domestic demand. As the real wage bill recorded gradual growth, private consumption also rose in the first half of the year. Final government consumption declined again.

The situation on the labour market improved in the first half of the year, and the outlook for future employment has continued to improve. Employment rose in both the private and public sectors. The largest contributing factors were the ending of the contraction in employment in manufacturing and construction, and an increase in employment in private-sector services. Accordingly there were also outflows from registered unemployment, which in the first half of the year were up 20% in year-on-year terms as a result of new hires. Inflows into unemployment owing to the expiry of temporary employment contracts declined again as a result of labour market reforms, and the unemployment rate also fell. The average real gross wage and the real wage bill in the first half of the year were up slightly in year-on-year terms.

Gross domestic product

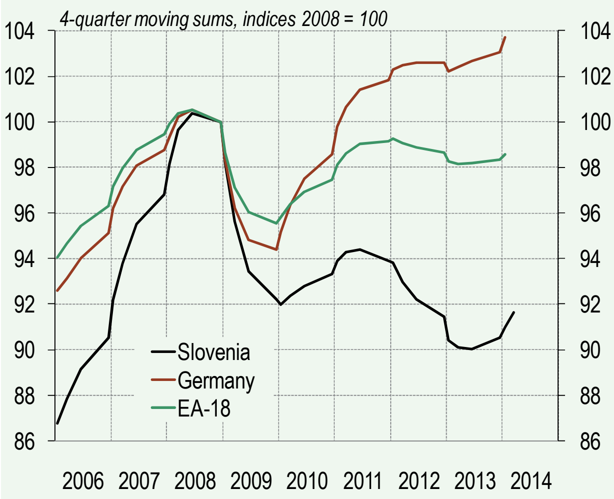
The economic recovery continued in the first half of the year, and activity was up in year-on-year terms in the majority of sectors. Quarterly GDP growth has been positive since early 2013, and as of the middle of last year has significantly outpaced average euro area growth. The level of economic activity in the first half of the year nevertheless remained significantly down on that just before the outbreak of the crisis in Slovenia. The gap between the level of activity in Slovenia and in the euro area overall widened by around 7 percentage points over this period.

Year-on-year growth in GDP averaged 2.5% over the first half of the year. The key was the high contribution

[3] When releasing the figures for 2014, the SORS changed over to the calculation of national accounts figures on the basis of the updated ESA 2010 methodology. The quarterly figures are not complete, as on this occasion the SORS did not release official seasonally adjusted figures alongside the detailed figures for the breakdown of GDP. These will be released on 30 September 2014. Bank of Slovenia estimates are used for the quarterly comparisons in the text, with the exception of GDP.

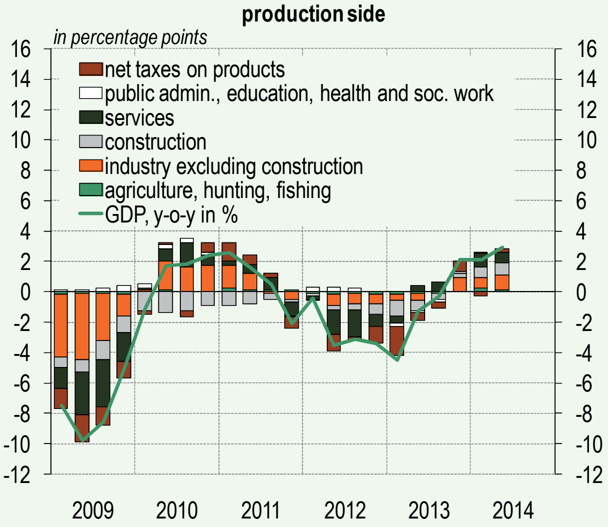
made by net trade, which was related to the favourable growth in exports and was also, though to a lesser extent than last year, the result of the slow pace of imports. The contribution to GDP growth by industry was positive in the first half of the year at just below 1 percentage point, primarily as a result of strengthened merchandise exports, despite the cooling foreign demand. The high growth in value-added in construction was maintained in the second quarter primarily as a result of increased investment in public infrastructure in connection with the utilisation of EU funds and of the elimination of the consequences of the harsh winter conditions. However, estimates of quarterly growth in activity and the monthly figures suggest a gradual slowdown in construction activity. Value-added in private-sector services also increased sharply in the first half of the year. The main factors beside exports of services were a slight increase in private consumption and increased reporting of revenue following measures to curb the grey economy at the end of last year. The total contribution made to GDP growth by private-sector services increased to 0.9 percentage points in the first half of the year. This year's sole year-on-year declines in value-

Figure 2.1: Level of real GDP



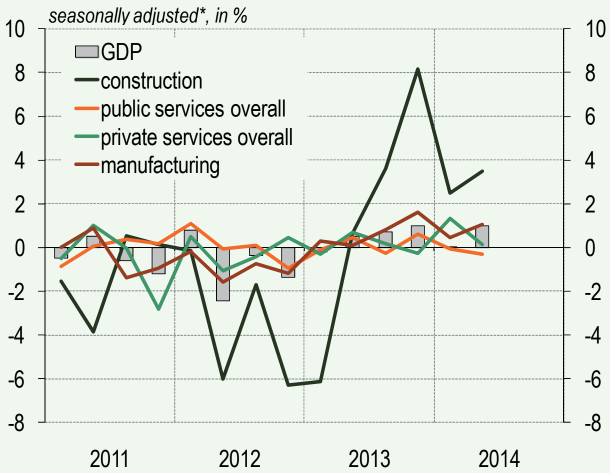
Source: SORS, Eurostat.

Figure 2.3: Contributions to y-o-y GDP growth, production side



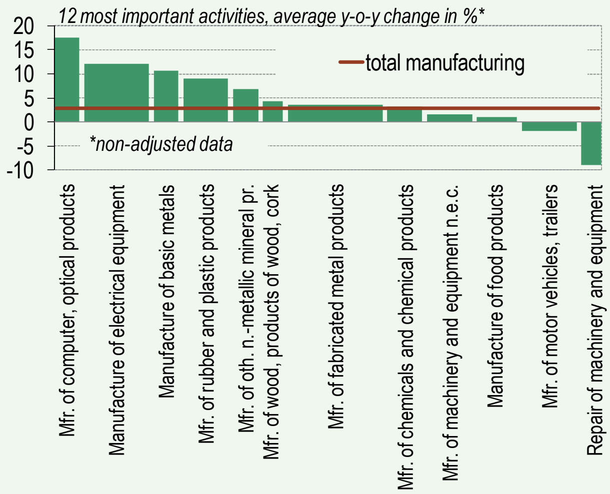
Source: SORS.

Figure 2.2: GDP quarterly growth rates in Slovenia



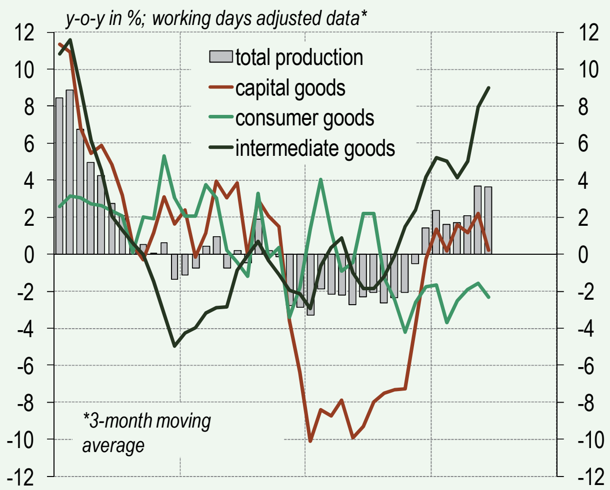
Note: * Bank of Slovenia's estimate.
Source: SORS, Bank of Slovenia calculations.

Figure 2.4: Manufacturing production: April 2014 - June 2014



Notes: Width of each column represents a share of activity in total value added in manufacturing in 2013. Pharmaceuticals are not included due to data confidentiality.
Source: SORS, Bank of Slovenia calculations.

Figure 2.5: Industrial production by main industrial groups



Source: SORS, Bank of Slovenia calculations.

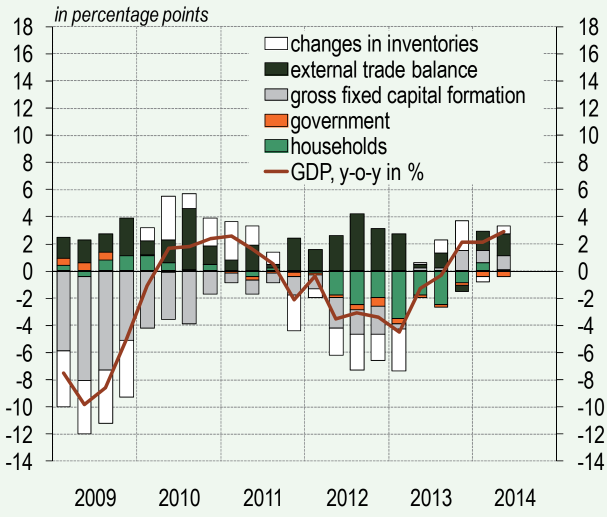
added among private-sector services were recorded by financial and insurance activities and by real estate activities.

Industry responded effectively to the slowdown in foreign demand, the majority of the most important sectors recording growth. After a decline in output in the majority of manufacturing sectors over almost the whole of 2013, the situation improved significantly at the end of last year. The reversal was the result of the recovery in demand in the euro area in the second half of 2013, while domestic demand also stabilised. Despite a slowdown in growth in the major euro area trading partners, growth in industrial production continued in the first half of 2014, sales revenue on markets outside the euro area having increased rapidly since the spring. In line with export growth, the largest increase was in production of intermediate goods. Production of capital goods also increased, although there have been signs of a stagnation in recent months. Production of consumer goods was alone in declining in the first half of the year, the sales revenues figures suggesting that the decline was largely the result of a decline in sales of consumer non-durables on foreign markets.

Aggregate demand

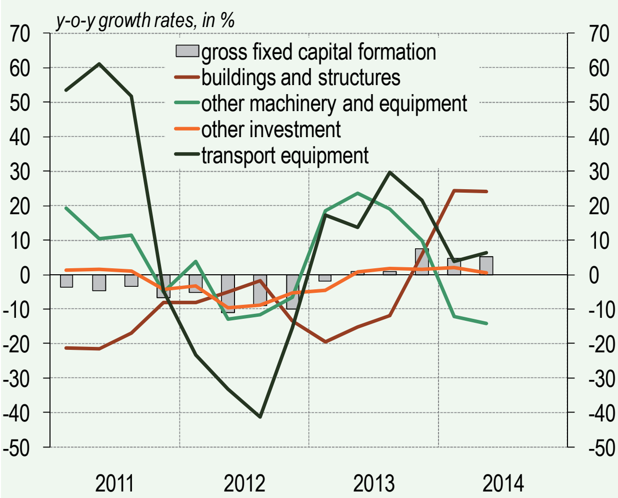
The increase in domestic consumption in the first half of the year was primarily the result of growth in gross investment. Developments in gross fixed capital formation were better than forecast, while there was also an increase in inventories. The breakdown of the investment growth was not the most favourable, investment in infrastructure having recorded the fastest growth while investment in machinery and equipment declined. Investment in machinery and equipment increased rapidly in

Figure 2.6: Contributions to y-o-y GDP growth, expenditure side



Source: SORS.

Figure 2.7: Gross fixed capital formation



Source: SORS.

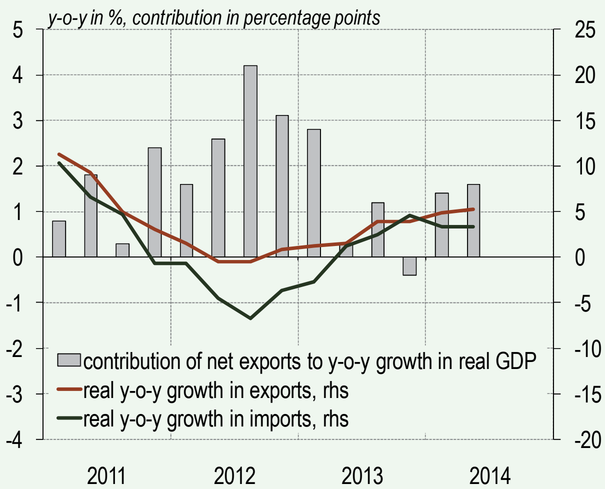
early 2013, primarily as a result of major investment in the energy sector, but the increase in production capacity has since stalled, or is even undergoing an accelerating decline according to estimates. Given the strong base effect from last year's sharp increase, these estimates are rather unreliable, and are partly contradicted by this year's relatively rapid increase in capacity utilisation in manufacturing. Capacity utilisation has thus almost reached its level of 2004, the last "equilibrium period" just before the onset of the overheating of the economy. The contraction in final household consumption came to an end at the end of last year, and household consumption has actually been increasing this year in line with the favourable developments in employment and wages and the low inflation. The year-on-year contraction in final government consumption in the first half of the year stood at almost 2%, primarily as a result of a decline in expenditure on goods and services, while there was also a slight fall in employment in public administration.

Growth in imports and exports in the first half of the year was higher than forecast. The still high level of foreign demand and the improvement in competitiveness were factors in the average growth of more than 5% in real exports in the first half of the year, largely as a result of high growth in merchandise exports. However, the estimates of quarterly growth reveal a slowdown in the high growth in merchandise exports, which is in line with the slowdown in demand from the EU and the uncertainty surrounding the future outlook for sales in certain markets outside the EU. In contrast to merchandise exports, exports of services strengthened in the early part of the year, primarily as a result of exports of transport services. Growth in imports continued in the first half of the year, the rate averaging 3.3%. While the quarterly rates of growth in merchandise imports were rather similar to those seen in the second half of last year, imports of services have increased sharply this year. This was primarily the result of the stabilisation of domestic demand, which also notably raised imports of travel services, while imports of business and technical services also increased. The contribution to GDP growth by net trade in the first half of the year was similar to the average contribution in 2013.

Labour market

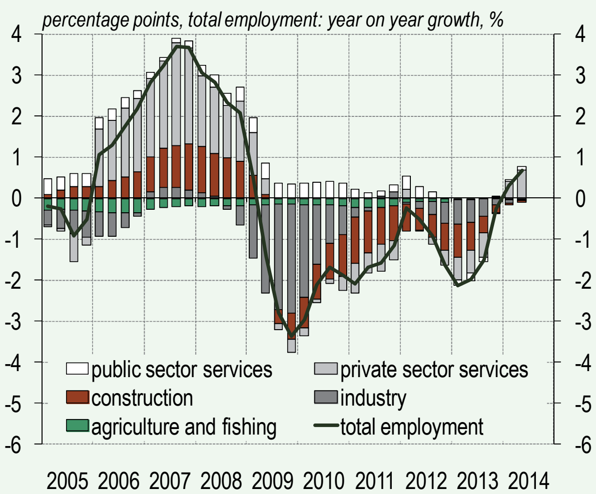
Growth in economic activity also had a positive impact on employment.[4] The workforce in employment at the end of the first half of the year was up 0.7% in year-on-year terms. Encouraging developments in the second quarter neutralised the adverse seasonal effect in the first quarter. The workforce in employment was thus

Figure 2.8: Foreign trade



Source: SORS - national accounts.

Figure 2.9: Contribution of sectors to changes in total employment



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

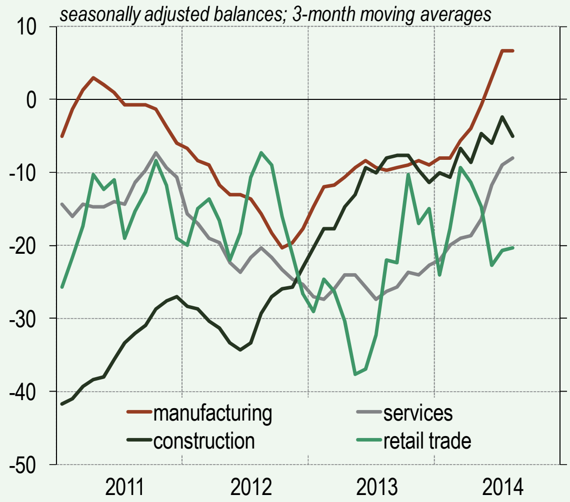
[4] The employment analysis uses national accounts figures, i.e. for employment according to the domestic concept.

higher at the end of the second quarter than at the end of the previous year for the first time since 2008. While in 2013 the fall in total employment was primarily curbed by a rise in the number of self-employed, the year-on-year increase in employment in the first half of this year was primarily the result of a reversal in growth in the workforce in employment, which after falling by around 3.4% in the first half of 2013 was up 0.2% in year-on-year terms in the second quarter of 2014. There were similar developments in the number of hours worked. The proportion of total employment accounted for by the self-employed remained at around a fifth, the level reached at the end of last year.

The year-on-year contraction in employment in the private sector came to an end. The workforce in employment at non-financial corporations was up 0.6% in year-on-year terms in the second quarter, the first increase since the beginning of 2009. The year-on-year contraction in employment in construction slowed significantly, to just under 0.5% in the second quarter, having stood at 10% in 2013. The workforce in employment in manufacturing recorded a slight increase for the first time since 2012, primarily as a result of the strengthening of exports. The largest year-on-year increase of 5.1% in the workforce in employment was recorded by the professional, scientific and technical activities sector, largely as a result of employment at employment agencies. The largest year-on-year fall in the workforce in employment was again recorded by the financial and insurance activities sector, at 2.5%.

Employment increased in mostly public services, although this was not the result of a rise in employment in the government sector. The workforce in employment in mostly public services was up 0.4% in year-on-year terms in the second quarter, but was down 0.2%

Figure 2.10: Expected employment



Source: SORS, Bank of Slovenia calculations.

Table 2.1: Employment

	2009	2010	2011	2012	2013	2Q13	3Q13	4Q13	1Q14	2Q14
	average annual growth in %					*y-o-y growth in %*				
A Agriculture, forestry and fishing	-1.8	-2.0	-2.5	-1.0	0.0	-0.3	0.1	0.4	-0.3	-0.3
BCDE Industry	-8.7	-5.7	-0.1	-1.1	-1.9	-2.5	-1.9	-0.7	-0.4	-0.1
F Construction	-0.9	-9.4	-11.4	-7.8	-7.1	-9.2	-5.6	-2.6	-0.8	-0.5
GHI Trade, accommodation, transport	0.2	-2.4	-2.4	-1.2	-1.2	-1.6	-1.2	-0.5	-0.9	-0.2
J Information and communication	4.0	0.8	0.3	2.1	2.3	2.0	2.3	2.7	1.9	2.3
K Financial and insurance activities	1.8	-0.7	-2.8	-1.7	-2.7	-2.9	-2.9	-2.5	-2.1	-2.5
L Real estate activities	4.2	0.0	-2.7	-1.4	0.9	1.9	0.0	0.0	-1.9	0.0
MN Professional, technical and other business activities	-0.5	2.6	0.7	1.4	-3.0	-3.2	-4.2	-1.1	4.7	5.1
OPQ Public administration and defence; education, health	2.2	2.3	0.9	1.1	-0.6	-1.0	-0.6	-0.1	0.2	0.4
RST Other activities	3.1	1.7	-1.9	0.2	6.1	4.9	6.5	7.7	2.3	3.2
TOTAL	-1.8	-2.2	-1.6	-0.8	-1.5	-2.0	-1.5	-0.3	0.3	0.7

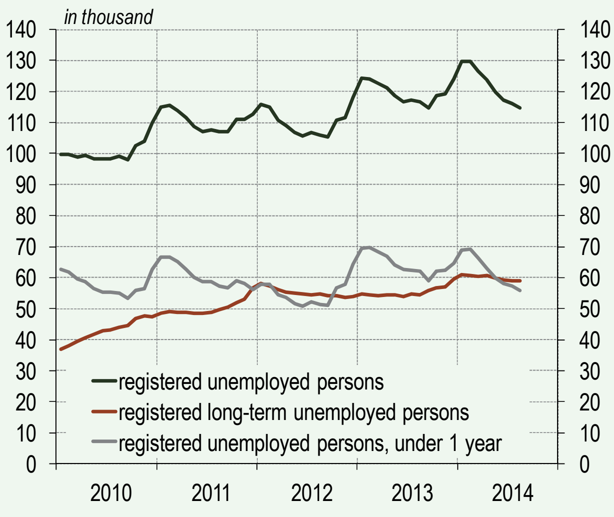
Source: SORS – national accounts, Bank of Slovenia calculations.

in the government sector. The contraction in employment thus continued in 2014 in sectors where government control is strongest. In sectors not under the direct control of the government, the workforce in employment continued to increase. This was confirmed by the monthly SORS figures, which are not completely comparable to the national account figures, but nevertheless reveal that employment in the health and social work sector and the education sector has been rising since the middle of last year, while employment in the public administration, defence and compulsory social security sector continued is falling in year-on-year terms.

The number of new hires in the first half of the year was up significantly on the same period last year. The number of unemployed people deregistering as a result of new hires in the first half of this year was up 20% on the first half of last year. This was the largest increase since the first half of 2008, and was the result of increased corporate demand for workers, and not the result of active employment policy. The number of people involved in active employment policy measures during the first seven months of this year was down almost 10% on the same period last year. The employment expectations indicators have improved, while the indicators of demand for workers in manufacturing are also up. The gap between the shortage of skilled workers and the shortage of workers in general, which is one of the indicators of structural mismatch on the labour market, remains unchanged.[5]

Since the peak in January, the unemployment rate has fallen. The number of registered unemployed recorded a seasonal increase in the early part of the year, but had fallen to around 114,800 by the end of August. In July the number of registered unemployed was down in year-on-year terms for the first time since October 2012. The favourable developments continued in August, the number of registered unemployed falling by 1.6%. Despite the positive current developments in employment, the average number of registered unemployed in the first half of the year was nevertheless up 2.7% on the first half of last year. The registered unemployment rate stood at 12.8% at the end of June, unchanged from the previous year. The decrease in unemployment is also evident in the figures for the ILO unemployment rate, which fell from 10.3% in the second quarter of last year to 9.3% in the second quarter of this year.

Figure 2.11: Long-term unemployed persons



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

Figure 2.12: Unemployment rate

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

[5] According to a survey by the Employment Service entitled Employment Preview 2014/1, just over a fifth of firms surveyed cited problems in recruiting suitable staff, particular low-skilled workers (drivers, security guards, cooks). A quarter of firms are expected to recruit before the end of the year, particularly in manufacturing, construction and marketable services, while employment agencies are also forecasting increased employment.

The number of deregistrations in the first half of the year was up in year-on-year terms. New hires accounted for approximately three-quarters of the deregistrations in the first half of the year. It is encouraging that the number of first-time new hires increased by just over a half. There was a sharp increase in the number of those transferred to other categories,[6] although they accounted for a negligible proportion of the deregistrations. Outflows from unemployment for reasons other than employment were down just under 19% in year-on-year terms. Of these, the number attributable to retirement was down more than 18%.[7] The number of long-term unemployed declined in the first half of 2014, but the proportion of long-term unemployed rose from 47% to 51% as a result of the smaller number of new registrations as unemployed.

The favourable developments on the labour market were also reflected in inflows into registered unemployment. The number of people newly registering as unemployed in the first half of the year was down 3.6% in year-on-year terms. The loss of temporary employment accounted for approximately half of those newly registering as unemployed, although the number of these was down 6% in year-on-year terms. This was partly attributable to labour market reforms that reduced the segmentation of the labour market by tightening restrictions on temporary employment. The number of first-time jobseekers recorded the sole increase among new registrations com-

Table 2.2: Labour cost indicators

	2009	2010	2011	2012	2013	2Q13	3Q13	4Q13	1Q14	2Q14
	nominal y-o-y growth, %									
Gross wage	3.5	3.9	2.0	0.1	-0.1	-0.5	0.3	0.6	0.9	1.1
Gross wage in the private sector	1.9	5.0	2.6	0.9	0.7	0.6	1.1	1.2	1.6	1.3
Gross wage in the public sector[1]	6.8	-0.1	0.0	-2.2	-2.3	-3.0	-1.6	-1.0	-1.1	0.2
Gross wage in manufacturing	0.9	8.9	3.9	2.5	2.8	2.9	3.0	3.6	3.9	2.8
Labour costs per hour worked[2]	3.6	1.2	2.0	-0.3	-2.1	-5.8	-1.1	2.1	2.3	2.3
Labour costs per hour worked in manufacturing[2]	5.7	3.2	1.9	2.9	0.6	-5.7	-0.5	4.4	3.1	2.6
Gross wage per unit of output[3]	10.2	0.4	-0.3	1.9	-0.6	-1.1	-1.0	-1.8	-0.9	-1.1
Gross wage per unit in manufacturing[3]	10.0	-5.1	0.3	3.9	1.8	3.1	1.3	-1.8	0.1	-0.7
Unit labour costs[3, 4]	8.5	0.5	-0.7	0.6	1.4	0.6	0.2	2.7	-1.3	-1.8
Compensation per employee[4]	1.9	4.0	1.6	-1.2	1.9	1.3	1.5	5.2	0.5	0.3
Output per employee	-6.1	3.5	2.3	-1.8	0.5	0.7	1.3	2.4	1.8	2.2
Output per employee (manufacturing)	-8.3	14.7	3.6	-1.3	0.9	-0.2	1.8	5.4	3.8	3.6
HICP	0.9	2.1	2.1	2.8	1.9	1.8	2.2	1.1	0.6	0.8
GDP deflator	3.4	-1.1	1.2	0.3	1.4	1.7	1.4	2.1	1.2	0.4

[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).
Source: SORS, Bank of Slovenia calculations.

[6] Other categories include people in active employment policy programmes and people who are temporarily unemployable.
[7] At the end of 2013 the period expired during which, under the old legislation, the Employment Service paid pension and disability insurance contributions for unemployed workers who filed an application before the end of 2010 and who were less than three years away from retirement.

Box 2.1: Survey of wage and labour cost dynamics

The survey of wage and labour cost dynamics was conducted within the framework of the ESCB's Wage Dynamics Network (WDN) working group, in which a survey in the majority of EU Member States is carried out.[1] Most of the questions in the survey are the same for all the participating countries, but some questions specific to Slovenia were added.[2] The purpose of the survey was to determine how the crisis affected wage and employment dynamics. Firms were asked about the impact of the economic environment on their performance, and on their methods of adjustment in the area of labour and wages. The survey was conducted in May and early June of 2014. It was sent to 2,997 firms, broken down by size in terms of employment (5 to 9 employees, 10 to 19, 20 to 49, 50 to 199, 200 and more) and by sector (Sectors C to N).[3] The initial findings of the analysis of the survey results are presented here.

The firms' responses to the question of the impact of the economic environment are as expected, and reveal that the main factors in the deterioration in corporate performance in the 2010 to 2013 period were the deterioration in clients' solvency, the decline in demand and the increased uncertainty of demand. The firms had more problems with the situation on the domestic market (falling demand and prices) than that on the foreign market. With regard to financing, the responses suggest that the firms had greater problems with loan terms than with obtaining new loans. For those without access to loans, this was a significant and long-lasting problem.

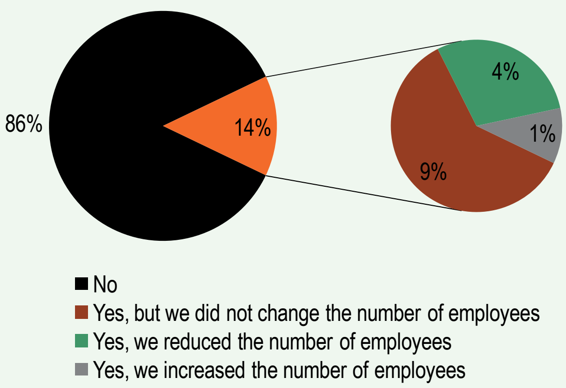
It can be concluded from the firms' responses on the methods of adjustment in employment that new firms[4] primarily created more-flexible jobs, mainly recruiting temporary employees, permanent employees on reduced hours, via agencies and via other forms of employment,[5] while older firms primarily cut jobs. In the 2010 to 2013 period 26% of firms had to make significant cuts in or structural changes to their workforces. The firms affected were mainly in the sectors of construction, manufacturing, and information and communication, while firms in the electricity, gas and water supply sectors were less affected. When making employment adjustments the firms mainly used dismissals and freezes/restrictions on recruitment, while they also stopped renewing temporary employment contracts and dismissed workers in more flexible forms of employment. Compared with 2010, in 2013 it was easier for the firms to temporarily lay off employees or to make them redundant on business grounds.[6] The majority of adjustments and also reallocations of workforce occur in the flexible segment of the labour market, in terms of both hiring and firing, which suggests signs of flexicurity, but almost exclusively in this segment of the labour market.

The firms cited uncertainty surrounding the economic situation, the high taxation of labour[7] and the inability to unilaterally make temporary wage cuts (without union consent) during adverse shocks as the main factors limiting permanent employment. The latter indicates that wage rigidity remains a major problem in responding to adverse shocks.

Only 14% of the firms made changes to their HR policy on account of new legislation, of which just 5% made changes to their employment levels. The most likely reason for this is that relatively little time has passed since the adoption of the labour market reforms, and that during this time there have been no major shocks that would force firms to make more significant adjustments in employment.

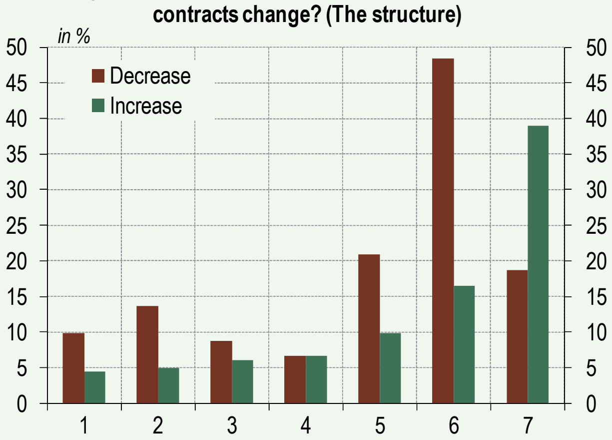
One of the objectives of the change in legislation was to reduce the segmentation of the labour market, and this objective was partly realised: following the adoption of the new legislation the proportion of employees in more flexible forms of employment declined, while the proportion of permanent employees increased. Judging by the firms' responses, per-

Figure 1: Has new labour market legislation (The Employment Relationship Act (ZDR) and the Labour Market Regulation Act (ZUTD) and other labour market policy measures affected your employment policy?



Source: Wage Dynamics Network Survey 2014, Bank of Slovenia calculations.

Figure 2: How did the share of workers with different contracts change? (The structure)



Note: 1) Contractual workers. 2) Agency workers. 3) Sole proprietors. 4) Pensioners (temporary work). 5) Students. 6) Temporary workers. 7) Permanent workers.
Source: Wage Dynamics Network Survey 2014, Bank of Slovenia calculations.

manent employment should primarily be encouraged by simplifying the administrative procedures for dismissal, reducing notice periods, and making use of tax allowances and subsidies.[8]

The firms made changes to wages more often before 2010 than in the 2010 to 2013 period. In the pre-crisis years they were mainly wage rises, while during the crisis the firms primarily wanted to reduce nominal wages. Resistance to nominal wage reductions is stronger, which is reflected in less frequent wage changes. However, one can not talk of greater downward wage rigidity. The proportion of firms making wage reductions increased from 4% in 2010 to just under 8% in 2013. This proportion was higher than the figure of just under 3% recorded in the 2003 to 2007 period, and higher than the EU averages of 2003 to 2007 (2.3%) and 2008 to 2009 (3.2%). This points to a decline in downward nominal wage rigidity, most likely as a result of the economic crisis. Where there was a decline in nominal wages, it was relatively large, and encompassed a large proportion of workers at each firm. The nominal wage reduction at firms that reduced wages averaged more than 5% in 2013 (approximately 7% in real terms), while the proportion of workers whose wages were reduced was close to a quarter.

Fewer than 40% of the firms in the sample had at least one employee on the minimum wage as at May 2014. Amendments to the Minimum Wage Act raised the minimum wage from EUR 597.42 in February 2010 to EUR 734.15 in May 2014, to which the majority of firms (63% of those with employees on the minimum wage) adjusted by cutting other costs. Just under a quarter of the firms did not hire new workers for this reason, while just over a fifth of the firms had to raise wages in excess of the minimum, an indication that the increase in the minimum wage at least partly passed through into an increase in other wages. Around 13% of the firms raised prices on account of the new minimum wage legislation, while approximately 7% of the firms dismissed workers on this account.

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[1] All EU Member States other than Denmark and Sweden.

[2] Primarily questions about the effects of the new legislation of 2013 on the labour market and the effects of the Minimum Wage Act of 2010.

[3] The survey included all firms with more than 200 employees alongside other firms. A total of 1,284 firms responded to the survey, or 43% of the total. This is almost double the number in the first survey conducted in 2008, responsiveness improving among firms of all sizes, most notably small businesses.

[4] Established after 2008.

[5] In addition to agency workers, this category includes sole traders, people working as intellectual service-providers or subcontractors, students on placements and retired workers.

[6] Under the Employment Relationships Act, which entered into force in April 2013, an employer can place a worker on temporary lay-off for a maximum of six months in an individual calendar year for the purpose of job preservation. During this time the worker has the right to wage compensation in the amount of 80% of his/her average wage in the last three months, but is obliged to undergo extra training during the lay-off period.

[7] According to the findings of the EBRD, firms in countries with low taxation also complain about taxation of labour, for which reason this response is given less significance in the analysis of the labour market (Schweiger, 2014, http://www.umar.gov.si/fileadmin/user_upload/publikacije/izzivi/2014/prezentacije/Helena_Schweiger.pptx). Another indication that the response relating to tax levels is of less relevance is that firms cite high prescribed wages (including minimum wages, wages determined by tariff brackets under collective agreements, and legally stipulated bonuses such as those for years of service) as the second-least important limiting factor in permanent employment, even though the labour cost to the firm comprises the employee's gross wage and all the levies paid by employers.

[8] These include partial allowances on payments of social security contributions and other benefits when hiring unemployed people, mothers, young people and seniors.

Figure 2.13: 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.

Figure 2.14: Total wage bill and average gross wage per employee

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

pared with the first half of 2013, at 9%, which was partly attributable to the improvement of the situation on the labour market, which encouraged this population group to exit from inactivity and to enter the labour market.

The average nominal gross wage per employee has also consistently increased since the middle of 2013 as a result of the positive economic developments. In the total economy it was up just over 1% in year-on-year terms in the first half of the year, which was largely attributable to an increase in the average nominal gross wage in the private sector. Wages in the private sector in the first half of the year were up 1.5% in year-on-year terms, primarily as a result of a rise of 3.4% in wages in export-oriented manufacturing sectors. Nominal gross wages in the sectors of construction, accommodation and food service activities, wholesale and retail trade and professional, scientific and technical activities, which are tied primarily to domestic demand, grew at rates of less than 0.5%. The sole sector to record a decline in wages in the first half of the year was real estate activities, at 1%. The average real gross wage in the total economy and the real wage bill in the first half of the year were up slightly in year-on-year terms, by approximately 0.5%.

3 Current Account and Competitiveness Indicators

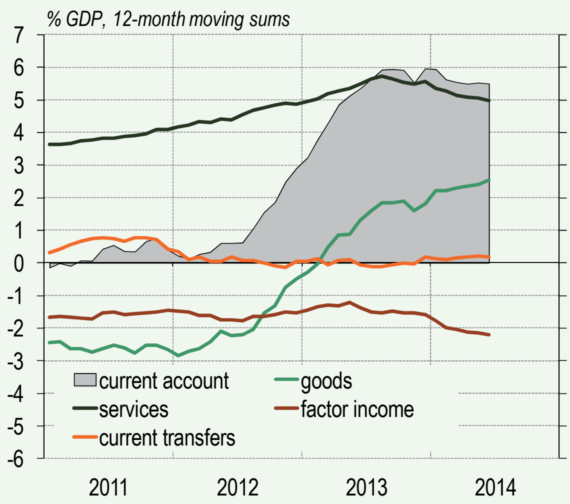
The current account surplus over the preceding 12 months stood at 5.3% of GDP at the end of June. It was down slightly in year-on-year terms during the first half of this year, but nevertheless remained above EUR 1 billion. The decline was mainly attributable to a decline in the surplus of trade in services, and a wider deficit in factor income. The merchandise trade surplus widened, while the nominal growth in merchandise exports was a significant factor in the growth in merchandise imports alongside the increase in industrial production and the growth in domestic demand in the first half of the year. Signs of a slowdown from the high rates of growth in both imports and exports began to appear in the middle of the year.

Slovenia's price competitiveness in the first half of the year strengthened in year-on-year terms on euro area markets, but deteriorated vis-à-vis major trading partners outside the euro area as a result of adverse developments in the euro exchange rate, although year-on-year growth in domestic prices was lower. Unit labour costs also recorded more favourable year-on-year developments in the early part of the year than in the majority of the trading partners. On foreign markets their contribution outweighed the effect of the year-on-year appreciation in the euro, as a result of which Slovenia's cost competitiveness improved. Slovenia's price competitiveness and cost competitiveness vis-à-vis major trading partners deteriorated compared with the end of last year.

Current account

After reaching record levels in 2013, the current account surplus began to gradually narrow in the early part of this year. It amounted to EUR 970 million in the first half of the year, just under EUR 140 million less than in the same period last year. The surplus of trade in services narrowed by just under 20% over the same period, as a result of a wider deficit in trade in other business services. The deficit in factor income has been widening rapidly this year, as a result of renewed growth in net outflows of income from FDI, and the financing of external government debt. The slight narrowing of the deficit in current transfers had a beneficial impact on the current account position in the first half of the year. Merchandise trade was the largest factor in the maintenance of a high current account surplus: the merchandise trade surplus in the first half of the year doubled in year-on-year terms as imports stagnated and exports to EU Member States recorded solid growth. The increase in the surplus was mostly the result of higher growth in exports, the level of

Figure 3.1: Components of the current account



Source: Bank of Slovenia.

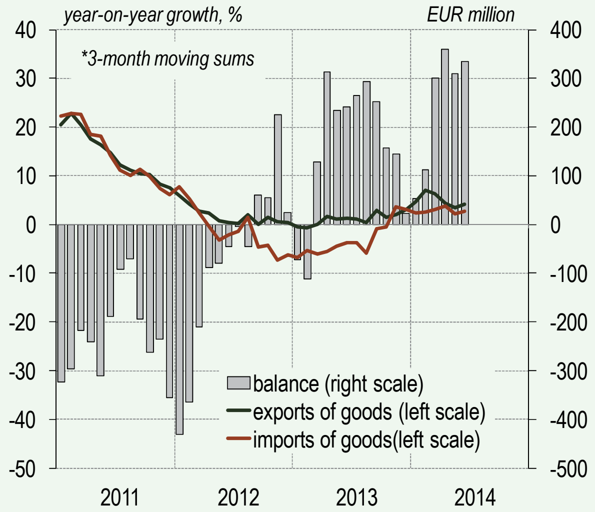
coverage of imports by exports[8] increasing from 103.5% to 105.8%.

Merchandise trade

Growth in merchandise imports and exports has been gradually slowing this year. Despite a sharp increase in year-on-year growth in merchandise imports and exports in June, the weaker developments in the two previous months reduced quarterly growth. Year-on-year growth in exports slowed from 6.2% in the first quarter to 4.2% in the second quarter, while growth in imports slowed from 3.1% to 2.7%. The quarterly merchandise trade surplus nevertheless widened from EUR 302 million to EUR 335 million. The merchandise trade surplus accounted for just over two-thirds of the current account surplus in the first half of the year, or EUR 637 million. The cumulative merchandise trade surplus over the last 12 months reached EUR 911 million or 2.6% of GDP in June, 1.3 percentage points more than a year earlier.

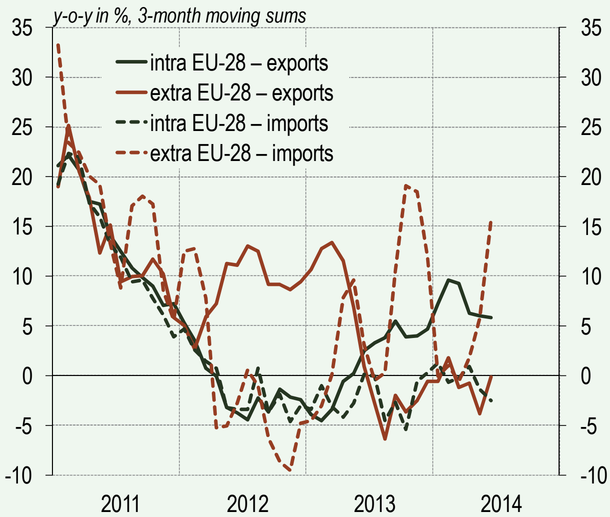
Year-on-year growth in merchandise exports to EU Member States slowed in the second quarter, but remained higher than overall growth in merchandise imports from EU Member States. This is an indication of an increase in Slovenian exporters' market share in the EU. According to SORS figures, year-on-year growth in merchandise exports to EU Member States slowed from 9.2% in the first quarter to 5.8% in the second quarter. There was an even larger slowdown in exports to EU Member States with their own currency, from 16.5% in the first quarter to 8.3% in the second quarter. Growth in total merchandise imports from the euro area and EU Member States with their own currency was rela-

Figure 3.2: Trade in goods*



Source: Bank of Slovenia.

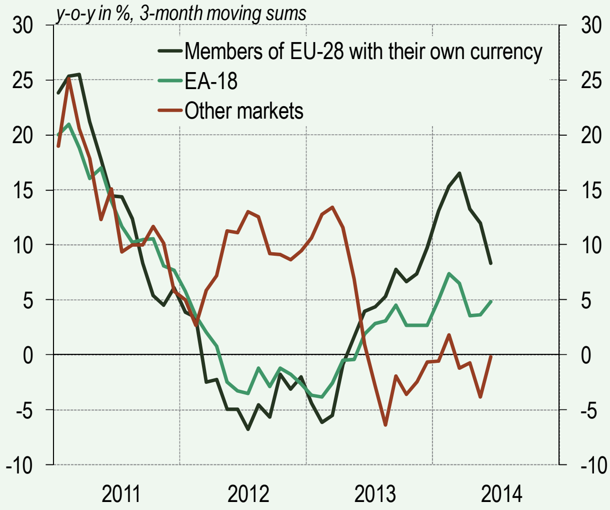
Figure 3.3: Goods trade by country groups



Source: Bank of Slovenia.

[8] According to SORS figures, the coverage of imports by exports stood at 97.0% in the first half of last year, and 101.9% in the first half of this year.

Figure 3.4: Exports of goods by country groups



Source: Bank of Slovenia.

tively modest in the first half of the year. The year-on-year rates stood at 0.5% for the former group, and 2.5% for the latter. The market shares of Slovenian exporters thus strengthened sharply on both markets. Growth in exports of intermediate goods and consumer goods slowed in both markets, while exports of capital goods increased by more than 10% in year-on-year terms. Growth in merchandise exports to non-EU countries outpaced growth in exports to EU Member States in June for the first time this year. This helped to slow the contraction in merchandise exports to non-EU countries from 1.2% in the first quarter to 0.2% in the second quarter. The significant slowdown in economic activity in the former Yugoslav republics prevented faster export growth. Although exports to certain former Soviet countries are increasing

Table 3.1: Components of the current account

	2005	2006	2007	2008	2009	2010	2011	2012	2013	1 year to June 14	H1 2014
						mio EUR					
Current account balance	-498	-545	-1,441	-2,028	-173	-50	146	1,026	2,101	1,964	969
1. Goods	-1,026	-919	-1,456	-2,144	-440	-830	-957	-171	645	911	637
2. Services	920	993	1,047	1,428	1,165	1,281	1,476	1,720	1,960	1,784	846
2.1. Transport	398	456	525	561	437	496	585	633	659	687	354
2.2. Tourism	743	783	834	904	891	1,002	1,158	1,278	1,345	1,321	579
- of which, exports	1,451	1,555	1,665	1,827	1,804	1,925	1,975	2,008	2,039	2,065	880
2.3. Other	-221	-247	-312	-38	-163	-218	-267	-190	-43	-223	-87
3. Factor income	-295	-440	-789	-1,030	-724	-588	-524	-540	-564	-793	-477
3.1. Labour income	128	107	50	8	96	150	234	376	348	336	157
3.2. Capital income	-424	-547	-839	-1,038	-820	-739	-758	-915	-911	-1,129	-634
4. Current transfers	-97	-178	-243	-282	-174	88	151	16	60	62	-38
						as % GDP					
Current account balance	-1.7	-1.7	-4.1	-5.3	-0.5	-0.1	0.4	2.8	5.8	5.3	5.3
1. Goods	-3.5	-2.9	-4.1	-5.6	-1.2	-2.3	-2.6	-0.5	1.8	2.5	3.5
2. Services	3.1	3.1	3.0	3.8	3.2	3.5	4.0	4.8	5.4	4.9	4.7
2.1. Transport	1.4	1.4	1.5	1.5	1.2	1.4	1.6	1.8	1.8	1.9	1.9
2.2. Tourism	2.5	2.5	2.4	2.4	2.5	2.8	3.1	3.5	3.7	3.6	3.2
- of which, exports	5.0	4.9	4.7	4.8	5.0	5.3	5.4	5.6	5.6	5.6	4.8
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.4	-0.6	-0.7	-0.5	-0.1	-0.6	-0.5
3. Factor income	-1.0	-1.4	-2.2	-2.7	-2.0	-1.6	-1.4	-1.5	-1.6	-2.2	-2.6
3.1. Labour income	0.4	0.3	0.1	0.0	0.3	0.4	0.6	1.0	1.0	0.9	0.9
3.2. Capital income	-1.4	-1.7	-2.4	-2.7	-2.3	-2.0	-2.1	-2.5	-2.5	-3.1	-3.5
4. Current transfers	-0.3	-0.6	-0.7	-0.7	-0.5	0.2	0.4	0.0	0.2	0.2	-0.2

Source: SORS, Bank of Slovenia.

sharply for the second consecutive year, the Ukraine crisis meant that exports to Ukraine and Russia in the first half of the year were down sharply in year-on-year terms, by just over 20% and just over 6% respectively.

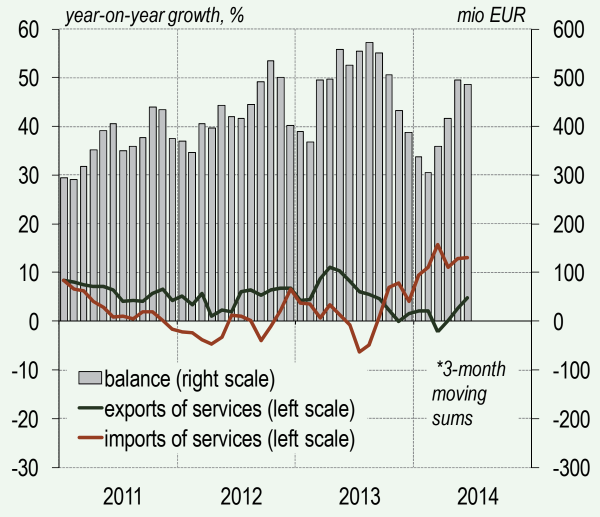
Despite the increase in industrial production and the relatively high growth in exports, the contraction in imports of intermediate goods, which stood at 2.6% last year, increased further in the first half of the year. Imports of intermediate goods declined by 3% in the first half of this year. Imports of capital goods declined by 0.5%, primarily as a result of a high basis in the first half of last year, partly in connection with investment in the energy sector. Domestic final consumption has gradually been strengthening since the second half of last year. This is also being reflected in growth in imports of consumer goods, which in the first half of the year were up just under 9% in year-on-year terms. Imports of cars, consumer durables and consumer non-durables also remained high in the early part of this year.

Improved terms of trade were another factor in this year's high growth in the merchandise trade surplus. Export prices fell by just over 1% on average in the first half of the year, and import prices by just over 2%. The terms of trade improved by 1% in the first half of the year, which contributed 0.6 GDP percentage points to the current account surplus. Import prices have been falling faster than export prices since the second half of last year. The largest factor was the fall in euro prices of non-food agricultural products. There was also a sharp fall in other industrial commodity prices and metals prices. After falling by just under 8% in the first quarter, the price of a barrel North Brent crude oil rose by just under 2% in the second quarter. Another major factor in the faster fall in prices of goods quoted in US dollars on the markets in the first half of the year was the simultaneous rise in the euro against the US dollar and other currencies.

Trade in services

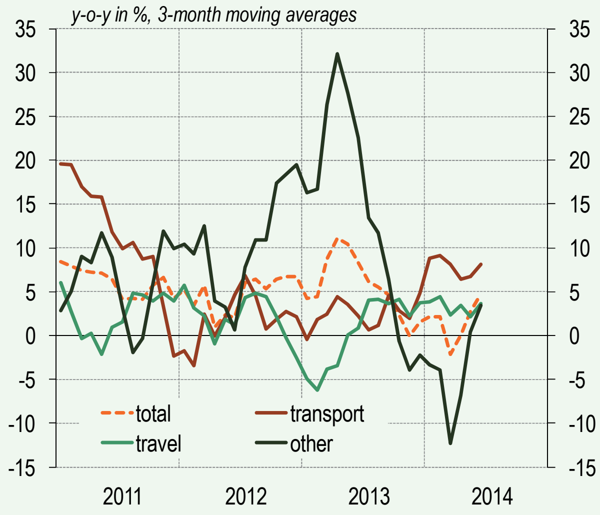
The surplus of trade in services narrowed in the first half of the year. Year-on-year growth in exports of services remained lower than growth in imports, despite strengthening in the second quarter. Year-on-year growth in exports of services increased from -2.1% in the first quarter to 4.8% in the second quarter. Growth in imports slowed by just under 3 percentage points over the same period to 13%. Imports of services were up more than 14% in year-on-year terms in the first half of the year, while exports were up 1.5%. The surplus of trade in services narrowed by EUR 176 million in year-on-year terms

Figure 3.5: Trade in services*



Source: Bank of Slovenia.

Figure 3.6: Services exports



Source: Bank of Slovenia.

to EUR 846 million. There was a slight year-on-year decline in the cumulative 12-month surplus, which stood at EUR 1,784 million or around 5.0% of GDP in June.

Year-on-year growth in trade in transport services strengthened in the first half of the year, in line with the solid growth in merchandise trade. Growth in exports of transport services stood at just over 8% in both quarters, while growth in imports was up 2 percentage points on the first quarter at 8.9% in the second quarter. There was a sharp increase in exports of freight transport services: freight rail transport was up more than 40%, sea and coastal freight water transport was up around 20% and freight transport by road was up around 10%. The sole decline was recorded by freight air transport. By contrast, exports of all the sub-categories of passenger transport declined, with the exception of road transport, which increased sharply. On the import side, there was a year-on-year decline in air and road freight transport in value terms, while sea and coastal freight water transport and, notably, freight rail transport increased. The surplus of trade in transport services in the first half of this year was up EUR 27 million in year-on-year terms at EUR 354 million.

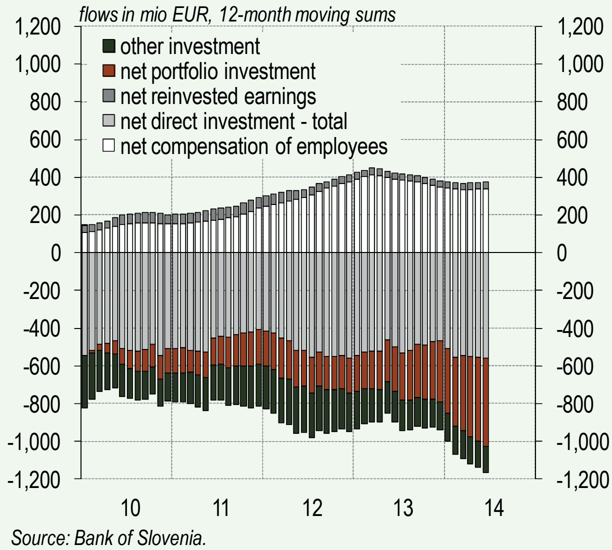
Growth in imports of travel services again sharply outpaced growth in exports of travel services in the first half of the year. Year-on-year growth in imports of travel services increased sharply in the first quarter, most notably as a result of business travel abroad doubling. Growth in imports of travel services slowed in the second quarter, but the rate over the first half of the year nevertheless stood at just under 20%. The dynamics within the first half of the year were favourable, growth in exports of travel services having remained high. Growth in imports of travel services in the second quarter declined sharply relative to the first quarter. The number of arrivals by foreign visitors in Slovenia in the first half of the year was up just over 7%, while the number of overnight stays was up 3%. Year-on-year growth in income from exports of travel services stood at 3.1%, an indication of the decline in average spending by foreign visitors. The surplus of trade in travel services narrowed by EUR 24 million in year-on-year terms to EUR 580 million, while the cumulative 12-month surplus stood at EUR 1,321 million at the end of June.

The largest contribution to the decline in the surplus of trade in services in the first half of the year came from other services. Exports of other services (services other than travel and transport) were down 4.5% in year-on-year terms, while imports were up more than 15%. The position in other services thus swung from a surplus of EUR 93 million in the first half of last year to a deficit of EUR 87 million in the first half of this year, a year-on-year deterioration of EUR 180 million. The largest factors were a year-on-year widening of the deficits in business and technical services and construction services in the total amount of EUR 125 million, and a decline of EUR 76 million in the surplus in foreign trade intermediation services from EUR 180 million in the first half of last year to EUR 104 million in the first half of this year.

Factor income and current transfers

The overall deficit in factor income in the first half of the year doubled in year-on-year terms. The deficit amounted to EUR 477 million. The deficit in capital in-

Figure 3.7: Net factor income



Source: Bank of Slovenia.

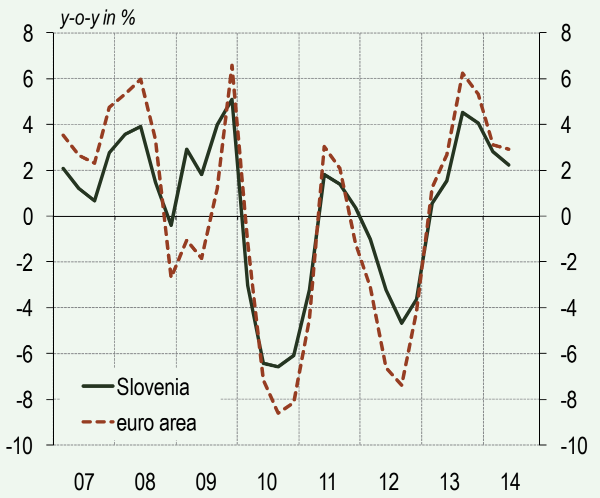
come widened by just under 33% in year-on-year terms to EUR 634 million. The largest factor in the widening deficit was net payments of income on investments in securities, where the deficit widened by EUR 133 million in year-on-year terms to EUR 251 million. As a result of government borrowing at high interest rates, payments for financing the government sector's external debt recorded a year-on-year increase of just under EUR 140 million to EUR 390 million. Government financing costs will increase further for the remainder of this year and in the coming years, as a result of borrowing at the end of last year and in the first quarter of this year.[9] As a result of debt repayments by the private sector, particularly the banks, net payments of interest to the rest of the world declined in year-on-year terms. The deficit in net income from FDI widened by EUR 94 million to EUR 316 million. In line with the growth in construction work and the corresponding employment of non-residents in the second half of last year and the first half of this year, there was an increase in outflows of labour income. As inflows stagnated, the surplus in labour income in the first half of the year narrowed by EUR 12 million in year-on-year terms to EUR 157 million. The cumulative deficit in factor income over the preceding 12 months widened by just over 40% in year-on-year terms to EUR 793 million or 2.2% of GDP in June.

The deficit in current transfers in the first half of this year was very similar to the deficit in the first half of last year. After a deficit in the first quarter, there was a surplus in current transfers in the second quarter, which was EUR 8 million wider in year-on-year terms at EUR 39 million. The surplus in government transfers stood at EUR 32 million, and was largely the result of significant disbursements of funds for the implementation of the common agricultural and fisheries policies, which in the first half of the year amounted to 69% of the projected annual quota.

Competitiveness Indicators[10]

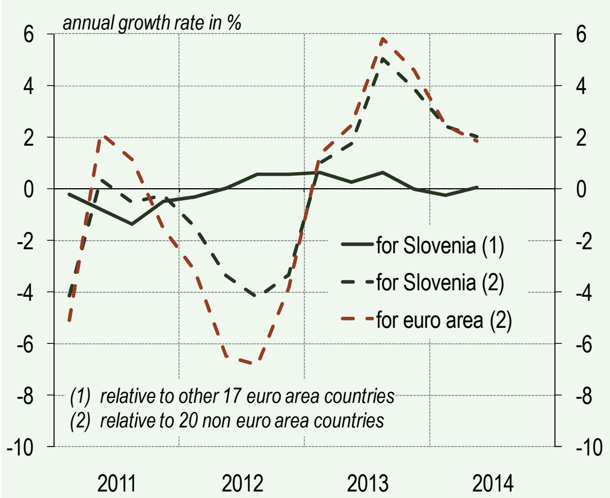
The harmonised nominal indicator of Slovenia's competitiveness measured against 20 major trading partners outside the euro area in the first half of the year increased by 2.5% in year-on-year terms, approximately at the level of last year's average. Growth in the comparable indicator for the euro area was 0.5 percentage points higher, as a result of the differences in the

Figure 3.8: Nominal harmonised cost competitiveness indicator (vis-a-vis 20 trading partners outside euro area)



Source: ECB.

Figure 3.9: Harmonised cost competitiveness indicators (based on HICP/CPI deflators)



Source: ECB.

9 The stock of government debt securities owned by non-residents amounted to EUR 14.1 billion at the end of 2013, but had increased to EUR 17.8 billion by the end of the first quarter of this year.

10 A rise in the value of the harmonised competitiveness indicators (appreciation) entails a deterioration in competitiveness, while a fall (depreciation) entails an improvement in competitiveness in comparison with the selected countries.

Box 3.1: Results of the CompNet project

As of 2012 a comprehensive competitiveness analysis project has been underway within the framework of the ESCB entitled CompNet,[1] in which the Bank of Slovenia is a participant. The objective of the project is to define the factors that drive productivity and competitiveness in EU Member States, with the aim of incorporating the findings in EU economic policy.

The CompNet project is divided into three work streams: analysis of macroeconomic competitiveness indicators, analysis of microeconomic (firm-level) competitiveness, and analysis of global value chains. The Bank of Slovenia is an active participant in the second group, which is studying countries' competitiveness based on firm-level data. In addition to Slovenia there are ten other EU Member States in the group, who have contributed data from firms in 58 sectors (according to NACE Rev. 2) for the 1995 to 2011 period. The data for the Slovenian firms comes from the AJPES database.

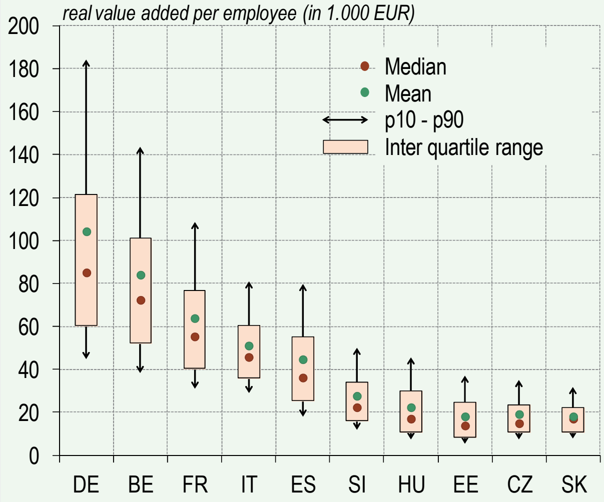
The microeconomic analysis within the framework of CompNet is faced with numerous methodological and legal obstacles deriving from differences between the participating countries in terms of the availability, comparability and accessibility of data. In addition to non-standardised time intervals for data availability, and a lack of harmonised rules for accounting measurement and reporting, the analysis is also sharply constrained by national legislation on the protection of corporate privacy. Legislation in a number of countries prevents public access to firm-level data, and the final results have been adjusted accordingly. Given the difficulties with data comparability and accessibility, more detailed analysis can only be conducted at the level of the individual countries.

This year the ECB compiled two reports within the framework of CompNet on the results of microeconomic analysis with an emphasis on labour productivity and total factor productivity (TFP). The research revealed that there are major differences in productivity between firms in terms of country and in terms of sector. In the majority of the participating countries the distribution of labour productivity was negatively asymmetric, which means that the majority of firms had productivity lower than the average in the country (Figure 1). Major differences between firms were also seen when firms were combined into sectors, where the differences were often even larger than between firms from different sectors.

There are considerable differences in total factor productivity, labour costs and size between the firms ranked in the far reaches of the distribution by labour productivity. More-productive firms are larger than less-productive firms in terms of headcount (Figure 2), while the sectors with relatively large distributions by productivity also have a higher average level of productivity.

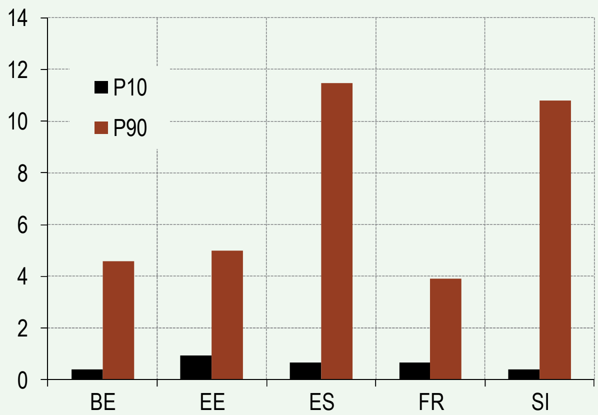
The pronounced differences between firms and the negative asymmetry of the distribution by productivity suggest poten-

Figure 1: Labour productivity (average 2003-2007)



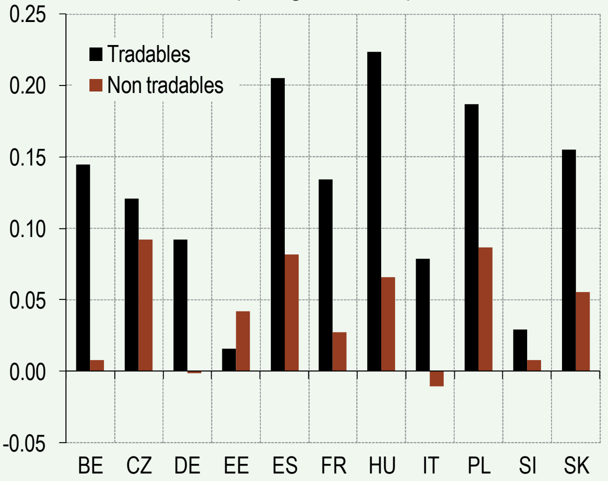
Source: ECB.

Figure 2: Relative (to the median) size of most and least productive firms (average 2003-2007)



Note: The size is determined by the number of employees. The average firm size in each productivity percentile has been divided by the size of the median productive firm.
Source: ECB.

Figure 3: Covariance between relative size and relative productivity in tradable and non-tradable sectors (average 2003-2007)



Source: ECB.

tials for improving productivity by reallocating production factors from less-productive to more-productive firms. The CompNet results reveal that the covariance between the relative size and relative productivity of firms, which is used as the standard measurement of the efficiency of the allocation of production resources (Olley-Pakes model), is greater in the tradable sector than in the non-tradable sector (Figure 3).

The findings presented also apply to Slovenian firms. In terms of productivity they have a negative asymmetric distribution at the level of sectors and the total economy, with pronounced differences between low- and high-productivity firms. The deviations from average productivity are also larger within sectors than between sectors. The ratio of the size of the firm of highest productivity to the size of the firm of average productivity is among the highest of the group of countries covered by the research, and indicates a positive correlation between size and productivity. This correlation is also indicated by the decomposition of sectoral productivity into the change in average productivity and the factor allocation effect, where the factor allocation effect is estimated as the covariance between the relative size and the relative productivity of firms. The latter is relatively low for Slovenia, albeit higher in the tradable sector than in the non-tradable sector.

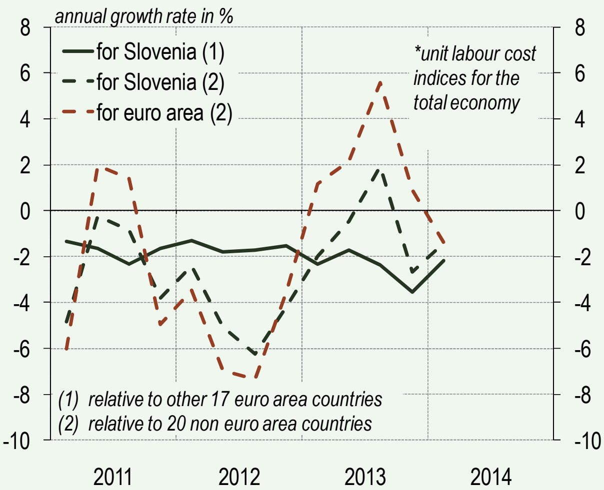
[1] For more, see http://www.ecb.europa.eu/home/html/researcher_compnet.en.html.

shares of individual currencies in the breakdown of international trade. The main reason for the faster increase in the euro area indicator was the greater impact of the euro's year-on-year appreciation against the US dollar and the Japanese yen.

Slovenia's price competitiveness in the first half of the year again deteriorated in year-on-year terms on markets outside the euro area, but improved slightly on the markets of the single currency as a result of slower growth in prices in the early part of the year. Slovenia's harmonised price competitiveness indicator relative to 20 countries outside the euro area as measured by the HICP was up 2.2% in year-on-year terms, largely as a result of the rise in the euro. The adverse movement in the euro exchange rate meant that price competitiveness measured in this way declined compared with the end of last year, despite slower growth in domestic prices. Slovenia's price competitiveness relative to other euro area countries in the first half of the year improved slightly in year-on-year terms, and was also up on the previous six months.

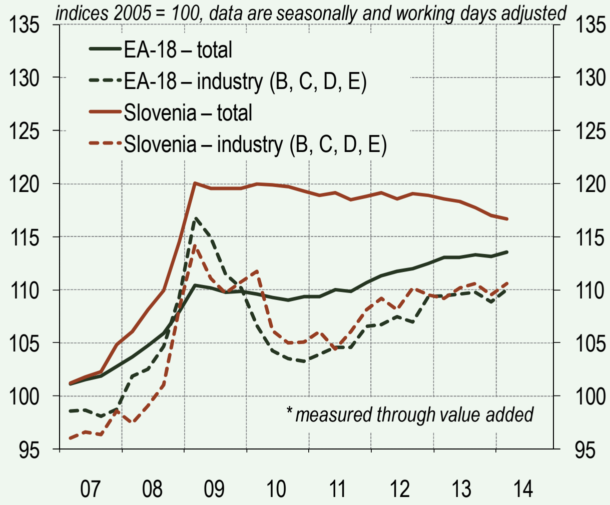
Slovenia's cost competitiveness on the markets of major trading partners in the first quarter strength-

Figure 3.10: Harmonized competitiveness indicators* (based on ULC deflators)



Source: ECB.

Figure 3.11: Nominal unit labour costs*



Source: Eurostat, Bank of Slovenia calculations.

ened again in year-on-year terms, but had been deteriorating in current terms for a lengthy period. The harmonised cost competitiveness indicator relative to other euro area countries as measured by ULCs was down just over 2% in year-on-year terms, which was attributable to higher growth in labour productivity and a decline in employee compensation. Nominal ULCs as measured by value-added declined by 1.5% in year-on-year terms in Slovenia, compared with an average rise of 0.5% across the euro area. Lower ULCs meant that Slovenia's cost competitiveness also improved on major markets outside the euro area, despite the adverse movement in the euro exchange rate. The harmonised indicator measuring cost competitiveness relative to 20 trading partners outside the euro area declined by 1.5% in year-on-year terms, lower ULCs contributing 4.2 percentage points towards the decline. There was a similar movement in the comparable indicator for the euro area over the same period. The quarterly dynamic in Slovenia's competitiveness was less favourable. The harmonised cost competitiveness indicator relative to other euro area countries increased for the first time since 2010, as a result of faster growth in employee compensation as growth in labour productivity increased. Alongside higher growth in ULCs, the current deterioration in competitiveness on markets outside the euro area was attributable to the rise in the euro. There were similar developments in the cost competitiveness of the euro area.

4 Financing

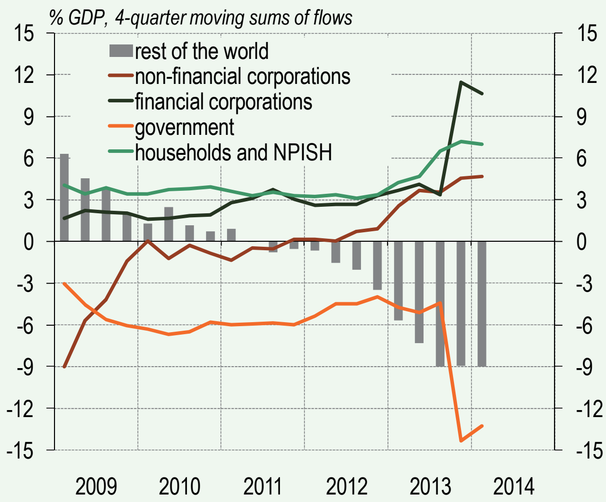
In a situation of increased household saving and weak corporate investment activity, the continuing of deleveraging by the private sector was reflected in an increase in the surplus of domestic saving over investment. Corporates became net savers in 2012, remaining in that position in 2013 and strengthening it in early 2014. This atypical position for the corporate sector is also a reflection of its accelerated deleveraging at banks. Should corporate deleveraging continue solely by means of debt repayments and without new financing, investment activity will remain weak, and corporates will be constrained in creating value-added and thereby economic growth. Households also increased their net saving, particularly in 2013, when as income stagnated they significantly reduced consumption and continued reducing the indebtedness at banks. Confidence in the domestic banking system gradually strengthened in the first half of 2014. This was reflected in an increase in deposits by the non-banking sector, to which almost all the sectors contributed. The increased confidence is the result of the successful process of the recovery, resolution and stabilisation of the banking sector, which is not yet complete and will continue to have an impact on bank balance sheet structure in the future. In 2014 the banks have continued reducing their liabilities to the Eurosystem and to banks from the rest of the world. The Slovenian banking system recorded a profit over the first half of the year, but an improvement in lending to the healthy non-banking sector will be necessary for the stable generation of future earnings.

Savings-investment gap by sector

Increased household saving, weak corporate investment activity and the measures to stabilise the banking system (together with the transfer of loans to the Bank Asset Management Company) in late 2013 and the early part of this year had a pronounced impact on the savings-investment gap in individual sectors of the economy. The one-year savings-investment (hereinafter: financial) surplus[11] vis-à-vis the rest of the world has stood at around 9% of GDP since the second half of 2013. Non-financial corporations[12] (hereinafter: corporates) continued to reduce investment, which was reflected in an increase in their financial surplus as they simultaneously accelerated their deleveraging. The savings-investment gap was zero even in the middle of 2012, but by the end of the first quarter of this year the corporate financial surplus had reached 4.7% of GDP. The household sector's financial surplus also strengthened sharply in 2013, ending the year at 7.2% of GDP. The main factor alongside stagnating income and continued deleveraging was a decline in consumption, i.e. in-

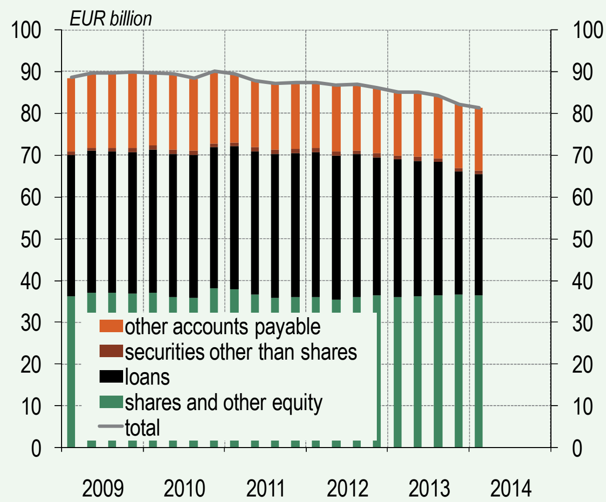
[11] The savings-investment gap is defined as the surplus of financial assets (savings) over financial liabilities (investments).
[12] According to the ESA 2010 definition, non-financial corporations (corporates) are legal entities that are market producers of goods and non-financial services.

Figure 4.1: Savings-investment gap



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

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



Source: Bank of Slovenia, consolidated data.

creased household saving. The situation on the labour market improved in the first half of 2014, as a result of which households moderately increased their consumption, reducing their financial surplus in the first quarter to 7% of GDP. As a result of government capital transfers designed to stabilise the banking system, financial corporations sharply increased their financial surplus towards the end of 2013, which was on the other hand reflected in an increase in the government sector's financial deficit.

Corporate financing and financial assets

Corporate financial liabilities stood at EUR 81.3 billion at the end of the first quarter of 2014, down EUR 4.7 billion on the end of 2012. This was primarily the result of a decline in liabilities from bank loans, where loan revaluations accounted for just over half of the decline.[13] The actual decline in loan liabilities was EUR 1.5 billion. In addition to the large decline in bank financing, there was also a decline of EUR 0.2 billion in domestic business-to-business financing via loans,[14] which was less affected than loan financing at banks. Corporate financing at banks contracted most in 2013, but the contraction continued in 2014: the year-on-year decline in bank loans stood at 12.6% in the middle of the year.[15] Liabilities from trade credits also declined, by EUR 759 million, liabilities to the rest of the world accounting for a third of this decline. Liabilities from shares and other equity in the first quarter remained at the same level as at the end of 2012, and were the most important source of corporate financing, accounting for 45% of the total. Loans received from the rest of the world were up EUR 0.6 billion, of which EUR 0.4 billion comprised a loan for the construction of the TEŠ 6 project.

Corporate financial assets amounted to EUR 41.6 billion at the end of the first quarter of 2014, down EUR 1.7 billion on the end of 2012. This was the result of a decline of just over EUR 2 billion in investments in shares and other equity, caused by negative revaluations. Investments in shares and other equity in the form of transactions increased by EUR 191 million, and at EUR 15.1 billion still accounted for the largest proportion of corporate assets. The second-largest corporate assets were trade credits and advances. Intra-sectoral

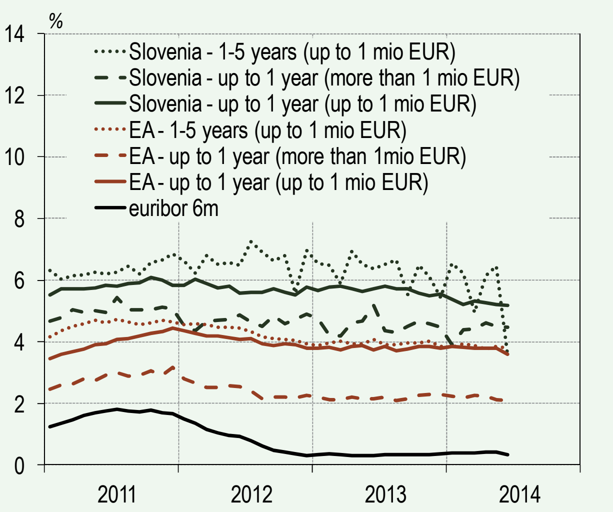
[13] The largest revaluation of loans comprised the transfer of bank loans to the Bank Asset Management Company (BAMC), which reduced corporate debt at banks by EUR 3.2 billion and increased liabilities from government sector loans by EUR 1 billion.
[14] The sharp decline in bank financing means that business-to-business loans account for an increasing proportion of corporates' loan financing.
[15] Year-on-year growth excluding the effect of the transfer of non-performing claims to the BAMC, the initiation of the orderly wind-down process at two banks, and the large loan impairments as a result of the asset quality review and stress tests.

trade credits and advances declined by EUR 486 million between the end of 2012 and the first quarter of 2014, almost equal to the increase in trade credits granted to the rest of the world. There were similar developments in business-to-business assets in the form of loans: loans between Slovenian corporates declined, while loans granted to the rest of the world increased. In line with the increase in exports and the weak domestic demand, corporates reduced domestic business-to-business lending, and invested some of these assets in the rest of the world. The largest increase in corporate assets was recorded by deposits at banks, which were up EUR 0.6 billion, the majority of the funds being earmarked for the construction of an energy facility (the TEŠ 6 project) in early 2013.

The decline in the banks' liability interest rates and the measures to stabilise the banking system at the end of 2013 helped to gradually reduce interest rates on new corporate loans, although they remained significantly higher than the euro area average. The interest rate on short-term corporate loans of up to EUR 1 million in the first half of the year was 1.7 percentage points higher than the euro area average, while the interest rate on short-term loans of more than EUR 1 million was 2.3 percentage points higher. There was a similar picture for long-term loans: the spread between interest rates in Slovenia and the euro area remained at 2 percentage points. The high asset interest rates are also a reflection of the higher indebtedness and thus the higher risk of Slovenian firms compared with the euro area average, but they are simultaneously an additional burden on corporates and are hindering their deleveraging and economic growth.

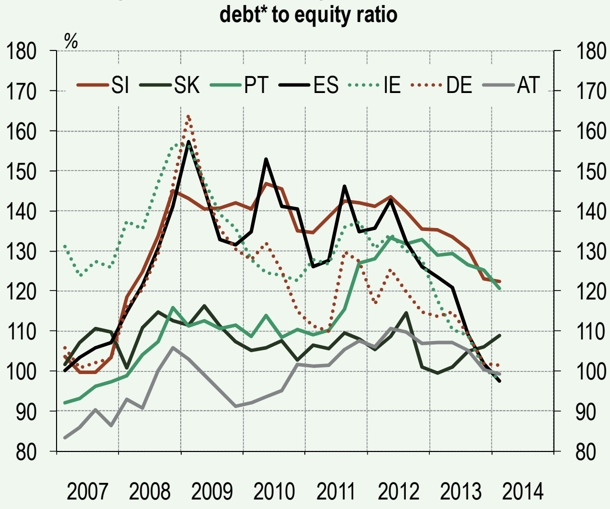
Corporates in Slovenia and in the majority of other euro area countries deleveraged further. Corporate indebtedness in Slovenia as measured by the debt-to-equity ratio at the end of the first quarter of 2014 was down 13 percentage points on the end of 2012 at 122%.[16] Domestic corporate indebtedness as measured by the ratio of debt to GDP stood at 84%, and remains below the euro area average. The difference between the two indebtedness indicators reveals the problems that Slovenian corporates have with an inappropriate financing structure i.e. with a lack of equity. The establishment of sustainable economic growth will require access to finance, which given new investment impetus should to a greater extent be based on equity and not only on debt financing.

Figure 4.3: Interest rates on loans to NFCs



Source: ECB, Bank of Slovenia.

Figure 4.4: Cross country comparison of NFCs debt* to equity ratio



*Note: * Securities other than shares, loans and other accounts payable.*
Source: ECB, Bank of Slovenia calculations.

[16] The largest decline occurred in the final quarter of 2013, as a result of the valuation of non-performing loans and the transfer of non-performing loans to the BAMC.

Box 4.1: Lending to Slovenian firms: analysis on the basis of micro data

The stock of bank lending to the Slovenian corporate sector has been declining over the last three years, most notably in 2013, when the stock of loans declined by 11%. Analysis was therefore conducted of corporate exposure to banks during the period between 2009 and 2013, November being selected as the cut-off date in order to eliminate the impact of December's results (of firms and banks). Firms were divided into two groups: less-indebted and more-indebted. A firm was defined as less-indebted if its total exposure to banks was less than EUR 2 million. The average number of firms in the sample was 25,700. Their total average annual exposure to banks was EUR 28.4 billion.

Three factors can have an impact on corporate exposure to banks between two successive cut-off times:[1]

1. A change in the number of firms or the amount of exposure as a result of debt repayment (or completed bankruptcy proceedings): a firm has a liability to at least one bank at time *t*, but no liabilities at time *t+1*,
2. A change in the number of firms or the amount of exposure as a result of a new credit relationship: a firm has no liabilities to banks at time *t*, but has liabilities at time *t+1*,
3. A change in the amount of exposure (no impact on the number of firms) as a result of an increase/decrease in firm exposure in existing credit relationships: a firm has a liability to at least one bank at time *t* and at time *t+1*.

The decline in the stock of bank lending was primarily a reflection of net repayments by firms that had previously been in a credit relationship with a bank. The less-indebted firms made net repayments of 11% of their total borrowing via loans in 2013 alone, while the repayments of the more-indebted amounted to 9%. In previous years net repayments by firms with an existing credit relationship were also more notable among the less-indebted firms, and less significant among the more-indebted.

Another factor in the decline in corporate exposure to banks in 2013 was the Financial Operations, Insolvency and Compulsory Dissolution Act, which made bankruptcy proceedings easier and faster for firms. The aforementioned law resulted in a significant exodus from the banks' credit portfolio,[2] particularly by less-indebted firms, but without a major reduction in the stock of loans. Among the more-indebted firms, the number of firms ending a credit relationship with a bank has been increasing since 2010, and this group has thus been reducing its exposure to banks over the years.

The sole factor that in previous years acted to increase corporate exposure to banks was the entry into a credit relationship by new firms, within which there was a large difference between the two groups. The amount of new lending to more-indebted firms (new customers) gradually declined between 2009 and 2013, but remained constant for less-indebted firms. It averaged just over EUR 400 million per year for the latter. Despite the constant amount of new lending made to less-indebted firms, the number of firms receiving the loans has gradually declined. The number of less-indebted firms newly entering into a credit relationship declined by a fifth in 2013.

The pace of deleveraging confirms that firms are adjusting in various ways in a situation of a sharp contraction in bank lending.[3] Firms facing hampered access to bank financing and stricter terms of financing are adjusting by reducing their demand for loans at banks and increasing their exploitation of alternative sources of financing, and by carrying out internal streamlining (use of retained earnings, reduction of investment, etc.). Firms that have at least one alternative possibility are thus making net repayments of their past bank liabilities. This became particularly evident in the second half of 2013, when firms became net savers, and further strengthened their net positive position in current terms in 2013. Despite the general pace of deleveraging, there is still a group of firms (mostly new SMEs) that predominantly lack any possibility of alternative financing, whose investments cannot be postponed until such time that they have internal resources, and that therefore need external sources of financing.

Less-indebted firms have a smaller number of relationships with banks than more-indebted firms. Three-quarters of less-indebted firms have a relationship with just a single bank, while more-indebted firms diversify their loans between banks: 70% of their lending has been obtained by means of parallel transactions with more than three banks. Transactions with a single bank account for almost half of the total bank exposure of less-indebted firms' total bank exposure,

Figure 1: Exposure of more indebted firms to banks

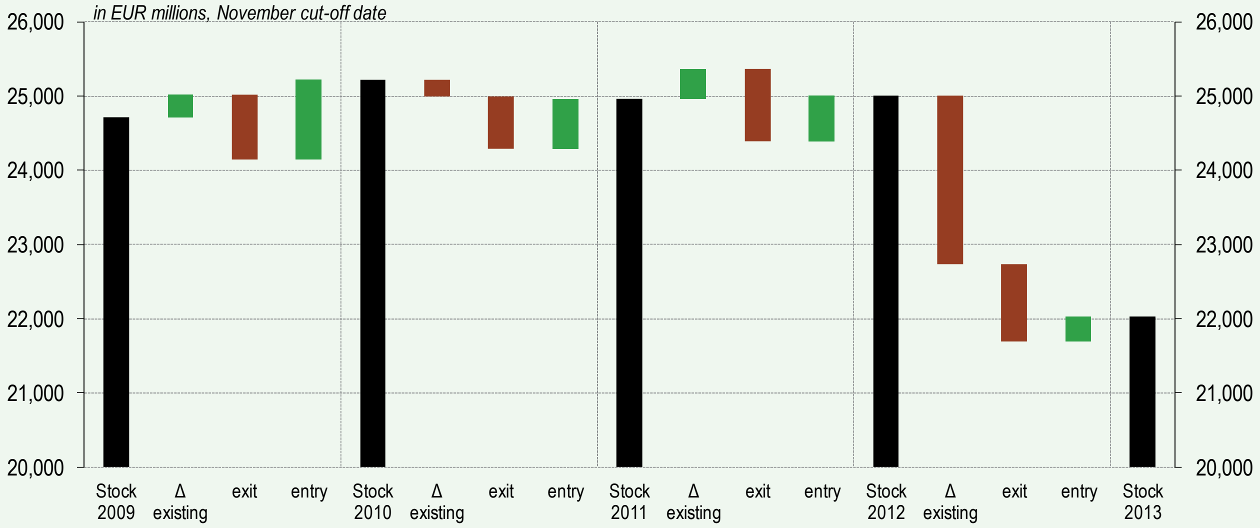
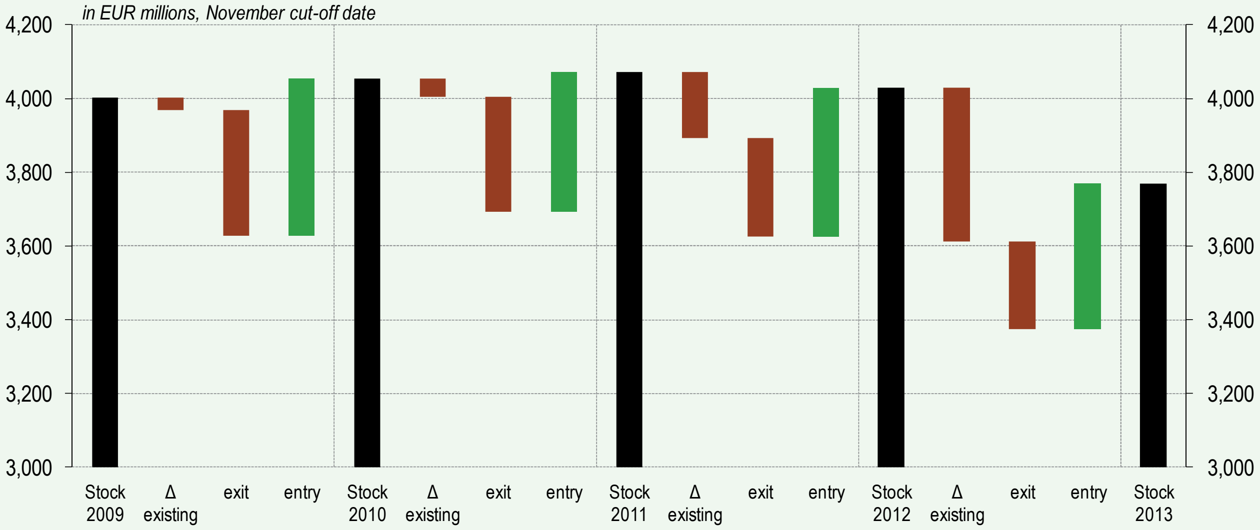


Figure 2: Exposure of less indebted firms to banks



Note: black columns – total exposure of firms to banks; red columns - reducing the exposure of firms to banks; green columns - increasing the exposure of firms to banks; Δ existing – net change in total exposure of firms, which had a credit relationship with at least one bank in both data cross-sections; exit - the amount of exposure of companies due to the repayment of debt or completed bankruptcy process; entry - the amount of exposure of companies due to new credit relationships; Source: Bank of Slovenia.

while simultaneous transactions with two banks account for a third. The sectoral breakdown of less-indebted firms does not show any major deviations.[4] For industrial firms 42% of lending is with a single bank on average, while 38% is with two banks simultaneously, compared with corresponding figures of 69% and 19% for firms in the real estate activities sector, and a half and a third for firms in construction and other services.

[1] Changes of status of indebtedness (transitions from less-indebted to more-indebted and vice-versa) were not controlled, although just 6% of firms were close to the threshold value of EUR 2 million (their indebtedness designation can change from year to year).

[2] More than 1,100 firms exited the banks' credit portfolio in 2013.

[3] The pace of deleveraging is also in line with the findings of the Survey on demand for loans by enterprises by sector and the Survey on the access to finance of enterprises, which explain the supply side and the demand side.

[4] The sectoral groups are defined according to NACE Rev. 2 as industry (other than construction), construction, services other than real estate activities, and real estate activities.

Box 4.2: Financing of SMEs

Small and medium-size enterprises (SMEs) are an important segment of the Slovenia economy, and not just in terms of number (99% of all firms in Slovenia are SMEs). SMEs provide three-quarters of all jobs in the private sector and account for more than 60% of the value-added generated by firms in Slovenia. In addition, they are an important instrument for promoting competitiveness in industry, and an important source of innovation, research and development.

SMEs face greater difficulties in accessing finance than do large enterprises, both generally and in Slovenia specifically. SMEs are primarily dependent on bank financing, and pay higher financing costs on average. There are several factors at work, notably including the greater uncertainty surrounding future performance, and the lower value of property, plant and equipment that the firms can use as collateral. Given the shallow, illiquid domestic capital market, their sources of financing are even more limited. Because innovation, research and development are important functions at the majority of SMEs, their investments usually cannot be deferred until they obtain sufficient internal resources, for which reason they are additionally dependent on external financing.

At the European level there are significant dedicated funds available for financing SMEs via various programmes of the European Investment Bank, the European Investment Fund and the European Mutual Guarantee Association. These programmes only provide funds via financial intermediaries (banks, the Slovene Enterprise Fund, regional development agencies, venture capital firms, investment firms, leasing companies, various funds, etc.[1]), which in turn finance the SMEs directly. On the domestic market the Slovene Enterprise Fund and SID banka offer significant financing for SMEs in conjunction with the commercial banks. Some of their financing programmes are available to firms directly, while others are available via financial intermediaries.

The central mission of the **European Investment Fund** (EIF) is to help European SMEs to access finance. The EIF's majority shareholder is the European Investment Bank (EIB), and together they form the EIB Group. The fund manages its own assets and the assets earmarked for it by the EIB or the EU, and distributes them to national financial intermediaries.

Relatively little EIF funding has been disbursed to Slovenia to date. As part of the Competitiveness and Innovation Programme (CIP) project carried out between 2007 and 2013, Slovenia drew down just over EUR 80 million of funding for promoting SME access to finance via the Slovene Enterprise Fund. Under the Progress Microfinance project begun in 2010, total funding of EUR 23 million has been drawn down by just three financial intermediaries to date.

Other than the two aforementioned programmes, Slovenia has to date not utilised other funding or products offered by the EIF. There are several instruments, primarily equity products, that could be utilised to increase capital at firms, such as the venture capital fund, co-investments with business angels, lower mid-market funds, and the technology transfer (a process that transforms the results of research into marketable products and instruments that can attract investment).

COSME 2014-2020 is a new EU programme that will serve SMEs between 2014 and 2020. COSME will help bridge the market gap in access to finance, in the internationalisation of business and in supporting enterprise. The programme will focus on vulnerable categories of firms that are currently under-nourished on the market, and will also encourage the development of entrepreneurial skills and young entrepreneurs. Its funding for the next seven years (for the entire EU) is currently projected at EUR 2.3 billion.

The **Horizon 2020** programme is the EU's central programme for promoting research and innovation. In the new financial period (to 2020) it will promote investments in key technologies and better access to capital, and will support SMEs in marketing innovative products and processes. It will allocate 20% of its funding to SMEs directly, a total of just over EUR 8.5 billion. The programme will primarily support firms in the establishment and start-up phase. A new feature is the possibility of combining funding between programmes.

There are also several mostly unexploited options for funding offered by the European Investment Bank (EIB). Slovenia has raised EUR 1.7 billion of funding at the EIB since 1998 for the purpose of financing SMEs, of which EUR 710 million has been in the last four years. Recently the EIB has been devoting more attention to the issues faced by SMEs and difficulties in accessing finance, for which reason it is offering several new initiatives:[2]

- EIB Trade Finance Initiative: the EIB provides guarantees to financial intermediaries that finance SMEs engaged in trade, both import and export.
- The Risk Sharing Instrument for Innovative SMEs is a guarantee fund for supporting SMEs that need investment financing and/or working capital to support research, development and innovation.
- The Skills for Jobs – Investing for Youth programme consists of two components. The first component, Jobs for Youth, encourages SMEs in recruiting young people, while the second, Investment in Skills, promotes investments in education, vocational training and student finance.

SID banka has been most active in recent years in the disbursement of EIB funds. By the end of 2013 it had borrowed EUR 300 million for the purpose of financing SMEs, offering these funds directly to SMEs via a variety of products, and indirectly to other banks for financing SMEs. The products currently available at SID banka for financing SMEs are direct financing from EIB resources, SID banka's development and incentive programme for microfinancing (loans of EUR 30,000 to EUR 100,000), SID banka's development and incentive programme for financing (loans of EUR 100,001 to EUR 1 million), the programme for the development of a competitive economy and internationalisation, and financing for technological development projects. Although the latter programme is currently closed, a new programme for the same purposes is expected to be announced in the autumn of 2014.

The **European Mutual Guarantee Association** (AECM) is an international non-profit organisation whose mission is to provide financial resources to firms with projects of commercial interest that are unable to provide sufficient collateral. Guarantees for bank loans issued by members of the AECM (including the Slovene Enterprise Fund and the Association of Regional Development Agencies) can compensate for the missing collateral, thereby allowing banks to issue loans to SMEs. The stock of liabilities from guarantees issued in Slovenia amounted to EUR 227 million at the end of 2012 (EUR 219 million by the Slovene Enterprise Fund and EUR 8 million by the Association of Regional Development Agencies).

The Slovene Enterprise Fund (SEF) adjusted some of its guarantee lines in previous years because of the impact of the financial crisis. The SEF currently provides micro guarantees for working capital, investment guarantees and guarantees for start-up firms. A loan secured by a guarantee from the SEF is more favourable for firms thanks to reduced collateral requirements, lower interest rates, longer loan maturities and the possibility of a repayment moratorium.

Banks are the most common financial intermediary in all of the aforementioned programmes. The stock of bank lending to SMEs in Slovenia amounted to just under EUR 7 billion in May 2014, just under a quarter of which was funded by earmarked funds. The majority of the earmarked funds were disbursed to banks from schemes operated by SID banka (59%), the EIB (20%) and the SEF (11%). In the given macroeconomic circumstances the utilisation of these earmarked funds is largely satisfactory, although in the event of adequate demand from financially viable firms (with a healthy core line of business) utilisation could further increase in the future.

An important segment of SMEs comprises firms that have a sound business plan and as-yet unrealised market potential, but have modest creditworthiness for various reasons (a short history as a going concern, a lack of assets, etc.). In these cases banks are usually unwilling to take up credit risk without adequate guarantees, for which reason in the rest of the world such firms are usually financed via venture capital funds and business angels. The European Investment Fund and the COSME programme offer funds and instruments dedicated to financing via venture capital funds and business angels, which at present are totally unutilised despite the existence of ten venture capital firms in Slovenia.[3] Certain venture capital firms have entered into a public-private partnership with the Slovene Enterprise Fund, and through them the SEF is providing firms with around EUR 19 million of specialist equity financing (venture capital and mezzanine capital) by the end of 2015.

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[1] For additional information on the current range of financial intermediaries and a brief overview of certain programmes, see http://europa.eu/youreurope/business/funding-grants/access-to-finance/.

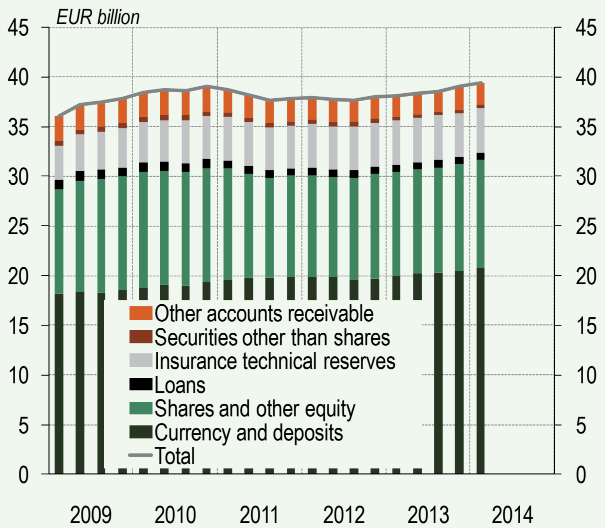
[2] The majority of these initiatives are not well-established and are in the pilot phase, and as a result demand would have to be greater for them to be established in Slovenia too.

[3] The Ministry of Economic Development and Technology administers a register of venture capital firms: http://www.mgrt.gov.si/si/zakonodaja_in_dokumenti/podjetnistvo_konkurencnost_in_tehnologija/drugi_pomembni_dokumenti/register_druzb_tveganega_kapitala/.

Household financing and savings

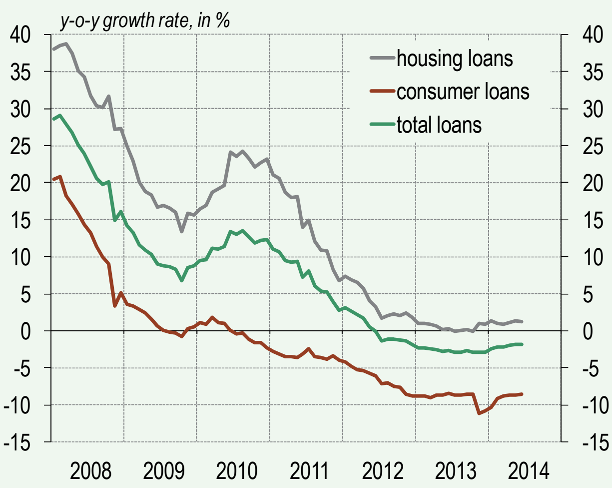
Households increased their assets by EUR 1.5 billion in 2013 and the first quarter of 2014, primarily as a result of an increase in investments in currency and deposits and a rise in the value of investments in shares and other equity. As their disposable income stagnated, the increase in households' assets in 2013 was primarily the result of a decline in consumption. The developments in Cyprus, the initiation of an orderly wind-down process at two banks and the uncertainty surrounding the results of the comprehensive assessment of the banking system sharply reduced household confidence in the domestic banking system last year. This was reflected in a decline in time deposits at domestic banks, and also in an increase in holdings of currency and sight deposits and in investments in the rest of the world (in the form of currency and time deposits). Confidence in the domestic banks was gradually restored after the release of the stress tests results and the recapitalisation of the largest banks. Households increased their deposits at domestic banks by EUR 397 million in the first half of 2014, equivalent to almost all of last year's outflow of household bank deposits. Investment in shares and other equity increased by EUR 354 million between the end of 2012 and the end of the first quarter of 2014, as a result of positive revaluations.

Figure 4.5: Financial assets of households (S.14 and S.15)



Source: Bank of Slovenia, non-consolidated data.

Figure 4.6: Loans to households



Source: Bank of Slovenia.

Household financial liabilities amounted to EUR 11.8 billion at the end of the first quarter of 2014, down EUR 322 million on the end of 2012. The largest factor in the decline was a decline in liabilities from bank loans, notably consumer loans. Although interest rates on consumer loans in Slovenia are almost 1 percentage point below the euro area average, consumer loans have been declining in year-on-year terms since the middle of 2010. The decline in the first half of 2014 amounted to 8.6%. After stagnating last year, housing loans were recording year-on-year growth of 1% at the end of 2013, which has now been maintained for just over half a year. Interest rates on new housing loans rose above the euro area average in the second half of last year, and were 0.4 percentage points above the euro area average in June of this year.

Slovenian household debt is half of the average household debt in the euro area. It amounted to 51% of annual disposable income or 32% of GDP at the end of the first quarter of 2014. Household debt to Slovenian banks accounted for three-quarters of total household debt, although the proportion of non-performing claims is merely around 4%. This ranks households as one of the lowest-risk bank customer groups.

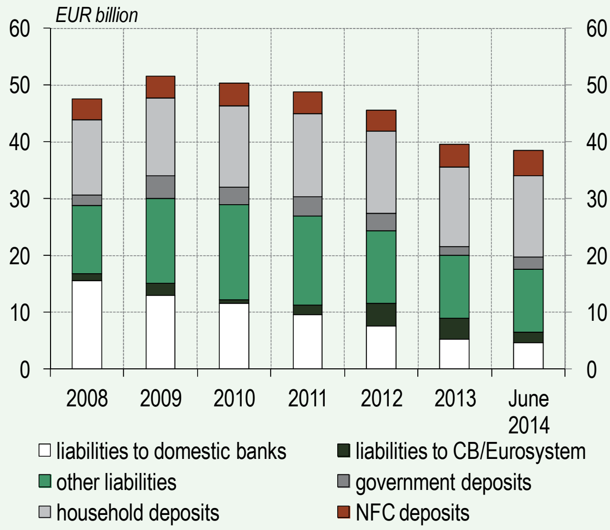
Bank funding

The process of the recovery, resolution and stabilisation of the domestic banking sector continued and had an impact on bank balance sheet structure. Total assets declined for the fourth consecutive year, and stood at 107% of GDP in June 2014. The banks continued the process of repaying debt to banks from the rest of the world in 2014, albeit at a slower pace than in the previous six years. Liabilities to foreign banks accounted for a third of total bank liabilities at the end of 2008, but just 12% at the end of June 2014. The banks increased their early repayments of 3-year LTROs this year, and reduced their liabilities to the Eurosystem by EUR 1.8 billion in the first half of the year. There were several factors at work: 1) the approaching maturity of the 3-year LTRO in the first quarter of 2015, which as of September 2014 the banks will be able to replace with a new non-standard ECB measure (the targeted LTRO); 2) the introduction of a negative interest rate on the ECB's deposit facility; 3) surplus liquidity in the banking system as a result of the recovery of the banking sector (improved confidence in the domestic banking system and the return of deposits to the banks, improved capital adequacy, lower exposure to credit risk); 4) the revocation of access to ordinary ECB instruments at the two banks undergoing the orderly wind-down process. Liabilities from debt securities also declined in the first half of the year, by EUR 108 million, primarily as a result of the prepayment of SID banka bonds.

The stock of deposits by the non-banking sector increased by EUR 1.5 billion in the first half of the year, virtually all sectors contributing to the increase. Household confidence in the domestic banking system strengthened, and in the first half of 2014 households returned almost all of last year's outflow of deposits to the banks. Corporates also increased their bank deposits in the first half of the year, by EUR 413 million. These were primarily deposits of shorter maturities. The largest contribution to the increase in deposits by the non-banking sector came from government deposits, which increased by EUR 618 million in the first half of the year, although this was primarily the result of the overnight placement of funds by the Ministry of Finance at the end of the month.[17]

The Slovenian banking system recorded a profit over the first half of the year, but for the stable generation of earnings in the future it will be necessary to increase lending to the healthy non-banking sector and to stem the deterioration in the credit portfolio.[18] The proportion of non-performing claims more than 90 days in arrears at the banks declined after the transfer of non-performing claims to the BAMC, but increased by 2 percentage points in the first half of this year to 15.3%. The banks disposed of half of their gross income in the first half of the year on operating costs, and a third on net impairments and provisioning. The remainder of EUR 85 million constituted their realised profit. Impairment and provisioning costs in the first half of the year were half of those in the same period last year.

Figure 4.7: Selected liabilities of domestic banks



Source: Bank of Slovenia.

[17] The current relatively good liquidity of the domestic banks is reducing the banks' demand for government deposits of shorter maturities, as a result of which the government is increasing its stock of overnight placements.

[18] The Bank of Slovenia has been trying since 2012 to encourage, accelerate and improve the processes of restructuring firms with good prospects and to improve the effectiveness of the recovery or write-off of claims against non-viable firms by means of various activities.

5 Public Finances[19]

The timely elimination of the excessive deficit, sustainable over the medium term and long term, is a priority task in the fiscal area, together with ensuring the sustainability of government debt. The reduction of the general government deficit will take place in conditions of weak economic activity, and will be additionally hindered by expenditure of a one-off nature and the rising share of interest expenditure. The key is a credible strategy of fiscal consolidation, and the widest possible consensus on measures to reduce the general government deficit and debt. The measures should be designed to minimise their short-term adverse impact on economic activity and on the weakest members of society. The general government debt had risen to 78.7% of GDP by the end of the first quarter of 2014, and is forecast to rise slightly further by the end of the year. The required yield on Slovenian long-term securities has fallen steadily since the measures to strengthen bank stability were taken at the end of last year. In recent months the government has primarily borrowed via treasury bills, mostly 12-month bills, whose interest rates have also fallen.

General government deficit

The general government deficit excluding support for financial institutions is forecast at 3.2% of GDP this year according to the Stability Programme (April 2014). Figures for public finance aggregates according to the ESA 1995 methodology are available only for the first quarter of this year. The general government deficit declined in year-on-year terms, and excluding support for financial institutions amounted to 4.2% of GDP over the last four quarters, down a little on the end of last year. After increasing last year, general government revenues were also up in year-on-year terms in the first quarter, while expenditure excluding support for financial institutions declined. According to the plans in the Stability Programme, this year's general government deficit is forecast at 4.1% of GDP, which includes 0.9% of GDP in support for financial institutions.

Transactions of a one-off nature have had a major impact on public finance developments in recent years, and are doing so again this year. Measures to stabilise the banking system had the largest impact on public finances. Bank recapitalisations have contributed more than 11% of GDP to the general government deficit in the last three years, the majority in 2013.[20] Measures to stabilise the banking system will widen the deficit again in 2014.[21] Two other transactions had a major impact on public finances in the final quarter of last

[19] All shares in GDP in this section are calculated on the basis of GDP figures under the ESA 1995 methodology.
[20] Bank recapitalisations contributed EUR 243 million (0.7% of GDP) to the deficit in 2011, EUR 61 million (0.2% of GDP) in 2012, and EUR 3,633 million (10.3% of GDP) in 2013.
[21] The European Commission approved state aid for Abanka in the amount of EUR 243 million in August. This was the second tranche of recapitalisation, the bank having received the first tranche (EUR 348 million) last December.

Table 5.1: General government deficit and debt in Slovenia 2009–2018*

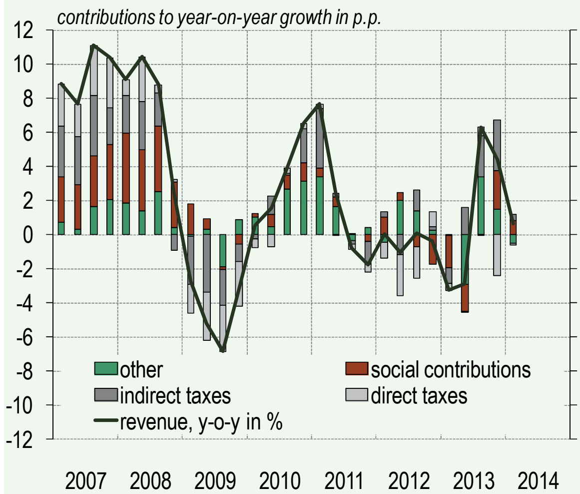
	SORS					Stability Programme					EC	
as % GDP	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2014	2015
Revenue	42.3	43.6	43.5	44.4	44.7	46.4	45.5	44.6	43.8	43.4	45.2	44.4
Expenditure	48.7	49.5	49.9	48.4	59.4	50.5	47.9	46.1	44.5	43.1	49.5	47.4
of which: interest	1.4	1.6	1.9	2.2	2.6	3.4	3.3	3.3	3.1	3.0	3.0	2.9
Net lending (+) / borrowing (-)	-6.3	-5.9	-6.4	-4.0	-14.7	-4.1	-2.4	-1.5	-0.7	0.3	-4.3	-3.1
excl. support to fin. Institutions	-6.3	-5.9	-5.7	-3.8	-4.4	-3.2	-2.4	-1.5	-0.7	0.3	-3.4	-3.1
Structural balance	…	…	…	…	…	-2.0	-1.5	-1.0	-0.7	-0.1	-2.5	-2.4
Debt	35.2	38.7	47.1	54.4	71.7	80.9	81.1	76.0	72.5	70.4	80.4	81.3
Real GDP (growth, %)	-7.8	1.2	0.6	-2.6	-1.0	0.5	0.7	1.3	1.7	1.7	0.8	1.4

** All data according to ESA 1995 methodology, except for the real GDP published by SORS, which is according to ESA 2010 methodology.*
Source: SORS (realisation), Ministry of Finance (April 2014), European Commission (EC, May 2014).

year: 1) the Supreme Court ruling in relation to funding for eliminating wage disparities, which according to the available figures increased the deficit by around 0.3% of GDP, and 2) the ruling in connection with compensation for people erased from the register of permanent residents, which contributed 0.4% of GDP to the deficit. The impact of the two rulings in increasing government expenditure is shown in Figure 5.2 under the categories compensation of employees and other. In addition, in July 2014 the European Court of Human Rights ruled that Slovenia has to repay savers who held old foreign currency deposits. According to the available figures, the principal amounts to around EUR 250 million, and interest on late payment will also have to be paid. Slovenia has one year to draw up a payment scheme. This May's payment of the concession fee for mobile telephony radio frequencies had a positive impact on public finances in the amount of 0.4% of GDP.

General government revenues have increased this year, as a result of the improved economic situation and also as a result of measures taken last year. The main impact on general government revenues in the first half of the year came from last year's rise in VAT rates. Revenues from indirect taxes were up 4.8% last year, and continued to rise in the first quarter of this year, primarily as a result of increased VAT revenues. According to the available figures, the rise continued in the second quarter of this year. Revenues from excise duties during the first seven months of the year were down slightly in year-on-year terms, despite this year's rise in excise duty levels. The situation on the labour market improved in the first half of this year, which had a beneficial impact on revenues from social security contributions. The year-on-year rate of growth stood at 2.3% in the first quarter, and growth will continue over the remainder of the year according to the available figures.

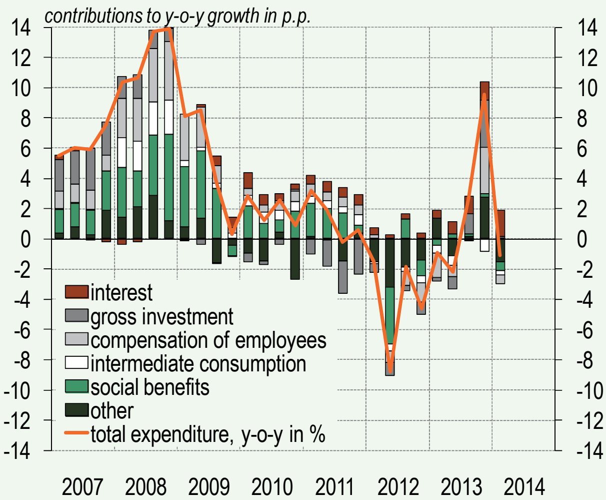
Figure 5.1: General government revenue



Source: SORS, Bank of Slovenia calculations.

General government expenditure declined in the first quarter of this year, despite significant growth in interest expenditure. It was down just over 1% in year-on-year terms (excluding bank recapitalisations). As in 2013, compensation of employees (excluding the effect of the court ruling in connection with wage disparities) declined in the first quarter of 2014, having remained subject to the impact of the measures in the field of public sector wages, while there was also a decline in employment. Expenditure on intermediate consumption was down 2.5%. Interest expenditure continued to increase, and was up almost 35%. Interest expenditure will exceed 3% of GDP in 2014, and is forecast to be around 0.6 GDP percentage points higher than last year. Social security benefits and support in the first quarter were down 1.4% on the same period last year. Unemployment benefits and expenditure on family benefits and parental benefits also declined. By contrast, expenditure on pensions increased, albeit by less than last year. The year-on-year rise in the number of pensioners began to slow, and stood at just over 1% over the first seven months of the year, while no pension alignment was carried out. Expenditure on government investment increased in the first quarter, and the current monthly figures suggest growth over the entire first half of the year.

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



Source: SORS, Bank of Slovenia calculations.

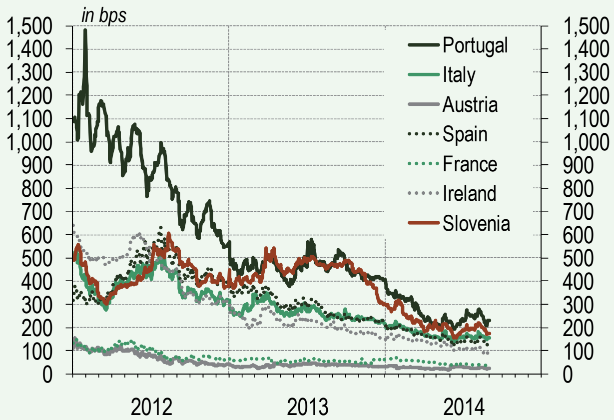
General government debt and government guarantees

The issue of long-term foreign currency bonds increased the general government debt in the first quarter of 2014. This was followed in the second quarter by the issue of long-term bonds in the domestic currency. The general government debt amounted to EUR 27,973 million or 78.7% of GDP at the end of the first quarter, up around EUR 2.7 billion on the end of last year. The increase in the debt was primarily related to February's issue of 5-year and 10-year bonds denominated in US dollars, which were hedged against currency risk. The total nominal value of the issue was EUR 2.6 billion. Bonds denominated in the domestic currency were issued again in April after a break of three years. The maturities of the two bond issues were 3.5 and 7 years, while the nominal value of each issue was EUR 1 billion. The coupon rates were 1.75% for the 3.5-year bond and 3.0% for the 7-year bond. The state budget, which accounts for the majority of the debt, additionally borrowed a total of EUR 0.8 billion until July via treasury bill issues. The corresponding interest rates were down significantly on last year's. The heaviest borrowing was via 12-month treasury bills, the rate on which stood at 0.29% in September 2014, compared with 2.95% a year earlier. The state budget repaid debt in the amount of EUR 1.9 billion over the first seven months of the year, of which EUR 1.5 billion related to the maturing of RS65 government bonds in April, while the remainder primarily comprised maturing treasury bills. The state budget increased its placements in bank accounts by almost EUR 2 billion during this period. According to the Ministry of Finance's April forecasts, the general government debt is expected to increase slightly further to reach close to 81% of GDP by the end of the year.

The high calls of government-guaranteed liabilities in the first half of the year were related to the implementation of measures to stabilise the banking system. A total of EUR 431 million of guarantees were called in the first seven months of the year, the majority (EUR 428 million) of which related to the orderly wind-down of Probanka and Factor banka. The guarantee is to be gradually repaid to the government on the basis of recourse claims. Government guarantees and sureties amounted to EUR 7.9 billion or 21.6% of GDP[22] at the end of the first half of the year, down on the end of last year. This was primarily related to the repayment of maturing loans by DARS d.d. and to the aforementioned guarantee call. Guarantees for obligations of DARS d.d. and guarantees for liabilities of EFSF relating to the assistance to euro area countries in financial distress accounted for approximately half of the stock of guarantees at the end of June.

The required yield on long-term Slovenian government bonds fell significantly over the first nine months of this year. It was down around 2.3 percentage points, at close to 2.6% in early September. The spread over the benchmark German long-term bond also declined by around 125 basis points to stand at around 175 basis points in early September. The fall in the yield began at the end of last year, after the measures to stabilise the banking system had been taken. The fall stalled temporarily in late April as a result of increased political tensions in Slovenia. The ECB's stimulative monetary policy also had a beneficial impact on the fall in yields on the government bonds of euro area countries.

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



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 09/24 is used after 1. January 2013.
Source: Bloomberg, Bank of Slovenia calculations.

Planned developments in the general government deficit

Slovenia is committed to eliminating the excessive general government deficit by 2015, which remains one of the priority tasks of economic policy. In June 2013 the EU Council extended Slovenia's deadline for eliminating the excessive government deficit by two years to 2015. The EU Council recommendation of June 2013 set the interim headline deficit targets as 3.7% of GDP in 2013 (or 4.9% including one-off expenditure for bank recapitalisations), 3.3% of GDP in 2014 and 2.5% of GDP in 2015. The improvement in the structural balance is thereby estimated at 0.7% of GDP in 2013 and 0.5% of GDP in 2014 and 2015. The target in 2013 was not met, the general government deficit having reached 4.4% of GDP excluding expenditure for bank recapitalisation, while the structural position improved by 0.2% of GDP according to the European Commission estimates of May 2014. In the April report on the general government deficit and debt the Ministry of Finance was forecasting a general government deficit of 3.2% of GDP this year excluding bank recapitalisations, while bank recapitalisations are forecast to contribute an additional 0.9% of GDP. The deficit is forecast to continue narrowing in the coming years.

The new government outlined certain fiscal policy guidelines in the coalition agreement. The adjustment is primarily to be made on the expenditure side, while changes are made to tax structure. Under the fiscal framework adopted, the excessive general government deficit should be eliminated by the end of 2015, provided that the deficit in 2014 does not deviate significantly from the forecast. The changes on the revenue side are to focus on changes in the structure of taxes, and not on rises in existing tax rates. These changes include: (i) equal taxation of all categories of taxpayers, and elimination of the existing differences in taxation levels, (ii) consideration of a change to personal income tax brackets in the sense of reducing the tax burden on the

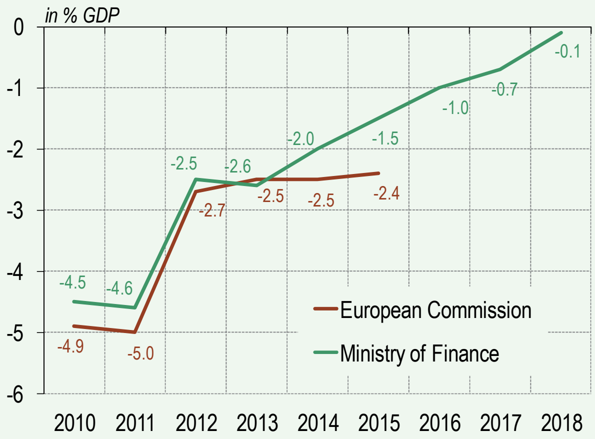
[22] GDP according to the ESA 2010.

wages of the highly qualified, (iii) more effective collection of existing public levies and measures to curb the grey economy (including the introduction of fiscal cash registers), (iv) the preparation of a real estate tax, and (v) more effective disbursement of European funds. The adjustments on the expenditure side are to be undertaken via (i) the renewal of measures already taken to restrain wages and labour costs, (ii) the maintenance of social transfers at the same levels until economic growth reaches 2.5%, (iii) constraints on growth in expenditure on pensions[23] and (iv) rationalization of public funds and institutions. Fiscally neutral green budget (tax) reforms are also to be carried out, under which the gradual abolition of environmentally harmful subsidies should create the conditions for gradually reducing the burden on labour.

The elimination of the excessive general government deficit in a sustainable manner and the achievement of a balanced structural position will require implementation of the measures of a structural nature. Measures that only reduce the general government deficit in the short term do not improve the structural position of the public finances, and merely entail postponing adjustments until the future. The restriction or linear contraction of certain discretionary expenditure (e.g. investment, subsidies, intermediate consumption) cannot be successful in the long term if it is not based on concrete measures.[24] Contraction during one period is followed by pressure to increase expenditure, and thus the deficit, in the following period. In addition, policies of these type are increasing the proportion of fixed budget expenditure, which is reducing the possibility of making adjustments in the coming years.

The medium-term target of a balanced structural position is expected to be achieved gradually. In the updated Stability Programme from April 2014, Slovenia forecast the attainment of an approximately balanced structural position in 2018. A balanced budget rule in the structural sense was written into the constitution in May 2013. The fiscal framework is expected to be strengthened in the future by the adoption of secondary legislation, the adoption of which is already behind the legal deadlines, and by the establishment of a fiscal council as an autonomous independent body.

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.
Source: EC, Ministry of Finance - Stability Programme, April 2014.

In the coming years Slovenia can be expected to see reforms of the pension and healthcare systems, and the regulation of long-term care. The aforementioned fields have long been defined as areas in which changes are demanded by the anticipated consequences of the ageing population for public finances. The long-term sustainability of public finances was improved slightly by the most recent pension reform, but the expenses of the pension system are expected to begin rising again after 2020. Further measures must therefore be drawn up. This is also one of the recommendations of the European Commission, which cites the need to adjust key parameters to ensure the sustainability of the pension system, including linking the statutory retirement age to gains in life expectancy. To ensure the financial sustainability of

[23] The budget is to provide additional funds for the annual bonus for pensioners in the amount of EUR 40 million, while at the same time a pension alignment is only to be made if economic growth in the previous year exceeds 2.5%. The current Bank of Slovenia projections suggest lower growth over the projection horizon.
[24] In July of this year the Ministry of Finance published its Rules on the completion of implementation of central government budget, which stopped liabilities being absorbed by this year's budget as of July.

health insurance, the coalition agreement envisages that in accordance with the principle of solidarity the burden in the form of contributions should be shared equally among the insured persons, while the Health Insurance Institute is to be relieved of responsibility for certain payments (e.g. physicians' specialisations). Supplementary health insurance is to be abolished, and replaced by levies. Certain existing resources will be earmarked for financing long-term care, while the possibility of additional resources will be studied.

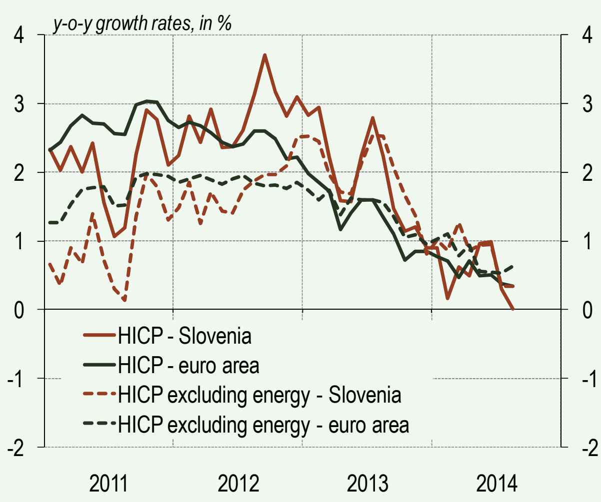
6 Inflation

The inflation dynamics this year have been affected by the continuation of relatively weak domestic demand, falling commodity prices on global markets, fiscal measures dropping out of the inflation calculation, and other base effects. Growth in the harmonised index of consumer prices averaged 0.6% over the first eight months of the year, 1.7 percentage points less than in the same period last year and almost the same as the euro area overall. The difference in price growth between Slovenia and the euro area overall derives largely from the pass-through of the effects of the consolidation measures and administrative measures from last year. Core inflation remains low this year. Despite certain positive developments in economic activity and the labour market, consumers remain cautious in their purchase decisions, as they face considerable uncertainty surrounding employment and future real disposable income.

Structure of inflation

The structure of inflation during the first eight months of the year changed compared with the same period last year. The contributions made by food and energy declined sharply, while there was no significant change in the contributions made by services and non-energy industrial goods. The contribution made by food prices recorded the largest decline. After recording high growth in 2013, prices of unprocessed food have been falling in year-on-year terms since February this year, which resulted in a negative contribution to inflation. The contribution made by prices of processed food also declined, which was due to the rise in excise duties on tobacco products in previous years dropping out of the calculation, falling food prices on global markets and domestic retailers' pricing policies. The contribution made to headline inflation by energy prices was lower than last year, as year-on-year growth in energy prices declined as a result of lower oil prices on global markets and base effects. The contribution made by services prices also declined slightly, largely as a result of last year's price rises related to administrative changes and fiscal consolidation dropping out of the calculation. In line with weak demand, prices of non-energy industrial

Figure 6.1: Inflation



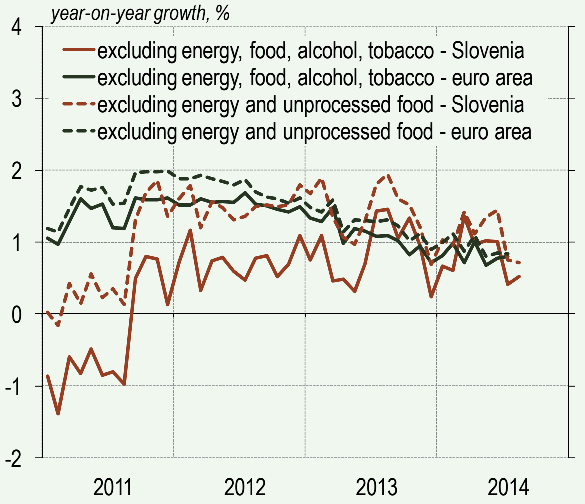
Source: Eurostat, SORS, Bank of Slovenia calculations.

goods continued to fall, albeit by less than last year. In the euro area the contributions made by all components also declined on average, most notably the contributions made by food prices and energy prices. The structure of inflation in the euro area overall in the first eight months of this year was similar to that in Slovenia.

Macroeconomic factors and core inflation indicators

Core inflation remained low and over the first eight months of the year it was on average at the euro area level. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged 0.8% over the first eight months of the year, unchanged on the same period last year. It was higher in the first half of the year, but slowed significantly in July as last year's rise in VAT rates dropped out of the inflation calculation. The narrowest core inflation indicator thereby fell slightly below the euro area average. Average year-on-year growth in the narrowest core inflation indicator over the first eight months of this year in the euro area overall was the same as in Slovenia. Services prices were the main factor raising its year-on-year rate in Slovenia, while prices of non-

Figure 6.2: Core inflation



Source: Eurostat, Bank of Slovenia calculations.

Table 6.1: Breakdown of the HICP and price indicators

	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2014	2010	2011	2012	2013	1H14	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14*
HICP	*100.0%*	2.1	2.1	2.8	1.9	0.7	1.8	2.2	1.1	0.6	0.8	0.2
Breakdown of HICP:												
Energy	*14.7%*	13.9	8.8	9.0	1.8	-1.0	1.6	1.0	-0.1	-2.3	0.2	-1.0
Food	*23.6%*	2.5	4.8	4.7	4.9	1.1	5.5	5.2	2.4	1.5	0.7	0.0
processed	*16.1%*	2.9	5.0	4.7	3.6	2.3	3.6	3.6	2.3	2.2	2.4	1.8
unprocessed	*7.5%*	1.7	4.3	4.5	7.6	-1.4	9.6	8.6	2.7	0.1	-2.8	-3.6
Other goods	*26.4%*	-2.2	-0.9	-0.2	-0.9	-0.6	-1.6	-0.7	-0.5	-0.5	-0.6	-1.1
Services	*35.2%*	1.2	0.0	1.5	2.2	2.1	2.3	2.9	2.0	1.9	2.3	1.5
Core inflation indicators:												
HICP excl. Energy	*85.3%*	0.3	1.0	1.8	1.9	1.0	1.8	2.4	1.3	1.1	0.9	0.3
HICP excl. energy and unprocessed food	*77.8%*	0.2	0.7	1.5	1.4	1.2	1.1	1.8	1.1	1.1	1.3	0.7
HICP excl. energy, food, alcohol and tobacco	*61.7%*	-0.4	-0.4	0.7	0.9	0.9	0.5	1.3	0.8	0.9	1.0	0.5
Other price indicators:												
Industrial producer prices on domestic market		2.0	3.8	1.0	0.3	-1.2	0.3	0.1	-0.3	-1.0	-1.4	...
GDP deflator		-1.1	1.2	0.3	1.4	0.8	1.7	1.4	2.1	1.2	0.4	...
Import prices[1]		6.5	5.6	2.3	-1.2	-1.5	-1.0	-2.5	-1.8	-1.8	-1.3	...

*Note: [1] National accounts figure. * Average for the third quarter is calculated only on the basis of data for July and August.*
Source: SORS, Eurostat, Bank of Slovenia calculations.

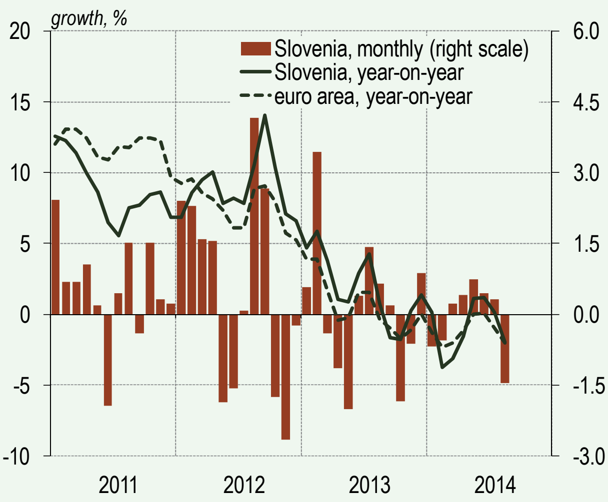
energy industrial goods reduce it. The low growth in this core inflation indicator was largely due to limited domestic consumption, as real household purchasing power in Slovenia having remained weak. The other two core inflation indicators also declined this year. Growth in the HICP excluding energy and unprocessed food averaged 1.1% over the first eight months of the year. That the rate is higher than the other two core inflation indicators is primarily attributable to this year's rise in excise duties on alcohol and tobacco products. Growth in the broadest indicator, the HICP excluding energy, averaged 0.8% over the first eight months of this year, the same as in the euro area overall.

Despite the improvement in economic activity, core inflation developments remained subject to the cautious behaviour of households. The improvement in the situation on the labour market and the increase in the real wage bill did not translate into a sustained increase in final consumption. The stock of consumer loans has continued to decline. The low level of core inflation still indicates an absence of demand-side inflationary pressures, Slovenian households having remained lacking in confidence in the future situation on the labour market, despite some positive developments. Wage growth has also been outpaced by productivity growth recently, an important factor in corporate cost adjustment. Given the fall in input commodity prices, there are also no major price pressures on the supply side.

Microeconomic factors and the structure of inflation

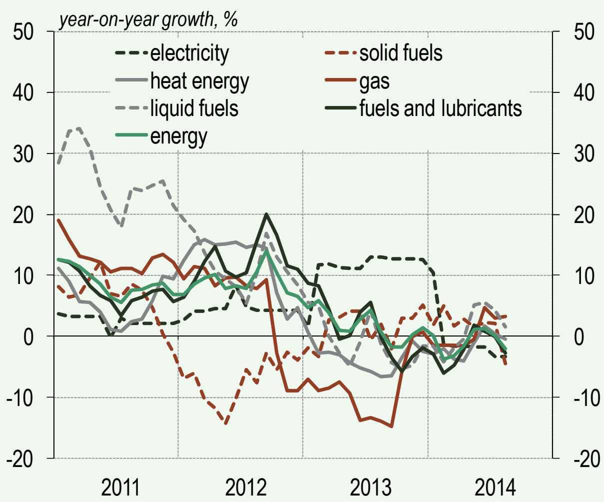
Year-on-year growth in energy prices declined in the first eight months of the year, primarily as a result of a fall in prices of refined petroleum products caused by lower import prices of oil and cuts in excise duties. Year-on-year growth in energy prices averaged -1.0% over the first eight months of the year, 4.0 percentage points less than in the same period last year, but 0.2 percentage points more than the euro area average. The main factor in the decline was a fall in prices of refined petroleum products, which was attributable to lower oil prices on global markets and cuts in excise duties. After last year's rise in the charge to support greater sustainability in electricity production dropped out of the calculation in February, electricity prices have been falling in year-on-year terms for the first time since the figures became available. Heat energy prices also fell. The year-on-year growth rate was reduced further in July by the effect of last year's rise in VAT rates dropping out of the calculation, energy prices having recorded the highest pass-

Figure 6.3: Energy prices



Source: Eurostat, Bank of Slovenia calculations.

Figure 6.4: Individual energy price categories



Source: Eurostat, Bank of Slovenia calculations.

Box 6.1: Impact on inflation of global and domestic factors

Inflation in Slovenia has fallen sharply since its peak of 3.7% in September 2012. The fall occurred during a period of low global economic activity, slow movements in global commodity prices, a rise in the euro, weak domestic demand and strengthened fiscal measures, most notably a rise in VAT, the effect of which had mostly dropped out of the inflation calculation by July of this year. The relative importance of global and domestic factors in the fall in inflation is assessed in this box. According to Bank of Slovenia estimates, the contribution made by external (i.e. global) factors to Slovenia's falling inflation during the period in question amounted to 2.0 percentage points, while the contribution made by all domestic factors amounted to 1.7 percentage points.

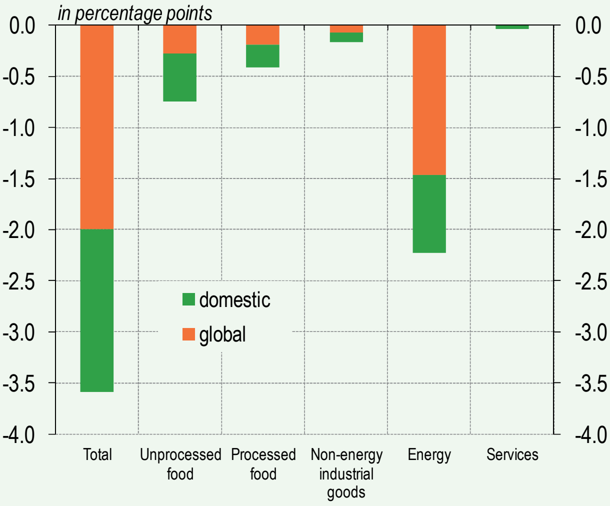
A number of external factors have acted to reduce inflation in recent years.[1] Oil prices on global markets, which after falling in the crisis rose rapidly between the beginning of 2009 and the beginning of 2012, stabilised. Prices of food commodities began falling in the second half of 2012, while prices of non-energy industrial goods have been falling since the end of 2011. The decline in these pressures has been supported by the euro's rise against the US dollar since mid-2012. The impact of all of these factors was to a great extent reflected in a fall in import prices of industrial products.

A more detailed assessment of the impact of global factors on domestic inflation is hindered by the fact that various factors can be interrelated, and can have an impact on retail prices through multiple channels. Their impact on final prices also depends on the response of domestic producers and retailers to changes in import prices.

The impact of global factors on headline HICP inflation can broadly be estimated via analysis of the contributions of individual components of the HICP. Some of them, energy prices for example, are more sensitive to changes in global prices than others. The contribution to inflation made by energy prices declined by 2.2 percentage points between September 2012 and August 2014, thereby accounting for 60% of the overall fall in inflation over this period.

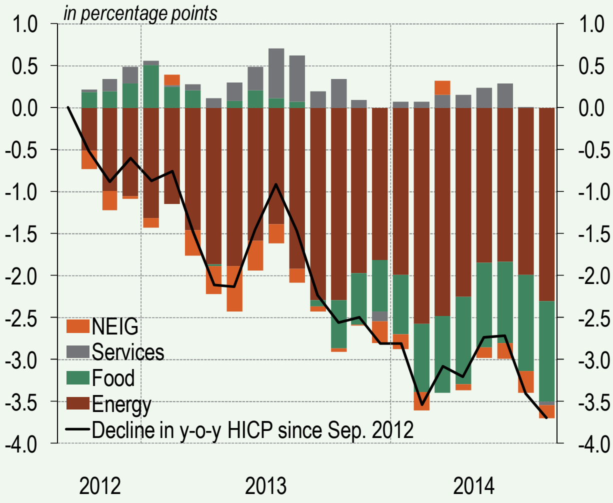
Among energy prices, refined petroleum products are notably under the strong, direct influence of global oil prices and the euro exchange rate against the US dollar. Developments in US dollar oil prices, refinery margins and the euro / US dollar exchange rate accounted for approximately 66% of the fall in year-on-year inflation in prices of refined petroleum products. The sharp deflationary impact of prices of refined petroleum products was not related solely to external factors, but also to domestic factors, in particular changes in the tax burden on final prices of refined petroleum products. Of the other energy price categories, prices of electricity and heat energy also contributed to the fall in inflation over the period in question, as did gas prices as a result of the entry of a new provider

Figure 1: Contributions of domestic and global factors to the decline in HICP during September 2012 to August 2014



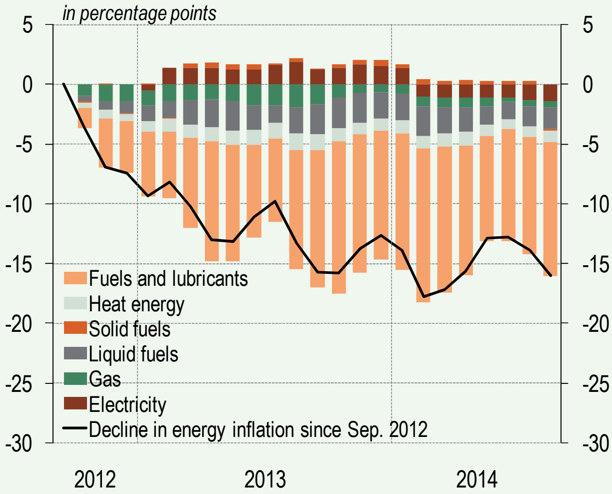
Source: Eurostat, Bank of Slovenia calculations.

Figure 2: Contributions to the decline in headline HICP inflation since September 2012



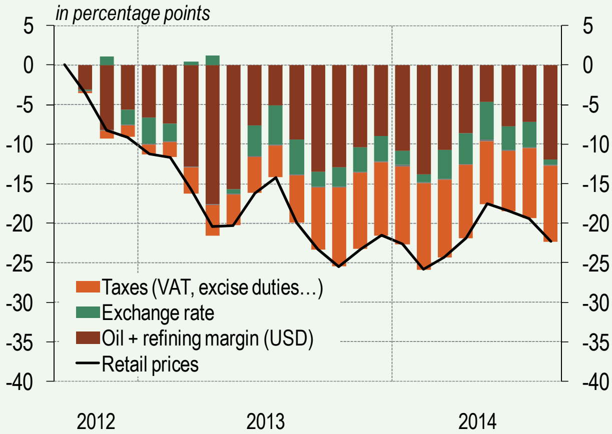
Source: ECB, Bank of Slovenia calculations.

Figure 3: Contributions to the desinflation in energy prices since September 2012



Source: ECB, Bank of Slovenia calculations.

Figure 4: Contributions to the decline in price inflation in liquid fuels since September 2012



Source: Ministry of Economy, Decree setting prices for petroleum products, Decree on the definition and methods of calculating a special fee for carrying out the public service obligation to form compulsory stocks of crude oil and petroleum products, Bank of Slovenia calculations.

into the market.

Food prices are the other component that has contributed most to the fall in inflation since September 2012. Their contribution to inflation had declined by 1.2 percentage points by August 2014, and is responsible for 30% of the fall in inflation over this period, most notably in the second half of 2013 and the first half of 2014. Prices of unprocessed food fell significantly. The fall in global prices of food commodities and, even more so, price adjustments by domestic producers and retailers acted to reduce prices of processed food. Rises in excise duties on tobacco prevented a further fall in prices of processed food.

While the decline in year-on-year inflation in the last two years has primarily been attributable to the fall in prices of energy and food, the contribution made by prices of non-energy industrial goods also declined, and the contribution made by services prices remained unchanged. Prices of non-energy industrial goods have thus responded to external factors, as numerous products are imported or are produced with a high proportion of imported inputs. They accounted for 4% of the fall in inflation over the period in question, or 0.2 percentage points. Here it should be noted that prices of non-energy industrial goods have been falling since mid-2009, in contrast to food and energy prices. Their fall in the last two years was thus not related to previous high growth. In addition, the previous sharp fall in Slovenian car prices was gradually neutralised between September 2012 and August of this year. By contrast, services prices are largely dependent on domestic factors, in particular domestic demand and labour costs. However, a fall in services prices was to a great extent constrained by fiscal consolidation measures and by frequent rises in individual categories of administered prices under conditions of rising fiscal pressure.

The impact of foreign and domestic factors on inflation dynamics in Slovenia was in line with developments across the euro area.[2] There too the fall in energy prices also accounted for the largest amount (50%) of the fall in inflation in recent years; the fall in food prices was the next most important deflationary factor (25%). The fall in inflation was thus largely attributable to external factors, although recently weak domestic demand inside the euro area has also made a significant contribution.

[1] See Figure 1.6 on page 15 and Figure 1.8 on page 16.

[2] ECB Monthly Bulletin, June 2014, available at https://www.ecb.europa.eu/pub/pdf/mobu/mb201406en.pdf.

through of VAT rates into final prices last year. By contrast, gas prices rose slightly in year-on-year terms. This was primarily attributable to a base effect, providers having made larger price cuts last summer than this summer. Year-on-year growth in prices of heating oil also increased, as a result of a rise in excise duties.

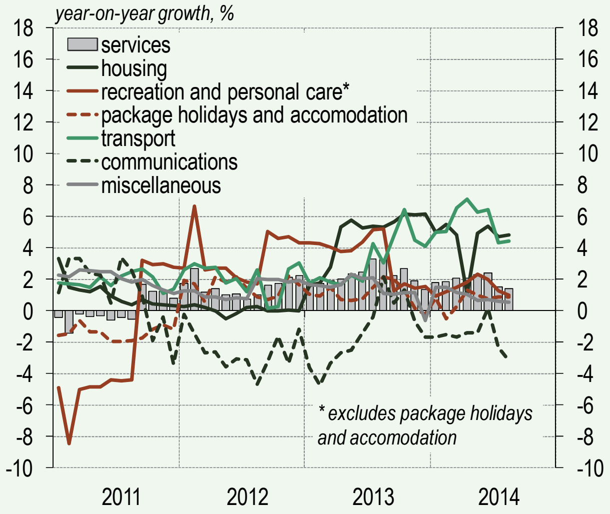
Year-on-year growth in food prices declined in the first eight months of this year, turning negative in August. This was attributable to domestic and foreign factors. Growth in food prices averaged 0.8% over the first eight months of the year, 5.0 percentage points less than in the same period last year, but 0.3 percentage points higher than the euro area average. Having recorded high year-on-year growth last year, prices of unprocessed food began to fall in February of this year. The year-on-year fall averaged 1.9% over the first eight months of the year, compared with a year-on-year rise of 9.5% over the same period last year. The main factor was a sharp fall in prices of vegetables, while year-on-year growth in prices of fruit and meat also declined sharply. Year-on-year growth in prices of processed food also declined, and averaged 2.2% over the first eight months of the year. The fall in prices was attributable to the effects of fierce competition in this segment of the market, and to a fall in food prices on global markets. Year-on-year growth in prices of alcoholic beverages and tobacco also declined sharply, despite the rise in excise duties in the spring. By contrast, year-on-year growth in prices of milk, cheese and eggs strengthened slightly.

Figure 6.5: Food prices

Source: Eurostat, Bank of Slovenia calculations.

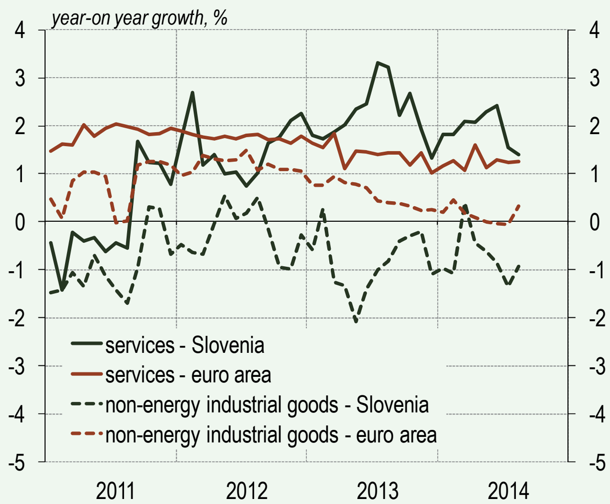
Year-on-year growth in services prices in the first eight months of this year was slightly slower than last year. The slowdown was primarily attributable to last year's fiscal measures and administrative measures dropping out of the calculation. Growth in services prices averaged 1.9% over the first eight months of

Figure 6.6: Services prices



Source: Eurostat, Bank of Slovenia calculations.

Figure 6.7: Services prices and prices of non-energy industrial goods



Source: Eurostat, Bank of Slovenia calculations.

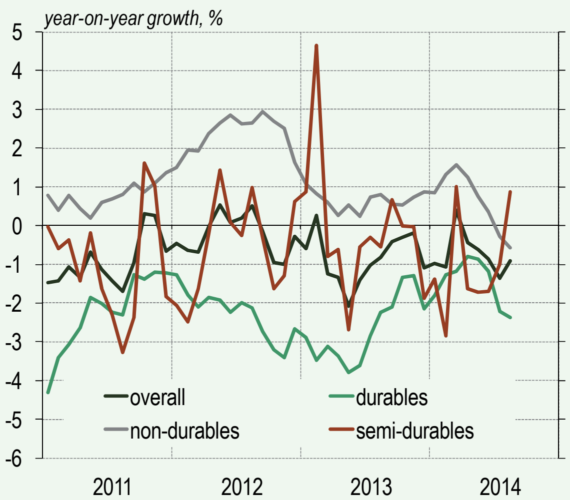
the year, down 0.4 percentage points in year-on-year terms, but 0.7 percentage points higher than the euro area average. Year-on-year growth in services prices was high in the first half of the year, partly as a result of the pass-through of last year's rise in VAT rates, the introduction of the financial services tax and rises in prices of municipal services. In addition, having mostly fallen last year, prices of transport services rose sharply, as a result of rises in prices of passenger transport by air and railway transport services. Year-on-year growth in services prices slowed in July and August, primarily as a result of last year's rise in VAT dropping out of the calculation. Growth in prices of catering services and package holidays and growth in health insurance prices also slowed.

Prices of non-energy industrial goods have continued to fall this year, as a reflection of weak consumer purchasing power. The year-on-year fall averaged 0.7% over the first eight months of the year, 0.3 percentage points less than last year, although the fall has deepened in recent months. Prices of non-energy industrial goods in the euro area rose by 0.1% over the same period. The main factor slowing the year-on-year fall in Slovenia was car prices. The fall in car prices averaged 0.4% over the first eight months of the year, 3.8 percentage points less than the same period last year, although the fall has deepened in the last two months. By contrast, prices of clothing and footwear and prices of sports equipment have fallen more sharply than last year, and accounted for more than 0.1 percentage points of the overall fall in prices of non-energy industrial goods. The gap in the rates of growth in these prices between Slovenia and the euro area has narrowed this year, although households remain uncertain with regard to the future development of disposable income, despite an improvement in certain economic indicators. This is stemming the increase in final consumption, and is restraining retailers in raising prices.

Industrial producer prices

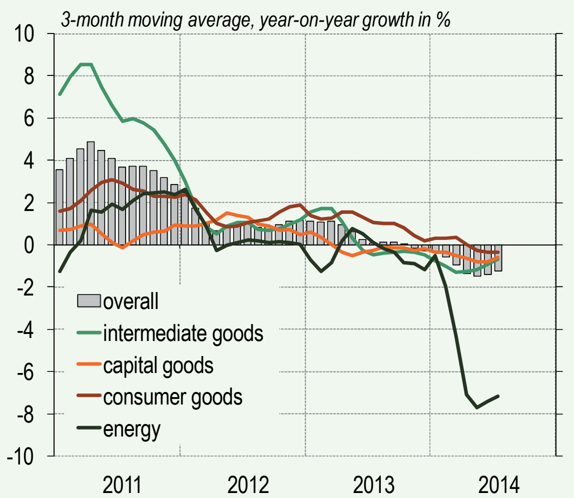
Industrial producer prices on the domestic market declined. The year-on-year growth rate over the first seven months of the year averaged -1.1%, 1.7 percentage points less than in the same period last year. All the broad economic categories contributed to the decline, commodity prices and energy prices making the largest contribution. The average year-on-year fall in prices in energy production deepened to 6.1% over the first seven months of the year, despite increased growth in prices in the water supply sector, as a result of a

Figure 6.8: Prices of non-energy industrial goods



Source: Eurostat, Bank of Slovenia calculations.

Figure 6.9: Industrial producer prices on the domestic market



Source: SORS, Bank of Slovenia calculations.

sharper fall in prices of electricity, gas and steam supply. Year-on-year growth in prices in the manufacture of rubber and plastic products declined. The year-on-year fall in prices in the manufacture of computer, electronic and optical equipment and in the manufacture of electrical equipment also deepened. Prices in the production of durable consumer goods consequently fell, while prices of capital goods also fell. By contrast, the year-on-year fall in prices in the manufacture of basic metals has been slowing in recent months. Despite increased growth in prices in the manufacture of basic pharmaceutical products, prices in the manufacture of consumer non-durable goods also fell in year-on-year terms, as a result of a fall in prices in the manufacture of food products, beverages and tobacco products.

7 Projections of Economic Trends and Inflation 2014–2016[25]

Alongside the strengthened economic activity in the first half of the year, another major factor in the economic growth forecast for 2014 was the extremely positive carry-over effect of growth from the previous year. Certain temporary factors, most notably high investment in infrastructure, were major factors in the high growth in the first half of the year. The high growth is expected to slow significantly over the remainder of the year as the global climate cools and the temporary factors ease. The largest upward revision in growth rates has thus been made for this year, while growth over the remainder of the projection horizon is forecast to remain below 2%. The largest upward revisions from the previous projections have been made in domestic demand components, most notably construction investment, as a result of one-off factors this year, and final household consumption, as a result of more encouraging developments on the labour market. Government consumption will remain under the influence of consolidation measures, while investment in machinery and equipment will recover very gradually given the unutilised production capacity and the still-uncertain situation in the international environment. The slightly faster growth in domestic demand components will contribute to increased imports, which alongside increased interest payments will reduce the current account surplus. This is forecast to narrow from 5.2% of GDP this year to 4.6% of GDP by the end of the projection horizon. As the VAT rise has dropped out of the calculation and energy prices have fallen, inflation has fallen sharply this year, and is forecast to remain close to 1%.

The risks to the economic growth projections are on the upside for this year, and on the downside for subsequent years. In addition to the carry-over effect and the high realisation in the first half of this year, the temporary absence of additional fiscal consolidation measures until the end of the year could also make a positive contribution to growth in domestic demand, to which the one-off factors that raised growth in the first half of the year could still make a contribution. Growth over the remainder of the projection horizon could be lower than forecast, as a result of additional cooling of the global climate, the renewed tightening of financing conditions on international markets and the potential further increase in political and economic tensions between Russia and the EU.

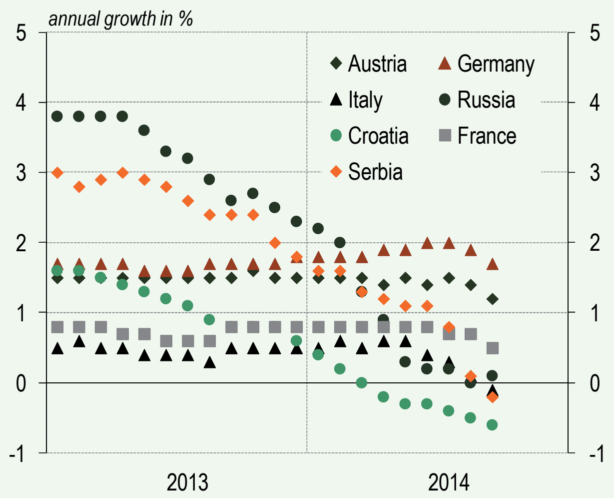
[25] *The projections were made on the basis of current statistical methodologies and data available on 8 September 2014. The projections of macroeconomic factors presented in this report are based on assumptions of the movement in variables from the international environment and certain domestic factors 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 (August 2014), the European Economic Forecasts (European Commission, Spring 2014), the OECD Economic Outlook (May 2014), and the IMF WEO update (April 2014). The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the appendix in the April 2008 Price Stability Report.*

The risks to inflation over the projection horizon are balanced. Rises in energy prices caused by a deterioration in the geopolitical situation in oil exporters and certain additional fiscal measures on the revenue side could be a factor in growth in prices being higher than forecast. The main factors likely to lead to lower inflation would be a slowdown in the global economic climate and a slower recovery in domestic demand.

International environment and external assumptions

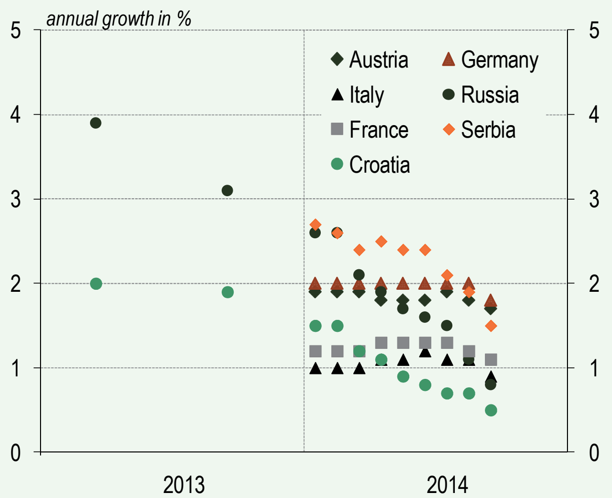
The expectations surrounding growth in the major trading partners have declined slightly relative to the most recent projections, as a result of the cooling global climate and geopolitical tensions. The second quarter saw economic growth stall in the euro area. Economic relations between Russia and the EU also deteriorated further, which has sharply reduced the economic growth forecast for Russia for this year and next year. There was a slight improvement in the situation on the

Figure 7.1: Projections of GDP growth in Slovenia's main trading partners for the year 2014



Source: Consensus Economics.

Figure 7.2: Projections of GDP growth in Slovenia's main trading partners for the year 2015



Source: Consensus Economics.

Table 7.1: Assumptions for the international environment

						Assumptions					
						2014		2015		2016	
	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
	annual average growth (%) if not stated otherwise										
Foreign demand*	-13.5	9.9	7.0	0.9	0.8	**0.7**	-0.9	**2.4**	-0.9	**3.1**	-0.5
Oil (USD/barrel)	62	80	111	112	109	**107**	-3	**107**	-3	**107**	-3
Non-oil commodities	-23.0	37.1	17.9	-7.2	-5.2	**-4.8**	-2.0	**0.1**	-1.9	**4.4**	-0.4
EMU inflation	0.3	1.6	2.7	2.5	1.4	**0.6**	-0.3	**1.1**	-0.2	**1.4**	-0.1
PPI Germany	-4.0	1.5	5.1	1.7	0.0	**-0.5**	-1.4	**0.6**	-1.3	**1.6**	-0.7

** Volume of imports from the basket of foreign partners.*
Δ: Difference between current assumptions and assumptions in April 2014 Macroeconomic Developments and Projections.
Source: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Economic Outlook.

labour market in the euro area relative to the previous projections, while the confidence indicators also suggest an expansion of economic activity, although they have declined slightly in recent months. Foreign demand is projected to increase by 0.7% this year, and by 2.4% and 3.1% in the next two years, significantly below its long-term average growth.

The assumptions for prices of oil and primary commodities have declined further since the previous projections. The main factor in the lower technical assumption for the US dollar oil price was a slight decline in realisation. US dollar oil prices are projected to average USD 107 over the projection horizon. Euro-denominated oil prices are projected to fall by around 2% this year. Primary commodity prices have been falling since the end of 2011, and are projected to fall by an average of 4.8% over this year. Very slow growth is projected for the following years, in line with the recovery of the global economy.

Inflation in the euro area will remain significantly below 2% over the projection horizon. Energy prices will remain the largest factor in inflation in the euro area, while growth in services prices will also remain low. The latter will curb core inflation, which will remain low over the projection horizon. Producer prices in Germany are expected to fall further this year, while their growth in the next two years is projected to be very low, and below the long-term average.

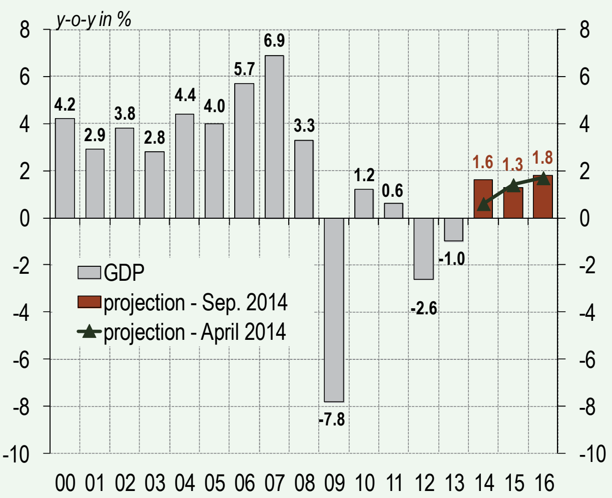
GDP growth

The GDP growth of 1.6% this year will largely be attributable to the favourable effect of the carry-over from last year, and investment in infrastructure at the local level. The absence or diminishing impact of the aforementioned factors at the turn of the year is expected to be the main factor, alongside slightly weaker international trade, in growth slowing to around 1.3% in 2015. The upward revision of 1 percentage point for this year is primarily the result of the unpredictable temporary factors of investment in infrastructure and a slightly faster recovery in the labour market, which resulted in increased final household consumption in the first half of this year. The profoundly positive pace of GDP growth in the first half of this year is likely to slow in the second half of the year, which will have an adverse impact on the carry-over of growth into 2015. In addition, the outlook for growth in the international environment has deteriorated since the previous projections, primarily under the influence of the Ukraine crisis and EU measures, and a slight deterioration in economic figures in the

Figure 7.3: Commodity prices

Source: ECB, Bloomberg, Bank of Slovenia assumptions.

Figure 7.4: GDP growth projection



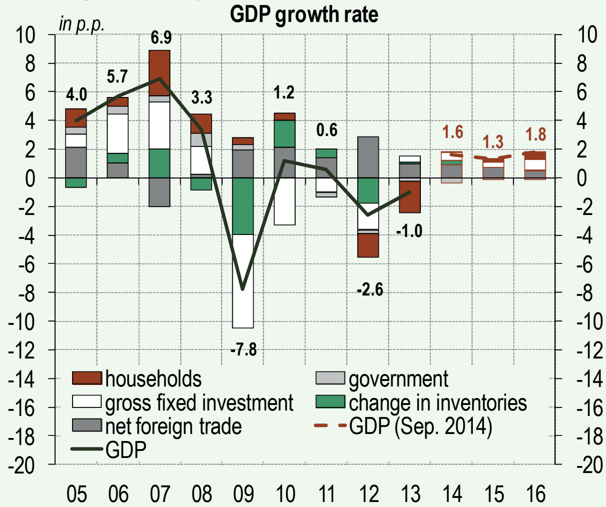
Source: SORS,Bank of Slovenia projections.

euro area. By contrast, the outlook on the labour market and the economic sentiment indicators have been improving this year, which will contribute to a faster recovery in domestic demand. The GDP projections for 2015 and 2016 are therefore practically unchanged relative to the previous projections.

Aggregate demand

The recovery in domestic demand will be slightly faster than forecast in the previous projections, as a result of more encouraging results and a better outlook on the labour market. Final household consumption is projected to grow by 0.1% this year, and by 0.5%

Figure 7.5: Projection of expenditure contributions to GDP growth rate



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

and 1.0% in the next two years. Household purchasing power will also gradually increase as a result of low inflation and the anticipated gradual fiscal consolidation, a real increase in wages having been forecast over the projection horizon. Persistently high unemployment will prevent higher growth in final household consumption.

The need for further fiscal consolidation will have an impact on government consumption. The government consumption forecast for this year is based on the measures adopted by the previous government, and takes account of the developments realised in the first half of the year. This year's significant decline in the average nominal wage in the government sector is primarily attributable to a base effect resulting from the inclusion of funds in connection with the elimination of wage discrepancies under 2013. A nominal stagnation or smaller increase in wages is projected for 2015, as a result of promotions undertaken in April 2014. Employment is projected to gradually fall. Another factor reducing government consumption is restraint of expenditure on intermediate consumption, which was still falling in the early part of this year. Government consumption is thus projected to decline by 1.7% this year, and by 0.4% in each of the following years. The fiscal consolidation measures taken into account in the projections are not sufficient to eliminate the excessive deficit by 2015.

Investment will be extremely high this year as a result of one-off factors, while investment in machinery and equipment will also increase very gradually in 2015

Table 7.2: Components of domestic demand

						Projection					
						2014		2015		2016	
	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
	real growth rates in %										
Domestic consumption	-9.5	-0.9	-0.8	-5.6	-2.1	**0.3**	0.9	**0.5**	0.2	**1.2**	0.0
Private consumption	0.9	1.0	0.0	-2.9	-4.0	**0.1**	0.8	**0.5**	0.3	**1.0**	-0.2
Government spending	2.4	0.1	-1.3	-1.5	-1.1	**-1.7**	-0.4	**-0.4**	0.1	**-0.4**	-0.1
Gross fixed capital formation	-22.0	-13.7	-4.6	-8.9	1.9	**3.3**	2.7	**1.8**	0.1	**3.9**	1.0

Δ: Difference between current projections and projections in April 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

and 2016. This year's sharp increase in gross fixed capital formation is primarily attributable to local government infrastructure projects, partly financed by European funds. The high growth in the second quarter also included the clear-up after the extreme weather conditions in the first quarter. The projection for growth in gross fixed capital formation for this year is estimated at 3.3% and is significantly higher than in the previous projections. In the absence of one-off factors, growth is projected at 1.8% in 2015 and 3.9% in 2016. Another factor in the relatively weak recovery in investment will be the anticipated absence of major government projects, while the pace of the disbursement of European funds represents an additional risk. More problematic is the weak growth or fall in investment in machinery and equipment, the means by which production capacity is expanded and potential growth strengthened. Investment is partly being constrained by the projected weaker growth in the major trading partners, while in addition utilisation of production capacity is still slightly below its long-term average.

The contribution to growth made by net exports will weaken over the projection horizon, as a result of weaker foreign demand and the faster recovery in domestic demand, but will remain positive. The reduction in the export growth projections is the result of the anticipated deterioration in Slovenia's major trading partners, including the effects of the current EU measures taken against Russia. Exports are projected to increase by 3.8% this year, while growth is expected to remain similar next year as a result of the aforementioned measures, despite the projected higher growth in foreign demand. Exports are projected to increase by around 5% in 2016, primarily as a result of a recovery in global trade. Imports will recover more quickly than exports, and more quickly than forecast in the April projections, the outlook for growth in domestic demand components having improved. Imports are projected to grow by 3.0% this year, and by 3.1% and 5.0% in the next two years. The slight downward revision in the import growth forecast for 2015 relative to the April projections is in line with weaker export growth as the result of measures in connection with EU-Russia relations.

Supply side

Despite the expected adverse impact of a slowdown in activity in the rest of the world, trends of faster growth in sectors dependent on the foreign market are still evident. The coming years are expected to see slower growth in construction, and slightly higher growth in sectors primarily dependent on the domestic market. Growth in value-added in manufacturing is projected to remain positive, but will decline slightly as a result of the adverse situation in the international environment, which is one of the major risks in the current projections. The same is true of private-sector services that are primarily dependent on foreign markets. The outlook in sectors dependent on the domestic market is relatively favourable, consumer confidence and the situation on the labour market both having improved. Growth in construction will be particularly notable this year, although the current rate of growth is already indicating a slowdown in construction activity, which is also expected over the remainder of the projection horizon.

Labour market

The unemployment rate will fall slightly further this year, but is expected to remain high over the projection horizon. The main encouraging figure is employment, which strengthened in the first half of the year as practically all segments of the private sector recorded an increase. This could rise slightly on aggregate over the year, for the first time in five years, but growth in the following years is projected to remain low and will not lead to any significant elimination of structural unemployment. Employment in the private sector is forecast to cumulatively increase by around 1.5% over the projection horizon. The implementation of fiscal consolidation is still expected to bring a further decline in employment in the

Table 7.3: Activity, employment and wages

						Projection					
						2014		2015		2016	
	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
	growth rates, %										
GDP (real)	-7.8	1.2	0.6	-2.6	-1.0	**1.6**	1.0	**1.3**	-0.1	**1.8**	0.1
Employment	-1.8	-2.2	-1.6	-0.8	-1.5	**0.1**	1.2	**0.2**	0.4	**0.6**	0.0
Compensation per employee	1.8	4.0	1.6	-1.2	1.9	**1.2**	0.2	**1.4**	0.1	**1.6**	0.0
Productivity	-6.1	3.5	2.3	-1.8	0.5	**1.4**	-0.3	**1.2**	-0.4	**1.5**	0.2
ULC (nominal)	8.5	0.5	-0.7	0.6	1.4	**-0.3**	0.3	**0.2**	0.4	**0.1**	-0.2
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	-5.7	-2.8	-1.3	-3.7	-2.1	**0.3**	0.8	**0.5**	0.2	**1.2**	0.1
Net exports	1.9	2.1	1.4	2.9	1.0	**0.9**	-0.2	**0.7**	-0.3	**0.5**	-0.1
Changes in inventories	-4.0	1.9	0.6	-1.8	0.1	**0.3**	0.3	**0.0**	0.0	**0.0**	0.0

Δ: Difference between current projections and projections in April 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

public sector, which is projected to cumulatively fall by around 2% by the end of 2016. In the wake of these developments, the unemployment rate is forecast to have fallen to around 9% by the end of the projection horizon.

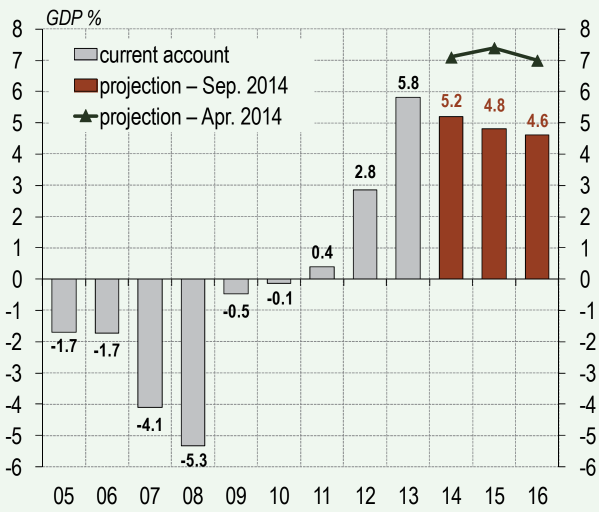
Wages in the private sector are projected to increase slightly faster than was forecast in the previous projections, while wages in the public sector are projected to stagnate over the next two years. Wage growth in sectors primarily dependent on foreign markets was in particular higher than forecast in the April projections, in the wake of slightly stronger employment. Wage growth remains moderate in most other sectors. Growth of this type in the private sector is also forecast over the projection horizon, in the absence of any major agreements between employers and unions. By contrast, wages in the public sector are forecast to stagnate over the projection horizon, once the base effects deriving from the elimination of wage disparities are excluded.

Foreign trade

The current account surplus will narrow to 4.6% of GDP by the end of the projection horizon, less than was forecast in the April projections. The main factor in the change in the current account dynamics will be the slightly faster growth in domestic demand components. The terms of trade are projected to make a positive contribution to the surplus this year, but are projected to curb the surplus next year in particular. The surplus is projected to narrow from 5.2% of GDP this year to 4.8% of GDP next year, and to 4.6% of GDP in 2016.

The largest contribution to the narrowing of the current account surplus will come from a widening defi-

Figure 7.6: Current account projection



Source: SORS, Bank of Slovenia projections.

Box 7.1: The Ukraine crisis and its impact on economic activity in Slovenia

In addition to political instability in the region, owing to the conflict in the east of the country the Ukraine crisis has increased the risk in doing business with Ukraine and its neighbours in general, most notably Russia. Trade with the two countries is very important to the Slovenian economy, as the relatively high surplus in merchandise trade with Russia during the crisis has been an important resource for financing Slovenia's external debt. The merchandise trade surplus with Ukraine and Russia accounts for more than three-quarters of the merchandise trade surplus with former Soviet countries. The merchandise trade surplus with Russia is three times larger than the surplus with Ukraine. This box examines certain aspects of merchandise trade with Russia and Ukraine, and assesses the potential consequences of the escalation of the Ukraine crisis for the Slovenian economy.

Chemical products account for the largest proportion of exports to Russia and Ukraine, at just under 60%. The largest proportion of this item comprises pharmaceutical products, both drugs intended for direct retail and semi-products intended for further processing. Machinery and transport equipment intended for industry account for just under a third of exports. Slovenia's total exports to Russia amounted to EUR 1,019 million in 2013, while exports to Ukraine amounted to EUR 251 million.

The main imports from Russia are imports of mineral fuels and lubricants, primarily oil and natural gas. This category accounted for 75% of Slovenia's total merchandise imports from Russia in 2013, and for just under 80% in the first half of 2014. Concentration by individual categories of merchandise is significantly smaller in merchandise imports from Ukraine, although total imports from Ukraine were negligible. Slovenia's total imports from Russia amounted to EUR 452 million in 2013, while imports from Ukraine stood at EUR 19 million.

The US and the EU began imposing sanctions in the second half of this year, which in addition to freezing Russian financial assets in the rest of the world will also prohibit the free movement of people, goods and services. In response Russia imposed sanctions of its own banning the import of certain foods from the EU. These sanctions directly reduced Slovenia's exports to Russia by around EUR 20 million.

The Ukraine crisis and the sanctions against Russia could have significant adverse consequences for the Slovenian economy. The effects of the sanctions estimated under various scenarios are seen in slowdowns of varying intensity in merchandise trade with Russia and Ukraine. Because of connections to the production chains of certain EU trading partners who themselves export heavily to Russia, the imposition of sanctions against Russia has had or will have a significant indirect impact on Slovenia's total merchandise exports and economic growth. The impact has been forecast for 2014 and 2015 with regard to a reference scenario of the projected merchandise imports from and exports to all countries other than Russia and Ukraine (see Table 2).

The forecasts of the impact of the Ukraine crisis on the Slovenian economy do not take account of the possibility of avoiding sanctions by increasing exports to countries not included in the embargo against Russia. These include the majority of former Soviet countries other than the Baltics, although increasing exports to these countries is associated with additional risks and costs.

In addition to the direct impact of merchandise trade on the current account, in transactions with Russia net inflows from travel services[1] are also significant, and were estimated at

Table 1: Shares of individual Current Account Balance items as % of GDP

	2009	2010	2011	2012	2013	H1 2014
Current Account Balance	-0.5	-0.1	0.4	2.8	5.8	5.3
Balance of goods[1]	-1.2	-2.3	-2.6	-0.5	1.8	3.5
Balance of goods former SU	1.7	1.8	1.8	2.6	2.8	2.5
Balance of goods Russia	1.0	0.9	1.0	1.6	1.6	1.4
Balance fo goods Ukraina	0.4	0.5	0.5	0.6	0.6	0.5

[1] *The balance of payments methodology.*
Source: SORS, Bank of Slovenia.

Table 2: Impact of the Ukraine crisis on economic activity in Slovenia

in %	2013	2014	2015		2013	2014	2015
Reference value		growth in %					
Total exports	2.3	4.0	4.0				
Total imports	0.2	2.3	2.4				
Scenario I.		growth in %		**Scenario II.**		growth in %	
Exports to Russia	8.0	-15.0	-20.0	Exports to Russia and Ukraina	8.7	-16.5	-21.8
Imports from Russia	19.2	-10.0	-15.0	Imports from Russia and Ukraina	20.6	-10.4	-15.5
		in percentage points				in percentage points	
Effect on exports		-0.9	-0.9	Effect on exports		-1.3	-1.4
Effect on imports		-0.3	-0.3	Effect on imports		-0.4	-0.4
Contribution to GDP		-0.3	-0.3	Contribution to GDP		-0.4	-0.5
				Indirect effects of lower exports on GDP		-0.1	-0.1

Source: SORS, Bank of Slovenia.

around EUR 50 million last year. Russia is also a significant investor in the Slovenian economy, particularly in the steel industry, health spa tourism and banking. Additional investments are anticipated in the construction of a gas pipeline across Slovenia, which are projected at around EUR 1 billion.

Under the first scenario, sanctions are imposed by the US, the EU and certain other countries, and by Russia. The sanctions have a negative impact on merchandise trade in 2014, the negative impact intensifying in 2015. Under this scenario merchandise exports to Russia are down 15% on the figure that would be recorded in the absence of sanctions in 2014, and down 20% in 2015. Imports from Russia are also down in both years, by a quarter in total. The decline in exports to Russia would reduce overall growth in merchandise exports by around 0.9 percentage points each year, or by just under 2 percentage points in total over the two years. The negative contribution by merchandise trade with Russia would reduce GDP growth by 0.3 percentage points each year, or by 0.6 percentage points over the two years. This is the estimated impact of the sanctions already imposed, solely on the basis of changes in merchandise flows with Russia included in the baseline scenario of the projections.

Under the second scenario there is a decline in merchandise trade with Ukraine in addition to the decline in merchandise trade with Russia. Given the conflict in Ukraine, the former is even larger than the decline in merchandise trade with Russia. In addition to the direct impact of the decline in merchandise trade with the two countries, the indirect impact of sanctions on total merchandise exports is also estimated. The indirect impact is estimated for Slovenia's four most important EU trading partners (Germany, Italy, France and Austria). In addition to the figures for Slovenia's exports to these countries and the figures for these countries' exports to Russia, OECD figures for the average import component of these countries' exports in 2005 are also used. The forecast thus obtained is increased by a factor of 1.5 to simulate the impact of an indirect decline in merchandise exports via all the other countries not included in the calculation.

The forecasts suggest a strong negative impact from the decline in merchandise trade with Russia and Ukraine on growth in total merchandise exports. Export growth would be 1.3 percentage points lower in 2014, and 1.4 percentage points lower in 2015. Growth in merchandise exports would thus be down just over 2.7 percentage points over the two years together. Under the second scenario there is again an increase in the negative contribution made to GDP growth by the decline in merchandise trade with the two countries in question, to 0.4 percentage points in 2014 and to 0.5 percentage points in 2015. To this forecast should be added the indirect estimated negative contribution by the decline in all other countries' merchandise exports to Russia, which is around 0.1 percentage points. The overall direct and indirect negative contribution to GDP growth made by the Ukraine crisis in 2014 and 2015 could exceed 1 percentage point.[2]

[1] The forecast was made by taking account of the number of visitors from Russia and the average spending by foreign visitors in Slovenia, which was lower on average than the actual spending by Russian visitors in Slovenia.

[2] It should be noted that the estimated impact on GDP is partial, as it takes account solely of the direct impacts on imports and exports, but does not include the indirect impact on developments in domestic demand components and on value-added in the sectors in question.

Table 7.4: Current account projections

						Projection					
						2014		2015		2016	
	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
Exports of goods and services	-16.6	10.1	7.0	0.3	2.6	**3.8**	1.0	**3.7**	-0.9	**5.0**	-0.1
Imports of goods and services	-18.8	6.6	5.0	-3.9	1.4	**3.0**	1.5	**3.1**	-0.8	**5.0**	-0.1
Current account: EUR billion	-0.2	0.0	0.1	1.0	2.1	**1.8**	-0.7	**1.7**	-1.0	**1.7**	-0.9
as % GDP	-0.5	-0.1	0.4	2.8	5.8	**5.2**	-1.9	**4.8**	-2.6	**4.6**	-2.4
Terms of trade*	3.5	-4.0	-1.4	-1.0	1.0	**0.3**	0.5	**-0.4**	0.2	**0.1**	0.6

** Based on national accounts deflators.*
Δ: Difference between current projections and projections in April 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

Figure 7.7: Terms of trade projections

Source: SORS, Bank of Slovenia projections.

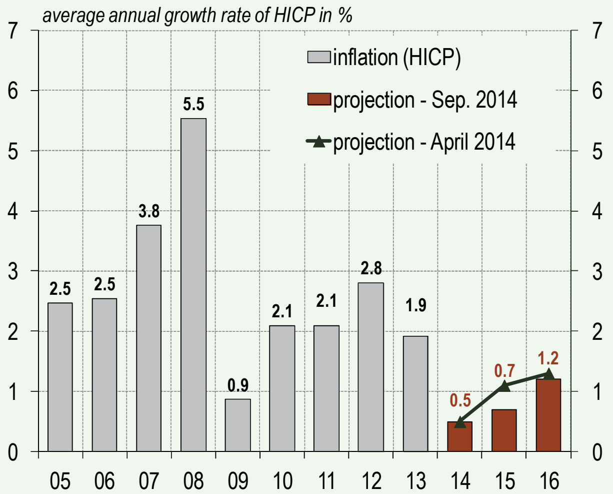
cit in factor income. The surplus of trade in merchandise and services is projected to reach around 8% of GDP this year, and to widen slightly further in the following years. The merchandise trade surplus will gradually widen from around 3% of GDP in 2014 to around 4% of GDP in 2016, while the surplus of trade in services will fluctuate around 5% of GDP. The deficit in factor income is projected to widen from around 3% of GDP this year to just over 4% of GDP by 2016. The main increase will be in interest payments.

Inflation

Average inflation is forecast at 0.5% in 2014, and is then projected to rise slightly in 2015 and 2016 but to remain around 1%. The inflation projection for this year is unchanged from the previous projections, but the projected structure has changed. Higher growth in energy prices and services prices was balanced by lower year-on-year growth in food prices and prices of non-energy industrial goods. Inflation developments this year will remain under the influence of relatively weak domestic demand and falling commodity prices on global markets. Slightly faster growth in prices of non-energy industrial goods and in prices of marketable services is forecast towards the end of the projection horizon in the wake of more favourable economic developments.

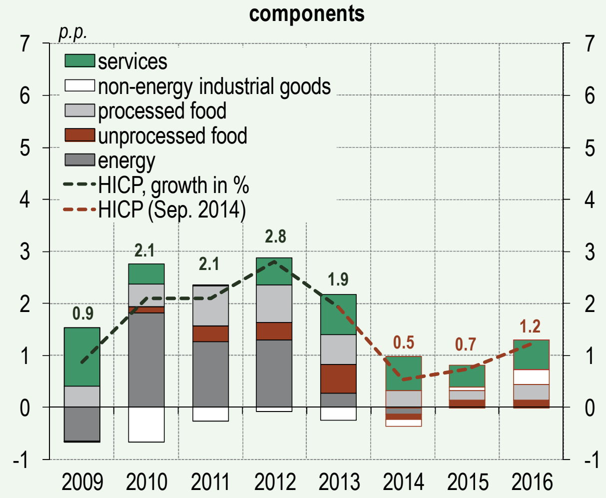
In the structure of inflation, a notably large contribution by services prices is forecast this year, while the contribution made by prices of industrial goods is forecast to be negative. Year-on-year growth in services prices will be higher than forecast in the previous projections, primarily as a result of a rise in certain prices in the first half of this year. The rate is projected to gradually slow over the rest of the year. Year-on-year growth in services prices is projected at 1.9% this year, and is projected to slow to 1.2% in 2015, before increasing to 1.6% in 2016. The fall in energy prices is projected to be

Figure 7.8: Inflation projection



Source: SORS, Bank of Slovenia projections.

Figure 7.9: Projections of contributions to inflation by components



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

slightly less than forecast in the April projections, as a result of higher oil prices on global markets in the second quarter of this year than in the same period last year. The further fall in energy prices is also forecast to reduce average annual growth in the following two years relative to the previous projections. Energy prices are projected to fall by 0.9% this year, and to remain unchanged on average in 2015 and 2016. Food prices are also projected to make a positive contribution to inflation this year, although the rate of growth will be significantly lower than forecasted in the previous projections. The difference is mainly due to a larger fall in prices of unprocessed food and a sharper fall in commodity prices on global markets. Average growth in food prices is projected at 0.8% this year, and at 1.3% and 1.8% in the next two years. This year's fall in prices of non-energy industrial goods is projected to be slightly larger than expected, primarily as a result of a larger fall in prices of clothing and footwear. Prices of non-energy industrial goods are projected to cease falling next year, and then

Table 7.5: Inflation projections

						Projection					
						2014		2015		2016	
	2009	2010	2011	2012	2013	Sep.	Δ	Sep.	Δ	Sep.	Δ
					average annual growth, %						
Consumer prices (HICP)	0.9	2.1	2.1	2.8	1.9	**0.5**	0.0	**0.7**	-0.4	**1.2**	-0.1
food	1.8	2.5	4.8	4.7	4.9	**0.8**	-1.0	**1.3**	-1.1	**1.8**	-0.5
energy	-4.5	13.9	8.8	9.0	1.8	**-0.9**	0.7	**0.0**	-0.5	**0.0**	-0.4
other goods	0.0	-2.2	-0.9	-0.2	-0.9	**-0.8**	-0.1	**0.0**	-0.3	**0.8**	0.2
services	3.2	1.2	0.0	1.5	2.2	**1.9**	0.6	**1.2**	-0.1	**1.6**	-0.1
Core inflation indicators (HICP)											
excluding energy	1.7	0.3	1.0	1.8	1.9	**0.8**	0.0	**0.8**	-0.5	**1.4**	-0.1
excl. energy and unprocessed food	1.9	0.2	0.7	1.5	1.4	**1.0**	0.1	**0.8**	-0.4	**1.4**	-0.1
excl. energy, food, alcohol and tobacco	1.7	-0.4	-0.4	0.7	0.9	**0.7**	0.3	**0.7**	-0.1	**1.3**	0.1

Δ: Difference between current projections and projections in April 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

to increase in line with growth in domestic private consumption.

Low domestic consumption will limit the rise in core inflation this year, although the rate is expected to have risen by the end of the projection horizon in line with the anticipated gradual growth in the domestic economy. Low domestic demand and the continuing uncertainty on the labour market are curbing growth in final consumer prices. There also no expectation of price pressures from commodity prices. In line with the projected improvement in economic activity and private consumption, core inflation is forecast to rise slightly towards the end of the projection horizon. Average growth in the HICP excluding energy, food, alcohol and tobacco is projected at 0.7% this year and in 2015, and is expected to rise to 1.3% in 2016.

The overall direct impact of government measures on inflation has been relatively high this year, primarily as a result of the pass-through of last year' measures. The rise in VAT rates in July 2013 will contribute approximately 0.4 percentage points to average inflation this year. The rise in excise duties on alcohol and tobacco this spring will contribute 0.1 percentage points to inflation this year. Last year's rise in the financial transactions tax rate also contributed to price growth in the first quarter. Should the government leave excise duties on refined petroleum products unchanged for the remainder of this year, their contribution to inflation will be neutral. The overall contribution of government measures to the inflation rate is thus projected at 0.6 percentage points this year, and around 0.1 percentage points in 2015.

The available indicators of monetary developments and inflation expectations for Slovenia suggest that no major price pressures can be expected in the medium term. The stock of loans to households at the end of the first half of the year was down 2.7% in year-on-year terms, primarily as a result of a decline in consumer loans. Loans will not lead to any major changes in domestic demand over the projection period. There will also be no major cost pressures on prices, as unit labour costs will remain cumulatively unchanged over the projection horizon. These developments and the reduction in inflation expectations on the part of consumers as of the middle of last year suggest low growth in prices in the future.

Risks and uncertainties

The risks to GDP growth have primarily turned to the upside in 2014, but are still on the downside in 2015 and 2016. After the comprehensive review of the banking

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			
		2014		2015		2014		2015		2014		2015	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	sep. 14/apr. 14	**1.6**	1.0	**1.3**	-0.1	**0.5**	0.0	**0.7**	-0.4	**5.2**	-1.9	**4.8**	-2.6
EBRD	sep. 14/maj 14	**0.7**	0.7	**1.0**	0.0	**1.1**	0.0	**…**	…	**…**	…	**…**	…
Consensus Forecasts	sep. 14/avg. 14	**0.9**	0.4	**1.0**	-0.1	**0.7**	-0.1	**1.5**	-0.2	**…**	…	**…**	…
European Commission	maj 14/feb. 14	**0.8**	0.9	**1.4**	0.1	**0.7**	-0.1	**1.2**	-0.1	**6.0**	-0.9	**6.2**	-1.6
OECD	maj 14/nov. 13	**0.3**	1.2	**1.2**	0.6	**0.7**	-1.0	**0.9**	-0.4	**6.3**	0.1	**7.4**	0.3
IMF	apr. 14/okt. 13	**0.3**	1.7	**0.9**	0.0	**1.2**	-0.6	**1.6**	-0.5	**6.1**	-0.9	**5.8**	-1.1
IMAD	mar. 14/sep. 13	**0.5**	1.3	**0.7**	0.3	**0.3**	-1.6	**1.1**	-0.3	**6.9**	1.9	**6.4**	1.3

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

system, the bank recapitalisations and the stabilisation of the political situation, government yield spreads fell sharply over this year, as a result of which the risks associated with the domestic environment have diminished compared with the previous projections. As a result of the carry-over effect, which was examined in detail in April's Macroeconomic Developments and Projections, and one-off investment activities this year, the risks turned to the upside in 2014, but are more strongly on the downside in the next two years, particularly in 2015. From a technical point of view, potential revisions to the figures when the next national accounts are released could also have an impact on the forecast for this year's economic growth.

Given the high ratio of imports and exports to GDP, foreign demand remains an extremely significant risk factor. While domestic demand, which remains the most significant limiting factor for corporate performance, remains weak, the outlook for growth in the major trading partners is also deteriorating. In addition to the stalling of growth in the euro area, a further increase in risk is attributable to the geopolitical tensions associated with the Ukraine crisis and the resulting economic sanctions. This will have an impact on Slovenian exports even this year, and more profoundly next year. The creation of the new flashpoints of conflict and uncertainties in oil-producing countries have increased. All of this is increasing uncertainty, which is having a significant impact on corporate investment activity, particularly in the business investment segment.

Unknowns in relation to further fiscal consolidation measures and the dynamics and effects of the privatisation of government-owned firms are adding to the uncertainty. The advent of the new governing coalition and the relative ambiguity of the coalition agreement with regard to specific fiscal measures are increasing the uncertainty surrounding the dynamics of fiscal consolidation and the privatisation process. There also remains a risk in association with meeting the international commitments for budget consolidation, as the measures adopted to date are not sufficient. The dynamics and effects of privatisation, particular with regard to developments in activity and employment at the privatised firms, remain uncertain.

In light of the more encouraging figures from the labour market, the risks of extremely high unemployment diminished slightly. The labour market is nevertheless expected to see a gradual recovery that does not eliminate structural unemployment and that continues to constrain growth in final household consumption. There remains a significant risk to the employment of highly-qualified young people, who in the event of any stagnation in employment could find it harder to enter the labour market, which would reduce the long-term potential of the economy.

The risks surrounding the inflation projections are balanced. Further fiscal policy measures within the framework of fiscal consolidation, such as potential rises in indirect taxes and administered prices, could lead to higher-than-forecast inflation. A fall in the euro would make an additional contribution. Energy prices and prices of other input commodities represent a risk of lower inflation and higher inflation in the current projections. In the event of a deterioration in the geopolitical crisis, these prices could rise on global markets, while the pace of global activity suggests a further fall in these prices. The main factor acting to reduce inflation would be lower economic activity as a result of reduced foreign and domestic demand, which would further delay the improvement in the situation on the labour market, thereby curbing labour costs and pressures on prices from the supply side. At the same time additional fiscal measures on the expenditure side, such as cuts in the wages of public sector employees, could further reduce price pressures from the demand side.

Better access to corporate financing could be one of the key factors in ensuring faster emergence from the crisis. Following their recovery the banks are adequately capitalised, while the ECB's non-standard measures are increasing liquidity and the availability of funding for credit growth. Extending the dysfunctional process of financial intermediation would merely entail a slow economic recovery without credit growth (a credit-less recovery). In such an event economic growth would be based solely on the accumulation of internal resources and retained earnings, and would remain below potential growth.

Successful corporate restructuring in the sense of deleveraging and increasing competitiveness is the next step that needs to be taken. The advent of foreign investors who could capitally strengthen firms and help to improve competitiveness via new skills and new deals, and the concentration of non-performing loans at the BAMC and their active resolution could entail faster progress on the road to economic recovery.