BANKA SLOVENIJE

BANK OF SLOVENIA

MONETARY POLICY REPORT

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1. INTRODUCTION AND SUMMARY

Joining the ERM II at the end of June 2004 was an important step on Slovenia's road to adopting the euro. In line with the Bank of Slovenia's commitment[1] and the joint programme of the Bank of Slovenia and the Slovenian government,[2] following negotiations with the European Central Bank, the European Commission and the central banks of the members of the EMU, Slovenia joined the ERM II on 28 June. The central rate was set upon entry at SIT 239.640 per euro, while the market rate may fluctuate around the central rate within agreed limits of ±15%. In addition to the other Maastricht criteria, another condition for adopting the euro is two years of participation in the ERM II without major deviations in the exchange rate from the central rate.

Entry into the ERM II brought to an end the trend of depreciation in the domestic currency. The principal objective of monetary policy after joining the ERM II remains ensuring price stability. Interest rate policy, subordinate to maintaining exchange rate stability, is primarily dependent on factors that lie outside of the Bank of Slovenia's control, such as interest rates abroad and Slovenia's risk premium. The fluctuation of the exchange rate in the vicinity of the central rate during the period of participation in the ERM II to date is in line with expectations.

With the fall in inflation this year, Slovenia is gradually approaching fulfilment of the Maastricht inflation criterion. The fall was achieved in a sustainable way, with the macroeconomic equilibria being maintained. The forecasts for price movements in the future are also optimistic. The year-on-year rise in prices was extremely low in September at 3.3%, owing to specific seasonal factors. The forecast is for the year-on-year rate to reach about 3.5% at the end of 2004, and 2.5% at the end of 2005, and for it to stabilise around this level. Bank of Slovenia assessments are that such a fall in inflation will allow the Maastricht inflation criterion to be met.

Economic activity will remain at a high level, but will not endanger price stability. With moderate growth in domestic demand, the contribution made by foreign trade to economic growth will gradually improve. Assessments are that given the relatively high level of import orientation domestic demand will not have an inflationary effect. With the gradual easing of domestic demand, and the gradual strengthening of export demand as the world economy recovers, the negative contribution made by foreign trade to economic growth will be neutralised in the coming years.

The Bank of Slovenia assesses that, as forecast, the macroeconomic trends are such that there is a possibility of meeting the Maastricht criteria by the deadlines established in the joint programme of the Bank of Slovenia and the Slovenian government for ERM II entry and adoption of the euro. A significant risk in meeting the inflation criterion in the future is the movement of commodities prices on world markets, in particular the oil price. Major pressures at the price level, such as those seen because of changes in oil prices, can be transferred to

[1] In November 2001 the Governing Board of the Bank of Slovenia approved and announced a clear-cut medium-term policy orientation: to put in place the conditions for joining the Economic and Monetary Union (EMU) at the earliest opportunity. Pursuit of this aim is the most effective way for the Bank of Slovenia to fulfil the task of achieving price stability laid down for it in the Bank of Slovenia Act. The Bank of Slovenia also undertook to prepare a regular inflation report as a way of reporting publicly on the implementation of its short-term monetary stance. This will contribute to greater transparency in the implementation of monetary policy. The Bank of Slovenia will also publish such reports on inflation together with forecasts of macroeconomic trends and explanations of short-term monetary policy orientations. The next inflation report will be drawn up in spring 2005.

[2] http://www.ecb.int/press/pr/date/2004/html/pr040627.en.html

wages, and higher labour costs can trigger a new inflationary cycle. An additional risk is the movement in aggregate consumption, or final consumption in particular, that could arise in the context of unwanted shocks on the wages side, a change in the behaviour of residents given the tax reforms announced and excessive state spending. Having begun, the anticipated rise in interest rates around the world is working to prevent such risks realising themselves.

The key to meeting the Maastricht criteria will be the action of fiscal and incomes policy, financial supervision and the implementation of structural reforms.[3] In the Programme for ERM II entry and adoption of the euro the Bank of Slovenia and the Slovenian government expressed their awareness that monetary policy during the period of participation in the ERM II must be aimed at ensuring the stability of the nominal exchange rate, and that fiscal policy and incomes policy will thus have to concern themselves with macroeconomic stability and further reduction of inflation. Fiscal policy this year has used adjustments in excise duties to prevent, as far as possible, high oil prices and major fluctuations on world markets being transferred to domestic prices for refined petroleum products. At the same time changes in indirect taxes have had an almost negligible effect on prices. In this context it is assessed that fiscal policy also had a restrictive effect on general government expenditure and public sector wages. The social partners also concluded an agreement this year on adjustments to wages in the private sector. The guidelines for the partial abolition of wage indexation already applied in the social partners' agreement for the public sector were also applied for this agreement. Consistent application of the agreements reached for adjusting basic wages and the implementation of the social agreement, which assumes that rises in real wages will lag one percentage point behind productivity growth, will make a significant contribution to preventing the occurrence of shocks that could make it harder for Slovenia to meet the Maastricht criteria.

[3] This is also mentioned by the joint communiqué by the ERM II committee upon Slovenia's entry into the ERM II. See http://www.ecb.int/press/pr/date/2004/html/ pr040627.en.html

2. INFLATION

Slovenia is getting closer to meeting the Maastricht price stability criterion. There was significant fall in inflation over the last year, the year-on-year rate reaching 3.3% in September. The pace of the fall in inflation has been slower this year, but in line with expectations. All the basic equilibria in the economy were maintained, which indicates that the fall in inflation was sustained and stable.

Maastricht price stability criterion closer to being met

The sustained fall in inflation is to a considerable degree the result of the appropriate combination of economic policies and the absence of inflationary pressures from the domestic environment. Coordination between the Bank of Slovenia and the government was again a key factor in continuing the disinflation process. By maintaining a relatively restrictive monetary policy stance with appropriate real interest rates and the gradual stabilisation of the exchange rate, the Bank of Slovenia mitigated inflationary pressures of a monetary nature. At the same time the government pursued a policy of holding rises in administered prices in line with the expected price increase, and by adjusting excise duties on refined petroleum products it mitigated the unexpectedly high oil prices on world markets. Slovenia's entry into the European Union and the abolition of customs duties additionally increased competition on markets for goods and services and created further conditions for easing inflationary pressures. These pressures were strengthened by growth in inventories, tougher conditions in the labour market and moderate final consumption.

Sustained fall in inflation resulting from:

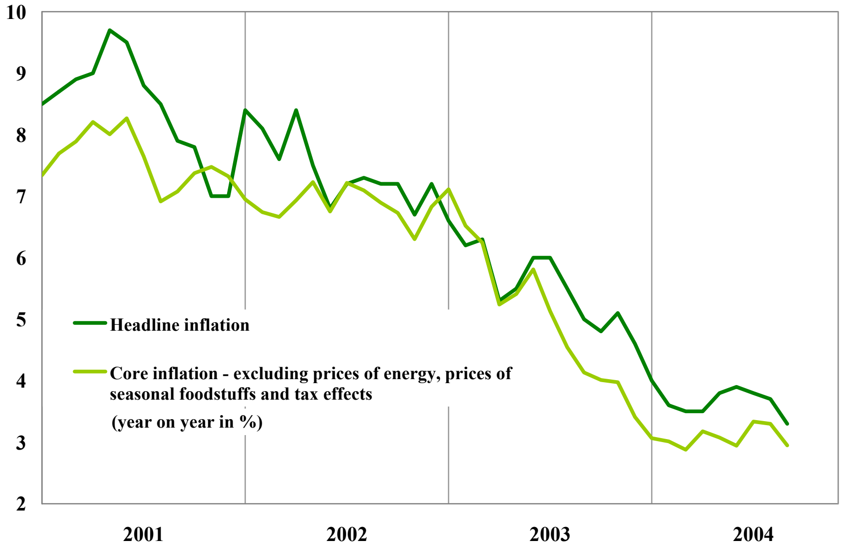
- **appropriate combination of economic policies**
- **absence of inflationary pressures from domestic environment**

2.1 Achieving Price Stability

There was again a sustained fall in inflation this year, the rate reaching 3.3% in September. After last year's rapid fall in the consumer price index, the disinflation process slowed down this year. The year-on-year inflation rate had fallen this year by 1.3 percentage points by September. Despite the slower decline, the rise in prices remains low at 3.3%. The disinflation process has been

Inflation process allowing most important macroeconomic equilibria to be maintained

Figure 2.1: Headline inflation and core inflation



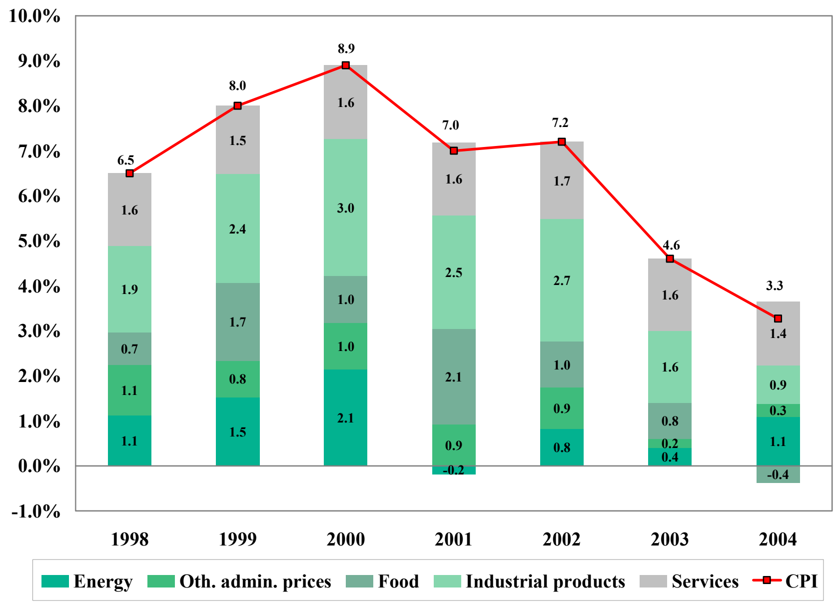
Source: Statistical Office of the Republic of Slovenia (SORS), ARC calculation.

successful, and the level of price rises is sustainable as the principal macroeconomic equilibria have been maintained (the balance of payments, public finances). This is particularly the case in comparison with other similar countries in which after several years of decline inflation leapt upwards this year. Core inflation developments correspond to expectations, fluctuating slightly above 3.0%.Despite the unexpected shocks in the international environment, the fall in headline inflation and the slowdown in core inflation, give rise to optimism for the continuation of the disinflation process.

Changes in structure of inflation allowing sustained decline

The structure of inflation itself points to a sustained fall. Most notable among free prices is the slowdown in the rise in food prices and prices of industrial products, while the rise in prices of services has undergone practically no change in recent years. The contribution of the latter to inflation has remained around 1.4 percentage points this year, while a slowdown in the years ahead will have a significant impact on the ongoing disinflation process. In recent years, and last year in particular, the largest contribution to the fall in inflation was made by slower rises in prices of industrial products and food prices. The contribution made by the former almost halved over the last year from 1.6 percentage points to 0.9 percentage points, while the latter even had a negative contribution, thus lowering inflation by 0.4 percentage points. The rapid decline in rises of prices of goods was anticipated and is to a considerable extent connected to increased competition on markets following Slovenia’s entry into the European Union, lower foreign prices and the stabilisation of the nominal exchange rate.

Figure 2.2: Structure of inflation – contributions by components



Source: SORS, ARC calculation.

High rise in administered prices as effect of rises in oil and refined petroleum prices

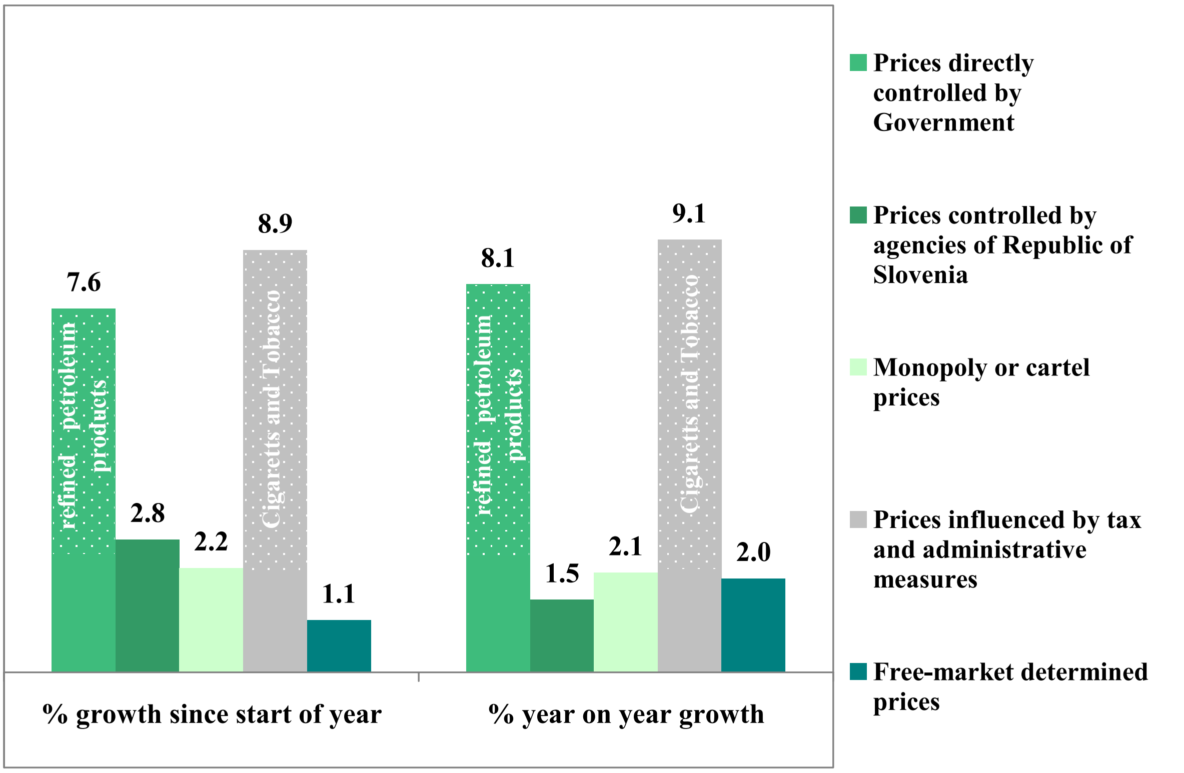
Administered prices rose quicker than expected this year owing to rises in oil prices and prices of refined petroleum products. The rise in administered prices over the last year was 8.1%, of which rises in prices of refined petroleum products accounted for 5.7 percentage points. The unexpected rise in oil prices on the world market and the consequent rise in the prices of refined petroleum products in Slovenia slowed the decline in inflation. Energy prices accounted for 1.1 percentage points of the year-on-year consumer price index of 3.3% in September, while other administered prices accounted for just 0.3 percentage points. It is the slowdown in the rise in administered prices in the last two years that has had a significant impact on the disinflation process. In the absence of external shocks inflation could have been even lower this year.

Energy price growth responsible for one-third of inflation

Fastest growth in administered prices and prices formed under influence of tax and administrative measures

The policy of regulating administered prices in 2005 and the more rapid harmonisation of excise duties on cigarettes will be an important factor in cutting inflation and meeting the Maastricht criteria. The rises in free prices, monopoly prices and prices administered by state agencies were already very low this year. Only prices administered by the government (8.1%) and prices formed under the influence of tax and administrative measures (9.1%) showed more significant rises. Of the latter, the rise in excise duties on cigarettes alone contributed about 0.2 percentage points to the inflation rate. The harmonisation of excise duties on cigarettes will have a direct impact on inflation for at least the next four years, but the harmonisation itself is required by EU directives. The contribution to inflation for the next two years is projected to be similar to this year's.

Figure 2.3: Consumer price index – September 2004



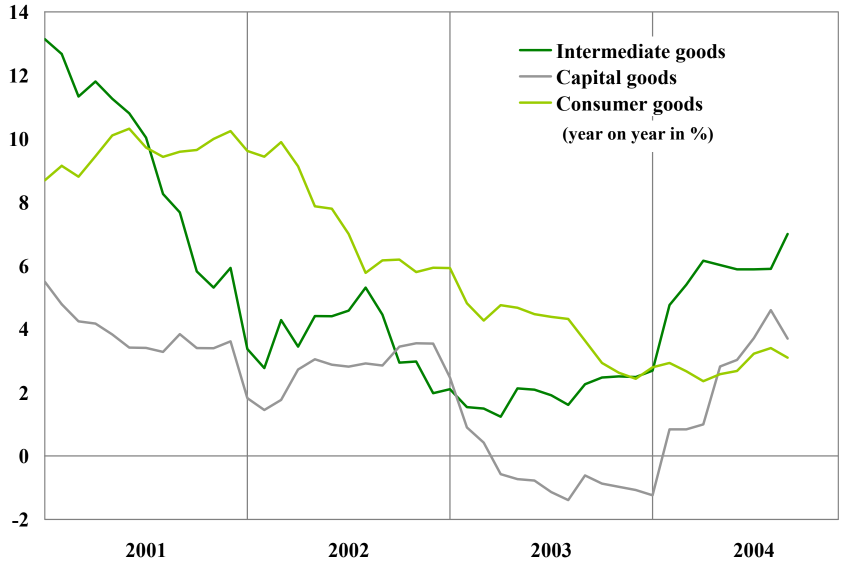
Note: Prices under the direct influence of tax and administrative measures were excluded from free prices. These included cigarettes and not-for-profit rents, which account for 3.5% of all products in the consumer price index.

Source: SORS, ARC calculation.

Slower transmission of producer price growth to consumer price growth

This year's higher rises in producer prices of manufactured goods will not significantly hinder the disinflation process. Apart from the movement of oil prices and other commodities prices on world markets, the greatest uncertainty in respect of further falls in inflation this year was brought about by the rapid rise in the prices of industrial products. The year-on-year rate more than doubled over the first nine months of the year to reach 5.0% in September. The largest rises were those in prices of intermediate goods (7.0%) and capital goods (3.7%), while those of consumer goods rose more slowly (3.1%). The rapid rise in the first of these is to a considerable extent the result of the low base from last year and the unexpected rise in oil prices and other commodities prices. Other factors in the faster rise in prices of capital goods in addition to the low base were the expansion of motorway construction, more housebuilding and the implementation of other major investment projects. Despite these more rapid rises, for the moment there is little sign of these factors being transferred to the consumer price index. The most likely reason for this is the temporary nature of the faster rises in producer prices of manufactured goods. An additional limiting factor is the increased competition on markets for goods following EU entry and the abolition of customs duties. More rapid rises in producer prices are likely this year to be reflected in lower corporate profits and not in higher consumer prices.

Figure 2.4: Producer prices of manufactured goods



Source: SORS, ARC calculation.

2.2 Determinants of inflation in 2004

In addition to coordinated economic policies, the process of cutting inflation this year was also promoted by the absence of inflationary pressures from the domestic economic environment, while unfavourable factors in the international environment (in particular the rise in commodities prices) prevented a faster decline in inflation.

Coordination of economic policies

Like last year, the coordination of economic policies again played a key role in the disinflation process. By gradually cutting nominal interest rates in line with falls in inflation, the Bank of Slovenia maintained a relatively restrictive monetary policy stance, thus again preventing any inflationary pressures of a monetary nature or from aggregate demand side this year. The gradual stabilisation of the exchange rate and the ending of the depreciation trend when the ERM II was entered restrained that part of inflation tied to the depreciation of the domestic currency. The government also contributed to cutting inflation by pursuing a consistent administered prices policy and by adjusting excise duties on refined petroleum products.

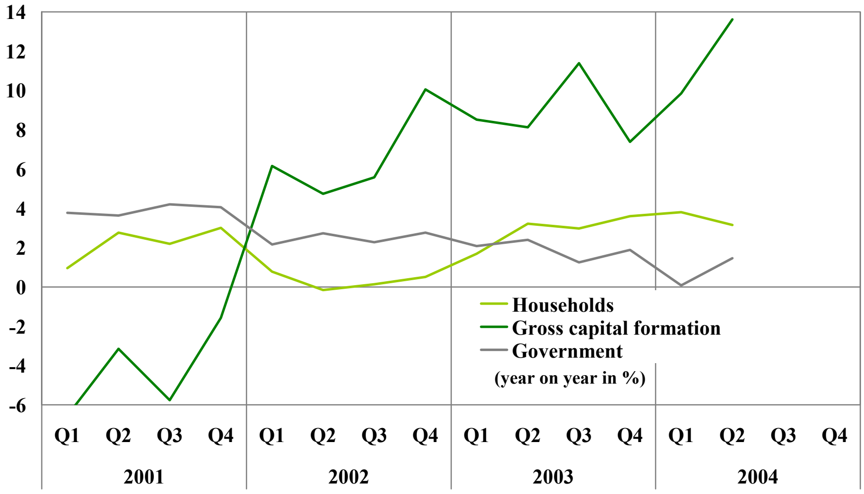
Absence of inflationary pressures from domestic environment

There were lower inflationary pressures in the domestic environment. The significant domestic factors that generated a pressure for lower prices included the high growth in inventories, the uncertain conditions on the labour market and low domestic consumption. Other factors worthy of note were the increased competition on goods markets after Slovenia joined the European Union and the abolition of customs duties, which saw falls in food prices in particular.

Domestic demand remains sluggish, and is not creating inflationary pressures

After low economic activity last year, the first half of this year saw a strong recovery. Year-on-year economic growth in the second quarter amounted to 4.6%, approximately 40% of which was attributable to increases in inventories. Faster growth in domestic consumption, however, is the result of faster growth in gross capital formation and not final consumption, which remains sluggish despite historically low interest rates. Household consumption has remained relatively low, while government spending is only strengthening slowly. Conditions on the labour market, still tough, and certain other structural factors such as the need to save for pensions and for housing helped to keep household consumption dynamics relatively slow this year. With interest rates so low, traditional bank saving was abandoned in favour of investments in domestic and foreign securities and in mutual funds. Like last year, domestic demand is still a factor that is not creating any inflationary pressures, allowing a further decline in prices in the future.

Figure 2.5: Growth in domestic consumption



Source: SORS, ARC calculation.

Gradual recovery of economy and moderate rise in labour costs preventing inflationary pressures on supply side

Increases in inventories, the tough conditions on the labour market and low wage increases also restricted inflationary pressures this year. The shrinking of the output gap is slowly but surely being reflected on the labour market. Employment has risen slightly this year, and the level of survey-based unemployment is at its lowest for two years. Despite the gradual strengthening of employment, conditions on the labour market are still tough, which is also pointed to by the accumulation of inventories. The market conditions in the economy are being reflected in the slower growth in labour costs, with the rise in gross wages continuing to fall. The year-on-year rise in wages in July was lower than the average for the seven months, while the real rise over the seven months averaged 1.7% year-on-year. In July and August there were adjustments to base wages in the public and private sectors. Following a 3.1% adjustment in the public sector, there was a lump-sum adjustment to base wages in the private sector of at least SIT 5,000 gross, with the actual amounts higher in the majority of business activities.

Greater exposure to foreign competition increasing pressure to cut prices

Greater exposure to competition on certain goods markets after Slovenia joined the European Union increased the pressure to cut certain prices. In the first six months of this year alone imports of goods rose by 11.6% in volume terms over the same period last year, with the fastest rise (17.6%) being seen for consumer goods. Alongside imports, there was also an additional supply of domestic consumer goods that could not be exported. Exports of consumer goods in the first six months of this year rose by just 4.6% in volume terms over the same period last year, with stronger competition abroad the principal factor behind this. In line with these trends inventories in the economy also rose. With an increased supply of foreign consumer goods on the Slovenian market competing with excess domestic supply, this is also contributing to the fall in domestic inflation.

Geopolitical and economic factors bring high rise in oil prices

Inflationary effects linked to high oil prices have been felt for more than a year, as oil prices have risen constantly since the second half of last year. The price of Brent crude rose from USD 30 per barrel at the beginning of January to a record USD 47 per barrel at the end of September, a leap of almost 57%. Both geopolitical and economic factors were responsible for a rise of this magnitude. While the former hindered growth in supply, the latter dictated faster growth in demand. Supply was held back primarily by the uncertain situation in Venezuela, the crisis in Iraq, tensions in Saudi Arabia, the uncertainty connected to the Yukos affair in Russia, weather conditions in the Gulf of Mexico and Opec's unwillingness to significantly increase oil production. Demand was primarily strengthened by the gradual recovery of the world economy and faster growth in China, where demand for oil is expected to rise by 13% this year. Oil reserves have therefore reached a historically low level.

Change in dollar movement this year did not ease rise in oil prices

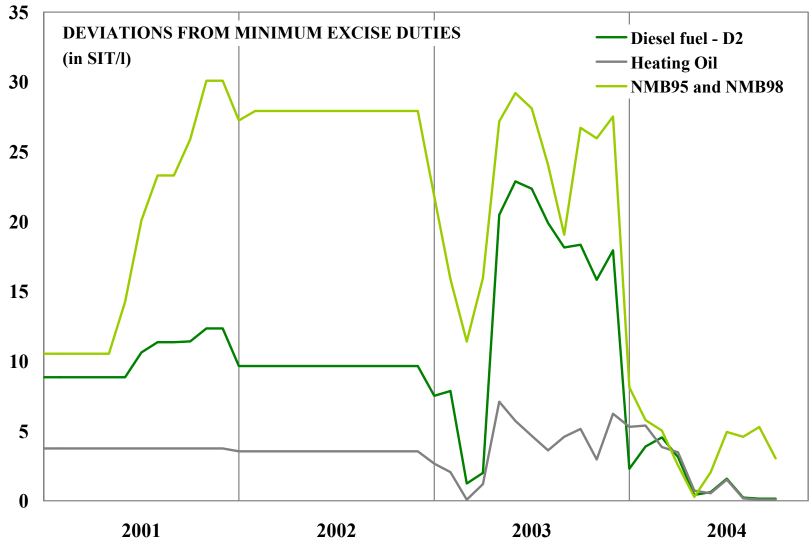
The gradual strengthening of the dollar against the euro at the beginning of the year and its subsequent stalling at 1.23 to the euro did not ease the rise in oil prices. Exchange rates had an effect on import prices via higher commodities prices, and thus on imported inflation. The strengthening of the dollar was to a considerable extent the result of signs of a gradual recovery in the American economy, the beginning of a gradual rise in interest rates in the USA and the consequent reduction of the interest rate differential between the USA and the eurozone.

2.3 Effects of Coordinated Monetary and Fiscal Policies

Appropriate level of real interest rates restricted aggregate demand

The Bank of Slovenia is pursuing its stated objective of price stability. Prior to entering the ERM II it conducted a monetary policy based on the adjustment of interest rates to the needs of sustained disinflation. By maintaining real interest rates at the right level and gradually stabilising the exchange rate, it eased inflationary pressures of a monetary nature and from aggregate demand.

Figure 2.6: Adjustment policy of excise duty on refined petroleum products



Source: Petrol d.d., ARC calculation.

Stabilisation of exchange rate is nominal anchor

The process of nominal convergence was supported by the balance of payments and the fiscal balance. Minor discrepancies between foreign and domestic interest rates enabled the exchange rate to stabilise immediately after entry into the ERM II. After entry interest rate policy became subordinate to exchange rate policy under the conditions set by the ERM II. The stabilisation of the exchange rate is a nominal anchor, but it is necessary to coordinate all macroeconomic policies to ensure it remains sustainable.

Government policy also supporting cuts in inflation

Decline in inflation was also supported by government economic policies. Pursuing an appropriate policy ensured that rises in administered prices were significantly restricted this year. The average rise in administered prices (excluding refined petroleum products, which are formed according to a model) did not exceed the rise in free prices and amounted to 2.4% year-on-year. In addition to restricting price rises a consistent price administration policy is also applying pressure on companies whose prices are covered by administrative measures to cut their prices, with the aim of increasing their competitiveness and efficiency.

Excise duty policy restricted by European Union directives

The government also mitigated the effect of high global oil prices on domestic prices by reducing excise duties on refined petroleum products. Here it was restricted by the European Union's directive on minimum excise duties. This year the minimum excise duties in euros rose by approximately 25%. The rise in the minimum excise duties and the rapid rise in oil prices in the first half of the year restricted the government in its excise duty adjustment policy. In the last year rises in prices of refined petroleum products have contributed one percentage point to inflation, but without the adjustments in excise duties it would have been more. In comparison with previous years, there were significantly fewer discretionary measures of a tax nature this year. The most important among them, those that had a direct impact on inflation this year, were the raising of excise duties on cigarettes and tobacco in January and July, with a total contribution of 0.2 percentage points towards inflation, which was carried out in order to adjust duty levels to those that apply in the European Union.

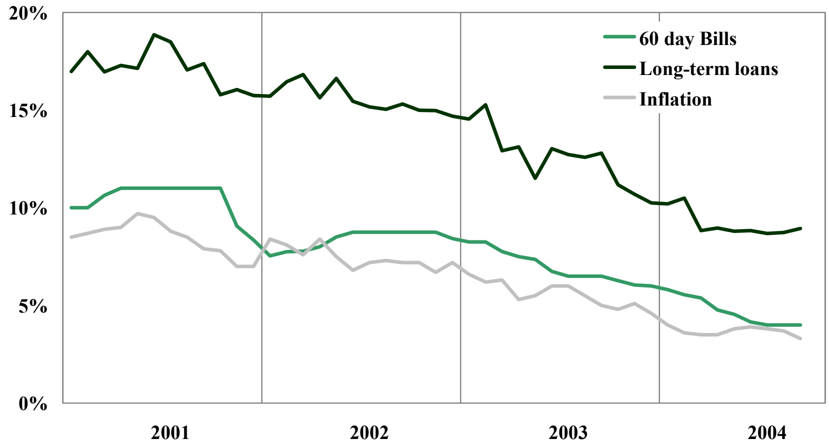
3. MONETARY POLICY IN 2004

3.1 Focus of Monetary and Exchange Rate Policy

Main focus of Bank of Slovenia and government is introduction of euro at beginning of 2007

In the Programme for ERM II entry and adoption of the euro[4] (the joint programme), the Bank of Slovenia and the government committed themselves to entering the ERM II by the end of 2004 and to creating the conditions to allow participation in the ERM II at the earliest possible opportunity. They also committed themselves to the earliest possible adoption of the euro, i.e. the beginning of 2007. With regard to the joint programme, the principal focus of monetary policy prior to entry into the ERM II continued to be a sustainable reduction of inflation. The sustainable fall in inflation while there were cuts in nominal interest rates allowed real interest rates to remain at a level that prevented excessive lending and consumption, and the associated inflationary pressures. The reduction in tolar depreciation was accompanied by cuts in nominal interest rates in line with the need to apply the principle of uncovered interest parity. This policy reduced the gap between domestic and foreign interest rates to a level that allowed the stabilisation of the exchange rate when the ERM II was joined.

Figure 3.1: Maintenance of real interest rates



Source: Bank of Slovenia.

Real interest rates are defined as the difference between the nominal interest rates and the inflation rate. In place of inflation it is better to use the projected inflation rate. As the latter is lower because of the falling inflation trend, the real interest rates are actually even a little higher than shown in Figure 3.1. It should be noted that the Bank of Slovenia has at all times kept interest rates at a level that has maintained the trend of falling inflation, even through the transmission to longer-term interest rates and with the projected changes in inflation and other macroeconomic aggregates being taken into consideration. The Bank of Slovenia raised its interest rates if there was any danger of a break in the disinflation trend.

Monetary policy aimed at stabilising exchange rate since ERM II entry

Since the ERM II was entered on 28 June, the exchange rate has been stable around the central rate of SIT 239.640 to the euro. Since then monetary policy has been aimed at stabilising the nominal exchange rate. Therefore it has been

[4] See Programme for ERM II entry and adoption of euro (November 2003), http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf

factors independent of the Bank of Slovenia that have primarily had an effect on monetary policy during the period of participation in the ERM II:

- interest rates in the eurozone, which are in essence shaped on the basis of the ECB's monetary policy
- the risk premium, which is shaped on the basis of foreign investors' perception of the country risk and currency risk
- price pressures of a non-monetary nature

3.2 Monetary Policy Measures Before ERM II Entry

Continuation of sustainable fall in inflation

Supported by other economic policies, monetary policy was aimed at a sustainable decline in inflation. Inflation fell gradually, from 4.6% in December 2003 to 3.9% when the ERM II was entered in June 2004. In so doing all the most important equilibria in the economy were maintained: the current account of the balance of payments is, in line with expectations, slightly in deficit (0.5% of GDP in the first six months of the year), as was the public finance position (1.5% of GDP).

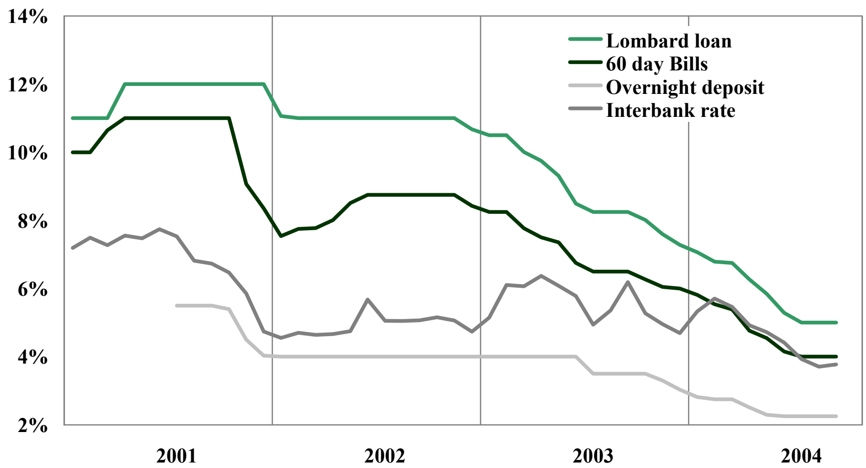
Gradual cuts in nominal interest rates…

With the trend of falling inflation, a gradual decline in nominal interest rates allowed real interest rates to be held at the desired level. This prevented excessive consumption and lending. The interest rates on Bank of Slovenia instruments fell between the end of 2003 and ERM II entry as follows:

- Bank of Slovenia refinancing rate: 5.0% to 3.5% (1.5 percentage points)
- Bank of Slovenia deposit rate: 3.5% to 2.25% (1.25 percentage points)
- 7-day foreign currency swap: 3.0% to 1.5% (1.5 percentage points)
- 7-day reverse foreign currency swap: 1.5% to 0.25% (1.25 percentage points)
- lombard loan: 7.25% to 5.0% (2.25 percentage points)
- 60-day tolar bills: 6.0% to 4.0% (2 percentage points)
- 270-day tolar bills: 6.75% to 4.25% (2.5 percentage points)
- overnight deposit: 3.0% to 2.25% (0.75 percentage points)

Over the same period the year-on-year inflation rate fell by approximately one percentage point, which means that there was no significant change in real interest rates.

Figure 3.2: Bank of Slovenia interest rates



Source: Bank of Slovenia.

The decline in nominal interest rates and the need to close interest parity was reflected in a gradual reduction in the depreciation of the tolar. The signalled current deprecation of the tolar was thus gradually reduced, from 2.5% at the end of 2003 to just 1.0% on an annual basis in June 2004. The uncovered interest parity, measured as the difference between the interest rate on 60-day tolar bills and the ECB's refinancing rate plus the current depreciation of the tolar fell over this period from 1.5 percentage points to 1.0 percentage points. The fall in the interest parity was in line with the fall in Slovenia's risk premium, which has been on a gradual downward path since the end of 2002.

… accompanied by stabilisation of tolar exchange rate

Table 3.1: Closing of uncovered interest parity

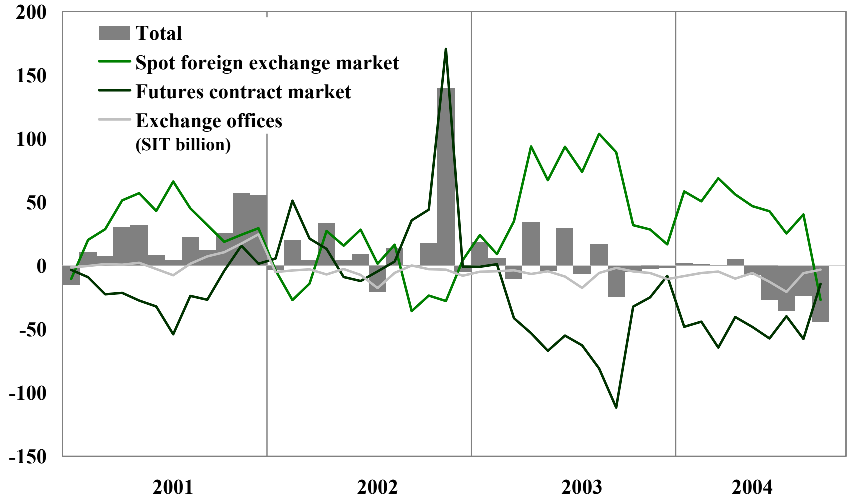
month	Change: 60-day SIT bill	Change: "swap rate"	Change: signalled exchg. rate dynamics	Change: interest rate of ECB refinancing	Level: 60-day SIT bill	Level: "swap rate"	Level: signalled exchg. rate dynamics	Level: interest rate of ECB refinancing
	Implementation of Uncovered Interest rate Parity rule in 2003							
March	-0.75	-0.5	-0.5	-0.25	7.5	4.0	3.0	2.5
May	-0.25	0	0	0	7.25	4.0	3.0	2.5
June	-0.75	-0.5	-0.2	-0.5	6.5	3.5	2.8	2.0
October	-0.25	-0.25	0	0	6.25	3.25	2.8	2.0
November	-0.25	-0.25	-0.3	0	6.0	3.0	2.5	2.0
	Implementation of Uncovered Interest rate Parity rule in 2004							
January	-0.25	-0.25	-0.25	0	5.75	2.75	2.25	2.0
February	-0.25	-0.25	-0.25	0	5.5	2.5	2.0	2.0
March	-0.25	0	0	0	5.25	2.5	2.0	2.0
April	-0.50	-0.25	-0.25	0	4.75	2.25	1.75	2.0
May	-0.25	-0.25	-0.25	0	4.5	2.0	1.5	2.0
June	-0.50	-0.5	-0.5	0	4.0	1.5	1.0	2.0
July	0.00	-0.5	-1.0	0	4.0	1.0	0.0	2.0

Source: Bank of Slovenia.

Between January and May 2004 the total supply of foreign exchange exceeded the total demand by just SIT 0.6 billion. There were no major surpluses or deficits of foreign exchange in the short term, while the largest excess supply of foreign exchange occurred in April (SIT 5.3 billion) and the largest excess demand was in May (SIT 7.1 billion). Because there were no major pressures on the exchange rate, there was no need for exchange rate interventions. During this period the Bank of Slovenia only intervened to signal the rate of nominal convergence, doing so five times for a total of just 13 days.

Foreign exchange market in equilibrium, Bank of Slovenia signals linked to dynamics of nominal convergence

Figure 3.3: Excess supply/demand on foreign exchange markets



Source: Bank of Slovenia.

3.3 Monetary Policy Measures After ERM II Entry

Slovenia entered ERM II on 28 June 2004

Slovenia entered the ERM II, one of the conditions for introducing the euro, on 28 June 2004. The central rate was set at SIT 239.640 to the euro in agreement with the relevant European institutions. The nominal exchange rate can fluctuate within a standard band of ±15% without the ECB being obliged to intervene.

Two-year participation in ERM II is condition for introducing euro

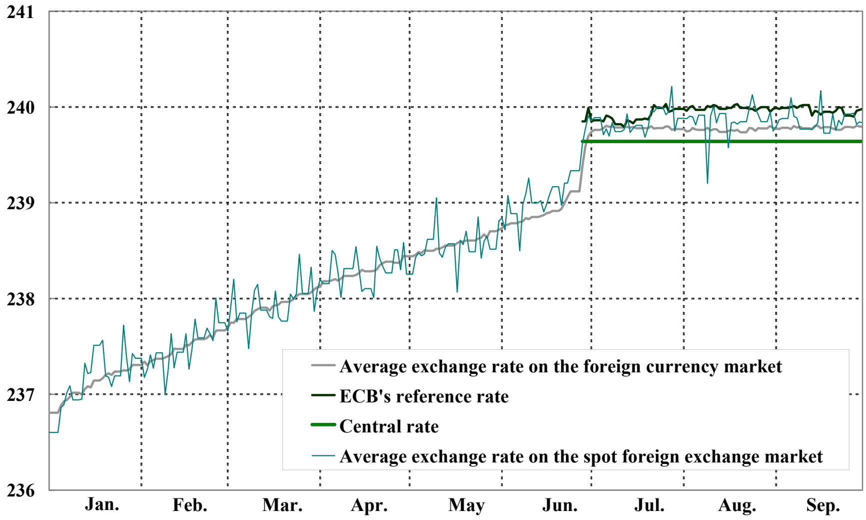
The ERM II is a framework allowing for different exchange rate regimes in EU member-states that are yet to adopt the euro as their currency. The basic features and obligations within the ERM II are:

- The central rate against the euro is set in conjunction with the relevant European institutions, with a standard fluctuation of ±15%.
- Participating in the ERM II for at least two years within the allowed limits of fluctuation in the exchange rate is one of the conditions for introducing the euro. When the stability of the exchange rate is being assessed it is important that fluctuations in the exchange rate within the wide band are an exception, and that the central bank does not intervene too often to defend the exchange rate.
- The central rate against the euro when entering the ERM II is not necessarily the exchange rate at which the national currency will be converted into euros when the euro is introduced.

Successful stabilisation of exchange rate

Since entry into the ERM II monetary policy has been aimed at maintaining the stability of the exchange rate. The discrepancies between the central rate and the market rate during the first period in the ERM II have been negligible. The average deviation of the exchange rate on the spot market[5] from the central rate during the period from ERM II entry to the beginning of October was 0.09%, with a maximum upwards deviation of 0.24% and a maximum downwards deviation of 0.18%. The deviation in the exchange rate on the exchange office market was somewhat smaller. The two exchange rates were above the central rate, a result of excess demand on foreign exchange markets, which amounted to

Figure 3.4: EUR/SIT exchange rate and deviation from central rate



Source: Bank of Slovenia.

[5] The spot market is intended for concluding transactions to be settled within two working days of the contract being concluded. All bank transactions with companies, households and non-residents and all transactions between banks are considered when the rate is calculated. The figures are published in Table 2.13.2 in the Bulletin of the Bank of Slovenia.

SIT 130.5 billion between June and September (see Figure 3.3). This excess demand was the result of balance of payments outflows and greater demand for foreign exchange from residents, which is also partly reflected in the increase in foreign currency deposits. The ECB's reference exchange rate, which reflects the quotation of certain banks on the foreign exchange market and not transactions actually concluded, was also at a level above the central rate, but its variation was lower than that of the exchange rate on the spot market. Its average deviation from the central rate was 0.13%, with a maximum deviation of 0.16%.

The deviation in the Danish krona from the central rate is shown by way of comparison. Denmark has been in the ERM II since 1999, and the central rate is DKK 746.038 to EUR 100, with an agreed band of fluctuation of ±2.5%. In the period to October this year the average deviation in the krona exchange rate from the central rate was 0.25%, with a maximum of 0.38% and a minimum of 0.11%. The exchange rate was below the central rate at all times, so the krona was appreciated against the central rate.

No need for exchange rate interventions

With the equilibrium in the foreign exchange market, there was no need for exchange rate interventions, although it was necessary to give a signal for a stable exchange rate policy within the ERM II. When the ERM II was entered the Bank of Slovenia intervened for three days on the foreign exchange market by setting the base exchange rate at the central rate, and thus signalling its intention to maintain a stable exchange rate. At the same time the Bank of Slovenia raised the price of the reverse foreign currency swap at the beginning of July, thereby allowing banks cheaper access to temporary foreign currency liquidity. At the end of July it intervened on the foreign exchange market quantitatively. With this sole quantitative intervention the Bank of Slovenia again signalled to banks that the tolar's trend of depreciation was at an end.

After ERM II entry, within the framework of the liquidity ladder, the Bank of Slovenia partly opened the possibility of the investment transformation of prescribed short-term foreign currency instruments into foreign currency loans. At the beginning of August it amended the regulation on the liquidity ladder, thereby allowing banks with a long foreign exchange position to have foreign currency loans that reach 120% of the balance of foreign currency swaps with the Bank of Slovenia when fulfilling the investment liquidity structure within the framework of the prescribed coefficients. Because this encouraged banks to use the instrument of foreign currency swaps, the Bank of Slovenia amended the regulation on the minimum level of liquidity in the middle of September to freeze credit ratings for foreign currency lending connected to swaps up to the amount of the average swap in August. Through these measures the Bank of Slovenia restricted the accelerated transformation of maturity periods within the framework of the prescribed investment structure of foreign currency liquidity instruments.

Bank of Slovenia interest rates unchanged

Given that there has been no significant change in the factors that essentially determine monetary policy after entry into the ERM II, the Bank of Slovenia has not altered its key interest rates since entry. Interest rates in the eurozone have remained unchanged in the last year. The last change in the ECB's key interest rate, a cut from 2.5% to 2.0%, was in June 2003. There has been no significant change in Slovenia's risk premium since it entered the ERM II. The year-on-year inflation rate fell between June and August by 0.2 percentage points, and by another 0.4 percentage points in September to reach 3.3%.

In July, with the aim of deferring the increased liquidity deriving from the maturity of tolar bills, the Bank of Slovenia began issuing long-term tolar deposits. The interest rate on the long-term deposit is 0.2 percentage points higher than that on 60-day tolar bills. A total of SIT 208 billion of long-term deposits was offered to banks by the end of September, with the actual subscription amounting to SIT 136.7 billion, of which SIT 76 billion was in

June, SIT 29.4 billion in July and SIT 31.3 billion in September. The stock of 270-day tolar bills fell by SIT 227 billion between the end of June and the end of September, primarily at the account of subscription of long-term deposits, increased subscription of 60-day tolar bills (SIT 57.8 billion) and net repayments of 7-day repos (SIT 212 billion).

Further adaptation of required reserve instrument to ECB standards

The Bank of Slovenia continued its gradual adjustment of the required reserve instrument to the standards of the ECB. Thus in September it:

- included future companies potentially involved in issuing electronic money among those obliged to maintain required reserves
- abolished the compulsory 50% daily fulfilment of required reserves
- regulated the obligation to fulfil required reserves in the event of bankruptcy
- set a 0% level of required reserves for repo transactions

These changes will first be applied in the November period for fulfilling required reserves.

Frame 3.1: Bank of Slovenia measures in 2004

9 January 2004

- The Bank of Slovenia cuts interest rates on all monetary policy instruments by 0.25 percentage points: for 60-day tolar bills from 6.0% to 5.75%, the max bid rate for 270-day tolar bills from 6.75% to 6.5%, for lombard loans from 7.25% to 7.0%, for overnight deposits from 3.0% to 2.75%, the spot/1-week buy/sell FX swap rate from 3.0% to 2.75% and the spot/1-week sell/buy FX swap rate from 1.5% to 1.25%.
- The Bank of Slovenia abolishes the regular daily offer of the 1-week buy/sell-back of FX bills. Henceforth it offers the instrument to banks as required.

12 January 2004

- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled rate of growth in the exchange rate is cut from 2.5% to 2.25% annually. The intervention lasts until 15 January 2004.

27 January 2004

- The Bank of Slovenia changes the required reserve system for the February fulfilment period (beginning 27 January 2004): the period for calculating required reserves is now wholly offset from the period of fulfilment, and the method for calculating interest on required reserves is altered.

6 February 2004

- The Bank of Slovenia cuts interest rates on all monetary policy instruments except overnight deposits by 0.25 percentage points: for 60-day tolar bills from 5.75% to 5.5%, the max bid rate for 270-day tolar bills from 6.5% to 6.25%, for lombard loans from 7.0% to 6.75%, the spot/1-week buy/sell FX swap rate from 2.75% to 2.5% and the spot/1-week sell/buy FX swap rate from 1.25% to 1.0%.
- The Governing Board of the Bank of Slovenia grants the Monetary and Exchange Rate Policy Committee the power to set the interest rate for occasional interventions using the 1-week buy/sell-back of FX bills in the range between the valid 60-day tolar bill and lombard loan rates.

9 February 2004

- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled rate of growth in the exchange rate is cut from 2.25% to 2.0% annually. The intervention lasts until 10 February 2004.
- The Bank of Slovenia restarts regular weekly offers of the 1-week buy/sell-back of FX bills. The amount offered is at least SIT 2 billion, with more as required. The Bank of Slovenia extends them once a week, and banks bid the interest rate. The max bid rate for the first offer is 5.6%.

5 March 2004

- The Bank of Slovenia cuts the interest rate for 270-day tolar bills from 6.25% to 5.75%, and at the same time changes the offer of 270-day tolar bills from a weekly auction to a limited-quantity closed offer, restricting the subscribers to banks that in the previous three months have conducted a sell/buy FX swap with the Bank of Slovenia, with the amount of subscription being restricted to the minimum amount of foreign exchange swapped in that period.

16 March 2004

- The Bank of Slovenia changes the weekly offer of the 1-week buy/sell-back of FX bills from an auction to a closed offer. The Bank of Slovenia makes a discretionary ruling on the quantity assigned after receiving banks' counter-offers.

18 March 2004

- The Bank of Slovenia cuts the interest rate for 60-day tolar bills from 5.5% to 5.25%, and the interest rate for 270-day tolar bills from 5.75% to 5.5%.

2 April 2004

- The Bank of Slovenia cuts the interest rates on all instruments of monetary policy: for 60-day tolar bills from 5.25% to 4.75%, for 270-day tolar bills from 5.5% to 5.0%, for lombard loans from 6.75% to 6.25%, for overnight deposits from 2.75% to 2.5%, the spot/1-week buy/sell FX swap rate from 2.5% to 2.25% and the spot/1-week sell/buy FX swap rate from 1.0% to 0.75%.

6 April 2004

- The Bank of Slovenia changes the weekly offer of the 1-week buy/sell-back of FX bills to a daily offer.

7 April 2004

- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled rate of growth in the exchange rate is cut from 2.0% to 1.75% annually. The intervention lasts until 9 April 2004.

3 May 2004

- The Bank of Slovenia changes the daily offer of the 1-week buy/sell-back of FX bills to a 1-week buy/sell-back of securities. The Bank of Slovenia expands the range of suitable securities from euro- and dollar-denominated Bank of Slovenia bills to tolar-denominated Bank of Slovenia bills and Republic of Slovenia treasury bills. In addition to banks, savings banks may participate in the offer.

7 May 2004

- The Bank of Slovenia cuts the interest rates on all instruments of monetary policy: for 60-day tolar bills from 4.75% to 4.5%, for 270-day tolar bills from 5.0% to 4.75%, for lombard loans from 6.25% to 5.75%, for overnight deposits from 2.5% to 2.25%, the spot/1-week buy/sell FX swap rate from 2.25% to 2.0% and the spot/1-week sell/buy FX swap rate from 0.75% to 0.5%.

10 May 2004

- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled rate of growth in the exchange rate is cut from 1.75% to 1.5% annually. The intervention lasts until 11 May 2004.

4 June 2004

- The Bank of Slovenia cuts the interest rates on all instruments of monetary policy except overnight deposits: for 60-day tolar bills from 4.5% to 4.25%, for 270-day tolar bills from 4.75% to 4.5%, for lombard loans from 5.75% to 5.5%, the spot/1-week buy/sell FX swap rate from 2.0% to 1.75% and the spot/1-week sell/buy FX swap rate from 0.5% to 0.25%.

7 June 2004

- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled rate of growth in the exchange rate is cut from 1.5% to 1.0% annually. The intervention lasts until 9 June 2004.

17 June 2004

- The Bank of Slovenia cuts the interest rates on all instruments of monetary policy except overnight deposits and the spot/1-week sell/buy FX swap rate: for 60-day tolar bills from 4.25% to 4.0%, for 270-day tolar bills from 4.5% to 4.25%, for lombard loans from 5.5% to 5.0%, and the spot/1-week buy/sell FX swap rate from 1.75% to 1.5%.

23 June 2004

- The Bank of Slovenia changes all offers of instruments of monetary policy and exchange rate policy so that at any time in the future they can be altered or cancelled with effect on the same day. At the same time it also changes the deadlines for submitting banks' counter-offers.

28 June 2004

- The Bank of Slovenia enters the ERM II. The central rate is set at SIT 239.640 to the euro, with a lower intervention point of SIT 203.694 and an upper point of SIT 275.586 to the euro (15% above or below the central rate).
- The Bank of Slovenia cuts the spot/1-week buy/sell FX swap rate from 1.5% to 1.0%.
- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled exchange rate is SIT 239.64 to the euro (the same as the central rate), and the intervention selling and buying exchange rates are SIT 239.16 and SIT 240.12 (base rate ±0-2%). The intervention lasts until 1 July 2004.

2 July 2004

- The Bank of Slovenia raises the price of the reverse foreign currency swap from 0.25% to 1.0%, thus allowing banks cheaper access to foreign currency liquidity. This eased the deprecation pressure on the tolar.

20 July 2004

- The Bank of Slovenia cuts the interest rate on 270-day tolar bills from 4.25% to 4.20%.

27 July 2004

- The Bank of Slovenia intervenes on the foreign exchange market.

4. ECONOMIC OUTLOOK[6]

In 2004 GDP will rise by around 3.8%, and with the recovery in the world economy and a gradual stalling in domestic demand GDP growth will remain at roughly the same level in the period to 2006. Inflation will continue to settle down, and the rise in prices will stabilise at a level around 2.5% by the end of 2005. The forecast is for the rate of price rises to be around 3.5% at the end of this year, and 2.5% at the end of 2005, while inflation will settle around that level in 2006.

The first part of this section presents the expected values for selected factors in the international environment. This is followed by a description of projections of economic activity, employment and wages. The third part shows the trend in demand in terms of individual components of expenditure. The external balance and conditions of financing are analysed in the fourth and fifth sections. The final section presents forecasts for price movements. A summary of the forecasts and a comparison with the estimates from April 2004 are given in Table 4.8 at the end of the section.

4.1 International Environment

Price pressures accompanying improved foreign activity

World economic growth is expected to strengthen this year, but despite gradually settling oil prices and commodities prices will remain at a high level. Based on favourable figures for the first half of the year and optimistic indications from the economic climate there is positive hope of a recovery in the world economy.

Table 4.1: Exogenous variables in international environment

				Forecast			2004 Forecast			2005 Forecast			2006 Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
Foreign demand	4.5	2.7	2.6	5.2	6.9	6.9	4.7	5.2	0.5	5.6	6.9	1.3	5.6	6.9	1.3
USD/EUR	0.90	0.94	1.13	1.22	1.22	1.22	1.26	1.22	-0.04	1.26	1.22	-0.04	1.26	1.22	-0.04
Oil USD/barrel	24.4	25.0	28.8	36.0	34.0	30.0	29.0	36.0	7.0	27.0	34.0	7.0	26.0	30.0	4.0
Commodities	-6.5	4.6	11.3	25.0	10.0	3.0	10.0	25.0	15.0	3.0	10.0	7.0	3.0	3.0	0.0
EMU inflation	2.6	2.2	2.1	2.1	2.0	2.0	1.8	2.1	0.3	1.7	2.0	0.3	1.7	2.0	0.3
PPI Germany	1.3	-0.3	1.7	1.1	1.3	1.3	0.6	1.1	0.5	1.2	1.3	0.1	1.2	1.3	0.1
EURIBOR 3m	4.3	3.3	2.3	2.2	2.7	3.1	2.4	2.2	-0.2	2.6	2.7	-1.2	2.9	3.1	0.2

Note: It is the case for the majority of the variables presented in the table that the foreign institutions have not yet published their forecasts for 2006, and the same values as the 2005 forecasts have therefore been assumed for these variables.

Sources: Consensus Forecasts, JP Morgan, OECD Economic Outlook, IMF World Economic Outlook, The International Petroleum Exchange London, ARC calculations.

With the positive contribution of foreign trade diminishing all the time, domestic expenditure should gradually strengthen in the eurozone, including final consumption as well as investment expenditure. Pressures on prices from the side of domestic demand in the eurozone will be restricted by the continuing unfavourable conditions on the labour market and by the agreements on relatively moderate wage rises already concluded. The expectation of significant

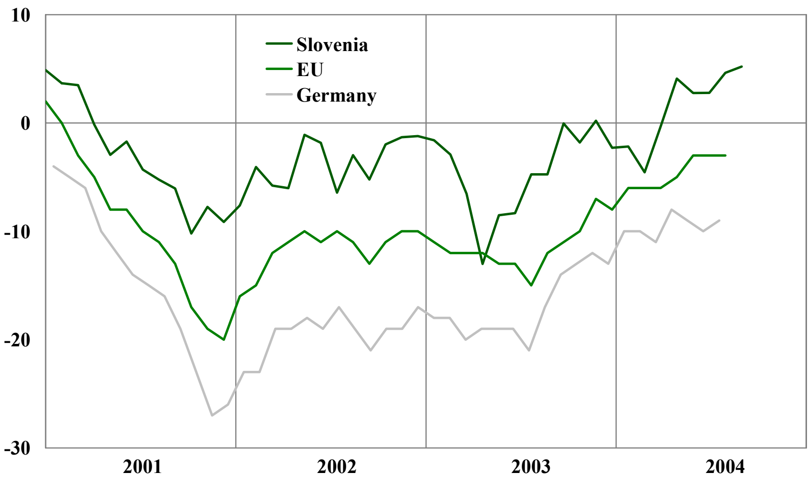
[6] The forecasts were made on the basis of information available and the statistical methodology applicable on 17 September 2004. The projection of macroeconomic factors in this section rests on assumptions for movements in variables in the international environment and certain domestic factors conditioned by economic policy decisions. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are the movements of the tolar exchange rate, public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature.

price pressures abroad from the demand side is low thanks also to the gradual nature of the recovery of the world economy and the tightening of monetary policy already underway. Given the ending of the weakening of the dollar against the euro this year, the existing high oil prices and commodities prices are being reflected in higher import prices, and despite the gradual nature of the rise in demand and higher supply they are to remain high. Supply factors, which in addition to heavy demand for commodities are causing the current high oil prices and commodities prices, also represent the most important risk factor in the future that could create significant inflationary pressures from abroad.

Further recovery of world economy anticipated

Foreign demand will strengthen this year and next year. Following relatively favourable figures on activity in the first quarter, among analysts the prevailing expectation is that the world economy will strengthen this year and next. This is supported by confidence indicators in the last few months in Slovenia's most important trading partners. With the decline in the positive contribution of foreign trade, economic growth in the principal partners in the eurozone should also be the result of increased domestic consumption in the eurozone. In addition to stronger investment activities, after stagnation in the last three years household spending should also strengthen slightly. The recovery of domestic consumption is extremely unevenly distributed among the eurozone countries, and is dependent primarily on the strengthening of the world economy. There is every indication that China's extremely rapid growth has temporarily come to an end, and that the recovery of the American economy is not as strong as had been anticipated a little previously. It is anticipated that fiscal restrictions and high deficits in the current account of the balance of payments will see demand from the countries of eastern and south-eastern Europe that is more sluggish than in comparison with previous years. The exception here is Russia, where the sustainability of the high level of economic activity depends strongly on the movement of oil prices.

Figure 4.1: Business confidence in Slovenia and abroad



Note: Ratio of positive to negative assessment of the economic climate in surveys of companies in manufacturing.
Source: SORS.

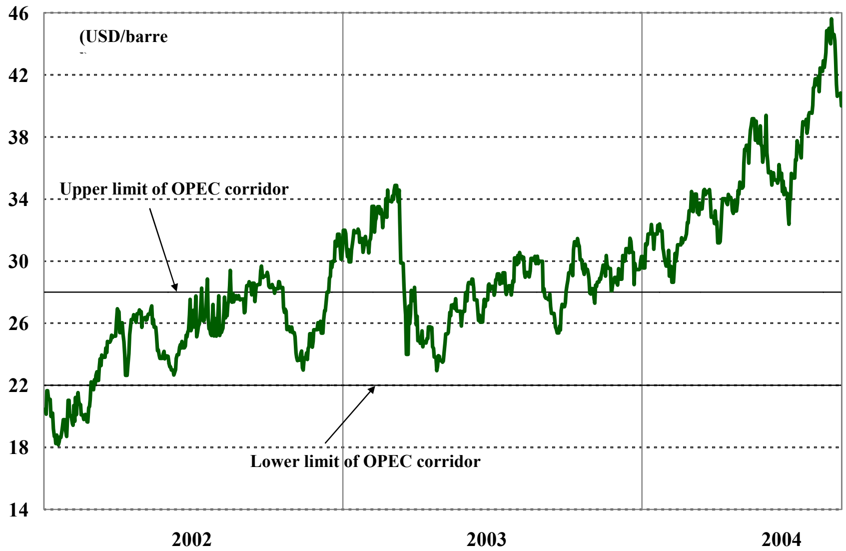
Euro/dollar exchange rate unchanged

The assumption in the forecasts was for the dollar/euro exchange rate to be at the level of 1.22 in the coming years. The rapid appreciation of the euro against the dollar in 2003 stopped in 2004, with the rate stalling around USD 1.22, which is approximately the average for the first eight months of 2004. This rate, which is more than 3% lower than the euro value used in the last forecasts, was used as a technical assumption of the exchange rate trend throughout the forecasting period.

Great uncertainty over anticipated fall in oil prices

The assumed oil prices were revised strongly upwards from the previous forecasts, but there is still an assumption that they will fall. This year oil prices have moved significantly above the upper limit of Opec's target corridor (which the members of the oil cartel are intending to revise upwards soon), and are notably higher than the prices assumed in the previous forecasts. In addition this year's rise in oil prices has not been accompanied by a weakening dollar. The average price of a barrel of Brent crude was USD 43 in August. The basic reasons for high oil prices include the political difficulties, disruptions to production and threats to distribution in Iraq, strong demand with the recovery of the world economy, the Yukos affair in Russia, political instability in Venezuela and Nigeria, and weather conditions in the Gulf of Mexico. Although the extremely rapid rise in recent months has seen forecasts for the price of oil change sharply, the majority of analysts feel that in the future the price will again settle down. Despite economic growth being somewhat moderate in the USA and China, and reserves beginning to be restocked, oil price forecasts remain significantly above the upper limit of Opec's target corridor (USD 28 per barrel). Futures contracts also point to the expectation that oil prices will remain relatively high for the next few years.

Figure 4.2: Oil price – Brent crude, USD/barrel



Source: Reuters.

Gradual easing of rises in commodities prices

After extremely rapid rises last year and this year, rises in commodities prices will begin to slow. With a continuation of the rapid rises from last year, the year-on-year rise in commodities prices expressed in dollar terms will reach as much as 30% this year. In the last six months metals prices have shown the fastest rise, the year-on-year rate exceeding 50% in April, with food prices showing the slowest rise, albeit at a year-on-year rate of 20%. Despite the rapid rises in commodities prices this year, there are specific signs of a slowdown, with the rate beginning to slow after a leap in April. The extremely rapid rises were primarily the result of strong demand for raw materials in China and the gradual recovery of the world economy. The somewhat slower growth in the Chinese economy should see slower rises in commodities prices in the future.

Fuel prices and tax measures having impact on eurozone prices

The consumer price index in the eurozone will fluctuate close to the ECB's target value of 2%. Although this level should only be exceeded in 2004, in the years ahead it is considerably likely that price rises will remain relatively high. Major factors behind the relatively rapid rise in prices this year were higher fuel prices, higher indirect taxes and higher administered prices. With the gradual easing of oil prices and other commodities prices, and a lower level of indirect taxes, the influences of such factors on the consumer price index should gradually lessen. It is fuel prices that represent the largest risk in these forecasts. An additional factor that could entail a higher rise in prices is the recovery of domestic demand. The possibility of higher inflationary expectations transferring themselves into wage rises is currently relatively low, as (in the light of the somewhat uncertain conditions on the labour market) the majority of wage negotiations in the eurozone were already concluded by the moderate wage rise agreements for the next two years. The rise in manufacturers' prices is also primarily the result of rapid rises in fuel prices and other commodities prices. Despite the relative strength of the euro it is anticipated that commodities prices will continue to encourage manufacturers to raise their prices in the future.

Interest rate rise expected abroad

Interest rates in the eurozone will gradually begin to rise. This year the interest rates on the euro have remained at a similar level to the second half of last year. In its recent reports the ECB warned that it will very carefully monitor all factors that could threaten price stability in the medium term (ECB Bulletin, June 2004). Here consideration was given to the fact that the current inflationary pressures are temporary in nature, and that the inflation outlook over a somewhat longer term is in line with the target. The majority of analysts therefore expects interest rates to remain unchanged to the end of the year, but that the ECB will restrict its monetary policy in 2005.

4.2 Activity, Employment and Wages

Ongoing process of real convergence not threatening disinflation trend

Economic growth in Slovenia will remain high in the coming years, and should be around 4% in the period to 2006. After three years of muted economic growth, projections for GDP growth in all years are higher than the estimated growth in potential product. Given this projected economic growth, the process of real convergence with the EU average will continue, as growth in Slovenia will be faster than that in the EU as a whole. Assessments are that this process will gradually close the output gap, which is still negative, and will therefore not entail any significant price pressures.

Table 4.2: Economic activity, employment, wages

				Forecast			2004 Forecast			2005 Forecast			2006 Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
	anual growth rate in real terms in %														
Real GDP	2.7	3.4	2.3	3.8	3.8	4.0	3.1	3.8	0.7	3.6	3.8	0.2	3.9	4.0	0.1
GDP/capita (EUR)	10,801	11,508	12,052	12,798	13,453	14,355	12,491	12,798	307	13,304	13,453	149	14,215	14,355	140
Employment	1.0	0.4	-0.4	0.5	0.7	0.4	0.4	0.5	0.1	0.5	0.7	0.2	0.8	0.4	-0.4
Net wages	3.1	2.1	2.2	1.5	1.7	2.0	1.8	1.5	-0.3	2.3	1.7	-0.6	2.1	2.0	-0.1
Productivity	1.8	2.5	2.7	3.3	3.1	3.6	2.7	3.3	0.6	3.1	3.1	0.0	3.1	3.6	0.5

Source: ARC.

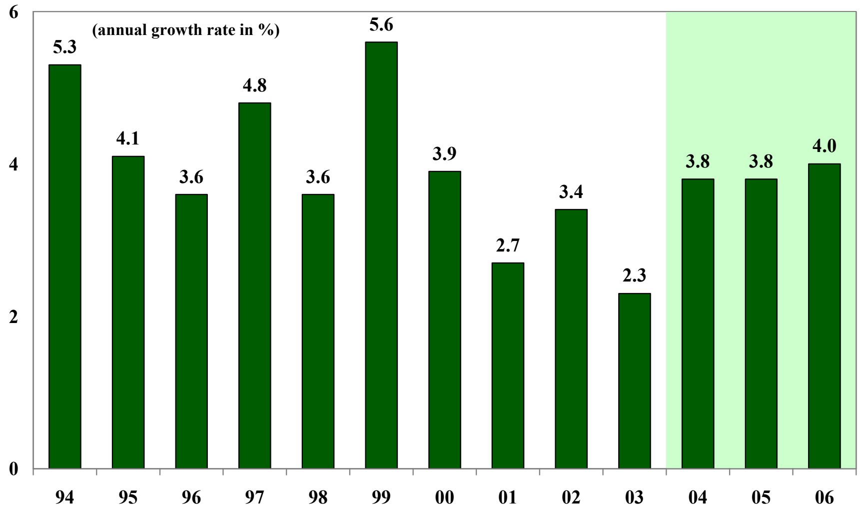
Positive changes in employment expected

The more optimistic outlook will also be reflected in developments on the labour market. Conditions on the labour market began to improve in parallel with the rise in economic growth at the end of 2003 and beginning of 2004. Here a substantial portion of the rise in employment can be attributed to the public sector. Nevertheless, certain signs, in particular an easing in the fall in employment in the small business sector and the fall in unemployment, point to an improvement of conditions in the private sector too. Further falls in employment in labour-intensive sectors are anticipated. Employment in the public sector is expected to rise by around 2% per year, primarily because of the need for recruitment in the armed forces and the police.

Wage growth to remain moderate

The agreements concluded by the social partners should see wage rises ease in the coming years. Real wages will rise between 1.5% and 2.0% per year, and will thus remain behind projected productivity growth. In addition to the public sector wage agreement concluded last year, there was also a private sector agreement concluded this year by the social partners, based on which it can be assessed that total wage rises will be relatively moderate in the future. Public sector wages will rise more slowly than wages in the private sector. On the basis of the public sector wage agreement it can be concluded that real wage rises in the public sector will remain almost unchanged in 2004, and will not significantly exceed 1% in the next two years. It is estimated that the rise in the average wage in the private sector will be around 1.5 percentage points higher than that in the public sector, thanks to the improved economic outlook.

Figure 4.3: Economic activity (real GDP growth)



Source: ARC.

Frame 4.1: Wage adjustments in the private sector

Like the social partners in the public sector in July 2003, at the end of April 2004 the social partners in the private sector concluded a wage agreement that entails a shift away from the previous practice of index-linking wages to past inflation levels. An agreement on the way in which basic wages in the private sector are adjusted was concluded at the end of May for two years, with the first adjustment using the new method being made in September for August's wages.

Under the new system wages in the private sector will be adjusted in line with expected inflation, the movement of the tolar/euro exchange rate and expected inflation in the EU. Instead of making an adjustment to the basic wage by a specific rate, the social partners agreed on lump-sum amounts, these entailing a rise of 3.2% in the average wage in the branch collective agreement in 2004, and of 2.7% in 2005. The minimum lump-sum adjustment to the basic wage was SIT 5,000 in 2004 and SIT 5,100 in 2005.

In the context of these defined absolute minimum amounts the trade unions in particular sectors must agree upon the actual adjustment. Here the provision of the social agreement from last year according to which the rise in real wages must remain at least one percentage point behind productivity growth still applies.

4.3 Elements of GDP Expenditure

Domestic consumption significant, and rise in foreign trade contribution to GDP growth

Despite the improvement in the contribution made by foreign trade, domestic consumption will remain the most important factor of economic growth in the next few years. The high economic growth in the first half of 2004 was to a large extent the result of strong investment expenditure, and while growth in final consumption remained moderate it did improve slightly in comparison with growth in 2003. A large part of the rise in investment expenditure was brought about by the accumulation of inventories, which contributed almost one-third of GDP growth in the first half of the year. It is estimated that in the coming years the contribution made by domestic consumption towards economic growth will continue to be strong, with consumer spending and investment expenditure having an equal share in this. The contribution towards economic growth made by foreign trade, which was negative in 2003, improved somewhat, with a high level of growth in imports and exports of goods being seen in the first half of the year. The negative contribution by foreign trade will continue, but will fall together with the anticipated easing in the growth in domestic consumption, which is largely import-oriented.

Table 4.3: Elements of demand

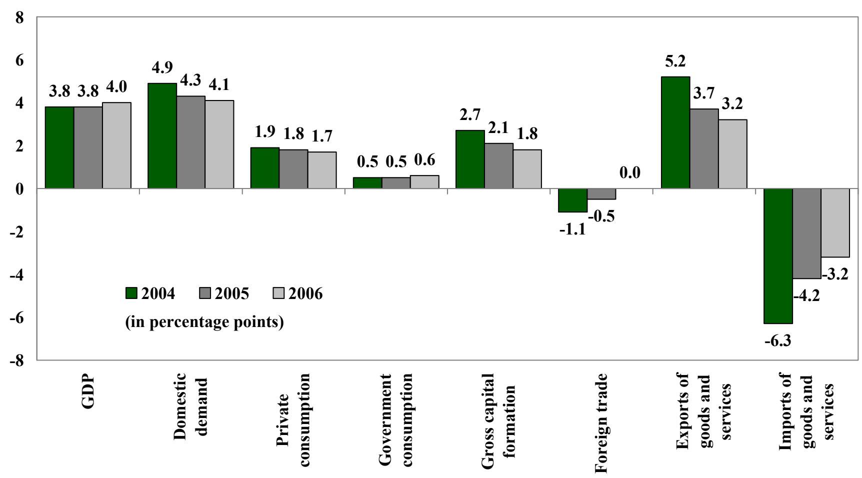
				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
	anual growth rate in real terms in %														
GDP	2.7	3.4	2.3	3.8	3.8	4.0	3.1	3.8	0.7	3.6	3.8	0.2	3.9	4.0	0.1
Domestic demand	0.9	2.1	3.9	4.7	4.1	4.0	4.4	4.7	0.3	4.4	4.1	-0.3	3.9	4.0	0.1
Household consumption	2.3	1.2	3.0	3.5	3.2	3.1	3.7	3.5	-0.2	3.8	3.2	-0.6	3.6	3.1	-0.5
Governemt consumption	4.0	2.5	2.8	2.6	2.1	2.8	3.4	2.6	-0.8	2.4	2.1	-0.3	2.2	2.8	0.6
Gross capital formation	-4.6	4.1	7.0	9.7	7.7	6.3	6.3	9.7	3.4	7.3	7.7	0.4	5.5	6.3	0.8
Exports of G&S	6.5	6.5	3.4	8.5	5.9	4.9	4.6	8.5	3.9	6.0	5.9	-0.1	6.7	4.9	-1.8
Imports G&S	3.0	4.9	6.3	9.9	6.2	4.8	6.7	9.9	3.2	7.2	6.2	-1.0	6.5	4.8	-1.7

Source: ARC.

Moderate growth in disposable income to restrict excessive increases in consumer spending

Growth in household consumption will be reasonably high, although it will gradually fall. Consumer spending was considerable in the months leading up to EU entry, in the first quarter in particular, and began to ease off in the second quarter. It is estimated that consumer spending will remain relatively high in the next few years, partly as a result of relatively low interest rates and partly as a result of the real appreciation of the tolar. With the favourable economic outlook, the rise in employment will also have an impact on a rather high level of consumer spending. Previous forecasts of consumer spending have been revised downwards, primarily because of the almost unchanged rate of growth in household consumption in the second quarter and the relatively moderate wage rises expected. The wage policy agreements reached will somewhat restrict excessive increases in disposable income, while institutional changes in the area of pension insurance will encourage people to make use of more long-term forms of saving.

Figure 4.4: Contribution of GDP elements to economic growth



Source: ARC.

Investment spending to remain high, but to gradually slow

Intensive investment activities will be seen in both the public and private sectors. Capital formation, one of the major factors of economic growth, continued to grow rapidly in the first half of 2004. A large proportion of the growth in capital formation (more than one-quarter in the first half of the year) continues to be accounted for by the accumulation of inventories, which have been rising for almost two years. High capital formation is also partly the result of strength in the housebuilding sector, with the value of housing construction work carried out more than doubling in the first half of the year. In the first half of the year capital formation by the private sector grew faster than capital formation by the state sector, which is also confirmed by figures on the value of civil engineering work undertaken, which grew more slowly than in the last few years. It can be expected in the years ahead that the growth in total capital formation will slow somewhat. The process of inventory reduction must begin, and for this reason capital formation will no longer grow at such high rates as those in the first half of this year. Sustained growth in capital formation, around 7% on a year-by-year basis, will be brought about by improved signals from abroad, favourable terms of financing inside and outside Slovenia, and the ongoing construction of infrastructure.

General government expenditure to rise gradually

Government consumption will rise more slowly than the other elements of GDP. General government expenditure in the first half of 2004 was extremely sluggish, thanks to both slower growth in wage expenditure and nominal cuts in expenditure on goods and services. The provisions of the public sector wage agreement and a rise in employment in the public sector by 2% a year were taken into consideration in the projection of government expenditure to the end of 2004. Under these assumptions the real growth in the average wage in the public sector will not significantly exceed 1%. The extremely low rate of growth in the first half of 2004 was taken into consideration for the expenditure on goods and services, with the assessment being that expenditure will rise somewhat faster in the future, making the real rate of growth in general government expenditure somewhat higher at the end of the projected period.

4.4 Balance of Payments

Current account deficit to remain at sustainable level

The current account will be in deficit in the coming years. In the first seven months of 2004 the current account deficit fell from 0.6% of GDP during the same period last year to 0.2% of GDP. Exports were up in the first half of the year thanks to the recovery in Slovenia's most important trading partners and accelerated export dynamics during the months leading up to EU entry, when companies were attempting to exploit more favourable trade agreements with non EU members.

Table 4.4: Current account of balance of payments

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
Exports of G&S	6.5	6.5	3.4	8.5	5.9	4.9	4.9	8.5	3.6	6.0	5.9	-0.1	6.7	4.9	-1.8
Imports of G&S	3.0	4.9	6.3	9.9	6.2	4.7	6.7	9.9	3.2	7.2	6.2	-1.0	6.5	4.7	-1.8
Current account:															
- EUR million	38	330	-91	-246	-433	-215	-238	-246	-8	-534	-433	101	-522	-215	307
- % BDP	0.2	1.5	0.1	-1.0	-1.6	-0.7	-1.0	-1.0	0.0	-2.0	-1.6	0.4	-1.8	-0.7	1.1
Terms of trade	2.7	2.7	0.2	-0.7	1.3	0.7	0.6	-0.7	-1.3	1.0	1.3	0.3	0.0	0.7	0.7

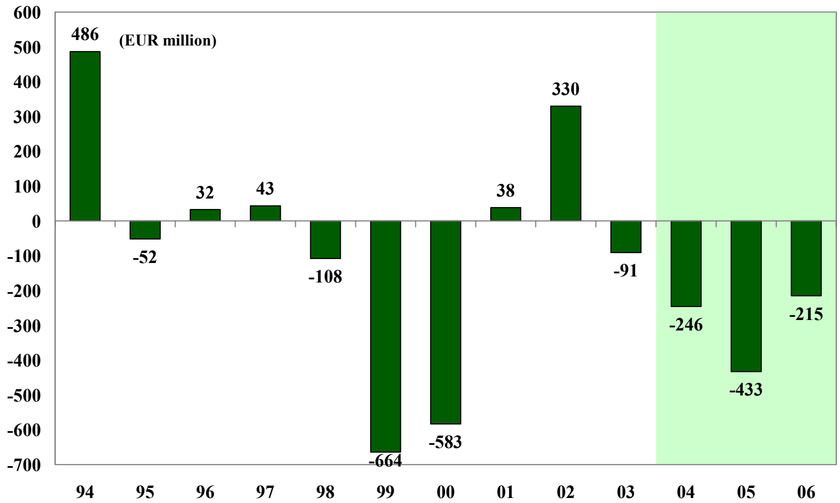
Source: ARC.

The changes in exports more than compensated for the somewhat higher domestic demand for foreign products. Because domestic demand was primarily oriented towards capital formation, it was not reflected to a great extent in a worsening of the current account balance. The terms of trade will have a negative impact on the current account in 2004 in particular, and will then improve again.

Current account deficit to amount to approximately 1% of GDP in coming years

The estimated deficit in current transactions will worsen to around 1.5% of GDP in 2005. The current account balance will also worsen this year and in the next two years compared with 2003 and the first seven months of this year. Last year's current account deficit of EUR 91 million is anticipated to rise to around EUR 250 million this year, equivalent to 1% of GDP., while in 2005 it is likely to amount to approximately 1.5% of GDP. The principal factors in the worsening of the balance of current transactions this year and in the next two years will be changes in the estimated level of foreign trade in goods and reinvested earnings,[7] which will be higher than the estimated current levels. With exports rising faster than imports the current account deficit will fall to around 0.7% of GDP in 2006.

Figure 4.5: Current account of balance of payments



Source: ARC.

Slowing of trade flows after high growth in first half of year

The largest contribution to the worsening of the current account balance will be a larger deficit in trade in goods. Exports of goods will strengthen in line with the rise in foreign demand, while the rise in imports will primarily be linked to the strengthening of domestic consumption. Here it was assumed in particular for 2004 that in the months leading up to EU entry expectations of less favourable pricing conditions in the period ahead for both imports and exports saw a partial time shift of goods trade from the second half of the year to the first half, and that the rise in goods trade will ease in the second half of the year. The rise in exports of goods is also higher than previously forecast because of the greater rise assumed in foreign demand. In the future the volume of goods exported will move in line with the recovery of the world economy. With the realisation of the forecast trends in inflation and labour costs, participation in the ERM II and the more stable tolar exchange rate will not significantly weaken the competitiveness of Slovenian exporters.

Imports to rise in line with size and structure of domestic consumption

The rise in the deficit in goods trade will in particular be caused by relatively high imports of capital goods and consumer goods. On the imports side a slowdown in the imports of goods is expected after the rapid rise in the first half of 2004. The high growth in imports of goods in the first half of 2004 coincided with higher consumer spending, high investment activity and high imports of

[7] Reinvested earnings are the portion of earnings that a foreign owner of a domestic company does not remit abroad but reinvests in the domestic company. In this case there is no actual flow of foreign currency. In the current account this item is recorded under "capital expenses", while its counter-item in the financial account is "foreign direct investments".

intermediate goods owing to the high level of exports. The rapid rise in imports of goods in the projections is in line with the sustained rise in domestic consumption. In the period to 2006, when they should equalise, estimates are that imports of goods will rise faster than exports. The basic uncertainty in the forecast for the volume of imports continues to relate to the size of the increase in domestic consumption.

Trend in terms of trade highly uncertain

The terms of trade will have a negative impact on the current account balance in 2004, but a positive impact later in the forecasting period, although the exact movement is shrouded in uncertainty. In 2004 the rise in import prices will outpace export prices by 0.7 percentage points, but in 2005 and 2006 the terms of trade will be 1 percentage point positive on average. The terms of trade will thus worsen the current account deficit by approximately 0.2% of GDP in 2004, but improve it by approximately 0.4% of GDP in 2005. The faster growth in import prices than in export prices in 2004 is primarily the result of the high oil prices and high commodities prices, while the favourable terms of trade in 2005 and 2006 result from assuming that these will ease. It is oil and commodity prices that represent the largest risk in forecasting terms of trade, as shocks on the supply or demand side on the commodities market (with unfavourable changes in exchange rates) could prevent the terms of trade making the positive contribution to the current account balance as expected.

Remaining components of current account relatively unchanged

No significant changes are anticipated in the other elements of the current account. The balance of trade in services will move in line with the rise in domestic demand and the strengthening of economic activity abroad. In 2004 it will thus improve somewhat and then begin to gradually worsen. The balance of labour income will remain unchanged, while the balance of capital income will worsen owing to low interest rates and unfavourable changes in foreign exchange reserves and the external debt on one side and reinvested earnings from FDIs in Slovenia on the other side. With Slovenia having joined the EU, transfer receipts are expected to increase slightly. Realisation is primarily connected to the ability to co-finance domestic projects from domestic sources that are not yet secured, and projections of transfers therefore demand prudence.

4.5 Terms of Financing

Financial flows with rest of world to be balanced

The financing of the economy will depend on the projected trends in the real sector and in the current account of the balance of payments. The sum of the estimated financial flows with the rest of the world in the next three years will be balanced, with neither the net inflow or outflow exceeding 0.6% of GDP. The main reasons for the reduction of net financial inflows in comparison with the previous projections are the smaller inflows from foreign direct investments and the higher outflows via residents' portfolio investments abroad. To a great extent the net outflow will also be the result of the maturity of government eurobonds in 2005. The volume of financial transactions with the rest of the world will increase in both directions, a result of Slovenia's ever-greater integration into the single European market, which is bringing smaller risks for foreign investors, the small size of the domestic market and full openness in capital flows, which allows residents to seek additional sources of financing abroad.

Favourable terms of financing to continue

It is assessed that the terms of financing will remain relatively favourable. Interest rates, which are only expected to gradually begin to rise at the start of next year, and Slovenia's low risk premium are facilitating relatively cheap access to sources of financing. The total freedom in the movement of capital and partly also the lack of sufficient funds and investment opportunities on the domestic market are encouraging Slovenia's economy to integrate further with the rest of the world.

Trade credits remain outflow items despite negative current account balance

Trade credits will remain among the most important outflow items in the capital account of the balance of payments. Trade credits this year will be lower than last year, and then they will begin to gradually increase. Given the balance of payments and public finance problems in trading partners from the former Yugoslavia and central Europe, financing will still be required for importers from these areas. This will be facilitated by both the relatively low level of interest rates abroad and equal access to sources of financing. At the same time Slovenian companies that are financing their customers in such a manner are exposed to greater risk.

Table 4.5: Financial flows with rest of world

				Forecast			2004 Forecast			2005 Forecast			2006 Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
	share of GDP (in %)														
Net financial flows	7.9	4.9	0.4	0.2	-0.6	0.5	-0.1	0.2	0.3	-0.5	-0.6	-0.1	1.4	0.5	-0.9
FDI	1.3	7.4	-0.4	-0.4	-0.2	0.0	0.2	-0.4	-0.6	0.3	-0.2	-0.5	0.4	0.0	-0.4
	balance at the end of the year														
Foreign exchange reserves															
- balance in EUR million	6,514	7,842	7,881	7,891	7,326	7,229	7,678	7,891	213	6,994	7,326	332	6,877	7,229	352
- share of GDP	30.2	34.1	32.7	31.1	28.2	26.2	30.7	31.1	0.4	26.3	28.2	1.9	24.2	26.2	2.0
External debt															
- balance in EUR million	10,403	11,483	13,051	14,629	15,923	17,381	14,349	14,629	280	15,283	15,923	640	16,621	17,381	760
- share of GDP	48.2	49.9	54.1	55.5	57.9	60.7	57.4	55.5	-1.9	57.4	57.9	0.5	58.5	60.7	2.2

Source: ARC.

Net outflow to rest of world via foreign direct investments

The net outflow via foreign direct investments will fall in the coming years, while the net outflow via portfolio investments will rise. The amount of direct investments in Slovenia and the amount of direct foreign investments by Slovenian residents in the rest of the world will both rise. No major acquisitions of Slovenian companies by foreign investors are anticipated, even though EU entry has made such investments less risky and thus more attractive. International trends of foreign investment show that after a period of high growth there is a consolidation phase, when foreign investors, rather than making new investments, are more involved in incorporating the newly acquired companies into their development strategies, checking the soundness of previous investments and in certain cases even disinvesting. Nevertheless it is anticipated that Slovenian companies will continue to invest in the rest of the former Yugoslavia, attempting to bypass the worsening in trading conditions brought about by higher customs duties and the abolition of preferential trade agreements when Slovenia joined the EU. Net outflows via portfolio investments by the private sector will rise slightly more. With the increase in residents' interest in alternative sources of investment and the simultaneous lack of appropriate instruments on the domestic financial market, the outflow to the rest of the world via portfolio investments by financial institutions (insurers, mutual funds) can be expected to be quite strong.

Sustained fall in foreign exchange reserves and rise in external debt

Owing to the worsening of the current account balance and, in part, the net outflow in financial transactions with the rest of the world, foreign exchange reserves will gradually fall in the coming years. The external debt will rise primarily because of greater borrowing by the private sector, but it will not worsen significantly as a proportion of GDP or as a proportion of exports of goods and services.

Increase both in loans raised and loans made abroad

The amount of foreign loans raised and foreign loans made will increase, and the balance of these will strengthen somewhat in comparison with 2003. The need to finance growing economic activity will increase the amount of loans raised abroad. Given the high level of activity in the first eight months of 2004, the item of loans raised abroad by banks for foreign currency lending in Slovenia has in particular been revised upwards. At the same time the amount of lending to companies from abroad will not rise significantly in the years ahead.

Total financing of economy to rise

The total amount of domestic and foreign financing will rise in the years ahead. Such a development is in line with increased economic activity and the high level of domestic consumption. The proportion of companies' financing accounted for by foreign loans will fall to about one-fifth of total lending. In line with the ongoing restructuring of debt, government borrowing on the domestic market will also rise rapidly. Strong lending by banks from abroad and the high growth in foreign currency deposits will see foreign currency lending grow fastest among all domestic lending. Given the large amount of lending by banks from abroad and the increase in foreign currency deposits this is understandable, as banks will thus balance their assets and liabilities in terms of currency.

Uncertainty regarding government borrowing

It is assumed that the government will not finance itself abroad by issuing securities. In the middle of 2005 liabilities from eurobonds in the amount of EUR 500 million fall due for payment, and the vast majority of the eurobond holders are non-residents. Given the available information, it is assumed that the government will not take on borrowing abroad in order to repay these liabilities. In this connection there is uncertainty regarding the possible new issues of government bonds and uncertainty regarding the amount of the released funds that foreign investors will be ready to reinvest in Slovenian securities. This would neutralise the outflow caused by the maturity of previous eurobond issues.

Rise in borrowing by companies and fall in household borrowing

With consumption relatively high, borrowing by companies will in particular rise in the years ahead. This will continue the trends from last year, when lending to companies grew at a considerable rate, foreign currency lending in particular. Net borrowing by companies, measured as the ratio of loans to deposits, will again begin to rise notably, while net household borrowing will remain relatively unchanged in the years ahead.

Maturity period of borrowing to increase

The trend of greater long-term borrowing at the expense of short-term borrowing will continue in the years ahead. On the side of demand for long-term lending, the continuation of the gradual recovery of investment expenditure will contribute most to this.

Contribution of net foreign assets to creation of M3 to remain negative

It is also anticipated that net outflows in the current and financial accounts of the balance of payments will see broad money created via domestic lending activity. The contribution made to the creation of broad money by flows with the rest of the world will be negative, as it has been since the second half of 2003. Here slightly higher growth in domestic lending has been assumed, owing to the increase in consumption.

Varying dynamics of monetary aggregates

The growth in monetary aggregates will ease, but with a varying dynamic. The net outflows to the rest of the world will see broad monetary aggregates slowing down more obviously. In line with increased economic activity and falling inflation the growth in narrow money will ease off more slowly.

Table 4.6: Monetary system

				Forecast			2004 Forecast			2005 Forecast			2006 Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
	annual average														
M1	9.7	16.9	12.3	14.1	12.0	9.3	12.9	14.1	1.2	11.9	12.0	0.1	10.9	9.3	-1.6
M3	22.7	23.5	14.1	6.5	6.9	7.4	11.3	6.5	-4.8	10.4	6.9	-3.5	9.2	7.4	-1.8
Credits total	18.7	17.3	11.8	16.9	18.1	16.9	17.0	16.9	-0.1	16.2	18.1	1.9	15.4	16.9	1.5

Source: ARC.

Shortening of deposit maturity periods expected

The maturity structure of tolar deposits will continue to change in favour of a higher proportion of short-term deposits. The shortening of maturity periods is also indicated by the latest figures, which show increased demand for transaction money in line with increased economic activity and falling inflation. Short-term tolar deposits will also grow faster than long-term deposits because the slope of interest rate curve is easing off.

4.6 Inflation

Projections show further fall in inflation

It is estimated that the process of a sustained fall in inflation will continue in the years ahead, with the rate stabilising around 2.5%. Taking exogenous variables and assumptions about economic policy into consideration, inflation will amount to 3.5% in the last quarter of 2004, and to 2.5% in the period when the Maastricht criteria are to be evaluated (the second half of 2005 and the first half of 2006). The revision of the forecast for 2006 downwards is primarily the result of the redistributed growth in administered prices being assumed to be lower than in previous forecasts, with the redistribution being dictated by the movement of the oil price. Part of the lowering of administered prices will also be transmitted to free prices.

Table 4.7: Price growth

				Forecasts			2004 Forecasts			2005 Forecasts			2006 Forecasts		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
	average annual growth rates in %														
Consumer price index	8.5	7.6	5.6	3.6	3.0	2.5	3.4	3.6	0.2	3.0	3.0	0.0	2.8	2.5	-0.3
Free prices	7.7	7.6	5.9	3.2	2.9	2.7	3.4	3.2	-0.2	3.0	2.9	-0.1	2.8	2.7	-0.1
Administered prices	12.5	7.5	4.8	6.1	3.6	1.4	3.0	6.1	3.1	3.2	3.6	0.4	2.9	1.4	-1.5
	annual growth rates in % (final quarter)														
Consumer price index	7.3	7.2	4.8	3.5	2.5	2.5	3.2	3.5	0.3	2.8	2.5	-0.3	2.8	2.5	-0.3
Free prices	7.9	6.9	5.1	2.8	2.7	2.7	3.2	2.8	-0.4	2.8	2.7	-0.1	2.8	2.7	-0.1
Administered prices	5.0	8.8	3.7	7.6	1.4	1.4	3.2	7.6	4.4	2.9	1.4	-1.5	2.9	1.4	-1.5

Source: ARC.

Oil prices introducing uncertainty to forecasts

The fall in total inflation will also be supported by low rises in free prices and a parallel easing in administered prices. Despite high oil prices it is assumed that the government will hold to the projected plan for raising other administered prices. The assumption is that owing to high oil prices administered prices will rise faster in 2004 and 2005 than free prices. Thus they will rise in 2004 by an average of 6.1%, and will be 3.6% higher in 2005. A significant risk here is the movement of oil prices, which with a significant deviation away from the assumptions could prevent the projected fall in the rate at which administered prices rise. Estimates are that free prices will rise by 2.8% on a year-on-year basis in the final quarter of 2004, and by 2.7% in the last quarter of 2005.

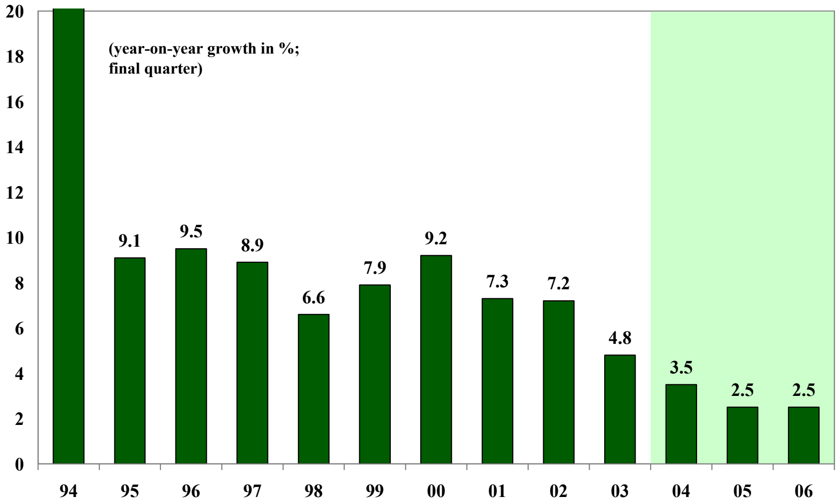
Price pressures from abroad to only ease slowly

Price pressures from abroad should begin to ease. The rise in the consumer price index abroad strengthened in particular this year because of the high rises in commodities prices. Because the euro did not strengthen appreciably against the dollar, the higher commodity prices were transferred to import prices, and also had a direct and indirect impact on prices in Slovenia. Given the assumptions, the average rise in import prices will accelerate further in 2005, thus preventing a faster fall in free prices. Despite the assumed strengthening of world economic growth, thanks to increasingly restrictive monetary policy abroad this will not entail any significant price pressures.

Key role of economic policies

It is anticipated that economic policies will continue to act to prevent shocks that could halt the lowering of inflation. Despite the relatively high rates of economic growth, the current level of economic activity continues to be lower than the estimated level of potential growth. At the same time economic growth is not driving final consumption, but rather an improvement in the contribution made by foreign trade and higher investment spending. Increased economic activity will therefore not be significantly reflected in price movements. By ensuring that real interest rates are at an appropriate level monetary policy has also contributed to this, which has prevented the occurrence of demand pressures. Despite slight acceleration because of the improved outlook for the coming years, wage rises should remain moderate, thanks also to the social agreement, which envisages the rise in real wages remaining a percentage point behind productivity growth. Fiscal policy in the first half of the year was also somewhat restrictive, with general government expenditure growing slowest among all the elements of domestic demand. It is thus expected that there will be no significant shocks from the side of final consumption in the future.

Figure 4.6: Inflation – year-on-year, final quarter

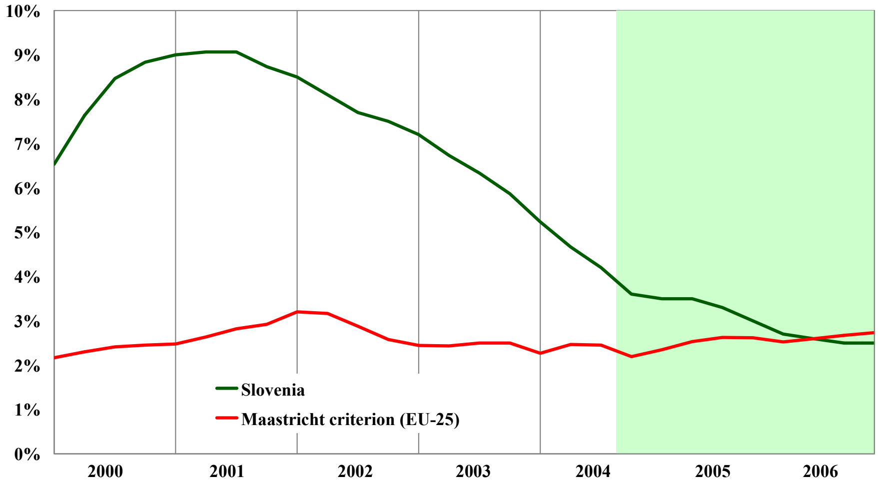


Source: ARC.

Little manoeuvring room for government to adjust excise duties

The forecasts assume that the government will continue its policy of adjusting excise duties on refined petroleum products to prevent high oil prices being transferred to domestic prices. Given the high oil prices this year the government cut excise duties to the level allowed by EU regulations, but could not entirely prevent an impact on higher prices of refined petroleum products. Despite excise duties being cut by 5.4% on petrol and by 7.6% on diesel in the period to September, prices of refined petroleum products rose by 13% in Slovenia on a year-on-year basis.

Figure 4.7: Inflation convergence criteria



Note: The inflation convergence criterion has been calculated by considering the three countries with the lowest actual and forecast inflation as the average of year-on-year consumer price indices in four quarters.

Source: Bank of Slovenia and European Commission.

Given any further rises in oil prices on world markets, EU regulations give the government almost no more manoeuvring space for further cuts in excise duties. In the event of oil prices gradually falling on world markets, the forecasts are based on the assumption that prices of refined petroleum products will remain unchanged and that the government will raise the excise duties appropriately. It was also assumed in the projections that the government will not make a significant contribution to raising prices by making discretionary adjustments to indirect taxation, apart from the adjustment to excise duties on tobacco mentioned previously. Estimates are that indirect taxes will contribute 0.3 percentage points towards inflation in 2004 and 0.1 percentage points in 2005.

Limited rise in household incomes to not generate inflationary pressures

Household incomes will not put pressure on price trends, either on the demand side or the supply side. The need to maintain competitiveness means that the gradual recovery of the economic outlook will prevent excessive wage rises in the private sector. The agreements reached between employers and unions over the mechanism for adjusting basic wages in both the private and public sectors will play an important role in preventing substantial inflationary pressures.

Frame 4.2: Forecasts by other institutions

Forecasts for Slovenia are compiled not only by domestic institutions but also by international and private organisations. It is useful to compare forecasts because they highlight differences in thinking concerning future economic trends. However, the forecasts are not directly comparable because they cover different periods and therefore do not take into account the same information. Furthermore, the forecasts rest on different assumptions with regard both to exogenous variables in the international environment and to economic policy action.

Notwithstanding these differences, there is a consensus that following relatively high growth in economic activity in Slovenia in 2004 similar growth will continue in 2005. A feature of these forecasts is significant upward revisions of economic growth in 2004, the average for all institutions being more than 0.7 percentage points. There are still differences regarding the sources of economic growth, with considerable differences between forecasts for the current account balance, a range of 1 percentage point of GDP being seen for 2004 (0.0% to –1% of GDP), while there is a consensus that in 2005 the current account deficit will again rise, the range expanding to 1.5 percentage points (–0.1% to –1.6% of GDP).

The inflation forecasts also differ, although the differences are significantly smaller than six months ago. Forecasts of average annual inflation range from 3.6% to 3.9% for 2004, and from 3.0% to 3.3% for 2005. Although smaller than six months ago, there are still differences between the forecasts of domestic and foreign institutions, with domestic institutions generally more optimistic with regard to a decrease in inflation.

Table: Comparison of forecasts for Slovenia and differences from previous forecasts

	Date of new / previous forecast	GDP (annual growth in %)				Inflation (annual average in %)				Current account (share of GDP in %)			
		2004		2005		2004		2005		2004		2005	
		new	diff.	new	diff.	new	diff.	new	diff.	new	diff.	new	diff.
Bank of Slovenia	Oct.04 / Apr.04	3.8	0.7	3.8	0.2	3.6	0.2	3.0	0.0	-1.0	0.0	-1.6	0.4
EIPF	Sep.04 / Mar.04	3.8	0.5	3.8	0.0	3.9	0.4	2.9	-0.8	-1.0	0.1	-1.2	0.1
IMAD	Oct.04 / Apr.04	4.0	0.4	3.8	0.1	3.6	0.3	3.2	0.2	0.0	0.2	-0.1	0.3
European Comission	Oct.04 / Apr.04	4.0	0.8	3.7	0.1	3.9	0.3	3.2	0.0	-0.2	0.3	-0.7	-0.1
IMF	Oct.04, Jul.04 / Apr.04	4.6	1.1	4.1	0.0	3.6	-0.1	3.2	-0.2	-0.6	0.0	-1.4	-0.4
Consensus Forecasts	Sep.04 / Apr.04	3.7	0.1	3.9	0.1	3.8	-0.6	3.3	-0.5	-0.1	0.2	-0.2	0.4

Sources: IMAD, EIPF, European Commission Economic Forecasts Autumn 2004, IMF World Economic Outlook, Consensus Economic Forecasts.

Table 4.8: Selected main indicators

				Forecast			2004 Forecast			2005 Forecast			2006 Forecast		
	2001	2002	2003	2004	2005	2006	Apr.	Oct.	Δ	Apr.	Oct.	Δ	Apr.	Oct.	Δ
Activity, employment, wages	*real growth rate in %*														
Real GDP	2.7	3.4	2.3	3.8	3.8	4.0	3.1	3.8	0.7	3.6	3.8	0.2	3.9	4.0	0.1
GDP/capita (EUR)	10,801	11,508	12,052	12,798	13,453	14,355	12,491	12,798	307	13,304	13,453	149	14,215	14,355	140
Employment	1.0	0.4	-0.4	0.5	0.7	0.4	0.4	0.5	0.1	0.5	0.7	0.2	0.8	0.4	-0.4
Net wages	3.1	2.1	2.2	1.5	1.7	2.0	1.8	1.5	-0.3	2.3	1.7	-0.6	2.1	2.0	-0.1
Productivity	1.8	2.5	2.7	3.3	3.1	3.6	2.7	3.3	0.6	3.1	3.1	0.0	3.1	3.6	0.5
Domestic demand	*real growth rate in %*														
Domestic demand	0.9	2.1	3.9	4.7	4.1	4.0	4.4	4.7	0.3	4.4	4.1	-0.3	3.9	4.0	0.1
Household consumption	2.3	1.2	3.0	3.5	3.2	3.1	3.7	3.5	-0.2	3.8	3.2	-0.6	3.6	3.1	-0.5
Government consumption	4.0	2.5	2.8	2.6	2.1	2.8	3.4	2.6	-0.8	2.4	2.1	-0.3	2.2	2.8	0.6
Gross capital formation	-4.6	4.1	7.0	9.7	7.7	6.3	6.3	9.7	3.4	7.3	7.7	0.4	5.5	6.3	0.8
Balance of payments	*real growth rate in %*														
Exports of G&S	6.5	6.5	3.4	8.5	5.9	4.9	4.9	8.5	3.6	6.0	5.9	-0.1	6.7	4.9	-1.8
Imports of G&S	3.0	4.9	6.3	9.9	6.2	4.7	6.7	9.9	3.2	7.2	6.2	-1.0	6.5	4.7	-1.8
Current account:EUR mio	38	330	-91	-246	-433	-215	-238	-246	-8	-534	-433	101	-522	-215	307
% GDP	0.2	1.5	0.1	-1.0	-1.6	-0.7	-1.0	-1.0	0.0	-2.0	-1.6	0.4	-1.8	-0.7	1.1
Terms of trade	2.7	2.4	0.2	-0.7	1.3	0.7	0.6	-0.7	-1.3	1.0	1.3	0.3	0.0	0.7	0.7
Net financial flows	7.9	4.9	0.4	0.2	-0.6	0.5	-0.1	0.2	0.3	-0.5	-0.6	-0.1	1.4	0.5	-0.9
in that: FDI	1.3	7.4	-0.4	-0.4	-0.2	0.0	0.2	-0.4	-0.6	0.3	-0.2	-0.5	0.4	0.0	-0.4
Foreign exchange reserves															
- balance in EUR mio	6,514	7,842	7,881	7,891	7,326	7,229	7,678	7,891	213	6,994	7,326	332	6,877	7,229	352
- share of GDP in %	30.2	34.1	32.7	31.1	28.2	26.2	30.7	31.1	0.4	26.3	28.2	1.9	24.2	26.2	2.0
External debt															
- balance in EUR mio	10,403	11,483	13,051	14,629	15,923	17,381	14,349	14,629	280	15,283	15,923	640	16,621	17,381	760
- share of GDP in %	48.2	49.9	54.1	55.5	57.9	60.7	57.4	55.5	-1.9	57.4	57.9	0.5	58.5	60.7	2.2
Monetary system	*average annual growth rate in %*														
M1	9.7	16.9	12.3	14.1	12.0	9.3	12.9	14.1	1.2	11.9	12.0	0.1	10.9	9.3	-1.6
M3	22.7	23.5	14.1	6.5	6.9	7.4	11.3	6.5	-4.8	10.4	6.9	-3.5	9.2	7.4	-1.8
Credits total	18.7	17.3	11.8	16.9	18.1	16.9	17.0	16.9	-0.1	16.2	18.1	1.9	15.4	16.9	1.5
Prices	*annual growth rate in % (final quarter)*														
Consumer price index	7.3	7.2	4.8	3.5	2.5	2.5	3.2	3.5	0.3	2.8	2.5	-0.3	2.8	2.5	-0.3
Free prices	7.9	6.9	5.1	2.8	2.7	2.7	3.2	2.8	-0.4	2.8	2.7	-0.1	2.8	2.7	-0.1
Administered prices	5.0	8.8	3.7	7.6	1.4	1.4	3.2	7.6	4.4	2.9	1.4	-1.5	2.9	1.4	-1.5
	average annual growth rate in %														
Consumer price index	8.5	7.6	5.6	3.6	3.0	2.5	3.4	3.6	0.2	3.0	3.0	0.0	2.8	2.5	-0.3
Free prices	7.7	7.6	5.9	3.2	2.9	2.7	3.4	3.2	-0.2	3.0	2.9	-0.1	2.8	2.7	-0.1
Administered prices	12.5	7.5	4.8	6.1	3.6	1.4	3.0	6.1	3.1	3.2	3.6	0.4	2.9	1.4	-1.5
External environment	*annual growth rate in %*														
Foreign demand*	4.5	2.7	2.6	5.2	6.9	6.9	4.7	5.2	0.5	5.6	6.9	1.3	5.6	6.9	1.3
USD/EUR	0.90	0.94	1.13	1.22	1.22	1.22	1.26	1.22	-0.04	1.26	1.22	-0.04	1.26	1.22	-0.04
Oil (USD/barrel)	24.4	25.0	28.8	36.0	34.0	30.0	29.0	36.0	7.0	27.0	34.0	7.0	26.0	30.0	4.0
Commodities	-6.5	4.6	11.3	25.0	10.0	3.0	10.0	25.0	15.0	3.0	10.0	7.0	3.0	3.0	0.0
EMU inflation	2.6	2.2	2.1	2.1	2.0	2.0	1.8	2.1	0.3	1.7	2.0	0.3	1.7	2.0	0.3
PPI Germany	3.0	-0.6	1.7	1.1	1.3	1.3	0.6	1.1	0.5	1.2	1.3	0.1	1.2	1.3	0.1
EURIBOR 3m (%)	4.3	3.3	2.3	2.2	2.7	3.1	2.4	2.2	-0.2	2.6	2.7	0.1	2.9	3.1	0.2

* Volume of the basket of foreign partner imports.
Sources: ARC, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, SORS.

5. MONETARY POLICY UNDER ERM II CONDITIONS

5.1 Sustainability of Equilibria After ERM II Entry

Joint Bank of Slovenia and government programme gives strategic basis, from point of view of economic policy, for earliest…

In the joint programme of the Bank of Slovenia and the Slovenian government for ERM II entry and adoption of the euro[8] (the joint programme), the two institutions evaluated different possibilities for adopting the euro as the domestic currency. The joint conclusion was that adopting the euro at the earliest possible opportunity was in the interest of Slovenia's economy and its people. The adoption of the euro is tied to the fulfilment of the convergence criteria (the Maastricht criteria). These ensure that a country that wishes to adopt the euro has met strict measurements of price stability, balance in public finances, the stability of the nominal exchange rate against the euro, and interest rates. The criterion of exchange rate stability is additionally tied to the obligation to participate in the ERM II, where the movement of the exchange rate is subordinate to the central rate set together with the Eurosystem. The joint programme therefore marked out the necessary direction of economic policy for the earliest possible entry into the ERM II and for meeting all the criteria as soon as possible.

… and most effective possible adoption of euro

When Slovenia joined the ERM II, at the beginning of July Ecofin discussed the convergence status of the Slovenian economy as described in the Convergence report. The assessment was that the macroeconomic scenario for the period to 2007 was realistic, and that this also held for the inflation forecasts, under the condition that good coordination of economic policies continues. Here Ecofin noted that the actual economic growth could differ from the assumed rate, which could cause imbalances between budget expenditure and actual revenues. There was therefore emphasis of the need for a more intensive focus on faster convergence on the Stability and Growth Pact's target of a balanced or surplus budget in the medium term. In the general economic policy guidelines that accompanied discussion of the Convergence report, the European Commission also touched on more specific elements of economic policy in its recommendations. In its reports it stated that economic policy must continue to endeavour to achieve a high rate of convergence. In so doing Slovenia must above all aim to ensure the disinflation process is sustainable, to focus structural changes on increasing the level of employment of older people, to improve the conditions for sustainable productivity growth and to support competition in all sectors of the economy, particularly in telecommunications and in public infrastructure services (electricity, utilities, railways, etc.).

Central exchange rate agreed with eurozone (SIT 239.640 to euro) is anchor for nominal tolar exchange rate

Together with Estonia and Lithuania, Slovenia was in the first group of new EU member-states to join the ERM II on 28 June 2004. The Bank of Slovenia stabilised the tolar exchange rate in the vicinity of the central rate set in negotiations with the Eurosystem at SIT 239.640 to the euro.[9] The joint assessment was that the market exchange rate of the tolar reflected the equilibrium exchange rate to a sufficient extent, and the central rate was therefore set with regard to the current market rate. The relatively early entry into the ERM II was made possible by favourable projections of inflation trends and credible coordination between the Bank of Slovenia's monetary policy and the government's fiscal policy. When joining the ERM II Slovenia committed itself in the communiqué of the ERM II committee (see Frame 5.1) to continuing

[8] http://www.bsi.si/html/publikacije/evropa/ERM2%20_BS_Vlada_200311.pdf

[9] For setting the central exchange rate a consensus was required among the Slovenian government and the Bank of Slovenia, the European Commission, the ECB and the governments and central banks of the Eurosystem and Denmark as a participant in the ERM II.

to take measures to cut inflation in a sustainable way, to maintaining competitiveness by exercising control over domestic costs, to giving fiscal policy a decisive role in controlling demand (supported by appropriate financial supervision) and to carrying out structural reforms at the right time to strengthen the economy's flexibility.

Frame 5.1: Communiqué of ERM II committee upon Slovenia's entry into ERM II[10]

At the request of the Slovenian authorities, the ministers of the euro area member-states of the European Union, the president of the European Central Bank and the ministers and the central bank governors of Denmark and Slovenia have decided, by mutual agreement, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee, to include the Slovenian tolar in the ERM II. The central rate of the Slovenian tolar is set at SIT 239.640 to the euro. The standard fluctuation band of plus or minus 15% will be observed around the central rate of the tolar. The agreement on participation of the tolar in the ERM II is based on a firm commitment by the Slovenian authorities to continue to take the necessary measures to lower inflation in a sustainable way: these include most notably measures aimed at further liberalising administered prices and advancing further with de-indexation, in particular of the wage and certain social transfer setting mechanisms. Continued vigilance will be needed so that domestic cost developments, in particular wages, are in line with productivity growth. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments. Fiscal policy will have to play a central role in controlling demand-induced inflationary pressures and financial supervision will assist in containing domestic credit growth. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and to maintain the overall competitiveness of the economy. The compulsory intervention points in the mechanism will be communicated by the ECB and the Bank of Slovenia, in time for the opening of the foreign exchange markets on 28 June 2004.

Maintenance of main macroeconomic equilibria points to sustainability of high level of convergence already achieved

When it entered the ERM II Slovenia had achieved a high level of nominal convergence. With the simultaneous stability of the economy, as indicated by the maintenance of the balance of payments and the fiscal balance, both the level of nominal interest rates and the rate of price increases were low enough to allow the transition to the ERM II system to be carried out without significant consequences for the national economy. When it joined the ERM II Slovenia had met the long-term interest rate criterion, while the inflation criterion was yet to be met, despite the continuing disinflation trend. Slovenia also met the fiscal criteria of the budget deficit and the public debt. However, as the Bank of Slovenia and the Slovenian government made clear in the joint programme, there are risks that could make it more difficult to meet the Maastricht criteria. These risks are examined in the next section.

5.2 Risks in Meeting Conditions for Adopting Euro

European Commission and ECB each draws up its own convergence report…

In the review of the fulfilment of the Maastricht criteria Slovenia will be subject to independent assessment by the European Commission and the ECB on the basis of methodology known in advance using the Eurostat database. Slovenia is already obliged to send information on the movement of macroeconomic variables to these institutions, and in the envisaged time frameworks the European Commission and the ECB each draws up its own report.

… to verify convergence criteria

The ERM II having been joined, the chances of adopting the euro at the beginning of 2007 are good. The projected trend for the fall in inflation is in line with the price stability criterion being met before the second half of 2006. Domestic and foreign assessments show that the low inflation rate achieved is sustainable, as the disinflation process itself did not cause any major macroeconomic imbalances. The expectation that policies that allow this

[10] http://www.bsi.si/html/projekti/evro/erm-ii-komunike.pdf

situation to be maintained are to be continued and strengthened is therefore expressed in all respects. Risks that would manifest themselves in deviations from the equilibria achieved cannot be ruled out in the future. Alongside the risks caused by the external environment, those that are under the control of domestic economic policy are of particular importance.

Inflation Criterion

Inflation shocks and inappropriate response in economic policy could jeopardise price stability criterion

Changes in the movement of domestic or foreign macroeconomic factors and changes in economic policy conduct can have a key influence on economic trends and inflation. Such changes with regard to the assumptions in the forecasts could cause economic trends, including inflation, to deviate significantly from the forecasts. Frame 5.2 illustrates the deviations from the basic scenario seen with certain alternative scenarios. The alternative scenarios present certain possible changes in the international environment and in domestic factors. Without an immediate and appropriate response using the available macroeconomic policies, even a small shock with inflationary effects would jeopardise the fulfilment of this criterion. With regard to domestic factors it is clear that the criterion of price stability would be transgressed in the event of excessive growth in domestic consumption or an acceleration in the rise in labour costs. Another potentially powerful inflationary factor is inflation in controlled prices, owing to both the direct effect on the level of prices and to the indirect effect of transmission to free prices. Oil prices also have a strong transitory impact on inflation when there are major rises of the size seen recently. Because they raise the actual level of prices, there can be additional transfer from prices to wages, and higher labour costs can trigger a new inflation cycle.

Frame 5.2: Simulation of possible risks to fulfilment of inflation criterion

In the period prior to the establishment of the conditions for abolishing the derogation, the responsiveness of economic policy and the ability to prevent shocks that could jeopardise the fulfilment of the Maastricht criteria will be of particular importance. Even though the projections indicate that Slovenia will also meet the inflation criterion within the period envisaged for verifying the criteria, the aim is to use simulations of some likely macroeconomic shocks to examine the possibility of deviations in the trends in the principal macroeconomic indicators. The alternative scenarios examined are those regarding which economic policy should be prepared to take prompt measures in the future.

All the simulations were done using the model employed by the Bank of Slovenia in its forecasts. In certain simulations (1, 2, 3 and 6) exogenous variables were changed, while in the remainder (4, 5 and 7) a change defining the scenario was added to the variable values from the basic scenario. All the other assumptions in the simulations are the same as those in the basic scenario. An overview of the shocks is given in the table.

Table: Definition of simulations

Simulation	Schock - change	Shock period
a) Foreign environment		
1. Oil price	Price higher than baseline by 5 $/barrel	Q404-Q406
2. Commodities price	Price 10% higher than baseline	Q204-Q406
3. Foreign demand	Higher than the level in the baseline by 1%	Q204-Q406
b) Domestic environment		
4. Wage increase	higher than baseline by 2 percentage points	Q204-Q406
5. Husehold consumption	higher than baseline by 1 percentage point	Q204-Q406
6. Government consumption	higher than baseline by 2 percentage points	Q204-Q406
7. Administered prices	equals an increase of free prices in baseline	Q105-Q406

The main points from the simulations are as follows. A rise in the oil price of just USD 5 per barrel from the basic scenario would raise inflation in the first two years by approximately 0.2 and 0.6 percentage points. Higher oil prices would see a significant deterioration in the current account balance. Each rise of USD 1 per barrel would worsen the current account of the balance of payments by approximately 0.1 percentage points of GDP. Higher commodities prices are expected to have a positive effect on inflation, but considerably smaller than the effect of higher oil prices, while they would bring about a sizeable worsening of the current account. Other shocks that would have a significant impact and result in higher inflation are primarily changes in elements of domestic consumption. Wage rises of 1% would raise inflation by 0.2 percentage points in the second year after the shock. If the wage rises also encouraged consumer spending, for each percentage point rise in consumer spending inflation would rise 0.2 percentage points in the first year and 0.6 percentage points in the second year. Higher general government expenditure would also result in higher inflation, but at a considerably slower rate, owing to the smaller proportion of total consumption it accounts for, it being lower than consumer spending. Increased demand from abroad would also raise inflation because of limited output capacity. If administered prices were to rise at the same rate as free prices from the first quarter of 2005 inclusive (in the basic scenario the rise in administered prices is lower than that of free prices from the third quarter of 2005 onwards), average inflation would rise by 0.1 percentage points in 2005 and 0.3 percentage points in 2006.

The simulations show that even minor shocks, both those from the external environment and those conditioned by domestic economic policy, could see inflation deviate from the Maastricht criteria. Therefore economic policy in the future will not just have to prevent the occurrence of domestically conditioned shocks, but also prevent shocks originating in the international environment from having negative consequences.

The table below gives the values of the variables used in the forecasts and the baseline scenario, and also the deviation in the macroeconomic aggregates in the event of the simulated shocks in percentage points from the baseline.

Table: Response of macroeconomic variables to simulated shocks

	GDP			Inflation			Current account		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Forecast - Baseline	3.8	3.8	4.0	3.6	3.0	2.5	-1.0	-1.6	-0.7
Alternative scenarios (deviations)									
a) Foreign environment	*deviations from baseline in percentage points*								
1. Oil	0.0	-0.1	-0.1	0.2	0.6	0.0	-0.1	-0.6	-0.7
2. Commodities	0.1	0.0	0.0	0.1	0.0	0.1	-0.1	-0.4	-0.4
3. Foreign demand	0.3	0.3	0.0	0.1	0.2	0.3	0.2	0.4	0.3
b) Domestic environment	*deviations from baseline in percentage points*								
4. Wages	0.0	0.1	0.1	0.1	0.3	0.4	0.0	-0.1	-0.3
5. Husehold consumption	0.2	0.7	0.6	0.1	0.2	0.6	-0.1	-0.2	-0.5
6. Government consumption	0.1	0.2	0.3	0.1	0.2	0.2	0.0	-0.1	-0.2
7. Administered prices	0.0	0.0	0.0	0.0	0.1	0.3	0.0	0.0	-0.1

Fiscal Criteria

a) Government Deficit

Deterioration in fiscal criteria must be prevented

At first sight, the risks related to meeting the fiscal criteria seem to be lower than those related to inflation. After all, the government deficit was at the level of 2% of GDP in 2003, lower than the formal limit of 3% of GDP. The substantive fulfilment of the criteria is seen in the sustainability of public finances, and is defined in the Stability and Growth Pact as a balanced or surplus budget position in the medium term. The structural and cyclical elements in the budget have an impact on whether the budget position is balanced or in surplus. A substantial proportion of Slovenia's deficit can be attributed to structural elements. Therefore achieving a balanced or surplus budget in the medium term would leave little room for increasing cyclical surpluses in periods of good economic growth to balance cyclical deficits during periods of recession. The majority of the risks on the expenditure side lie in removing the structural rigidities. Expenditure must bear the brunt of the burden of making adaptations to achieve substantive sustainability in public finances in line with the Stability and Growth Pact, particularly as joining the European Union has brought significant changes in the structure of revenues. The shift in recording tax liabilities from customs authorities to tax authorities requires careful monitoring and updating of the rules for collecting taxes, in order to ensure that it does not cause any unexpected drop in tax revenues. On the revenue side it is furthermore necessary to tackle the effectiveness of tax collection, the utilisation of project co-financing from EU budget funds, the effects of healthcare reform and control of expenditure, particularly total wages in the years ahead. Data quality has an important role in the verification of the fiscal criteria, in particular the adaptation of methodology to the requirements of Eurostat. Member-states must ensure that the methodology is fully compatible and the data they send to Eurostat is totally reliable. Given that Slovenia also brought its methodology in the area of public finances into line with the requirements of Eurostat, the methodological changes that arose after the publication of the Convergence Programme in August are examined in Frame 5.3. The changes in Eurostat's methodology affected all member-states and brought a significant restructuring in their public finance data. Slovenia too has seen its past data on the government deficit and public debt change considerably for this reason, including the forecast for 2004. It will be necessary to assess as quickly as possible what changes the new methodology will bring to the forecasts presented in the Convergence Programme. Not all the elements for this assessment are yet available. Frame 5.4 examines the risks related to meeting the fiscal criteria as assessed by the Bank of Slovenia.

Frame 5.3: Methodological changes to government finance statistics

Twice a year the Ministry of Finance draws up a Reporting of Government Deficits and Debt Levels (the so-called notification). As a member of the European Union, Slovenia is obliged to send the aforementioned report to the European Commission twice a year, first by 1 March and then by 1 September. The report contains figures on the deficit and the debt for the last four years, together with forecasts for the current year. These figures are the basis for verifying the fulfilment of the Maastricht deficit and debt criteria, and have to be drawn up in line with the ESA 95 methodology.

This September's report on the government deficit and debt is based on the general government accounts for 2000 to 2003 published at the end of August. The Eurostat mission visited Slovenia this January to clarify how to apply the methodology prescribed for drawing up data on the general government sector. The Statistical Office and the Ministry of Finance committed themselves to applying the methodology by the time of the second report this year, which they did. At the end of August the Statistical Office first published figures on the basic aggregates of the general government sector.[11] The figures were also used to draw up the September report on the state sector deficit and debt.

The most significant update in the methodology consists of changes in institutional coverage. Following the update to the institutional classification, public funds are included in the general government sector, the most important of these being Kapitalska družba (KAD) and the Slovene Restitution Fund (SOD). Each year SOD has generated a deficit of a little more than 0.1% of GDP, except in its year of establishment, when the

Table: Comparison of figures from March and September notifications

(in % GDP)	2000	2001	2002	2003	2004
Net lending(+)/net borrowing (-)					
Mar.04	-3.0	-2.7	-1.9	-1.8	-1.6
Sep.04	-3.5	-2.8	-2.4	-2.0	-2.1
change	-0.5	-0.1	-0.5	-0.2	-0.5
Debt					
Mar.04	26.7	26.9	27.8	27.1	28.0
Sep.04	27.4	28.1	29.5	29.5	30.4
change	0.7	1.2	1.7	2.4	2.4

[11] http://www.stat.si/doc/temagr_310804.doc

current deficit was 3.5% of GDP (the estimated value of restitution of private property nationalised after the war). In addition SOD generated a deficit of 0.1% of GDP in 2002 and 2003 because of repayment of claims for war damages. In 2003 the general government deficit also increased because of the deficit recorded by the public housing funds, as a result of the purchase of housing for subsequent sale within the framework of housing saving schemes. In the years ahead the sale of this housing will generate a current surplus of the same amount. Other changes in institutional coverage also have a minor effect on the figures, for example the exclusion of pharmacies, the majority of pensioners' homes, and student halls of residence from the general government sector.

The methodological changes are reflected in a slightly higher general government deficit and debt, while owing to the institutional updates described above the level of general government revenues and expenditures is also higher. Owing to the aforementioned updates of the methodology the deficit in individual years between 2000 and 2003 is 0.1 to 0.5 percentage points higher than the figures published previously. The figure for the debt was also appropriately updated. Owing to the changes the general government revenues and expenditures are on average 2.2 and 2.5 percentage points higher respectively on average as a proportion of GDP in the previous four years.

b) Public Debt

Little risk of failure to meet the public debt criterion

The smallest risk regarding the fulfilment of the Maastricht criteria is related to public debt, which at its current level of approximately 30% of GDP is well below the allowed level of 60% of GDP. In exceptional circumstances the debt can exceed 60% of GDP, but it must show a falling trend and a satisfactory rate of approaching the reference level. No significant increase in Slovenia's public debt as a proportion of GDP is expected in the years ahead. There should not be any major debts taken over or guarantees redeemed, while because the debt is primarily denominated in tolars and euros any changes in exchange rates will not affect the level of debt. An intensive substantive debate about the methodology for recording the public debt is also underway at the relevant European institutions. The public debt is defined as the gross general government debt, not including the liabilities that are covered by the financial assets of any government institutions. In the majority of EU member-states a large proportion of such financial assets are in the hands of pension funds, but in Slovenia they are primarily held by public funds.

Frame 5.4: Possible risks of fulfilling fiscal criteria

The Ministry of Finance is forecasting a general government deficit in the amount of 2.1% of GDP and a debt of 30.4% of GDP this year. The Convergence Programme envisages a gradual reduction of the general government deficit in the years ahead, with the target of the budget being in balance or in surplus by 2007 not being met. According to government plans, this year the deficit should remain at approximately the level

Table: General government deficit and debt, 2000 to 2006 (ESA 95)

	Published by SORS, 31.Aug.04				Convergence Programme **			
in % BDP	2000	2001	2002	2003	2003	2004	2005	2006
Revenues	44.7	45.1	45.7	46.3	44.0	45.1	44.0	43.6
Expenditures	48.2	47.9	48.1	48.4	45.8	47.0	45.7	45.1
Balance	-3.5	-2.8	-2.4	-2.0	-1.8	-1.9*	-1.8	-1.5
Central government	-3.0	-2.5	-2.1	-1.9	-1.6	-1.6	-1.8	-1.5
Local government	0.1	0.0	-0.2	0.0	-0.1	-0.1	0.0	0.0
Social security funds	-0.5	-0.2	-0.1	-0.1	-0.1	-0.2	0.1	0.1
Debt	27.4	28.1	29.5	29.5	28.6	29.1	29.5	29.4

Notes: * Owing to methodological changes the new Ministry of Finance projection is 2.1% of GDP. Neither the figures for revenues and expenditures nor the surplus/deficit figure for the years from 2004 onwards are in line with the methodological changes.
** The figures are not comparable, as they were published before the methodological changes had been applied.
Sources: SORS, Eurostat, Ministry of Finance.

achieved last year, and is likely to be 0.2 percentage points of GDP higher than forecast in the convergence programme. This discrepancy is exclusively the result of methodological changes (see Frame 5.3), as the Convergence Programme was drawn up before these came into effect.

In circumstances of high economic growth, as expected in the 2004 to 2006 period, it is necessary to set more ambitious targets so that the general government deficit can faster approach a balanced position. The simultaneous reduction of the structural deficit should follow the guidelines applying to the eurozone that require an annual reduction of the structural general government deficit in the amount of 0.5 percentage points of GDP until (at least) a balanced position is achieved. Therefore the key is that cyclically conditioned higher revenues are not earmarked for increasing general government expenditures, and that the reduction of the structural general government deficit facilitates the action of automatic stabilisers in the future.

The assessment is that general government revenues will depend primarily on the following in the years ahead:

- an appropriate taxation policy, as cutting the tax burden too quickly could lead to a rise in the deficit
- the effectiveness of the tax administration in connection with its ability to collect taxes, which must be supported by legislation and regulations of adequate quality
- the possibility of drawing on the EU budget funds that are available, as the experience of other countries shows that some time is necessary before a country is able to draw on the available funds in full
- the level of economic growth achieved, and the associated risk of lower revenues in the event of growth slowing

It is the policy of general government expenditure in the sense of the structure and level of spending that will be the decisive factor in cutting the general government deficit. An increase in the high and relatively fixed proportions of spending on wages and transfers entails a risk to the chance of meeting the target of a balanced budget in the near future.

Exchange Rate Stability Criterion

Bank of Slovenia committed to maintaining conditions for exchange rate stability

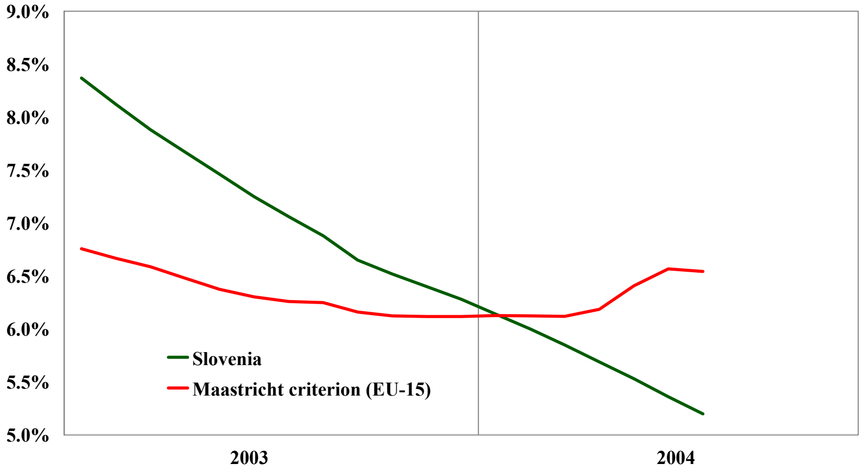
The risks related to exchange rate stability are limited. Given that the nominal central rate is assessed as being in line with its equilibrium in real terms, there is no reason to expect with regard to economic forecasts that additional inflationary pressures or a weakening of the foreign trade balance could be triggered by the exchange rate itself. Therefore no immediate need or pressure to change the central rate can be expected. The movement of the actual exchange rate since ERM II entry has been extremely stable, as seen in this report. The Bank of Slovenia guarantees the conditions for a stable foreign exchange market, for which it has suitable monetary policy instruments and sufficient foreign exchange reserves. Thus there is no reason for tension on the foreign exchange market or instability in the tolar exchange rate, given the realisation of the projected economic trends and appropriate economic policies.

Criterion of Long-Term Nominal Interest Rates

Criterion of low long-term interest rates having already been met reflects market confidence in successful convergence

The final convergence criterion is low long-term nominal interest rates on government securities. Slovenia also meets this criterion at present, and its fulfilment in the future is dependent to a great extent on long-term inflationary expectations and expectations regarding the sustainability of the budget deficit. The very reason that the long-term interest rate itself is a criterion is that it encompasses the market expectations regarding inflation and fiscal stability, which are built into it via implicit risk premiums. If the market expectations are favourable, this also entails them being in line with the inflation and fiscal criteria in the long term, and risk premiums are small and long-term interest rates are low. Meeting this criterion confirms the credibility of macroeconomic policy in Slovenia in achieving low inflation and high fiscal stability. If the favourable trends in the main macroeconomic factors continue, as illustrated in this report, this will continue to be seen in the fulfilment of the interest rate criterion.

Figure 5.1: Interest rates convergence criterion



Source: Eurostat.

Extended participation in ERM II also brings risks, particularly if excessive real appreciation occurs

Failure to meet any of the Maastricht criteria would mean extending the period within ERM II until such time as all the criteria are met simultaneously. Because the convergence reports are drawn up in a two-year cycle, this dictates the period of extension. Slovenia could interrupt this period by making its own request for a repeat convergence assessment, but preparing such an assessment would require a specific procedural period on which Slovenia would not have much influence. In itself, remaining longer in ERM II would not necessarily entail increased costs, but an inflation shock would cause an excessive real appreciation and a decline in the competitiveness of the economy. This effect would directly impair the current account, or the external equilibrium, and slow down economic activity. But indirectly it would also be reflected in a deterioration of the public finance position as a result of a drop in revenues linked to economic activity and an increase in expenditures (higher unemployment transfers, anti-cyclical measures, etc.). Such a deterioration in the macroeconomic equilibria would further delay, at least temporarily, the possibility of meeting the criteria, and consequently prolong the period in the ERM II. A deterioration in the macroeconomic equilibria could even threaten the sustainability and thus the credibility of the central rate, and lead to an attack on the currency if the financial markets believed there was a possibility of a devaluation. If the central bank were unable to withstand a speculative attack on the currency, serious damage would be caused to the financial system and to the real economy, and eventually a devaluation would once again encourage inflationary pressures. Control of the macroeconomic equilibria, particularly the current account and the public finance position, at a sustainable level is the key to ensuring the credibility of economic policies and the central rate, and is a precondition for a successful participation in the ERM II.

5.3 Increasing Need for Coordination of Economic Policy

As new environment, ERM II requires coordination of macroeconomic policies

In order to ensure that the risks associated with participation in the ERM II do not manifest themselves, effective and credible coordination of macroeconomic policies is required. The setting of the central rate and the need to stabilise the exchange rate around it make it impossible for monetary policy to respond independently to macroeconomic developments and to risks in meeting the criteria for adopting the euro. It is for this reason that the Bank of Slovenia and the government define the tasks of macroeconomic policy after entry into the ERM II in the joint programme. The key role in ensuring price stability and balancing economic activity is assumed by fiscal policy. At the same time the

Bank of Slovenia and the government committed themselves when joining the ERM II (see Frame 5.1) to strengthening financial supervision, to advancing de-indexation, to liberalising administered prices and to carrying out structural reforms to increase the economy's flexibility and maintain its competitiveness.

Monetary policy must work in accordance with stable tolar exchange rate…

Monetary policy will ensure stabilisation of the nominal exchange rate of the tolar around a central rate, which is a precondition for adopting the euro. For successfully carrying out its tasks in the ERM II the Bank of Slovenia already has suitable instruments and relevant experience at managing the exchange rate of the tolar. The transition to tolar stability against the euro has not caused any difficulties, and the market exchange rate since joining the ERM II has been practically the same as the central rate the whole time.

… therefore successful response to inflation shocks by interest rates is no longer possible

With the priority focus of monetary policy being to maintain the stability of the exchange rate, it will no longer be able to respond appropriately in the event of macroeconomic shocks occurring during participation in the ERM II. Monetary policy can be used as an independent instrument for managing macroeconomic developments and inflation, or as an instrument for stabilising the exchange rate. Using monetary policy to stabilise the nominal exchange rate will thus limit its use in maintaining low inflation or managing aggregate demand and aggregate activity. Although a stable exchange rate can itself be an effective anchor for inflationary expectations and long-term price trends, it is a very weak instrument for managing domestic demand. If domestic demand rises above the supply side potential output, inflationary pressures arise. If monetary policy is focused on exchange rate stabilisation, it cannot adjust interest rates to a level that would calm down the excess demand. Therefore the risk arises of a new inflationary cycle in the domestic economy.

Fiscal policy to play key role in managing economic cycles and inflation

The task of managing macroeconomic activity, primarily by influencing aggregate demand, and hence indirectly also inflation, was therefore assumed by fiscal policy after ERM II entry. Fiscal policy has a range of instruments at its disposal. The first instrument of fiscal policy will be the planning of public expenditure so that it will be used as an anti-cyclical stabiliser of the economy with the aim of restraining the shock of domestic consumption and preventing the emergence of inflationary cycles. The necessary anti-cyclical action will require sufficient budget reserves in order that the Maastricht fiscal criteria (and the Stability and Growth Pact following adoption of the euro) are not jeopardised.

Occurrence of fiscal shocks incompatible with successful participation in ERM II

In addition to managing economic activity via influence on aggregate demand, government policy will have to prevent the emergence of fiscal shocks of a cost-push nature in the economy and the consequent direct upward pressure on inflation. This relates mainly to restricting increases in tax levels and excise duties above the level required by harmonisation with European Union regulations. It is necessary to generate pressure to lower prices through price liberalisation. At the same time it is necessary to retain the possibility of adjusting relative prices within the aggregate if there exist microeconomic grounds for this. An administered prices policy thus designed encourages structural reforms and better cost control at companies that are not compelled to improve their competitiveness because of the monopoly structure of the market.

ERM II requires cooperation between all social partners

As far as incomes policy is concerned, public sector wages and social transfers will need to be restrained so that they do not cause a deterioration in the budget balance and in order to encourage equal wage dynamics in the private sector. Excessive wage rises in the public sector could also provoke wages in the private sector, while excessive rises in labour costs would jeopardise the fulfilment of the price stability criterion and the competitiveness of the economy.

5.4 Positions of Governing Board of Bank of Slovenia

The Governing Board of the Bank of Slovenia believes that the joint programme and the joint communiqué of the ERM II committee upon Slovenia's entry into the ERM II represent a framework for administering economic policy that will facilitate successful participation in the ERM II and the earliest possible adoption of the euro.

Joint programme and ERM II committee joint communiqué form basis for rapid, effective adoption of euro and

The joint programme defines the risks that could arise on the road to adopting the euro, and reviews the possibilities for responding appropriately to them from the point of view of coordination of macroeconomic policy. In this context the joint programme puts forward, with economic logic and effectiveness, the necessary guidelines for the Bank of Slovenia's monetary policy and the economic policy under the oversight of the government. With its evaluation of the risks the joint programme is also the basis for appropriate preventive action by economic policy. Effective response to risk and appropriate prevention of inflation shocks are of key importance to the successful adoption of the euro. This entails the fulfilment of the Maastricht criteria without the occurrence of macroeconomic imbalances in the economy that could later be once again reflected in increased inflation or slower economic growth. In line with its commitments the Bank of Slovenia will attend to exchange rate stability, the stability of the financial system, and the credibility and sustainability of the central rate.

Implementation of joint programme and current economic outlook in line with adoption of euro at beginning of 2007

The Governing Board of the Bank of Slovenia anticipates that consistent application of the joint programme and the communiqué of the ERM II committee will allow the adoption of the euro at the beginning of 2007. This report presents projections of economic trends and their impact on the fulfilment of the criteria for adopting the euro. The risks related to meeting the criteria are assessed as manageable from this point of view. Under the condition that all economic policies function in line with the guidelines described in the joint programme and the commitments in the joint communiqué, all the criteria are expected to be met on time, which would allow the adoption of the euro at the beginning of 2007.