BANKA SLOVENIJE

BANK OF SLOVENIA

MONETARY POLICY REPORT

APRIL 2005

Published by:

Bank of Slovenia
Slovenska 35
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The Monetary Policy Report is based on figures and information available at the end of March 2005, except where stated otherwise.

Ta publikacija je razpoložljiva tudi v slovenskem jeziku.

ISSN 1854-0295 (print version)
ISSN 1854-0309 (electronic version)

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1. SUMMARY AND BANK OF SLOVENIA POSITION

As expected, the disinflation process continued in 2004 at a slightly slower pace. There was a sustained fall in inflation, with the main macroeconomic equilibria being maintained. Although the high commodity prices on world markets were a particular inflationary factor, the restrictive but coordinated economic policy and certain structural factors in the favourable macroeconomic environment worked to reduce inflation.

Projections indicate that in the absence of shocks at home or abroad inflation in the years ahead will settle at around 2.5%, which would allow the Maastricht criteria to be met. The absence of both supply-side and demand-side shocks will be a key factor in this. Although no shocks that could notably prevent inflation remaining at the recently reached low level are anticipated, oil prices remain the basic source of uncertainty. Economic growth will slightly exceed the estimated potential growth in the future, but the principal macroeconomic equilibria will nevertheless be preserved to a large degree. In addition to relatively high domestic demand, which is not forecast as entailing any inflationary pressure, recovery among the most important trading partners will contribute to the continuation of high economic growth. Net exports are thus expected to make a neutral contribution to economic growth.

The Governing Board of the Bank of Slovenia believes that the programme for ERM II entry and adoption of the euro adopted by the Slovenian government and the Bank of Slovenia and the communiqué by the ERM II committee when Slovenia joined the ERM II represent the framework for administering an economic policy to facilitate a successful period in the ERM II and the earliest possible adoption of the euro.

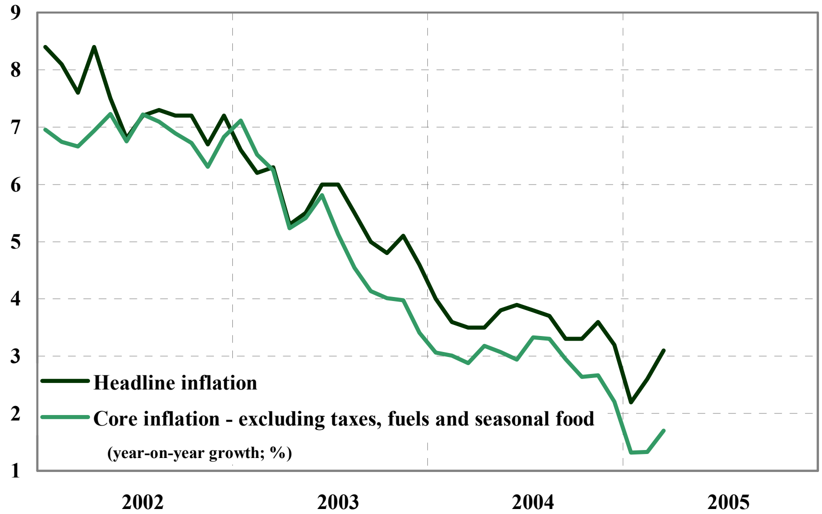
The joint programme defines the risks that could arise on the road to adopting the euro, and reviews the possibilities for responding appropriately to such risks from the point of view of coordination of macroeconomic policy. In this context the joint programme puts forward, with economic logic and effectiveness, 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. An 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 exchange rate.

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 policy functions 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.

2. INFLATION TRENDS AND FACTORS

The disinflation process slowed in line with expectations in 2004. Having fallen by 2.6 percentage points in 2003 and 1.4 percentage points in 2004, the 2005 decline in year-on-year inflation should be slightly lower as well.

Figure 2.1: Headline and core inflation



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

As the Maastricht price stability criteria are approached, we also get closer to the zone in which the real convergence process means that a level of price growth is attained over the longer term. The lower limit of this zone is an annual rate of about 2.5%. Restrictive economic policy and the current favourable macroeconomic environment allowed inflation to fall in line with expectations in 2004. Commodity prices and structural factors had a different impact on inflation in 2004.

2.1 From a sustained disinflation trend to exchange rate stabilisation

Reducing inflation and adopting the euro are the basic goals of monetary policy

In November 2001 the Governing Board of the Bank of Slovenia set its goals as adopting the euro at the earliest possible opportunity and reducing inflation to the price stability convergence criterion.[1] At the same time the Governing Board laid down a clear monetary policy strategy that should effectively facilitate meeting this target.[2] The Governing Board keeps the public informed about its administration of monetary policy in its half-yearly reports. Monetary policy has been based on a long-term influence on inflation via controls of monetary aggregates, and on total activity and the medium-term inflation dynamics via the adjustment of real interest rates. It is real interest rates that have maintained a disinflation trend that has tied down inflationary expectations and thus allowed gradual disinflation to be achieved without major costs to the economy, those that the Bank of Slovenia felt it was possible to avoid. The role of the exchange rate was subordinated to the needs of monetary policy. By guiding the dynamics of the nominal exchange rate the Bank of Slovenia closed the gap between

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[1] Bank of Slovenia's monetary policy guidelines (http://www.bsi.si/html/eng/publications/mon_policy/guidelines.pdf).

[2] The monetary policy strategy is also presented in the publication *Short-Term Monetary Policy Guidelines*, for example, May 2003

domestic and foreign interest rates, which prevented interest-elastic capital inflows and allowed monetary policy to be shaped to domestic needs. At the same time the nominal dynamics in the exchange rate were in line with the preservation of the real external equilibrium, or were neutral over the medium term with regard to inflation and the real sector dynamics.

Monetary policy is a significant factor in the process of reducing inflation

From today's standpoint, such monetary policy, which was feasible in the period before Slovenia joined the EU and the ERM II, proved to be highly successful in meeting its objectives. By appropriately adjusting real interest rates the Bank of Slovenia restricted domestic consumption, and reduced excess aggregate demand and the output gap, which gradually slowed the rise in nominal labour costs and other domestic cost factors. After 2000 this action revived the disinflation trend seen before 1999, when a series of inflation shocks led to a practical doubling of inflation to almost 10%. As seen in previous Bank of Slovenia reports, the reduction of inflation was hindered by inflation shocks primarily of a fiscal nature, and partly by the indexation processes in the wage system. The success of the disinflation process is confirmed by the sustainability of the low inflation rate achieved. The external equilibrium has been preserved, which rejects any need for adjusting the tolar exchange rate. Conditions of macroeconomic and price stability were guaranteed for companies throughout the process. High interest rates also partly prevented public sector borrowing and contributed to the fiscal balance being maintained. With an appropriate fiscal policy in place there was thus no need for additional tax pressures, which would have been rapidly reflected in price rises.

The need for and commitment to coordinated economic policy

The sustained reduction of inflation with the maintenance of the external and fiscal equilibria allowed Slovenia to join the ERM II early. The Bank of Slovenia's April 2004 forecasts were pointing to the fact that the price stability criterion would be met by 2006, given the right management of economic policy. Another condition for adopting the euro is two years of participation in the ERM II, where the stability of the domestic currency against the euro must be maintained. Ensuring an economic environment in line with exchange rate stability envisages the Bank of Slovenia subordinating its interest rate policy to this goal, which makes it impossible to simultaneously attend to the direction of medium-term inflation trends. Entry into the ERM II was therefore contingent on the adoption of an appropriate programme for coordinating economic policy, where the government undertook to ensure that fiscal policy would support the maintenance of price stability. The Bank of Slovenia and the Slovenian government coordinated and adopted the programme for ERM II entry and adoption of the euro in November 2003. Shortly after having joined the European Union on 1 May 2004, Slovenia also entered the ERM II on 28 June 2004 together with Estonia and Lithuania.

Thanks to the balances attained, entry into the ERM II brought no shocks to the economy

When Slovenia entered the ERM II the nominal central rate was set at SIT 239.640 to the euro. The stabilisation of the exchange rate at this level was made easily feasible because the disinflation process was practically complete, and the macroeconomic projections pointed to a great likelihood of the price stability criterion being met. It was necessary to reach a consensus among the Slovenian government, the Bank of Slovenia, the European Commission, the ECB and the governments and central banks of members of the eurozone and of the ERM II in setting the central exchange rate. The overall assessment was that the market exchange rate reflected the real balances to a sufficient degree. This assessment proved to be correct after Slovenia joined the ERM II, as setting the nominal central exchange rate brought no significant change in the economy's competitiveness. In the nominal convergence process, approaching the Maastricht price stability criterion also entails approaching the lower limit of what is sustainable in terms of real convergence. The Bank of Slovenia is anticipating a convergence criterion of an annual rate of around 2.5% in 2006. This threshold is only reachable in Slovenia with a strict incomes policy and restrictive fiscal policy, and with the right management of microeconomic and structural factors that could cause a temporary rise or fall in inflation away from its equilibrium level.

2.2 Macroeconomic inflation factors

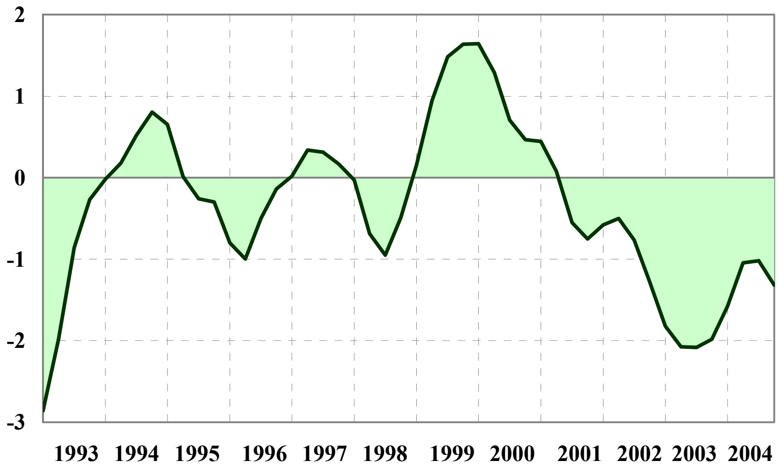
In addition to the coordinated action of monetary and fiscal policy and certain institutional and structural factors, another beneficial factor in the process of lowering inflation in 2004 were the macroeconomic circumstances on both the supply side and the demand side. Despite high economic growth the output gap remained negative, while domestic demand did not increase excessively given the accelerated nominal convergence and stabilisation of the exchange rate. Neither did slightly higher growth in total wages stimulate demand to the point that it would act in an inflationary manner. At the same time growth in average real wages remained behind the estimated growth in productivity, thus limiting cost pressures on price increases. Commodity prices increased companies' costs and thus had an indirect impact on making the disinflation process slower than it would have been in the absence of exogenous price shocks.

The output gap remains negative despite higher growth in domestic demand

The output gap is closing faster than expected

The output gap closed more quickly than forecast, but remained negative. Economic activity expanded by a high 4.6% in 2004, 0.8 percentage points in excess of the preliminary forecast. The relatively large negative output gap that arose during the previous three years of lower economic growth[3], passing 2% in 2003, closed faster than expected. Nevertheless, given an estimated rise in potential output of around 3.7% and the rise in GDP last year, the gap between potential output and the actual level of economic activity remained negative at around 1%. With the faster closing of the output gap in 2004, rapid economic growth actually slowed down the process of lowering inflation, although the negative output gap remains one of principal factors in the reduction of inflation.

Figure 2.2: Output gap



Remark: The potential GDP is estimated as a trend, whereby the decreasing growth rates of potential GDP are in line with the process of real convergence.
Source: ARC estimate

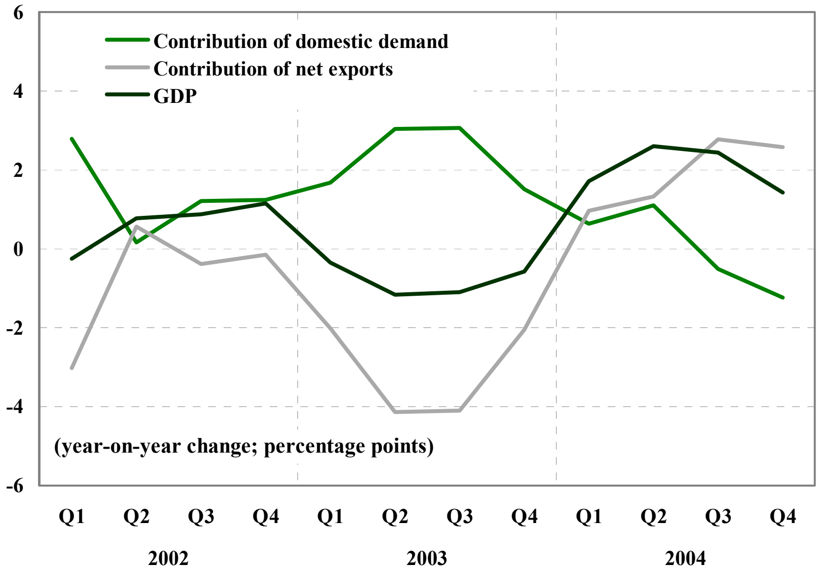
In line with expectations higher demand did not have inflationary effect

Domestic demand components strengthened in line with our expectations in 2004, remaining at a level that currently does not cause any inflationary pressures. Domestic demand rose by 4.7% in 2004, entirely in line with the previous forecasts. Both household spending and investment spending grew in line with expectations. Household spending last year was strongest in the

[3] Average GDP growth between 2001 and 2003 was lower than 3%.

beginning of the year, just before Slovenia joined the EU, and slowed gradually in the second half of the year. The increase in stocks did much to maintain investment at a high level last year, although there was a slowdown in the middle of the year and even the beginnings of a fall in stocks at the end of the year. Notwithstanding, stocks were responsible for almost one-third of investment growth in 2004. Among the components of domestic demand, only general government spending recorded a major deviation from the forecast, with the restrictive policy on expenditure on goods and services and on public sector wages meaning that general government spending in 2004 was almost a percentage point lower than originally forecast. Foreign trade made a significant contribution to the increase in economic activity, with the contribution of net exports strengthening by more than 2 percentage points, while the contribution of domestic demand to economic growth in 2004 remained virtually unchanged from the level it was in 2003.

Figure 2.3: Contributions by components of GDP, 2002 to 2004



Source: SORS, ARC calculation

The increase in domestic demand was to a large extent contingent on lower interest rates and high lending activity. With the stabilisation of the exchange rate at the point of ERM II entry and the focus on stability in the context of fully liberalised capital flows, monetary policy lost its independence in setting the interest rates. Under these conditions the Bank of Slovenia tried to maintain the highest interest rates that would still allow the foreign exchange market to stabilise. Nevertheless real interest rates were slightly lower in 2004.

Wage growth is still sustainable, but labour costs are rising too fast

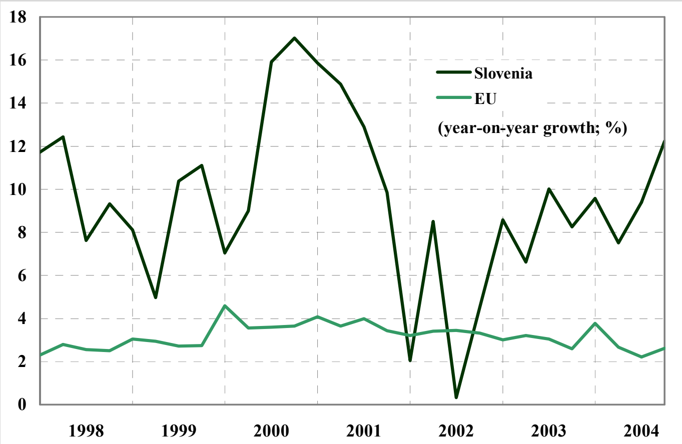
Wage growth was very high at the end of the year

Real wages grew faster than forecast. Given the very slow growth in the first half of the year, our previous forecast for average annual growth in real wages was revised downwards 0.3 percentage points from the preceding forecast to 1.5%. Still, actual real net wages increased by 2.0% over the year. This deviation upwards was primarily brought about by wages in the private sector, and within that in service activities. The economy also grew faster than expected in the second half of the year, while good performance and results saw private sector companies distribute surpluses at the end of the year, which strongly accelerated wage growth. Public sector wages also recorded rather rapid growth in the second half of the year, but despite this they fell in real terms on average over the year. Such trends at the end of the year were particularly unwelcome from the point of view of the transmission of rapid wage growth into the next year and a slight cooling of the economy, as wages only respond to changes in economic activity with a certain lag in time.

Box 2.1: Labour costs and labour market flexibility

Total labour costs comprise employees' gross earnings, i.e. wages or salaries, social security contributions and taxes paid by the employer, and all indirect costs in connection with employment[1]. According to the Eurostat definition, all market activities (activities C to K in the national accounts definition) are taken into consideration in the estimate of labour costs, while public services are excluded. The Eurostat figures[2] show Slovenia being among the countries with the fastest-growing total labour costs per hour in the EU in 2004.

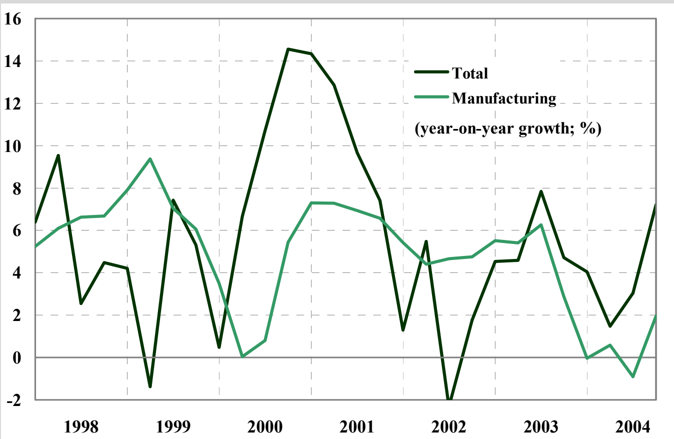
Figure: Labour costs per actual hour of work



Source: Eurostat, ARC calculation

According to Eurostat, the average year-on-year rate of growth in 2004 in labour costs defined in this manner amounted to 2.9% in the EU25, but 9.7% in Slovenia. In the manufacturing sector, a prominent tradable sector, labour costs per hour rose by 3.0% in 2004 in the EU25, but by 7.3% in Slovenia.[3]

Figure: Unit labour costs*



* Unit labour costs are calculated on the basis of the GDP figure for the economy as a whole, and on the industrial output figures for the manufacturing sector.

Source: SORS, ARC calculation

These differences can partly be explained by differences in the current rates of economic growth and ex-post measured productivity. At the same time, a feature of 2004 was that in Slovenia public sector wage growth contributed most to lower wage growth in the economy as a whole, and the public sector was excluded from the above calculations. Even excluding the final quarter from comparisons of labour costs, where the year-on-year rates of growth in certain areas exceeded 25%, particularly in activities where there is clearly a lack of competition (mining, distribution of electricity, gas and water, construction), it will be necessary to focus particular attention on the structuring and dynamics of labour costs. In both the ERM II and in the monetary union labour costs are one of the basic factors in ensuring the competitiveness of the economy and price stability.

Labour market flexibility is an important factor in ensuring the economy responds appropriately to asymmetric shocks or new factors that could threaten the competitiveness of companies. Flexibility particularly comes to the fore in conditions of a stable exchange rate, i.e. in the ERM II or in the monetary union, when monetary policy and exchange rate policy can no longer respond to and mitigate the effects of shocks. From the point of view of the long-term development of the economy, labour market flexibility is of key importance to the redirection of the labour force away from sectors with poor prospects and towards those with a better future. Labour market flexibility can be examined from the point of view of wages and from the point of view of employment. Wage flexibility, on which the indexation method has a great impact, was already discussed in the Monetary Policy Report of October 2004.[4]

Flexibility in the size of the workforce is usually expressed in terms of the ease of laying staff off and employment transience. The ease of laying staff off is usually measured by the Employment Protection Legislation indicator (EPL), which looks at the legislative protection offered to employees from various points of view. New labour legislation[5] has seen labour market flexibility as expressed by the EPL increase in Slovenia, and it now ranks ahead of some members of the eurozone. Greater employment transience would in particular be guaranteed by greater employee mobility and a strengthening of less typical or more flexible forms of employment, while at the same time employment policy measures should be aimed at reducing structural unemployment and increasing employability among certain groups of the unemployed. Slovenia remains behind the EU average in the area of atypical forms of employment.[6] Given that the proportion of people in temporary employment in Slovenia is at almost the same level as the EU average, it is clear that in order to increase the proportion of flexible forms of employment it is necessary to promote self-employment, part-time employment and work from home. When it comes to labour market flexibility it is also necessary to consider the social aspect of those in the labour market and the costs associated with job mobility (transport, etc.), the costs associated with frequent job changes (the loss of the specific human capital tied to the position), the costs associated with on-the-job motivation and the risk of job loss, etc. Denmark represents the model for the successful combination of a flexible labour market and a relatively high level of social security (or “flexicurity”).

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[1] Beside wages, total labour costs also include contract payments, alimentation expenses and costs of travelling to and from work, expenses on business travels, compensation on off-the-office work, holiday allowances, anniversary awards, etc. The most recent SORS figures for 2003 show the vast majority (80.7%) of labour costs per actual hour of work to be accounted for by employees' earnings, followed by employers' social security contributions (14.3%) and taxes (3.9%). The results of a detailed survey will be known in September 2005, but it is estimated that in 2004 there was an additional shift in favour of the proportion of payments made on the basis of performance and funds paid to employees by employers in connection with supplementary pension insurance.

[2] Detailed figures on labour costs and other labour market statistics are available at http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/&product=EU_MASTER_labour_market&depth=2&language=en

[3] Here the SORS figures show labour costs per hour in the economy as a whole (A to O) to have risen by 8.7% in 2004, while the Eurostat employment-adjusted figures for labour costs in activities C to K show a rise of 8.5%. The figure for the rise in labour costs per hour in the manufacturing sector accords with the Eurostat figure of 7.3%.

[4] http://www.bsi.si/html/eng/publications/mon_policy/MP_ang_y4q4.pdf (Box 4.1)

[5] Slovenia moved from 26th to 16th place on the EPL indicator scale after passing the Employment Act (Ribaud, Jauiregui, Sanchez-Paramo (2002), Does Eurosclerosis Matter? Social Protection Discussion Paper Series No. 0202, World Bank. In addition, according to the IMF report (Adopting the Euro in Central Europe, 2004), the EPL indicator for Slovenia is higher than for the most of the new EU member states, while it is lower than for some less developed old EU member states.

[6] Employment in Europe 2004, DG Employment and Social Affairs, European Commission, 2004.

Although wages lagged behind productivity, total labour costs grew too fast

With a real rate of 2.0% in 2004 under conditions of rapid economic growth, growth in gross wages was behind productivity growth, and thus adhered to the social agreement. Because wage growth lagged the productivity growth, the higher labour costs measured by gross wages did not cause any cost pressures. Nevertheless the sector-by-sector figures for growth in real wages warn that in some sectors wages are being shaped in contravention of the social agreement. Other labour-related costs rose significantly more in 2004. Taking total labour costs into consideration, the rise in these can be concluded as causing greater cost pressures. Companies have not transmitted them into higher prices yet, which is why according to the national accounts figures they were rather restrictive in the area of employment, despite the favourable economic climate. So far there has not been a significant deterioration in the competitiveness of the tradable sector owing to high growth in labour costs, as confirmed by good export results.

Box 2.2: Real wage growth and productivity growth

The social agreement for 2003 to 2005 envisages the real rate of growth in the average gross wage remaining at least a percentage point behind productivity growth. This target was met for Slovenia as whole in 2004, with productivity growth estimated at 4.5% and real growth in the average gross wage of 2.0%. However the detailed figures show that some sectors failed to meet the target set by the social agreement. Among the more important sectors, wages grew faster than productivity in the construction sector and the education sector, while catering, retail, and real estate and business services also failed to meet the target.

Table: Indices of growth in real gross wages and estimated productivity by sector in 2004*

	Average gross wage in real terms	Estimated productivity	**Gap**
A Agriculture, hunting, forestry	101.2	115.4	-14.2
B Fishing	*101.5*	*99.8*	***1.7***
C Mining and quarrying	*105.8*	*104.1*	***1.7***
D Manufacturing	103.4	106.5	-3.1
E Electricity, gas, steam and water suply	104.4	106.6	-2.2
F Construction	*103.4*	*102.8*	***0.6***
G Wholesale and retail trade, motor vehicle repair	*103.0*	*103.8*	***-0.8***
H Hotels and restaurants	*102.0*	*102.0*	***0.0***
I Transport, storage, communications	103.0	105.4	-2.4
J Financial intermediation	102.3	108.3	-6.0
K Real estate, renting and business activities	*101.9*	*100.8*	***1.1***
L Public administration, compulsory social security	96.9	98.2	-1.3
M Education	*101.5*	*100.8*	***0.7***
N Health and social work	97.9	100.0	-2.1
O Other social and personal services	*102.3*	*102.7*	***-0.4***
TOTAL	102.0	104.5	-2.5

*Sectors that failed to meet the target set in the social agreement of real growth in wages remaining at least 1 percentage point behind productivity growth are indicated in bold
Source: SORS, ARC calculation

The rapid wage growth seen in service activities in particular is causing inflationary pressures of a cost nature. This was visible even in 2004, with the most rapid price rises being recorded in housing, education, and catering and accommodation services.

The stabilisation of the tolar exchange rate and the weak dollar are having a favourable effect on import prices

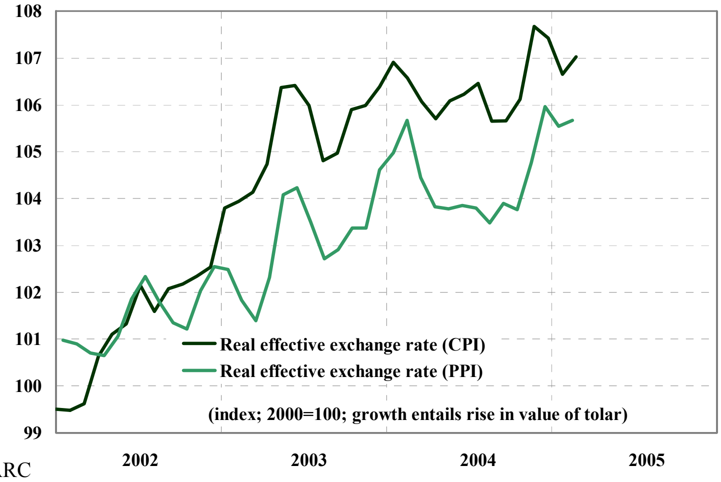
The stable tolar exchange rate after ERM II entry had a favourable effect on expectations and import prices

With the appreciation of the real effective tolar exchange rate slightly more significant than expected, there was an additional reduction of inflationary pressures on the supply side. Because the fall in the dollar was more than 10% greater than expected, the value of the tolar as expressed by the nominal effective exchange rate rose more than anticipated. At the same time price movements at home and abroad were more or less in line with expectations, and the appreciation of the real effective exchange rate was therefore greater than expected. Via import prices this had a favourable effect on the disinflation process, or on the prices in the tradable sector that are primarily determined by import prices. The stabilisation of the tolar/euro exchange rate at the point of entering the ERM II itself contributed to an easing in prices tied to the euro, and of inflationary expectations.

The weak dollar mitigated the effect of high commodity prices

In line with our expectations, favourable movements in USD/EUR rate slightly mitigated the negative impact of high oil and commodity prices on the movement of inflation. The dollar averaged 1.24 against the euro in 2004, compared with the exchange rate of 1.22 that we assumed earlier, or the rate of 1.26 forecast one year ago. The euro gained 10% against the dollar, so that while the price of Brent crude expressed in dollars rose by 32.6%, the price expressed in euros rose by just over 20%. Commodity prices expressed in euros rose only by just over 5%. Despite the euro's rise against the dollar, the high commodity prices and energy prices in particular restricted any excessive strengthening of household spending, owing to the relatively high proportion of consumer spending for which they account, while at the same time owing to the pressure on company costs and the consequent fall in profits they acted as a brake on investment activity.

Figure 2.4: Real effective exchange rate



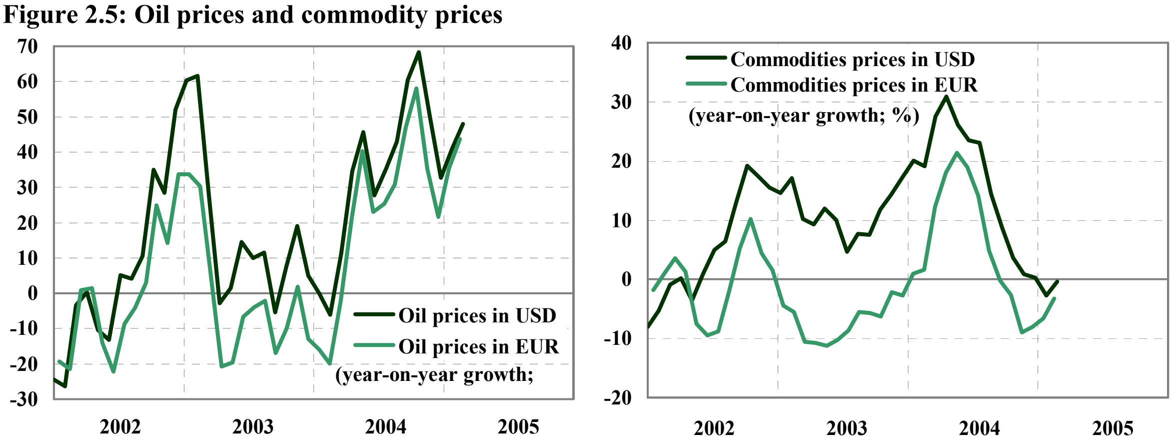
Source: ARC

Commodity prices are giving rise to cost pressures

Commodity prices and oil prices in particular had an inflationary effect

Commodity prices have increased by significantly more than we had assumed, and via import prices slowed down the disinflation process. The assumption about the movement of oil prices in the most recent forecasts proved to be similar to the actual movement in 2004, while there was a larger discrepancy in the assumed movements of commodity prices. The actual oil price was USD 2 per barrel higher, while commodity prices rose 9 percentage points less than had been forecast. There were somewhat larger average deviations from the assumptions made in the forecasts from one year ago, with the average oil price in 2004 USD 10 per barrel higher, and the actual rate of growth in commodity prices of 16% some 6 percentage points in excess of the assumption made last April. Despite the government's policy of making acyclic adjustments in excise duties, oil prices significantly retarded the process of lowering inflation over the whole of 2004. The government policy of adjusting excise duties had a neutral effect on excise duties on petrol over the whole year, while there was a slight rise in excise duties on diesel. With its policy of adjusting excise duties the government also prevented shocks being transmitted to domestic prices in the context of major fluctuations of oil prices on the world market. Nevertheless commodity prices and oil prices contributed to higher import prices and via these increased cost inflationary pressures, while at the same time together with unfavourable oil prices they caused a deterioration in the terms of trade of almost half a percentage point more than was forecast one year ago.

Figure 2.5: Oil prices and commodity prices



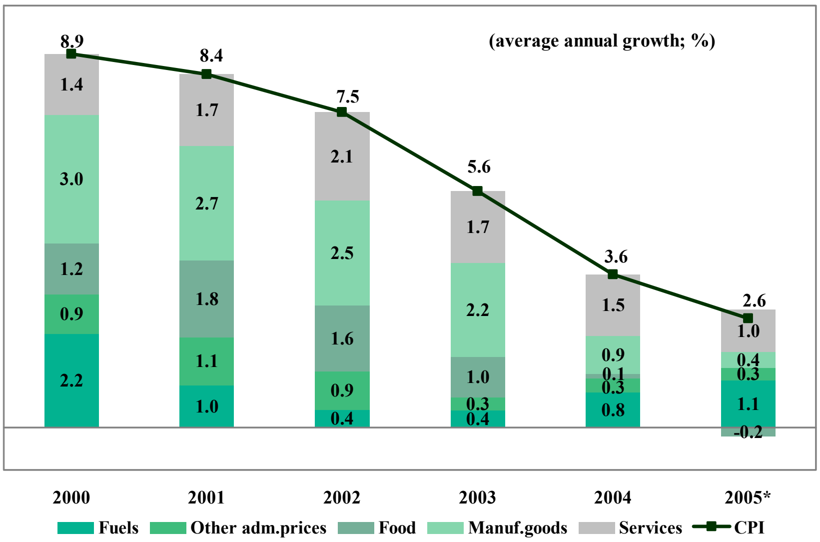
Source: Reuters, The Economist; ARC calculation

2.3 Microeconomic and structural inflation factors

Structural changes had a beneficial effect on the disinflation process last year

In addition to the right economic policies and favourable macroeconomic factors the fall in inflation in recent years was made possible by certain structural changes. These were of particular significance last year and at the beginning of this year, when unfavourable trends in the foreign environment and the accelerated closing of the output gap in the last year were already strongly retarding the disinflation process.

Figure 2.6: Structure of inflation – contributions by components



* Average growth in first quarter of 2005
Source: SORS, ARC calculation

The most prominent are:

- falls in food prices
- abolition of administrative barriers to trade with the EU
- gradual decline in prices of services

The most prominent structural changes acting to lower inflation last year were falls in food prices, the elimination of administrative trade barriers with the EU, and the gradual slowing of growth in prices of services, which continue to account for the most sustained component of inflation. However the current inflation rate both last year and this year has remained under the influence of the temporary high growth in fuel prices, which do not entail major duration from the point of view of direct effects. The potential risk of a sustained rise in inflation is presented by the effects of the transmission of high growth in energy prices to other prices, which are yet to be seen.

High growth in energy prices prevented a more rapid fall in inflation

The policy of adjusting excise duties mitigated the major fluctuations in oil prices…

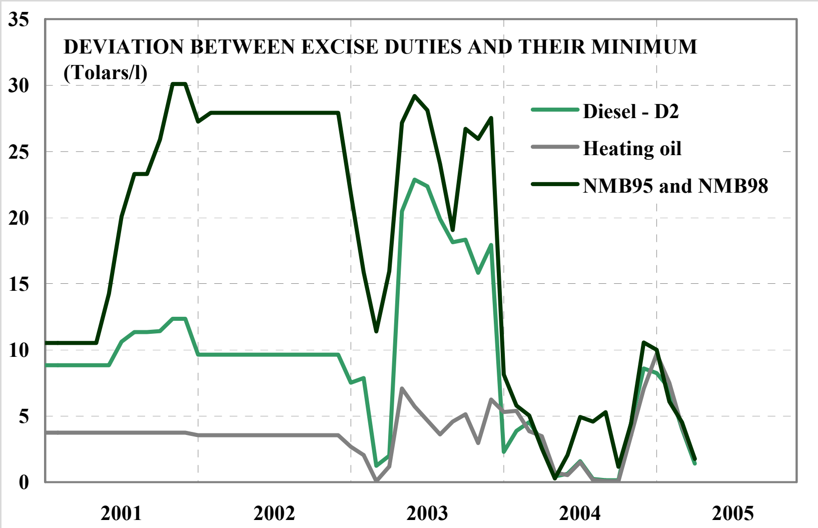
… but did not restrain the trend of rising prices of refined petroleum products

Energy prices rose by around 11% last year, and accounted for approximately 1.1 percentage points of the inflation rate. As in 2003, last year the government mitigated the sharp rises in oil prices on the world market by adjusting excise duties on refined petroleum products. The policy of adjusting excise duties proved to be successful last year, mitigating the large monthly fluctuations in oil prices without artificially restraining the trend of rising prices for refined petroleum products (see Box 2.3). The figures show foreign prices for the most important refined petroleum product to have risen by 21.6% while domestic prices rose by just 7.7%. The direct transmission of rises in foreign prices to domestic prices was thus approximately 35%. Despite the high rises in energy prices, it does not appear yet there will be major additional effects on inflation, primarily via growth in wages. Although the average nominal wage rose by 5.7% last year, this growth was more likely to have been a consequence of high economic growth than rises in energy prices. Of greater importance are the indirect effects that high oil prices have on inflation. These were expressed in the form of higher prices for transport services, gas prices and prices for heating services. The total effect on inflation was 0.13 percentage points.

Box 2.3: Effectiveness of excise duties policy adjustment on refined petroleum products

As in 2003, last year the government mitigated the transmission of sharp rises in oil prices on the world market to domestic prices by adjusting excise duties on refined petroleum products. In so doing it was restricted by the EU directive on the minimum excise duties, which rose in the last year by additional 25% in euros. The rise in the minimum excise duties and the rapid rises in oil prices were therefore restricting the government in its adjustment policy already in the first half of the year. There was a similar situation in October 2004 and April 2005, when the government again had to cut the excise duties on refined petroleum products to the minimum (see figure). Despite several cuts in excise duties, the government also raised excise duties in certain months last year, particularly towards the end of the year in November and December, when the oil price again fell below USD 40 per barrel.

Figure: Policy of adjusting excise duties on refined petroleum products



Source: ARC calculation

Rises in the prices of refined petroleum products contributed approximately 1 percentage point to inflation last year, which is approximately 0.1 percentage points more than the price rises would have contributed had the government not pursued excise duties adjustment policy: the initial estimates are that the contribution of rises in the prices of refined petroleum products would have contributed approximately 0.9 percentage points to inflation had excise duties remained unchanged. Although the effect was almost equal, the policy of acyclic adjustments in excise duties reduced fluctuations in energy prices, preventing disruption to the economy, restraining inflationary expectations and minimising the secondary effects on inflation. Because it is easier to adjust prices upwards than downwards, high fluctuations in energy prices could cause excessive cost inflation, particularly when the price rises are of a temporary nature.

Additional calculations show that the effect of the transmission of rises in foreign prices of refined petroleum products to domestic prices last year was lowest for unleaded petrol at 35%, while the largest effect was in prices of heating oil at approximately 63% (see table). The transmission effect for diesel was approximately 47%. The larger transmission effect for diesel has again made diesel more expensive than unleaded petrol this year.

Table: Effect of transmission of foreign prices of refined petroleum products to domestic prices

Year-on-year % (Dec 03 to Dec 04)	NMB95	NMB98	Diesel - D2	Heating oil
World price of refined petroleum (USD)	31.1	28.9	52.5	58.6
Exchange rate (SIT/USD)	-7.1	-7.1	-7.1	-7.1
World price of refined petroleum (SIT)	21.8	19.8	41.7	47.3
Domestic price of refined petroleum (SIT)	7.7	7.5	19.5	30.0
Transmission of foreign to domestic prices[1]	35%	38%	47%	63%

Remark: [1] Calculation: domestic prices in tolars / foreign prices in tolars.

Source: ARC estimate.

A relatively rigid administered prices and excise duties policy

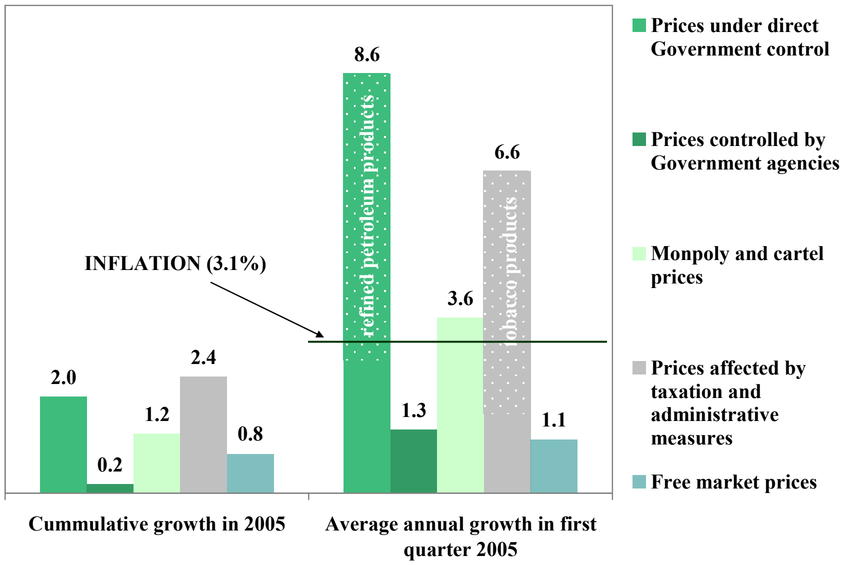
Growth in administered prices last year was again faster than growth in free prices

Administered prices changed more slowly last year and the previous year than in the preceding years, but the rate of growth still exceeds the rate of growth of free prices. The latter rose by 2.2% last year, while administered prices rose by approximately 3.9% ignoring energy prices. Although the government partially held to its plan for managing administered prices in 2004 and 2005, which details the growth of prices of certain products, that it adopted in December 2003, it was unable to meet the broader guidelines of the plan, which envisage administered prices rising more slowly than free prices. When the plan was adopted, the expectations of the speed of disinflation were clearly more pessimistic than was subsequently the case, while there was no adjustment in the dynamics of administered prices to this. Although the rise in administered prices in the last two years was not inflationary, with a more restrictive administered prices policy headline inflation would be even lower.

Changes in excise duties on cigarettes placed additional limits on the reduction of inflation last year

Changes in excise duties on cigarettes also placed limits on the faster reduction of inflation. Last year alone changes in excise duties on cigarettes contributed approximately 0.2 percentage points to inflation, and further changes are expected to produce the same contribution in 2005 and 2006. Changes in excise duties on cigarettes could therefore have an important influence on whether the Maastricht criteria are met, as they will directly impact on inflation over the next three years. The impact of the unfavourable inflationary effects of changes in excise duties on cigarettes will be that much greater in the event of further rises in oil prices on the world market, which because of asymmetric effects on inflation in individual countries could raise domestic inflation faster than the Maastricht criterion.[4] Nevertheless growth in free market prices, monopoly prices and prices under the control of general government agencies remained low last year, and in line with total inflation.

Figure 2.7: Consumer price rises



Note: Prices under the direct influence of taxation and administrative measures last year were excluded from free market prices. These included cigarettes and non profit rents, which account for 3.9% of all products in the consumer price index.
Source: SORS, ARC calculation

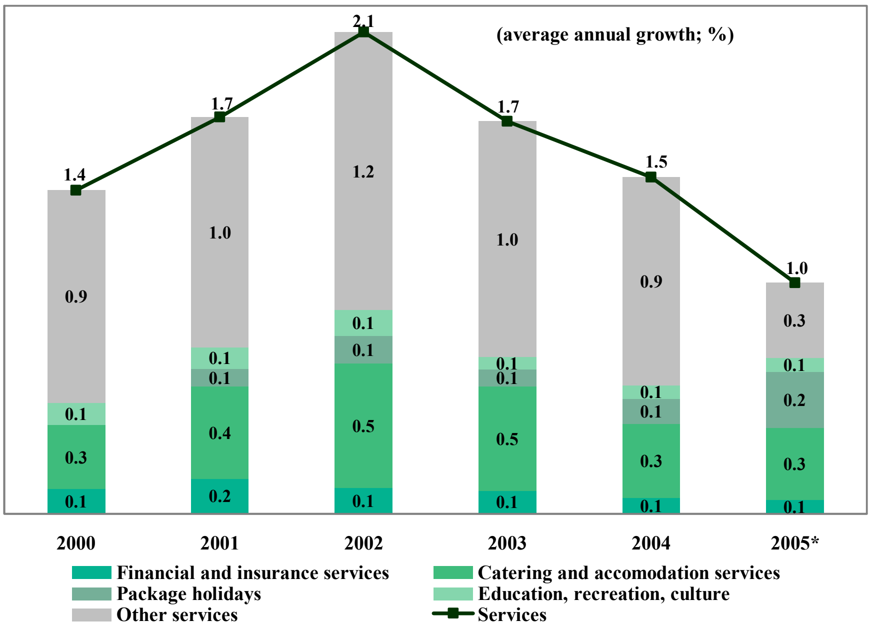
4 The asymmetry in the effects of rises in oil prices on the inflation in individual countries is primarily the result of the different weightings given to refined petroleum products in the indices of the individual countries and different excise duty levels on the basic purchase price for individual refined petroleum products.

Prices of services finally under the influence of the disinflation process[5]

After several years of sustained rises, prices of services began to gradually slow last year. The average annual rate of growth in prices of services fell from 7.1% in 2003 to 6.3% last year, and averaged 4.2% in the first quarter of this year. However growth in the prices of the most important services remains high. The most sustained growth continues to be recorded by catering and accommodation services, which contributed approximately 0.3 percentage points to average annual inflation. The proportion of the contribution accounted for by rises in prices of holidays has risen much in recent years, owing to both faster growth in prices and an increasing weighting in the consumer price index.

Average growth in prices of services was just 4.2% in the first quarter of this year

Figure 2.8: Contributions to inflation by component of services



* Average growth in first quarter of 2005
Source: SORS, ARC calculation

Falls in food prices last year temporarily reduced inflation

Food prices fell last year, and this contributed strongly to the fall in inflation. Over the year food prices fell by 0.8%, reducing inflation by approximately 0.8 percentage points. There were two main factors in the fall in food prices: the abolition of customs duties on certain products when Slovenia joined the EU, and the general fall in food prices in the EU.

The main factors in the fall in food prices of 0.8% last year were…

The initial estimates show that the abolition of customs duties on food products when Slovenia joined the EU lowered food prices by approximately 2%. The seasonal nature of the prices meant that the effect of abolition was seen over a longer period of several months. Despite the deregulation of food prices in 2002, which raised the level of competition even before Slovenia joined the EU, competition increased further last year. The figures show that imports of food products rose by approximately 16% following the abolition of customs duties. Food prices fell further last year because of a general fall in food prices in the EU of 1.5%. This was primarily a matter of older member-states being faced with competition from the new members (where food prices rose in general).

… the abolition of customs duties and fall in food prices in the EU

The overall effect of the fall in food prices following EU entry was about 3.5%, which reduced inflation by approximately 0.7 percentage points. With the exception of rises in the prices of seasonal food, rises in the prices of other food

Despite rises in the prices of seasonal food, other food prices have continued to fall in recent months

[5] Services include those with free prices not under the control of the government.

products continue to slow in all the sub-groups, the level being similar to that in the EU.

Elimination of administrative barriers

The elimination of administrative barriers promoted the flow of goods, increased indirect competition…

Average annual growth in prices of manufactured goods amounted to 2.3% last year, significantly lower than in previous years, when it was around 6%. There are several reasons for the slowdown, the most important of which is the abolition of customs duties following Slovenia's entry into the EU. The abolition of customs duties eliminated both price and administrative barriers to the flow of goods between Slovenia and other EU member-states. This increased the flow of goods, while Slovenian companies became more exposed to indirect competition from abroad.

… and brought faster adjustments in the prices of seasonal products

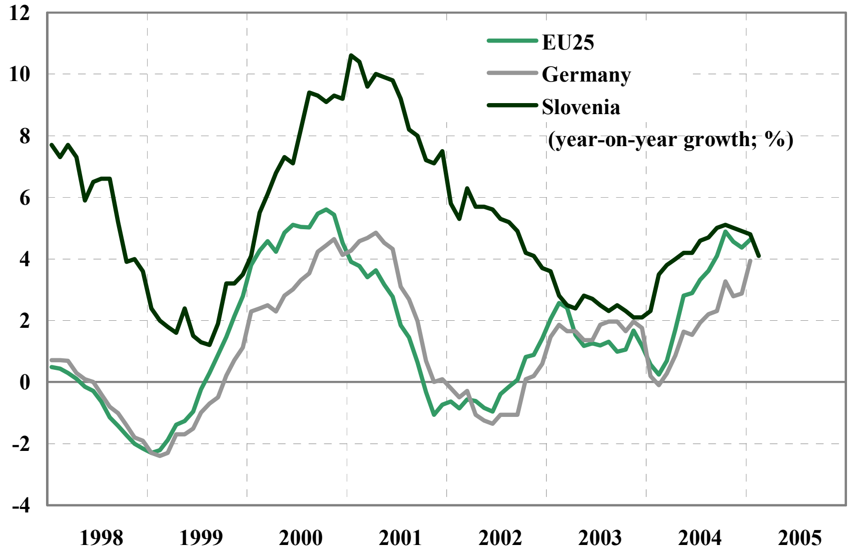
In addition to lower prices, the faster flow of goods and increase in indirect competition brought faster adjustments in the prices of seasonal products. These could be seen in both the prices of seasonal food and the prices of clothing and footwear. In the recent period in particular, changes in the seasonal component have caused major fluctuations in the year-on-year inflation rate, which has thus become less indicative in analysis of the disinflation process.

Growth in producer prices is in line with EU movements

High growth in producer prices last year was temporary in nature, and movements were in line with those in the EU

After several years of decline, year-on-year rates of growth in producer prices rose again in 2004. Year-on-year growth in producer prices stood at 4.9% at the end of the year, up 2.8 percentage points from December 2003. Despite the higher growth last year, growth in producer prices has gradually slowed in recent months, and is now moving in line with producer prices in the EU. Year-on-year growth fell from 4.9% in December to 3.8% in March.

Figure 2.9: Comparison of producer prices

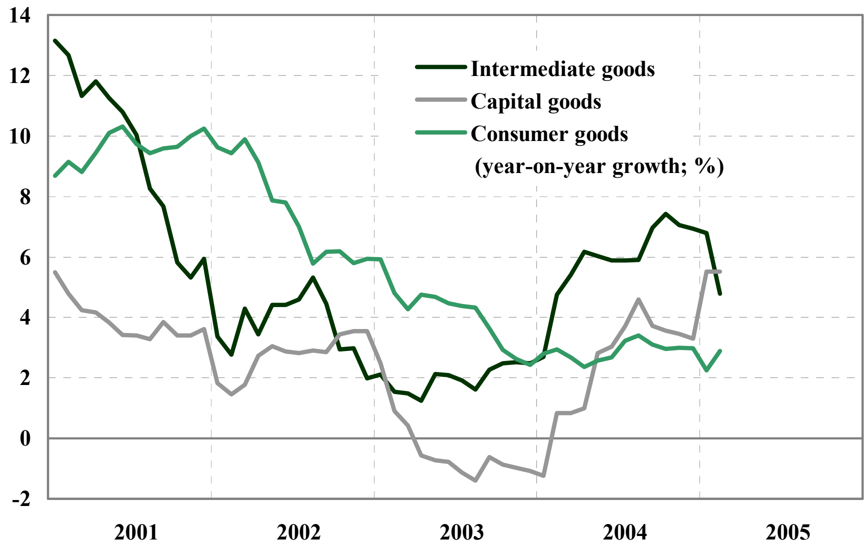


Source: Eurostat

Accordance between movements of producer prices in Slovenia and the EU points to a probable high level of convergence

Last year's faster growth in domestic producer prices was of a temporary nature, and was primarily the result of faster growth in producer prices abroad, and partly also the lower base from the previous year. The level of accordance between the movements of producer prices in Slovenia and those in the EU as a whole and in Germany over the last two years points to the probable high level of convergence in these prices. The history of higher year-on-year growth in Slovenia is thus primarily conditioned by a gradual catch-up with price levels in the EU. Competition on the final consumption side is restraining faster transmission of growth in producer prices to growth in consumer prices, which is therefore slower and in line with transmission in the EU.

Figure 2.10: Producer price components



Source: SORS, ARC calculation

The rapid growth in prices of intermediate goods was the result of high commodity prices

The fastest rise among producer prices last year was recorded by intermediate goods at 6.9%, with prices of raw materials rising by 7.1% and energy prices by 6.4%. There was similar movement in the year-on-year rates of growth in prices of capital goods, which rose sharply towards the middle of the year but slowed to 3.3% by the end of the year. Prices of consumer goods were more settled, rising by 3.0% in 2004. The rapid growth in prices of intermediate goods was primarily the result of the low base from the previous year, and the rises in prices of oil and other raw materials. Apart from the low basis, another factor in the faster growth in prices of capital goods was the increased level of motorway construction, housebuilding, and other major investment projects.

3. MONETARY POLICY

The main focus of the Bank of Slovenia and the government is introducing the euro at the beginning of 2007

The primary objective of monetary policy is price stability. Inflation is gradually falling, while the basic macroeconomic equilibria have remained in line with forecasts. The Bank of Slovenia and the Slovenian government committed to the adoption of the euro at the beginning of 2007 in the Programme for ERM II entry and adoption of the euro.[6] The Bank of Slovenia thus aimed to use its monetary policy and exchange rate policy to create the conditions to allow the as early as possible participation in the ERM II.

3.1 Monetary policy instruments in the ERM II

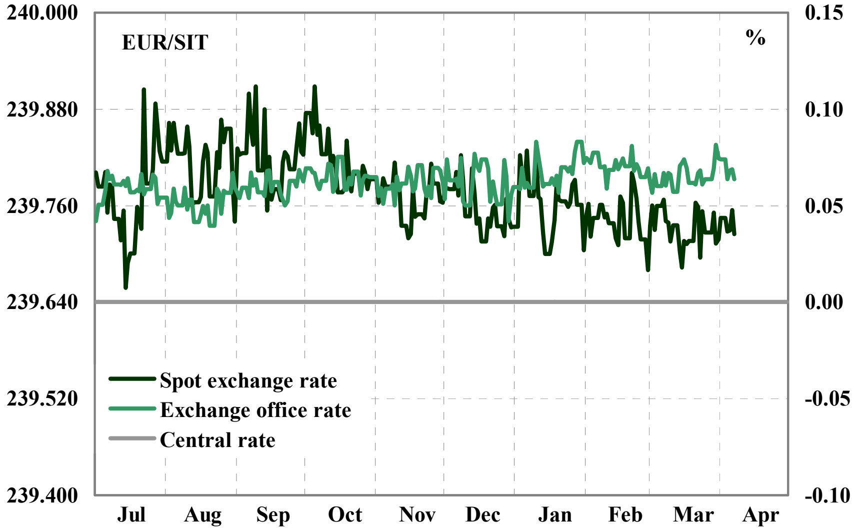
Slovenia entered the ERM II on 28 June 2004

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 exchange rate is allowed to fluctuate within a standard band of ±15%.

The market exchange rates' deviations from the central rate have been negligible

Since entry into the ERM II, the Bank of Slovenia has maintained the stability of the exchange rate. The discrepancies between the central rate and the market rate during the participation to date in the ERM II have been negligible. The average deviation of the exchange rate on the spot foreign exchange market[7] between the day of entry and the beginning of April 2005 was 0.06%, with a maximum deviation of 0.11%. The volatility of the exchange rate on the exchange office market was even lower. The two exchange rates were above the central rate.

Figure 3.1: Market exchange rates and deviation from central rate



Source: Bank of Slovenia

The foreign exchange markets are in equilibrium

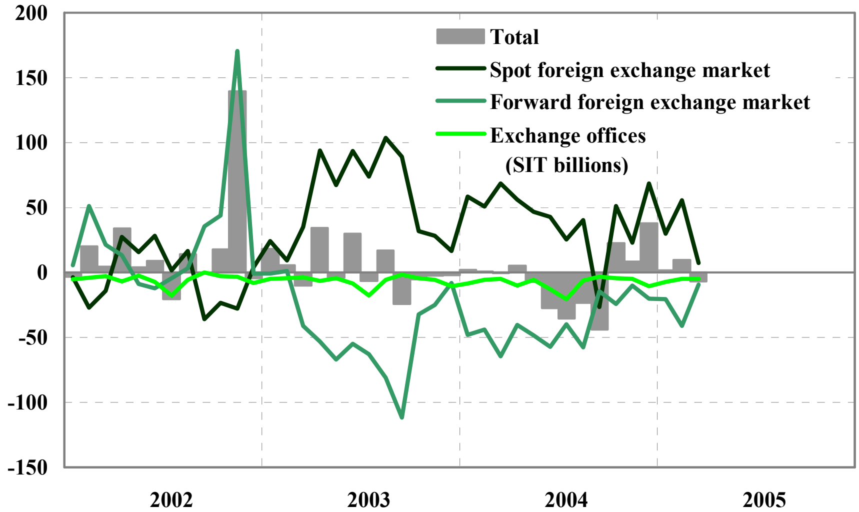
Since Slovenia joined the ERM II there has been no major excess foreign exchange supply or demand on the foreign exchange market. Excess demand on the foreign exchange markets between July 2004 and March 2004 amounted to SIT 28.8 billion. This period can be divided into three sections: the excess demand in the third quarter of 2004, the excess supply in the final quarter of

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

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

2004, and the balance between supply of and demand for foreign exchange in the first quarter of 2005. Demand was always in excess of supply on the forward market and the exchange office market, while on the spot market the supply of foreign exchange was greater than demand.

Figure 3.2: Excess supply/demand on foreign exchange markets



Source: Bank of Slovenia

No need for exchange rate interventions

With the equilibrium on the foreign exchange markets, there was no need for exchange rate interventions by the Bank of Slovenia. 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, thus signalling to banks its intention to maintain the central exchange rate and end the period of depreciation. At the beginning of July the Bank of Slovenia raised the price of the sell/buy foreign exchange swap, thereby allowing banks cheaper access to temporary foreign exchange liquidity. Because ERM II entry made a stable exchange rate the main focus of monetary policy, the Bank of Slovenia also included the possibility of directly intervening on the inter-bank foreign exchange market by selling or purchasing foreign currency among its instruments. The Bank of Slovenia used this instrument once only, on 27 July 2004, when it sold foreign exchange directly. This again signalled that the tolar's trend of depreciation was at an end.

Maintaining a stable exchange rate makes the Bank of Slovenia' interest rate policy subordinate to factors that are independent of the bank. The most important of these are:

- 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 and liquidity risk

The key Bank of Slovenia interest rates remain unchanged

The ECB refinancing rate has remained unchanged since June 2003 at 2.0%. Neither is there any indication from movements on the foreign exchange markets that Slovenia's risk premium has changed since it entered the ERM II. The Bank of Slovenia has therefore made no change in its key interest rates since ERM II entry.

On two occasions, in December and April, the Bank of Slovenia raised the buy/sell foreign exchange swap rate and thus the refinancing rate by a total of 0.5 percentage points. The purpose of this structural adjustment was to ensure continuing stability on the money market.

In April the interest rates on the Bank of Slovenia's instruments were as follows:

- refinancing 3.5%
- buy/sell foreign exchange swap 1.5%.
- sell/buy foreign exchange swap 1.0%.
- lombard loan 5.0%.
- 60-day tolar bills 4.0%
- overnight deposit facility 2.25%

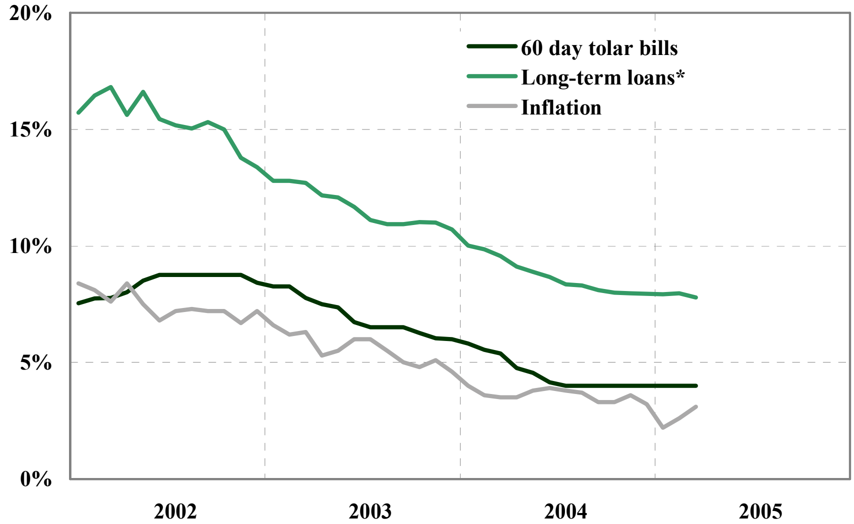
The difference between the 60-day tolar bill and the key ECB interest rate has remained unchanged since ERM II entry at 2 percentage points.

3.2 Monetary policy and macroeconomic developments

The Bank of Slovenia has maintained interest rates at the highest possible level

Within the framework of the limitations imposed by the ERM II, the Bank of Slovenia has maintained interest rates at the highest possible level still in line with stability on the foreign exchange market. The Bank of Slovenia has thereby attempted to prevent inflationary pressures that could trigger excessive lending or spending. Inflation has fallen by 0.7 percentage points since ERM II entry, while the Bank of Slovenia's interest rates have remained unchanged.

Figure 3.3: Maintenance of real interest rates



* includes loans with a TOM (base rate) clause until October 2002, and nominal interest rates alone since November 2002
Source: Bank of Slovenia

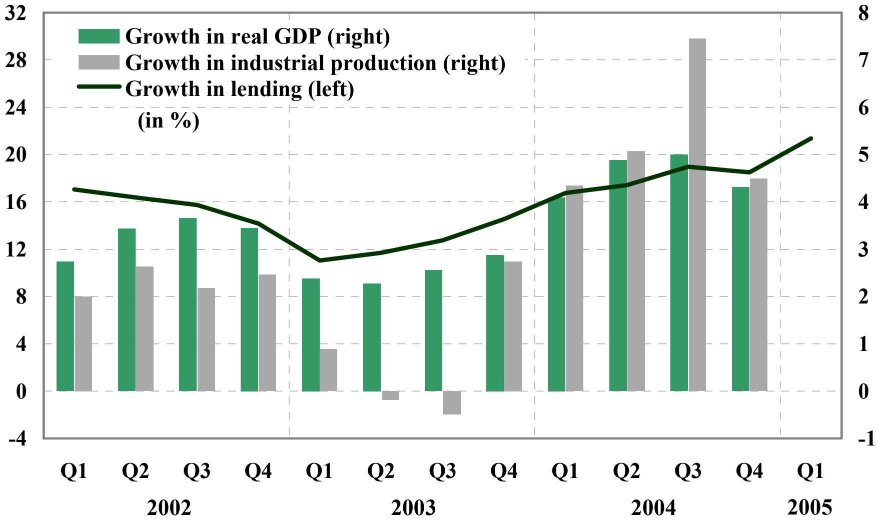
Increased lending in line with other macroeconomic trends

Increased lending activity is associated with higher economic growth and a gradual lowering of interest rates. Economic growth began to strengthen in the middle of 2003, when year-on-year growth in real GDP stood at less than 2.5%, and year-on-year growth in industrial production was even negative. In the final quarter of 2004 real GDP growth stood at 4.3%, while growth in industrial production was 4.5%. A factor in the revival of economic activity and lending is the fall in real interest rates that began early in 2004 and is primarily the result of the need for nominal convergence and ERM II entry. Lending began to gradually strengthen in the middle of 2003, when year-on-year growth stood at approximately 10%. By the beginning of 2005 year-on-year growth in lending had reached more than 20%.

Since ERM II entry enterprises lending and household lending have continued to strengthen, while general government lending has remained unchanged. In June

2004 year-on-year growth in enterprise lending stood at 17.7%, while the rate for household lending was 16.0%. Growth in enterprise lending and household lending had increased by 6 percentage points by February 2005. During the same period year-on-year growth in general government lending remained more or less unchanged.

Figure 3.4: Lending and economic activity

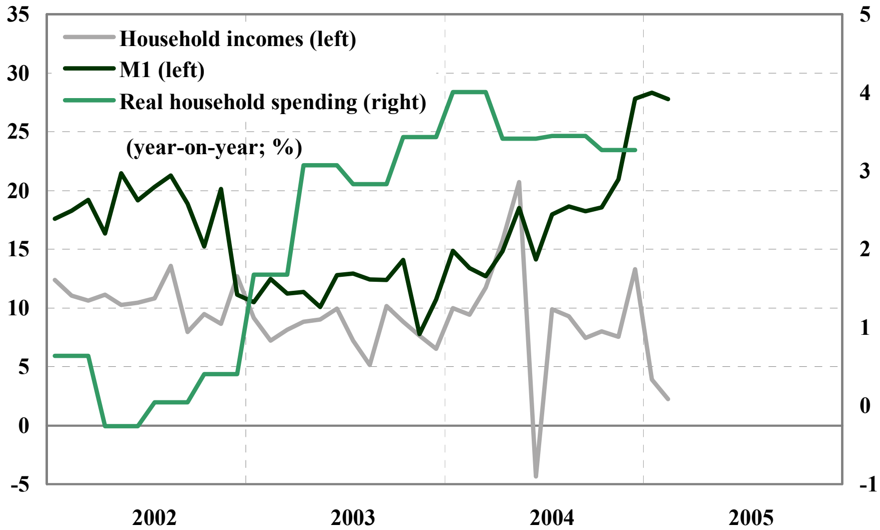


Source: Bank of Slovenia

The relatively strong growth in M1 is linked to higher domestic consumption

The increase in M1 is the result of stronger domestic consumption and larger household incomes. As can be seen in the figure, the longer-term trends in the movement of M1 are linked to growth in household spending. Household spending began to significantly strengthen at the beginning of 2003, reaching a rate of growth of 4.0% in the first quarter of 2004. The relatively high groth rates have been maintained throughout 2004. Year-on-year growth in M1 has been strengthening since the middle of 2003, when it was below 8%, and had reached more than 25% by the end of 2004 and the beginning of 2005. The short-term volatility in M1 is to a large extent linked to household incomes. There is a particularly clear temporary rise in year-on-year growth in M1 in the middle and end of 2004, which can be attributed to rises in supplementary payments (fringe benefits and year-end bonuses) and probably also in part to the difference in the scheduling of payments with regard to the previous year.

Figure 3.5: M1, household incomes and household spending

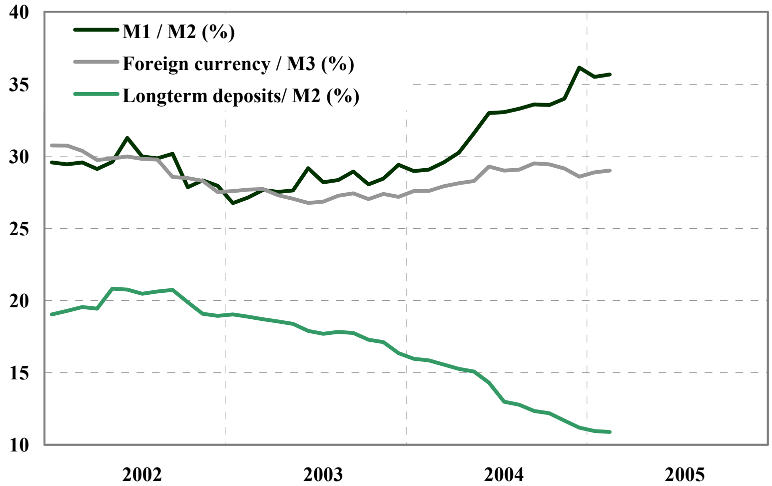


Source: Bank of Slovenia

A fall in the average maturity period of deposits

The fall in the average maturity period of deposits and the changes in the currency structure are the result of higher domestic consumption and of the flatter slope of yield curve. M1 as a proportion of M2 has been growing since the middle of 2003, when it stood at 25%, and had passed more than 35% by the beginning of 2005. The proportion of M3 accounted for by foreign currency deposits fell in the period to the middle of 2003, and then rose until the middle of 2004. After ERM II entry the proportion remained around 29%. The increase in foreign currency deposits prior to ERM II entry can be attributed to the uncertainty regarding the time of entry and the setting of the central rate. The proportion of M2 accounted for by long-term tolar deposits has fallen in the last two years, which can be attributed both to the uncertainty regarding the time of entry and to the decline in interest rates and flattening of the yield curve slope. In the two years prior to February 2005 the average interest rate on tolar time deposits with a maturity period of up to one month fell by just under 2 percentage points, while that for deposits with a maturity period of more than one year fell by more than 4 percentage points.

Figure 3.6: Maturity and currency structure of deposits

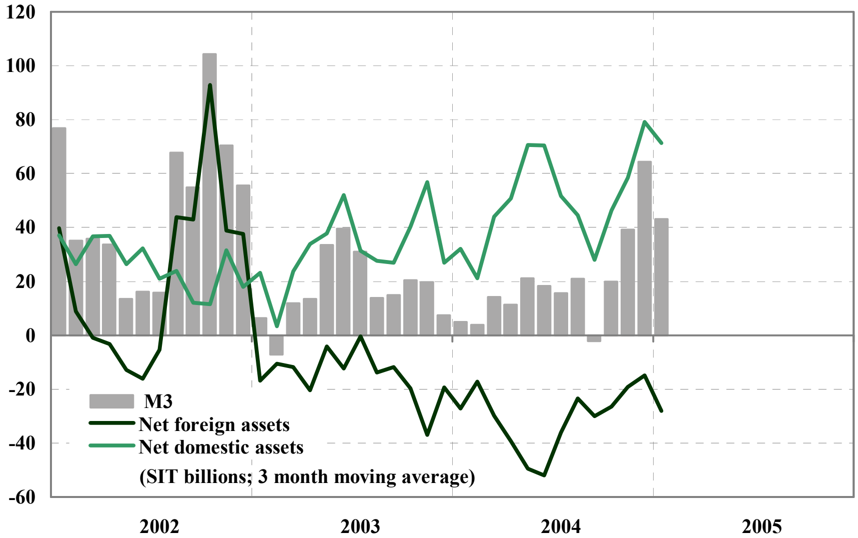


Source: Bank of Slovenia

The slow growth in broad monetary aggregates is the result of balance of payments outflows…

Despite relatively strong lending activity, growth in the broad money aggregates remains modest because of balance of payments outflows. As can be seen from the figure, the net foreign assets (NFA) figure, which shows the contribution of

Figure 3.7: M3



Source: Bank of Slovenia

balance of payments flows to growth in M3, has been falling since the beginning of 2003. Thus NFA fell by SIT 197.0 billion in 2003 and by SIT 328.0 billion in 2004. Nevertheless the increase in M3 in 2004 was SIT 76.6 billion higher than in 2003, as a result of stronger lending activity. The large growth in M3 at the end of 2004 was linked to higher household incomes and greater lending activity.

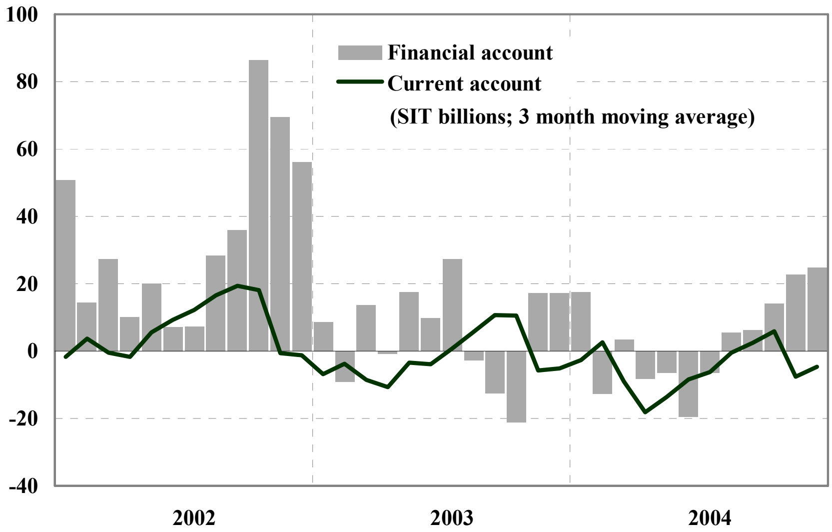
… the decline in deposit rates, and increased alternative saving opportunities

The slow growth in broad money is the result of the decline in deposit rates and increased alternative saving opportunities at home and abroad. Household investments abroad, investments in mutual funds and investments in supplementary pension and life insurance rose by SIT 93 billion in 2002, by SIT 98 billion in 2003, and by more than SIT 200 billion in 2004 according to the provisional figures. The largest rise in 2004 of SIT 117 billion was recorded by investments in mutual funds, which represent approximately 3% of M3.

Balance of payments movements have not caused any major pressures on the exchange rate

Since the beginning of 2003, balance of payments movements have not brought about any major imbalances on foreign exchange markets and thus pressures on the exchange rate. The current account was in deficit in the first half of 2004, but was balanced in the second half of the year, so that the total deficit in 2004 was 0.9% of GDP. There was a net outflow in the financial account in the first half of the year, and a net inflow in the second half. The main financial inflows were loans from abroad, principally in banks, while the main outflows were portfolio investments.

Figure 3.8: Current account and financial account



Source: Bank of Slovenia

3.3 Structural adjustments to ease the transition to the euro

With the planned adoption of the euro in mind, the Bank of Slovenia continued to make certain structural adjustments aimed at easing the transition to the conditions of operation in the eurosystem. These adjustments relate to the replacement of 270-day tolar bills with long-term deposits, the gradual relaxation of minimum foreign currency liquidity within the framework of the liquidity ladder, the level of swapped foreign exchange, and the system of required reserves.

Introduction of long-term tolar deposits

In July 2004 the Bank of Slovenia began offering long-term tolar deposits with the aim of sterilising excess liquidity from the maturity of 270-day tolar bills issued during the takeover of Lek. The interest rate offered on the long-term tolar deposits is 0.2 percentage points higher than the interest rate on 60-day tolar bills, while the time that the deposits mature extends into the period after the planned adoption of the euro. In 2004 banks used 55% of the possible subscription, and there were SIT 156.7 billion of long-term tolar deposits at the end of the year, and SIT 160.8 billion at the end of February 2005.

Relaxation of minimum foreign currency liquidity and replacement of swaps with final purchases of foreign exchange

In order to increase banks' flexibility in transacting on foreign exchange markets, the Bank of Slovenia gradually relaxed the minimum foreign currency liquidity within the framework of the liquidity ladder, and offered to replace foreign exchange swaps with permanent purchases. In 2004 the Bank of Slovenia reduced the minimum level of liquid assets in foreign currency from 80% to 70% of short-term liabilities in foreign currency and the level of required subscription to foreign currency bills from 45% to 35% of liquid assets in foreign currency. In 2005 the level of required subscription to foreign currency bills was reduced further to 25% of liquid assets in foreign currency. The level of foreign currency bills had fallen from SIT 555.3 billion at the end of 2003 to SIT 501.7 billion by February 2005. In 2004 the Bank of Slovenia also offered banks the opportunity to make a final sale of foreign exchange from cumulative Bank of Slovenia buy/sell swaps. In seven offers banks were offered a total of SIT 409.8 billion of foreign exchange to sell, with SIT 331.8 billion of foreign exchange being finally sold to the Bank of Slovenia.

Adjustment of required reserve instrument

The Bank of Slovenia continued to adjust the required reserve instrument to the ECB standards. At the end of October 2004 it:

- included companies issuing electronic money among those obliged to maintain required reserves,
- abolished the mandatory 50% daily maintenance of required reserves,
- regulated the obligation to maintain required reserves in the event of bankruptcy,
- set a 0% level of required reserves for repo transactions.

In March 2005 the Bank of Slovenia lowered the level of required reserves for tolar liabilities with maturity period of up to 90 days from 4.5% to 2%. Thus the level of required reserves for all liabilities with maturity of up to two years is now 2%, in line with the arrangements in the eurosystem. The level for liabilities falling due in more than two years remains at 0%. The Bank of Slovenia wanted to delay the liquidity effect of the change until after the adoption of the euro, so banks and savings banks were obliged to place the excess liquidity arising from the lowering of required reserves in the amount of SIT 37 billion in long-term deposits with the Bank of Slovenia maturing at the end of March 2007.

Box 3.1: Diary of Bank of Slovenia measures since ERM II entry

<u>28 June 2004</u>

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 buy/sell foreign exchange 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). The intervention lasts until 1 July 2004.

<u>2 July 2004</u>

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

<u>20 July 2004</u>

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

<u>27 July 2004</u>

The Bank of Slovenia intervenes directly on the inter-bank foreign exchange market by selling foreign exchange.

30 July 2004

The Bank of Slovenia offers banks long-term tolar deposit as a replacement for 270-day tolar bills for the first time. The interest rate is 0.2 percentage points higher than that on 60-day tolar bills. Banks had subscribed SIT 160.8 billion of long-term tolar deposits by February 2005.

27 October 2004

The Bank of Slovenia continues to adjust the required reserve instrument to the ECB standards. In so doing, the Bank of Slovenia:

- includes companies issuing electronic money among those obliged to maintain required reserves
- abolishes the mandatory 50% daily maintenance of required reserves
- regulates the obligation to maintain required reserves in the event of bankruptcy
- sets a 0% level of required reserves for repo transactions

19 November 2004

As part of the replacement of foreign exchange swaps with final purchases, the Bank of Slovenia purchases SIT 75.3 billion of foreign exchange from banks.

3 December 2004

As part of the replacement of foreign exchange swaps with final purchases, the Bank of Slovenia purchases SIT 22.6 billion of foreign exchange from banks.

23 December 2004

The Bank of Slovenia raises the buy/sell foreign exchange swap rate from 1.0% to 1.25%, and thus the refinancing rate from 3.0% to 3.25%. The aim of the structural adjustment is to ensure continuing stability on the money market.

1 February 2005

The Bank of Slovenia revokes the provision pursuant to which credit institutions that had failed to repay one-day liquidity loans by the end of payment transactions had to take a lombard loan at the lombard loan interest rate plus 4 percentage points. Now they can take loans at the lombard loan rate without paying the premium.

27 March 2005

The Bank of Slovenia continues to adjust the required reserve system to the ECB standards. The level of required reserves for tolar deposits with maturity of up to 90 days is cut from 4.5% to 2.0%. Those obliged to maintain required reserves must take up the amount of liquidity released (SIT 36.9 billion) by 29 March 2005 in long-term deposits with the Bank of Slovenia, maturing on 30 March 2007.

7 April 2005

The Bank of Slovenia raises the buy/sell foreign exchange swap rate from 1.25% to 1.5%, and thus the refinancing rate from 3.25% to 3.5%. The aim of the structural adjustment is to ensure continuing stability on the money market.

4. ECONOMIC OUTLOOK[8]

With the world economy gradually recovering and domestic demand remaining fairly high, GDP growth will remain at a relatively high level until 2007. The rise in prices is forecast to stand at 2.4% at the end of the year, and a similar movement is expected in 2006. The first part of this section presents the assumed movement of 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 domestic demand in terms of individual components of spending. The external balance and terms 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 October 2004 are given in Table 4.8 at the end of the section.

4.1 International environment

Gradual, uncertain recovery and an absence of inflationary pressures from abroad

After rapid growth in the first half of the year and then a slowdown at the end of last year, this year's growth in Slovenia's most important trading partners will be lower than last year's. The recovery of domestic demand remains considerably uncertain in the eurozone trading partners in particular. Household spending is weak in these countries owing to slow wage growth, and investment activity is characterised to a great extent by outflows of investment abroad. Higher net exports and thus stimulus for economic recovery will be restricted in the future by the strength of the euro and the gradual cooling of the Chinese and US economies. In addition to the anticipated tightening of monetary policy, price pressures on the side of domestic demand will continue to be restricted by somewhat unfavourable conditions on the labour market and slow wage growth. Price pressures on the foreign supply side are also expected to be slightly lower than last year, as it is anticipated that the slowdown in growth in commodity prices already being seen will be accompanied by an end to the rapid rise in oil prices. Nevertheless supply-side factors will remain the most significant risk factor that could bring about significant inflationary pressures from abroad.

Table 4.1: Assumptions for international environment

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
Foreign demand	4.5	2.7	2.6	6.3	6.1	6.9	6.9	6.9	6.1	-0.8	6.9	6.9	0.0	…	6.9	…
USD/EUR	0.90	0.94	1.13	1.24	1.32	1.32	1.32	1.22	1.32	0.10	1.22	1.32	0.10	…	1.32	…
Oil USD/barrel	24.4	25.0	28.8	39.0	45.0	45.0	45.0	34.0	45.0	11.0	30.0	45.0	15.0	…	45.0	…
Commodities	-6.5	4.6	11.3	16.0	3.0	3.0	3.0	10.0	3.0	-7.0	3.0	3.0	0.0	…	3.0	…
EMU inflation	2.6	2.2	2.1	2.1	1.8	1.7	1.7	2.0	1.8	-0.2	2.0	1.7	-0.3	…	1.7	…
PPI Germany	1.3	-0.3	1.7	1.6	1.9	1.3	1.3	1.3	1.9	0.6	1.3	1.3	0.0	…	1.3	…
EURIBOR 3m	4.3	3.3	2.3	2.3	2.4	2.8	3.1	2.7	2.4	-0.3	3.1	2.8	-0.3	…	3.1	…

Sources: JP Morgan, Consensus Forecast, OECD Economic Outlook, IMF World Economic Outlook

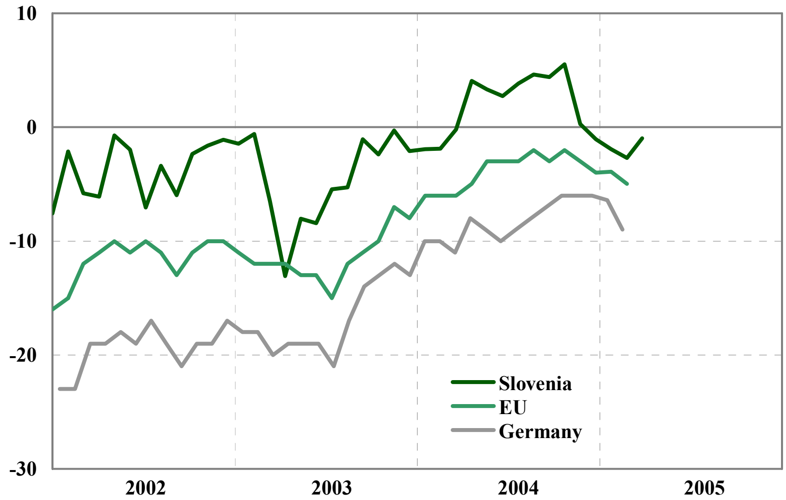
Particularly weak spending in the eurozone

After fairly high growth in 2004, foreign demand will slow slightly this year. The current forecasts are that after stalling at the end of last year foreign demand will only strengthen gradually this year and next year. This is supported by

[8] The forecasts were made on the basis of information available and the statistical methodology applicable on 17 March 2005. 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.

indicators of confidence in the most important trading partners, which have improved only slightly in the last few months. Domestic spending remains rather weak in the eurozone partners. Household spending is being held in check by low wage growth, while low labour costs should be strengthening enterprise profits, these being used in the future to expand investment activity. Owing to higher expected returns it is considerably likely that investment activity will be transferred abroad, outside the eurozone. The slowest recovery in domestic spending is anticipated in the most important eurozone trading partners. Additional factors slowing down recovery and a higher contribution towards economic growth by net exports are the strength of the euro and the return of the extremely high growth seen in the world economy, in particular the USA and China, to a level sustainable in the long-term. Demand in the countries of eastern and south-eastern Europe will be slightly slower in comparison with previous years owing to fiscal restrictions and high current account deficits, while demand from Russia will remain high.

Figure 4.1: Business confidence in Slovenia and abroad



Source: SORS, ARC calculation

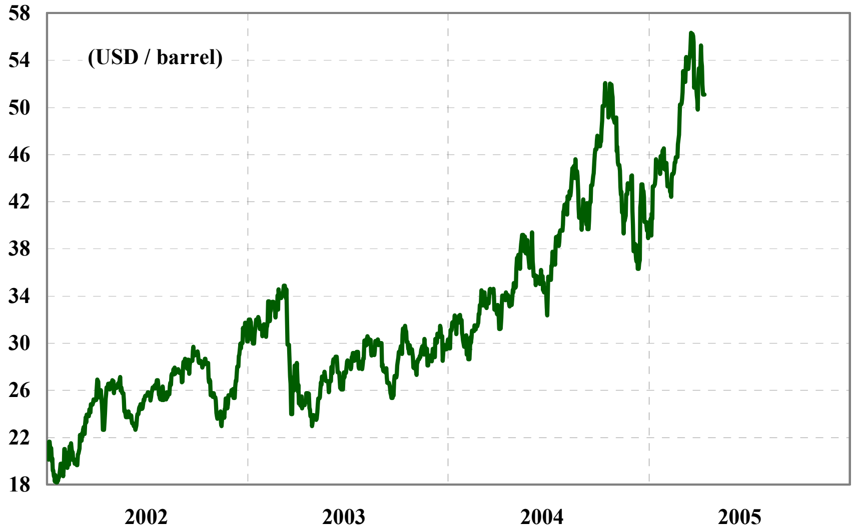
The euro/dollar exchange rate assumption puts the euro 8% stronger than in previous projections

The assumption is for the euro to be at USD 1.32 in the years ahead. The trend of dollar depreciation against the euro seen since the beginning of 2002 continued in the last three months of last year. The large decline in the value of the dollar was then followed by a correction at the beginning of this year, but since February the dollar has again lost ground against the euro. The assumption made in our forecasts is that the euro would remain at USD 1.32, which corresponds to the actual exchange rate at the end of February, and represents a gain of more than 8% in the strength of the euro in the years ahead in comparison with the last forecasts.

Oil prices to remain high

Oil prices will remain high throughout the projections period. The previous oil price assumptions have been revised significantly upwards, by USD 11 per barrel in 2005 and USD 15 per barrel in 2006. The rise in the oil price in 2004 was larger than expected by the majority of analysts. Although political tensions in individual exporting countries were to a certain extent a factor in this, it is likely that a more important factor was strong demand, which was up 2.7 million barrels per day from 2003 (taking the total rise during 2000 to 2003 to 3.1 million barrels per day). At the end of January, Opec also officially announced that it was temporarily abandoning the target band of USD 22 to USD 28 per barrel. In their statements some of the more important representatives of the cartel gave an expected figure of USD 40 to USD 50 for the oil price range in 2005. This year the price of a barrel of Brent crude had risen from USD 40 to USD 50 by the end of February, thus reaching the record levels seen last October. Forecasts by foreign institutions for the yearly average are around USD 45 per barrel. Although forwards contracts point to a slightly lower oil price level in 2006 and 2007, a price of USD 45 per barrel has been assumed throughout the entire forecasting period.

Figure 4.2: Oil price



Source: Reuters

Slowdown in commodity prices

After a spurt of growth in the middle of 2004, commodity prices are already beginning to slow. The current rate of growth has declined considerably in recent months from the exceptionally high level in the first half of last year. In the final quarter of last year food prices in dollars fell 6% year-on-year, and while year-on-year growth in metals prices remained high at 30%, primarily as a result of exceptionally high demand from the Chinese economy, in recent months metals prices have been practically unchanged. This year it is anticipated that the effect of somewhat slower growth in metals prices and the fall in food prices will cancel each other out so that commodity prices remain unchanged, while in line with the recovery of the world economy it has been assumed that dollar commodity prices will show moderate growth in 2006 and 2007.

Prices in the eurozone close to the target value

The consumer price index in the EU will also be close to the ECB target value in the future. Forecasts by international institutions put inflation in the eurozone in 2005 below 2% for the first time in six years, and thus in line with the ECB target (close to but below 2%). The major factors in the decline in the rate of growth in prices in comparison with previous years should be favourable trends in wages, administered prices and food prices, and the appreciation of the euro, while the contribution of indirect taxes should also be lower than in previous years. Considerably more risky than forecasting inflation is predicting the movement of fuel prices, which are forecast to rise slightly more slowly this year than last year, when they accounted for 0.4 percentage points of the year-on-year inflation rate. Other factors in lower inflation this year should be a slight decline in economic growth and growth in spending that is still relatively low. The rise in producer prices last year was primarily affected by the rapid rise in fuel prices and other commodity prices. At the end of 2004 the year-on-year rate of growth in the PPI in Germany stood at 2.9%, while foreign analysts are mostly expecting a slowdown in growth of commodity prices this year, and thus slower growth in producer prices.

A rise in interest rates expected abroad

Analysts are forecasting that interest rates in the eurozone will begin to gradually rise. The interest rates on the euro have remained unchanged since June 2003, while the Euribor has averaged around 2.3%. The majority of analysts expect the ECB to gradually start raising its interest rates in the second half of 2005, but this depends to a great extent on the anticipated economic recovery in the eurozone. Our forecasts assume a rise in the ECB interest rates in the second half of 2005, and a further rise in 2006.

4.2 Economic activity, employment and wages

Continuation of real convergence on the EU average

Economic growth will hover around 4% in the coming years. GDP growth will remain higher than the estimated growth in potential output throughout the period of the projections. This growth will continue to facilitate a process of real convergence on the EU average, as the rate will be higher than average economic growth in the EU. The high growth in 2004 and the anticipated continuation of a higher current rate of growth in economic activity than in estimated potential output will see slightly faster closing of the output gap than forecast previously. For this reason inflationary pressures on the side of excess demand could begin to arise in the second half of 2006, which will also be reflected in the current account deficit remaining around 1% of GDP.

Table 4.2: Economic activity, employment and wages

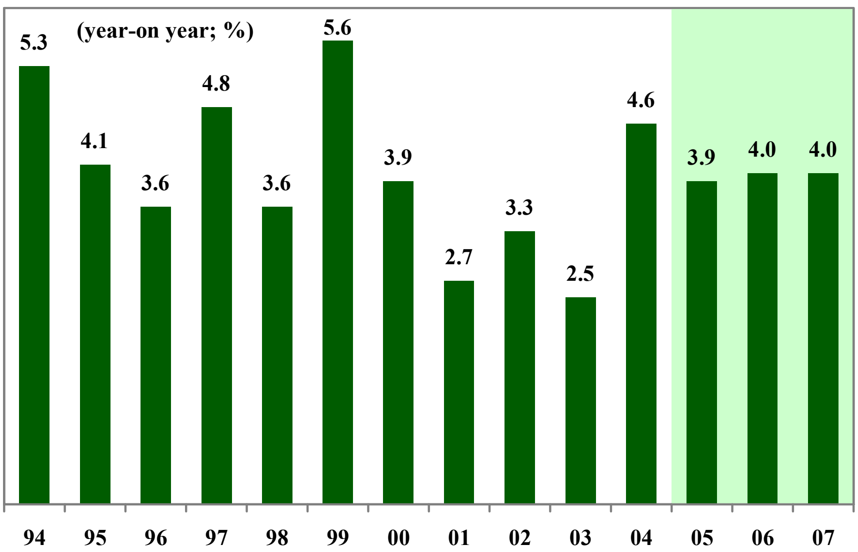
					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
	real growth rate (%)															
Real GDP	2.7	3.3	2.5	4.6	3.9	4.0	4.0	3.8	3.9	0.1	4.0	4.0	0.0	…	4.0	…
Per capita GDP (EUR)	10,864	11,628	12,201	12,942	13,807	14,712	15,700	13,453	13,807	354	14,355	14,712	357	…	15,700	…
Employment	1.8	0.7	0.3	0.6	0.6	0.3	0.5	0.7	0.6	-0.1	0.4	0.3	-0.1	…	0.5	…
Net wages	3.1	2.1	1.8	2.1	2.5	2.2	2.0	1.7	2.5	0.8	2.0	2.2	0.2	…	2.0	…
Productivity	1.8	2.5	2.7	3.3	3.3	3.7	3.5	3.1	3.3	0.2	3.6	3.7	0.1	…	3.5	…

Source: ARC

The favourable employment trends will continue

The main factor affecting the current rate of growth in employment will be jobs in the public sector. The reasonably good general economic outlook was reflected last year in developments on the labour market, although the figures in the national accounts report that employment rose by only 0.1% over the year on average, with a 1.9% rise in the general government sector and no change in the rest of the economy. In this context, having moved unfavourably in the first half of the year, employment in the private sector began to grow again in the second half. The transmission of positive shifts will see solid growth in employment continue this year at least. It is expected that a good portion of the rise in employment will be in the public sector, where employment should continue to rise by approximately 2% a year, as a partial decline in the outlook this year will place limits on the rise in employment in the private sector already underway.

Figure 4.3: GDP projections



Source: ARC

Wage growth will be in line with the social agreement already concluded

Wage growth will be limited in the coming years. A major part in this will be played by the expectation of responsible cooperation between the social partners in approving new wage increase mechanisms for 2006 and 2007. Slightly higher wage growth can be expected in 2005, primarily as a result of the partial transmission of the extremely rapid current rate of wage growth in the private sector and the acceleration of public sector wage growth at the end of 2004. The increases to the basic wages have already been agreed, although the details are yet to be formulated for those in the public sector. The wage agreements between the social partners are yet to be concluded for subsequent years. With regard to the wage agreements, it is anticipated that the agreements to be concluded will make the best contribution to maintaining the competitiveness of the economy. Based on the public sector wage agreement already concluded, after declining in real terms in 2004 average wages in the public sector will record real growth of 1.3% this year, while wage growth in the private sector will be 1.5 percentage points higher. Owing to the less optimistic economic outlook and high basis from last year, it is expected that the current rate of growth and year-on-year growth in labour costs will slow this year. Should this not happen, continuation of the rapid growth of the element representing the majority of costs at companies could be reflected in inflationary pressures, a decline in competitiveness and a slowdown in employment.

Box 4.1: Public sector wage adjustment in 2005

Social partners have reached an agreement on the adjustment of wages in the public sector for 2005 in early April. Basic principles on wage adjustment have already been reached in the June 2003 Agreement on basic wage adjustment and holiday allowance for 2004 and 2005. Based on that agreement, one half of the initially proposed adjustment of 3%, that is 1,5%, should be used on regular wage adjustment, while the rest should be used to remove the inequalities in the system of public sector wages. Nevertheless, based on April 2005 agreement, wages will adjust by 2%, which is more than proposed initially. Additionally, the portion of funds, that are to be paid into Budget and the purpose of which is to remove the inequalities in public sector wage system, has remained non-defined and is subject to further negotiation between the Government and trade unions of the public sector.

4.3 Components of spending

Domestic spending will remain high

Domestic demand will be the most important factor in economic growth in the next few years. With net exports expected to stall because of the slow pace of the recovery in foreign demand, the contribution to economic growth made by domestic spending will decline only slightly in comparison with 2004. Despite this decline domestic demand will almost fully compensate for the temporary stalling of foreign demand. Although the high economic growth in 2004 was primarily the result of a significant improvement in the negative contribution of net exports, the contribution to economic growth made by domestic spending also rose primarily on account of household spending. The contribution to economic growth made by investments remained mostly unchanged from 2003. It is expected that in 2005 the contribution to economic growth made by domestic spending will fall, primarily owing to slower growth in investments, while the contribution made by general government spending will strengthen slightly from the previous year.

The contribution of net exports will gradually become neutral

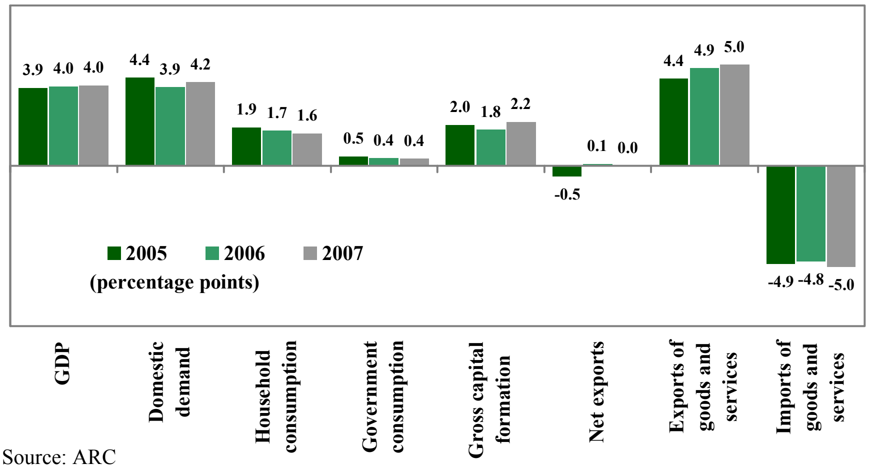
The contribution made to economic growth by net exports will worsen in 2005. After improving by 2 percentage points in 2004, the contribution made to economic growth by net exports will again decline owing to slower growth in foreign demand, and thus a widening of the gap between current rates of import and export growth. The contribution to economic growth made by net exports in 2006 and 2007 will be neutral, in line with the recovery abroad and the gradual slowdown in growth in domestic demand. The main factor that could contribute to lower economic growth in Slovenia during the period of the projections is a further delay in the recovery of activity in the most important trading partners, which would further expand the negative contribution made to economic growth by net exports.

Table 4.3: Components of spending

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
	real growth rate %															
Domestic demand	0.9	2.3	4.7	4.7	4.3	3.8	4.1	4.1	4.3	0.2	4.0	3.8	-0.2	…	4.1	…
Household consumption	2.3	0.3	2.7	3.5	3.5	3.2	3.0	3.2	3.5	0.3	3.1	3.2	0.1	…	3.0	…
Governm. consumption	3.9	1.7	2.6	1.7	2.4	2.1	2.0	2.1	2.4	0.3	2.8	2.1	-0.7	…	2.0	…
Gross capital formation	-4.3	7.4	10.5	9.1	7.0	6.0	7.2	7.7	7.0	-0.7	6.3	6.0	-0.3	…	7.2	…

Source: ARC

Figure 4.4: Contributions by components of spending



Source: ARC

High household spending limited by disposable income

Household spending will remain at a rather high level in the future, the main factors in this being relatively high wage growth in 2005 and the real appreciation of the tolar. The positive outlook regarding employment will also have a favourable impact on household spending, particularly in the first half of 2005. Wage policy agreements will slightly restrict the increase in disposable income in the future, while institutional changes in pension insurance will encourage people to use long-term forms of saving. The main risk factors in forecasts of consumer spending are wages and pensions. The wage growth dynamics was high at the end of 2004 and the beginning of 2005, and the wage agreement for 2005 has not yet been reached. In connection with the relatively high and uncertain growth in wages, pensions also represent a risk factor in the realisation of household spending forecasts, if they are to become tied to wages.

Investment spending will be promoted by activity in the private sector

Despite a slight slowdown, the investment activity dynamics will remain high, and will thus significantly contribute to the maintenance of high economic growth. The main features of the high investment activity in 2004 were housebuilding and investment in equipment, while growth in government investment activity, primarily investments in the construction of infrastructure, was slightly slower. The decline in stocks seen at the end of last year is expected to continue for the next year at least. Housebuilding will continue to record high growth, while investment in equipment will slow slightly. Apart from the statistically conditioned high basis, the main factors in the decline in growth from the previous year will be lower profitability owing to high raw material prices in 2004 and a decline in companies' expectations regarding the recovery in foreign economies. Based on projected general government budget expenditure and owing to the need for a restrictive policy in public expenditure, government investment activity will also be relatively slow.

General government spending will strengthen slightly

The contribution to economic growth made by general government spending this year will be slightly higher than last year. General government spending was the slowest-growing component of domestic demand in 2004. However there was a notable acceleration in government spending during the year, with the highest year-on-year growth being recorded in the final quarter. With growth in expenditures for goods and services relatively slow, wage expenditures rose slightly at the end of the year, with both promotions and a rise in the number of employees, which was up 2% on average over the year, being factors in this rise. Given the relatively low basis from 2004 and the transmission of wage growth to 2005, and taking the public sector wage agreement into consideration, general government spending is expected to strengthen slightly in 2005 in comparison with 2004, while the contribution made to economic growth by general government spending will also increase. It is estimated that government spending will slow after 2005 and grow at a rate of 2% per year.

4.4 Balance of payments

An increase in the current account deficit

The current account deficit will rise slightly further in the coming years. The deficit rose from 0.4% of GDP in 2003 to 0.9% of GDP in 2004. Although there were favourable export trends, domestic spending also strengthened, and with it demand for imports. The export trends were particularly good in the period leading up to EU entry, when companies were trying to exploit the preferential trade agreements with non-EU-members then still in force. However increased domestic demand caused a rise in imports, which given the favourable trade agreements was mostly seen in imports from non-EU-members in the period before EU entry, and then mostly in imports from EU member-states after the remaining trade barriers were abolished when Slovenia joined the organisation. The terms of trade will bear a negative impact on the current account in 2005 in particular, and will afterwards begin to improve and have a neutral effect on the current account.

Table 4.4: Current account

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
	real growth rates %															
Exports of G&S	6.3	6.7	3.2	12.6	6.7	7.3	7.3	5.9	6.7	0.8	4.9	7.3	2.4	…	7.3	…
Imports of G&S	3.0	4.9	6.8	12.4	7.2	6.8	7.0	6.2	7.2	1.0	4.7	6.8	2.1	…	7.0	…
Current acc.: EUR mio	38	335	-91	-238	-440	-360	-380	-433	-440	-7	-215	-360	-145	…	-380	…
% GDP	0.2	1.5	0.1	-0.9	-1.6	-1.3	-1.2	-1.6	-1.6	0.0	-0.7	-1.3	-0.6	…	-1.2	…
Terms of trade	0.9	1.9	0.0	0.0	-0.8	-0.1	0.2	1.3	-0.8	-2.1	0.7	-0.1	-0.8	…	0.2	…

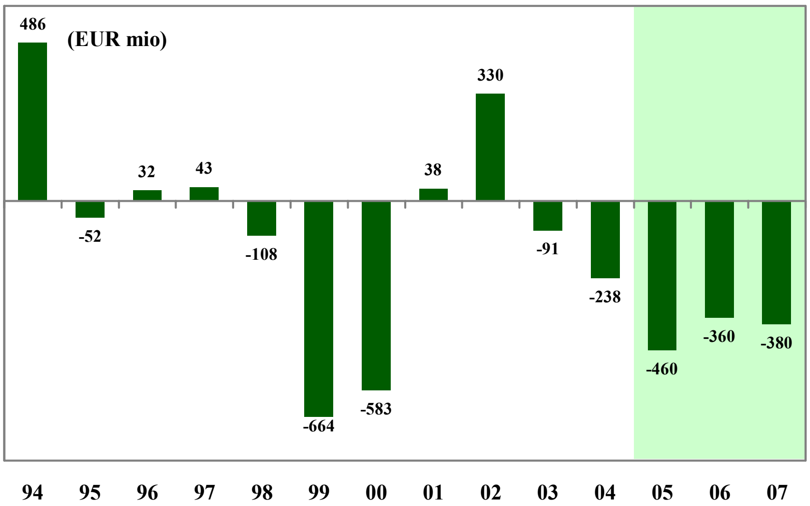
Source: ARC

The current account deficit will amount to approximately 1.5% of GDP in the coming years

The estimated current account deficit will widen to approximately 1.6% of GDP in 2005, representing a worsening in comparison with 2004. The current account deficit is expected to widen from last year's EUR 238 million to approximately EUR 440 million or 1.6% of GDP, but should then begin to shrink in 2006 to reach approximately 1.3% of GDP. The main factors behind the worsening of the current account during this year and the next two years will be changes in the forecast trends of trade in goods and reinvested earnings,[9] which will be larger than currently forecast.

[9] 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. Here 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".

Figure 4.5: Projection of current account



Source: ARC

A slowdown in the high growth in goods trade seen in 2004

The increase in the deficit of goods trade will primarily be a consequence of a decline in export growth. Slower demand from abroad will bring about a decline in exports of goods. Despite a slight fall in investment activity and with growth in household spending remaining the same, imports of capital goods and consumer goods will remain at a relatively high level. A slowdown in imports of capital goods in the second half of the year reflects slower growth in investment activity at the end of the year. The growth dynamics of imports and exports will gradually equalise over the course of the projection period with the recovery of foreign demand and a slowdown in domestic spending. There are two basic risks in the projections. The first is related to the onset and the size of the recovery of foreign demand and the resulting developments in Slovenia's exports, while the second relates to the continuation of domestic demand at a high level and the movements in imports associated with this.

The terms of trade have a mostly neutral effect on the current account

The terms of trade will have a negative impact on the current account in 2005, but a neutral effect over the remainder of the projection. Rises in import prices will exceed rises in export prices by 0.8 percentage points in 2005, but rises in import and export prices will equalise in the next two years. The terms of trade will thus cause the current account deficit to widen by approximately an extra 0.3% of GDP in 2005. That import prices show a faster rise than export prices is primarily the result of the transmission of the rapid rise in oil prices and commodity prices from 2004 to 2005, which will slow during the year and contribute to an equalisation of import and export prices by the end of the year. The assumptions of no change in oil prices and of very slow growth in commodity prices represent the largest risk in the forecast of the terms of trade. Unfavourable shocks on world markets could see the negative contribution to the current account made by the terms of trade worsen further.

A slight deterioration in other foreign trade

A slight deterioration is also expected in the balance of trade in services, which will move in line with the continuation of relatively high domestic demand and the decline in economic growth abroad. It will therefore deteriorate slightly in 2005, before beginning to gradually improve. Net labour income will remain unchanged, while net capital income will deteriorate because of low interest rates and unfavourable movements in foreign exchange reserves and external debt on one side and because of reinvested earnings from non-residents' foreign direct investments in Slovenia on the other. With Slovenia having joined the EU, inward transfers are expected to increase slightly. They were lower than expected last year, as realisation is primarily linked to the ability to co-finance domestic projects with domestic resources. As these are yet to be secured, the projection represents a risk factor in the forecast of the movement of the current account.

4.5 Terms of financing

Balanced financial transactions with the rest of the world

The scope and manner of 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 amount of financial transactions with the rest of the world is expected to continue to grow in the coming years. It is forecast that the financial account will be in balance overall over the next three years. This year a surplus of outflows over inflows is expected, primarily owing to the maturity of government eurobonds in the amount of 2% of GDP, while in 2006 there should again be a net inflow, of approximately 0.7% of GDP. The main reason for the increase in net financial outflows in 2005 in comparison with previous projections is an increase in outflows via portfolio investments abroad by residents. The anticipated maturity of government eurobonds in 2005 will also be a major factor in net outflows. Financial transactions with the rest of the world will rise in both directions. This is a result of Slovenia's greater involvement in the single European market, which brings less risk to foreign investors, the small size of the domestic market and the total openness to capital flows, which allows residents to seek additional sources of financing or investments abroad.

Table 4.5: Financial transactions with the rest of the world

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
Net financial flows (% GDP)	7.9	4.9	0.6	-0.1	-2.0	0.7	1.1	-0.6	-2.0	-1.4	0.5	0.7	0.2	…	1.1	…
of which: FDI	1.3	7.4	-0.4	0.0	0.5	1.2	1.0	-0.2	0.5	0.7	0.0	1.2	1.2	…	1.0	…
Forex reserves (EUR mio)	6,514	7,842	7,881	7,891	7,323	7,567	8,019	7,326	7,323	-3	7,229	7,567	338	…	8,019	…
- % GDP	30.2	34.1	32.7	31.1	26.5	25.7	25.5	28.2	26.5	-1.7	26.2	25.7	-0.5	…	25.5	…
Foreign debt (EUR mio)	10,403	11,483	13,051	15,397	16,618	18,278	19,888	15,923	16,618	695	17,381	18,278	897	…	19,888	…
- % GDP	48.2	49.9	54.1	59.5	60.2	62.1	63.3	57.9	60.2	2.3	60.7	62.1	1.4	…	63.3	…

Source: ARC

The terms of financing remain favourable

The terms of financing will remain relatively favourable. Despite the beginning of a gradual rise at the end of this year, low foreign interest rates and Slovenia's low risk premium will allow for relatively cheap access to sources of financing.

An increase in net inflows via direct investments and outflows via portfolio investments

Net inflows via direct investment will rise in the coming years, as will net outflows via portfolio investments by the private sector. With regard to direct investments, a rise is expected in both foreign investment in Slovenia and investments abroad by Slovenian companies. Higher inflows are expected from foreign direct investment in the context of investments in the car industry, while in the opposite direction certain major foreign investors have announced their withdrawal from Slovenia. The foreign investment promotion act adopted last year and the anticipated further steps to encouraging foreign investment should show some effects in the coming years. Given the numerous announcements by businesses concerning investments abroad that are intended or already underway, it is expected that in the coming years Slovenian investments abroad will also strengthen, particularly in the Balkans and in countries in transition. In terms of financial outflows, portfolio investments abroad are expected to continue to grow, but at a slower rate than last year's record level. The return on the domestic stock exchange, which is already lower than last year and is likely to remain so, will probably mitigate the rise in the number of new investors, while at the same time it is expected that a higher proportion of investments will be directed abroad, partly to the more risky markets of eastern Europe.

A slight decline in foreign exchange reserves and a sustained increase in external debt

Owing to the worsening of the current account and net outflows in financial transactions with the rest of the world, foreign exchange reserves could record a slight decline in 2005 in particular, and then financial inflows will again cover the current account deficit. The external debt will rise primarily owing to private sector borrowing, but there will be no significant increase as expressed as a proportion of GDP or as a proportion of exports of goods and services.

A decline in net inflows from foreign loans

The amount of foreign loans received and made will increase, with the net figure declining slightly in comparison with 2004. Although there will be a slight slowdown in economic activity in 2005, given the low growth in domestic deposits banks will be compelled to look abroad for some of the sources for financing their lending activities. Banks are also likely to borrow in part by issuing bonds abroad, as they did towards the end of last year. Liabilities of EUR 500 million on eurobonds fall due for payment in the middle of 2005, and it is assumed that when this foreign debt is repaid the government will not finance itself by issuing securities or by borrowing abroad.

The level of corporate financing remains high

The total amount of domestic and foreign financing will rise further in the coming years. These movements are in line with the continuation of relatively high economic activity and the high level of domestic spending. The proportion of enterprise financing accounted for by foreign loans will remain at around one-third of total lending. In line with the ongoing restructuring of debt, government borrowing on the domestic market will also rise rapidly. With borrowing by banks abroad strong and high growth in foreign currency deposits, foreign currency lending will record the highest rate of growth within domestic lending. Given the large amount of bank borrowing from abroad and the rise in foreign currency deposits, this is understandable, as banks will thus close their currency position.

Enterprise and consumer borrowing will rise

With spending relatively high, enterprise borrowing and consumer borrowing will rise in the coming years. This will see a continuation of the trend from the last year, when enterprise lending rose sharply, and foreign currency lending in particular. Net borrowing by enterprises, as measured by the ratio of credits to deposits, will again rise, while net consumer borrowing will also rise. With the favourable terms of financing continuing and the relatively high level of private spending, the main feature of consumer borrowing in 2005 in particular will be the release of funds from the National Housing Saving Scheme. At the end of 2005, which is expected to bring a slowdown in household spending and a decline in funds from the National Housing Saving Scheme, consumer lending is also expected to slow.

The trend of an increase in long-term borrowing at the expense of short-term borrowing will continue in the coming years. On the demand side of long-term lending, the continuation of the relatively high growth in investment spending will be the main factor in this.

Table 4.6: Monetary system

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
	Average annual growth rate (%)															
M1	9.7	16.9	12.3	20.8	17.5	13.4	12.1	12.0	17.5	5.5	9.3	13.4	4.1	…	12.1	…
M3	22.7	23.5	14.1	5.3	7.8	7.6	7.8	6.9	7.8	0.9	7.4	7.6	0.2	…	7.8	…
Total credit	18.7	17.3	11.8	18.2	21.8	17.7	15.5	18.1	21.8	3.7	16.9	17.7	0.8	…	15.5	…

Source: ARC

The contribution of net foreign assets to M3 formation remains negative

It is still expected that broad money will be generated via domestic lending, given the balance of payments outflows. The contribution made by flows with the rest of the world will be negative, as it has been since the second half of 2003. Given the increase in spending, it has been assumed that growth in domestic lending will be slightly higher.

Slow growth in broad money and stronger growth in narrow money

With net outflows to the rest of the world, growth in broad money aggregates will be low. Growth in narrow money will be slightly higher in line with increased economic activity and falling inflation.

A shortening of the maturity periods of deposits

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 lower inflation. Short-term tolar deposits will also grow faster than long-term deposits because the slope of the yield curve is getting more flat.

4.6 Inflation

Inflation remains at approximately 2.5%

The level of inflation of approximately 2.6% reached in the first quarter of 2005 is already at the lower threshold of the long-term balance that can be expected in an economy still undergoing the process of real convergence. The exogenous variables and economic policy assumptions having been taken into consideration, the inflation forecast for the final quarter of 2005 is 2.4%, while the average forecast for the period in which the Maastricht criteria are to be evaluated (the second half of 2005 and the first half of 2006) is 2.5%. The revision of the forecasts downwards in 2005 is primarily the result of structural and institutional factors that contributed to a fall in inflation in the second half of 2004 and the beginning of 2005. The revision of the inflation forecast upwards in 2006 is mainly the result of economic growth being faster than expected in 2004, the continuation of high economic growth in 2005 and 2006, and the associated faster closing of the output gap.

Table 4.7: Inflation

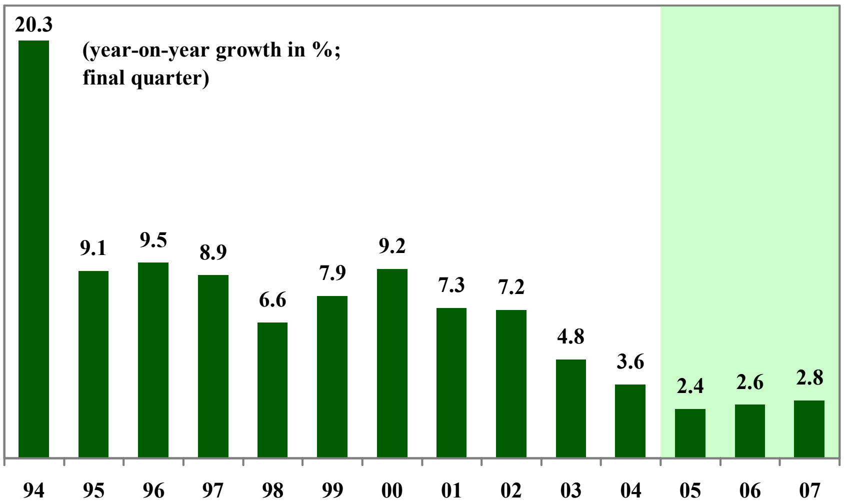
					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
	final quarter; year-on-year growth rate (%)															
Consumer prices	7.3	7.2	4.8	3.6	2.4	2.6	2.8	2.5	2.4	-0.1	2.5	2.6	0.1	…	2.8	…
Free prices	7.9	6.9	5.1	2.3	2.2	2.7	3.0	2.7	2.2	-0.5	2.7	2.7	0.0	…	3.0	…
Administered prices	5.0	8.8	3.7	9.5	3.6	1.4	1.4	1.4	3.6	2.2	1.4	1.4	0.0	…	1.4	…
	average annual growth rate (%)															
Consumer prices	8.5	7.6	5.6	3.6	2.5	2.5	2.6	3.0	2.5	-0.5	2.5	2.5	0.0	…	2.6	…
Free prices	7.7	7.6	5.9	3.2	2.3	2.6	2.9	2.9	2.3	-0.6	2.7	2.6	-0.1	…	2.9	…
Administered prices	12.5	7.5	4.8	6.6	4.5	1.4	1.4	3.6	4.5	0.9	1.4	1.4	0.0	…	1.4	…

Source: ARC

Administered prices will significantly contribute to lower inflation

With free prices continuing to record low growth, slower growth in administered prices will also contribute to stable prices. Within our forecasts of the movement of administered prices it was envisaged that the movement of fuel prices will depend on the assumption of no change in the oil price on world markets, and that prices of refined petroleum products on the domestic market will therefore remain unchanged. At the same time it was assumed that prices of all other administered prices will move in line with the movement of free prices. Thus growth in administered prices overall will continue to exceed growth in free prices in 2005, while in 2006 and 2007 growth in administered prices will lag behind growth in free prices on average owing to the lack of growth in prices of refined petroleum products. A significant risk in these projections is the movement of oil prices, which in the event of significant deviation from our assumptions could prevent the projected fall in growth in administered prices. The forecast is for free prices to grow by 2.2% year-on-year in the final quarter of 2005, before the positive output gap starts to bring about an acceleration in growth in free prices, with the a rate of 2.7% forecast for the final quarter of 2006.

Figure 4.6: Inflation projections



Source: ARC

No significant price pressures are expected from abroad

The exogenous assumptions from the international environment point to an easing in price pressures from abroad. The rise in consumer prices abroad was again higher than the target value in 2004, as inflation was encouraged by high commodity prices and tax policy measures including higher indirect taxation. Should the assumptions prove to be correct, average growth in import prices in 2005 is expected to be slightly lower and in the second half of the year will facilitate the continuation of growth in free prices at the low level already attained. Despite the assumptions of recovery in world economic growth after 2005, with monetary policy increasingly restrictive abroad this should not entail any significant price pressures.

Fiscal policy will significantly contribute to inflation remaining low

In its adjustment of excise duties at the end of March the government had practically reached the minimum allowable level. In the context of high oil prices the government lowered excise duties in the last year to the level allowed by EU regulations, but was unable to entirely prevent them resulting in higher prices of refined petroleum products. In the event of oil prices remaining unchanged on world markets, as proceeds from our assumptions, the forecasts are made under the assumption that the government will keep excise duties at the current level. The projections also assume that apart from the increases in excise duties on tobacco already announced the government will not significantly contribute to price rises through discretionary changes in indirect taxation. Our forecast is that increases in indirect taxation will contribute 0.2 percentage points to inflation in both 2005 and 2006.

Household incomes will not have an inflationary effect

In the projections household incomes are neutral with regard to pressures on price movements. Despite slightly higher wage growth in 2005, which is primarily the result of the transmission of high growth from the end of 2004, wages and total household incomes will not generate any significant pressures on the movement of prices either on the supply side or on the demand side. The slight slowdown in the economic outlook will place restrictions on excessive wage growth in the private sector, while both the public sector wage agreement and the limitations of the national budget with regard to increases in expenditure will successfully rein in excessive wage growth in the public sector. The main risks of excessive wage growth come in the form of the public sector wage agreement for 2005, details of which are yet to be fully coordinated, the wage agreements for 2006 and 2007, which are yet to be reached for either the private sector or public sector, and high growth in other employment income, which made a significant contribution to the high rise in household incomes in 2004.

Box 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 actions.

On this occasion the forecasts by the various institutions are very similar. There is a consensus that relatively high economic activity will continue in Slovenia in 2005 and 2006. The revisions to economic growth in both 2005 and 2006 are very small. There remain some differences regarding the structure of economic growth, in particular regarding the current account. Although the differences are significantly smaller than in the previous round of forecasts, they still amount to 1.8 percentage points of GDP in 2005 and 2.1 percentage points of GDP in 2006. All the institutions are forecasting a widening of the deficit in 2005, followed by a contraction in 2006.

There are also differences in the inflation forecasts, and they are similar to those from half a year ago. Inflation forecasts have typically been revised downwards for both 2005 and 2006, by an average of 0.5 percentage points and 0.3 percentage points respectively. The average annual inflation forecast ranges from 2.3% to 3.0% for 2005, and 2.0% to 2.8% for 2006. The gaps between the inflation forecasts by domestic and foreign institutions have narrowed in the last half year.

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

	Date of forecast new / previous	GDP (annual growth; %)				Inflation (annual average; %)				Current account (as % of GDP)			
		2005		2006		2005		2006		2005		2006	
		new	change	new	change	change	new	change	new	new	change	new	change
Bank of Slovenia	Apr 05/ Oct 04	3.9	0.1	4.0	0.0	2.5	-0.5	2.5	0.0	-1.6	0.0	-1.3	-0.6
EIPF	Mar 05/ Sep 04	3.8	0.0	4.4	…	2.8	-0.1	2.2	…	-1.9	-0.6	-1.6	…
IMAD	Apr 05 / Oct 04	3.8	0.0	4.1	0.2	2.5	-0.5	2.3	-0.4	-0.9	-0.5	0.3	0.7
European Comission	Apr 05/ Oct 04	3.7	0.1	4.0	0.2	2.6	-0.8	2.6	-0.4	-1.0	-0.2	-0.8	0.2
IMF	Apr 05/ Oct 04	4.0	-0.1	4.0	…	2.3	-0.9	2.0	…	-1.4	0.0	-2.2	…
Consensus Forecasts	Mar 05 / Sep 04	3.8	-0.1	3.9	…	3.0	-0.3	2.8	…	-0.1	0.1	-0.1	…

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

Table 4.8: Selected main indicators

					Forecast			2005 Forecast			2006 Forecast			2007 Forecast		
	2001	2002	2003	2004	2005	2006	2007	Oct	Apr	Δ	Oct	Apr	Δ	Oct	Apr	Δ
Activity, employment, wages	*real growth rates (%)*															
Real GDP	2.7	3.3	2.5	4.6	3.9	4.0	4.0	3.8	3.9	0.1	4.0	4.0	0.0	…	4.0	…
Per capita GDP (EUR)	10,864	11,628	12,201	12,942	13,807	14,712	15,700	13,453	13,807	354	14,355	14,712	357	…	15,700	…
Employment	1.8	0.7	0.3	0.6	0.6	0.3	0.5	0.7	0.6	-0.1	0.4	0.3	-0.1	…	0.5	…
Net wages	3.1	2.1	1.8	2.1	2.5	2.2	2.0	1.7	2.5	0.8	2.0	2.2	0.2	…	2.0	…
Productivity	1.8	2.5	2.7	3.3	3.3	3.7	3.5	3.1	3.3	0.2	3.6	3.7	0.1	…	3.5	…
Domestic demand	*real growth rates (%)*															
Domestic demand	0.9	2.3	4.7	4.7	4.3	3.8	4.1	4.1	4.3	0.2	4.0	3.8	-0.2	…	4.1	…
Household consumption	2.3	0.3	2.7	3.5	3.5	3.2	3.0	3.2	3.5	0.3	3.1	3.2	0.1	…	3.0	…
Governm. consumption	3.9	1.7	2.6	1.7	2.4	2.1	2.0	2.1	2.4	0.3	2.8	2.1	-0.7	…	2.0	…
Gross capital formation	-4.3	7.4	10.5	9.1	7.0	6.0	7.2	7.7	7.0	-0.7	6.3	6.0	-0.3	…	7.2	…
Balance of payments	*real growth rates (%)*															
Exports of G&S	6.3	6.7	3.2	12.6	6.7	7.3	7.3	5.9	6.7	0.8	4.9	7.3	2.4	…	7.3	…
Imports of G&S	3.0	4.9	6.8	12.4	7.2	6.8	7.0	6.2	7.2	1.0	4.7	6.8	2.1	…	7.0	…
Current acc.: EUR mio	38	335	-91	-238	-440	-360	-380	-433	-440	-7	-215	-360	-145	…	-380	…
% GDP	0.2	1.5	-0.4	-0.9	-1.6	-1.3	-1.2	-1.6	-1.6	0.0	-0.7	-1.3	-0.6	…	-1.2	…
Terms of trade	0.9	1.9	0.0	0.0	-0.8	-0.1	0.2	1.3	-0.8	-2.1	0.7	-0.1	-0.8	…	0.2	…
Net financial flows (% GDP)	7.9	4.9	0.6	-0.1	-2.0	0.7	1.1	-0.6	-2.0	-1.4	0.5	0.7	0.2	…	1.1	…
of which: FDI	1.3	7.4	-0.4	0.0	0.5	1.2	1.0	-0.2	0.5	0.7	0.0	1.2	1.2	…	1.0	…
Forex reserves (EUR mio)	6,514	7,842	7,881	7,891	7,323	7,567	8,019	7,326	7,323	-3	7,229	7,567	338	…	8,019	…
- % GDP	30.2	34.1	32.7	31.1	26.5	25.7	25.5	28.2	26.5	-1.7	26.2	25.7	-0.5	…	25.5	…
Foreign debt (EUR mio)	10,403	11,483	13,051	15,397	16,618	18,278	19,888	15,923	16,618	695	17,381	18,278	897	…	19,888	…
- % GDP	48.2	49.9	54.1	59.5	60.2	62.1	63.3	57.9	60.2	2.3	60.7	62.1	1.4	…	63.3	…
Monetary system	*average annual growth rate (%)*															
M1	9.7	16.9	12.3	20.8	17.5	13.4	12.1	12.0	17.5	5.5	9.3	13.4	4.1	…	12.1	…
M3	22.7	23.5	14.1	5.3	7.8	7.6	7.8	6.9	7.8	0.9	7.4	7.6	0.2	…	7.8	…
Total credit	18.7	17.3	11.8	18.2	21.8	17.7	15.5	18.1	21.8	3.7	16.9	17.7	0.8	…	15.5	…
Prices	*final quarter year-on-year growth rate (%)*															
Consumer prices	7.3	7.2	4.8	3.6	2.4	2.6	2.8	2.5	2.4	-0.1	2.5	2.6	0.1	…	2.8	…
Free prices	7.9	6.9	5.1	2.3	2.2	2.7	3.0	2.7	2.2	-0.5	2.7	2.7	0.0	…	3.0	…
Administered prices	5.0	8.8	3.7	9.5	3.6	1.4	1.4	1.4	3.6	2.2	1.4	1.4	0.0	…	1.4	…
	average annual growth rate (%)															
Consumer prices	8.5	7.6	5.6	3.6	2.5	2.5	2.6	3.0	2.5	-0.5	2.5	2.5	0.0	…	2.6	…
Free prices	7.7	7.6	5.9	3.2	2.3	2.6	2.9	2.9	2.3	-0.6	2.7	2.6	-0.1	…	2.9	…
Administered prices	12.5	7.5	4.8	6.6	4.5	1.4	1.4	3.6	4.5	0.9	1.4	1.4	0.0	…	1.4	…
Foreign environment	*average annual growth rate (%)*															
Foreign demand*	4.5	2.7	2.6	6.3	6.1	6.9	6.9	6.9	6.1	-0.8	6.9	6.9	0.0	…	6.9	…
USD/EUR	0.90	0.94	1.13	1.24	1.32	1.32	1.32	1.22	1.32	0.10	1.22	1.32	0.10	…	1.32	…
Oil USD/barrel	24.4	25.0	28.8	38.3	45.0	45.0	45.0	34.0	45.0	11.0	30.0	45.0	15.0	…	45.0	…
Commodities	-6.5	4.6	11.3	16.0	3.0	3.0	3.0	10.0	3.0	-7.0	3.0	3.0	0.0	…	3.0	…
EMU inflation	2.6	2.2	2.1	2.1	1.8	1.7	1.7	2.0	1.8	-0.2	2.0	1.7	-0.3	…	1.7	…
PPI Germany	3.0	-0.6	1.7	1.6	1.9	1.3	1.3	1.3	1.9	0.6	1.3	1.3	0.0	…	1.3	…
EURIBOR 3m (%)	4.3	3.3	2.3	2.3	2.4	2.8	3.1	2.7	2.4	-0.3	3.1	2.8	-0.3	…	3.1	…

* Import volume of a basket of foreign trade partners.
Sources: ARC, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, SORS.

5. ECONOMIC POLICY UNDER THE ERM II

5.1 Adoption of the euro – the joint objective of the Bank of Slovenia and the Slovenian government

Adopting the euro is the main focus of economic policy

The adoption of the euro at the beginning of 2007 is the primary objective of both the Bank of Slovenia and the Slovenian government. In November 2003 the Bank of Slovenia and the government adopted the programme for ERM II entry and adoption of the euro (the joint programme), in which they committed themselves to creating the conditions to allow the euro to be adopted at the beginning of 2007.[10] In it they also emphasised the importance of the effective and credible coordination of economic policy. A new government came to power in December 2004, but its priority objective remains meeting the convergence criteria and preparing for the adoption of the euro.

Widespread support for the euro

There is also widespread support for the adoption of the euro among the public. Opinion polls show that 38% of Slovenes favour immediate adoption of the euro, while support reached only 19% in other new EU member-states.[11] Some 56% of respondents also feel that adopting the euro will benefit Slovenia, while 66% are personally happy to see the euro replace the tolar. Slovenia ranks first among all the new EU member-states in all of these questions.

Slovenia is a member of the EMU with a derogation

When it joined the EU, Slovenia became a member of the economic and monetary union with a derogation, and at the same time renounced full autonomy in monetary policy. Slovenia will become a full member of the EMU after it adopts the euro. Irrespective of this, the Treaty Establishing the European Union (the Treaty) stipulates that the exchange rate policy of an individual country becomes a matter of EU common interest even prior to the adoption of the euro.

5.2 Achieving economic convergence

Meeting the convergence criteria is a prerequisite for adopting the euro

A high level of sustained convergence is a prerequisite for adopting the euro. In accordance with Article 122 of the Treaty this is assessed by the European Commission and the ECB, which verify whether the convergence criteria have been met and draw up convergence reports. The two institutions made their most recent review of the criteria of price stability, government finances, exchange rates and interest rates in October 2004 for the ten new member-states and Sweden. In addition to meeting the aforementioned economic criteria, before adopting the euro a member-state must also ensure compatibility between its national legislation and the Treaty and statute of the ESCB.

Slovenia has met two of the economic convergence criteria

The European Commission and ECB convergence reports found that at the time in question Slovenia had met two of the convergence criteria, namely the government finances and long-term interest rates. The reference value for price stability was exceeded, but since the middle of 2001 the disinflation process has again resumed, after having stalled in 1999 owing to the introduction of VAT, a rise in domestic demand, high wage growth and increases in import prices. With Slovenia having entered the ERM II on 28 June 2004, it will only be able to meet the exchange rate criterion in the middle of 2006. The individual economic convergence criteria and projections of when they will be met are presented below.

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[10] http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf

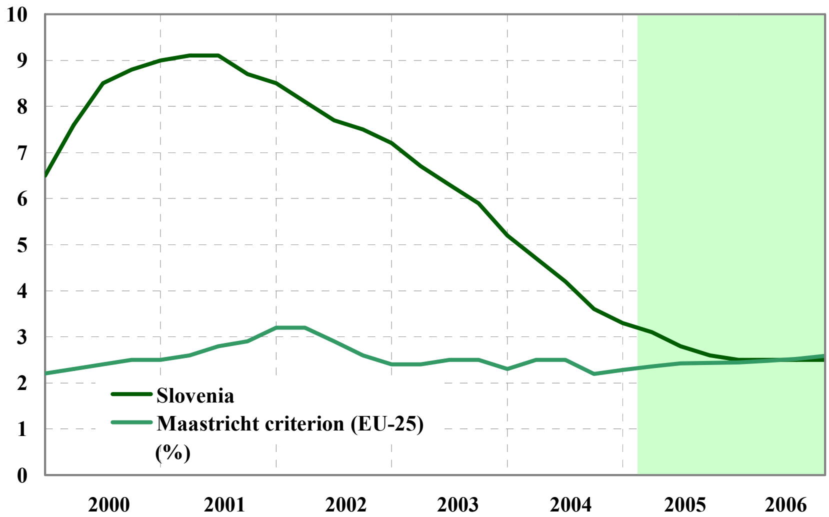
[11] Introduction of the Euro in the New Member States, European Commission and EOS Gallup Europe, October 2004.

Price stability criterion

The macroeconomic equilibria were maintained during the disinflation process

After the inflation shocks of 1999, the disinflation process resumed in Slovenia in 2001, and the inflation rate has fallen since then from 10% to less than 3%. This process was the result of a number of important political decisions, in particular the introduction of a new monetary policy framework, the objective of which was to ensure that there was a gradual, sustained fall in inflation. The maintenance of the macroeconomic equilibria was testimony to the sustained nature of the disinflation throughout the process. Slovenia is thus the only one of the new member-states that simultaneously enjoys a balance in the current account and relatively balanced public finances.

Figure 5.1: Price stability criterion



Source: European Commission, Bank of Slovenia, ARC calculation

According to forecasts, Slovenia should meet the price stability criterion in the middle of 2006

Given the Bank of Slovenia macroeconomic forecasts, Slovenia should meet the price stability criterion in the middle of 2006. The macroeconomic forecasts show inflation falling to 2.5% in the middle of 2005, and then fluctuating around this level. The European Commission spring 2005 forecast, which includes quarterly inflation forecasts for EU member-states, was used to predict the movement of the reference value. Inflation in the three countries with the best price stability results in the period envisaged for measuring the criterion for Slovenia, that is the third quarter of 2005 to the second quarter of 2006 inclusive, should amount to 1.0% on average. As a consequence the price stability reference value would be 2.5%.

Numerous risks to the fulfilment of the criterion

The projected fulfilment of the price stability criterion is thus on the edge, and is therefore exposed to subordinate risks. Section 5.3 examines and quantifies the most important macroeconomic risks that could endanger the fulfilment of the criterion. It can be seen that even the smallest deviation in the movement of macroeconomic factors from the forecast could raise inflation above the likely reference value. The risks thus demand a prompt reaction from the available macroeconomic policies and, where possible, preventive measures.

The catching-up process is increasing the risk of failure to meet the price stability criterion

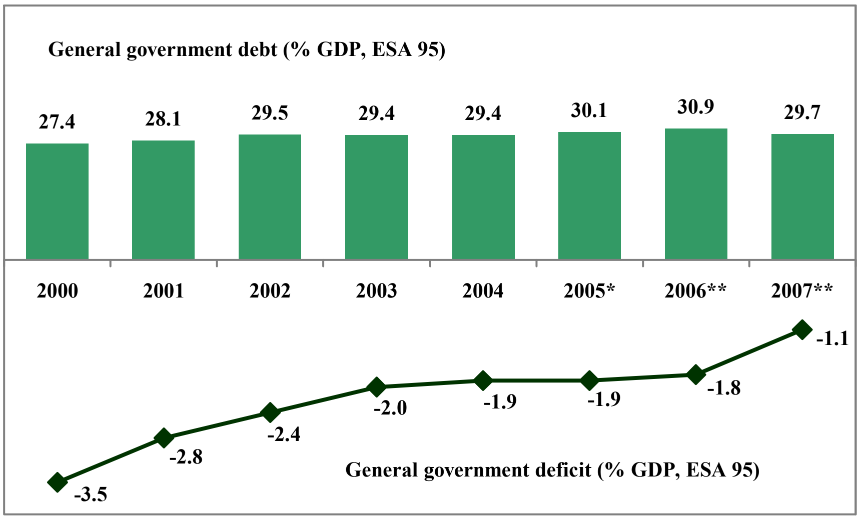
The process of catching up entails a higher equilibrium inflation rate in Slovenia, which partly hinders the fulfilment of the price stability criterion. Because of real convergence process, the equilibrium inflation rate in Slovenia is between 1 and 1.5 percentage points higher than in the more developed countries in the eurozone (the Balassa-Samuelson effect). This effect will also be seen after the euro is adopted. Given that the calculation of the reference value allows for a deviation of 1.5 percentage points from the average inflation rate in the three countries with the best price stability results, the Balassa-Samuelson effect does not a priori prevent the price stability criterion from being met with the right economic policy. A higher equilibrium level nevertheless restricts manoeuvring space in meeting the criterion, as the countries usually included in the calculation of the reference value are generally more developed and have lower inflation rates. In this context meeting the criterion is more difficult for faster-growing, less advanced economies.

Government finances criterion

Slovenia has met the government finances criterion since 2001

Slovenia meets the government finances criterion in terms of both the government deficit and general government debt. Figures in line with the ESA 95 methodology show that Slovenia has met the fiscal criterion since 2001. General government debt as a proportion of GDP has been considerably stable throughout at around 30%, while the reference value is 60%. However the government deficit exceeded the reference value of 3% of GDP in 2000, but has fallen gradually since then, reaching 1.9% of GDP in 2004.

Figure 5.2: Government finances criterion



* 2005 forecasts from the General Government Deficit and Debt Report (SORS and MoF, March 2005)
** 2006 and 2007 forecasts from the updated Convergence Programme (MoF, January 2005)
Source: General Government Deficit and Debt Report (SORS and MoF, March 2005)

Slovenia is also forecast to meet the criterion in the reference period, i.e. in 2005 and 2006

Forecasts show that Slovenia will continue to meet the fiscal criterion in the future. The General Government Deficit and Debt Report (SORS and MoF, March 2005) states that the deficit should amount to 1.9% in 2005 and the debt to 30.1%.[12] The Convergence Programme envisages the deficit falling further, to 1.8% in 2006 and to 1.1% in 2007. Neither will there be any threat to the fiscal criterion being met by the movement of general government debt, which will be significantly below the reference value.

Fulfilment of the criterion could be jeopardised by macroeconomic fluctuations…

The European Commission estimates that the projected government finance position in Slovenia's case will not guarantee sufficient security reserves within the framework of normal macroeconomic fluctuations.[13] Any deterioration in the macroeconomic environment reflected in lower economic growth than expected would lower general government revenues, while at the same time it would increase general government expenditure owing to the functioning of automatic stabilisers.

[12] http://www.gov.si/mf/slov/tekgib/por_prim_dolg_marec_05.pdf (currently available only in Slovene)
[13] http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/183

… and uncertainty on the revenues side

There is considerable uncertainty on the revenues side. First, the reform of direct taxes, i.e. personal income tax and corporate income tax, entails uncertainty with regard to the size of the tax revenues. The movements in the first months of the year have been in line with expectations, but given the complexity of the two taxes and the fact that the changes will be felt over a long period, it is impossible to reliably estimate the end-of-year revenues this year and next year. Second, in the event of oil prices remaining high, revenues from excise duties will be low, while there is some uncertainty with regard to VAT, despite the extremely high revenues seen in the last four months. Third, a reserve is also required because of uncertainty in the disbursement of funds from the EU budget.

An improvement in the disbursement of funding from the EU budget is required

The first experience of disbursement of funding from the EU budget points to the need for effective action in this area. Last year Slovenia drew on SIT 44 billion of such funding, which is significantly lower than the amount of funding available. The experiences of other countries that joined the EU last year have been similar. In the coming years we are counting on a strengthening of absorption capacity and ever-increasing disbursements, particularly of funding earmarked for structural policy and agriculture. Although it is forecast that inflows from this source will compensate for the annual decreases in the lump-sum rebate (which Slovenia will receive until 2006 inclusive), it is nevertheless our assessment that more effort will be required in this area. This will particularly be the case for the period of the new financial perspective for 2007 to 2013, when Slovenia is likely to have more funding available.

The Convergence Programme envisages only very gradual reduction of the deficit

The progress in fiscal consolidation planned in the Convergence Programme is relatively slow. Despite the projected fall in the deficit, the medium-term target of balanced general government finances in the period to 2007 is unlikely to be achieved. The European Commission notes that the significant fall in the deficit in 2007 is solely the result of projection of higher revenues. The experience of previous convergence and pre-accession programmes also indicates that Slovenia was unsuccessful in meeting its medium-term targets, and that forecasts were generally over-optimistic. With relatively high economic growth expected in the 2005 to 2007 period, Slovenia should be able to take advantage of the favourable conditions to reduce its structural general government deficit, as making the adjustment during a period of low economic activity is considerably more difficult. Owing to deterioration in the demographic conditions, particular attention must also be focused on sustaining the public pension system, where shifts away from the measures already taken could cause additional pressures on general government finances over the longer term (see Box 5.1).

Efforts to reduce expenditure and increase the flexibility of the budget

In the future it will be vital to reduce general government expenditure and increase its flexibility. Slovenia's general government revenues and expenditure as a proportion of GDP are rather high in comparison with other countries at a similar level of development, and even in comparison with certain very developed economies. The reduction of the general government deficit should primarily focus on reducing expenditure. In addition it will be necessary to restructure the budget in the sense of greater flexibility, particularly in light of the fact that since ERM II entry fiscal policy has to bear the main burden in managing asymmetric macroeconomic shocks.

Box 5.1: Sustainability of the public pension system

Expenditure by the Pension and Disability Insurance Institute amounted to 13.4% of GDP last year (compared with 13.6% of GDP in 1999), of which pensions accounted for 10.9% of GDP (compared with 11.4% of GDP in 1999). Since the pension reform enacted in 2000 and the change in the indexation mechanism for pensions in 2001, the proportion of expenditure accounted for by pensions has thus already fallen.

Changes in the main parameters of the public pension system were factors in the reduction of pension expenditure and thus the implicit liabilities in the public pension system:
- After the reform the average retirement age rose by two years to 58 years and seven months in 2004.
- The ratio of the average old age pension to the average wage fell to 70.2% last year from 75.8% in the year before the reform.

A change in the pension adjustment system contributed to an improvement in fiscal sustainability in the long term. During the nineties, pensions in Slovenia were adjusted in line with wages, which was reflected in a very high replacement level. The change made to the pension adjustment mechanism in 2001 led to pension increases falling behind wage growth. Thus last year for example the basic pension rose by 4.9% (and the average pension and social security supplement by 4.5%), while the average wage rose by 5.7%. Were pensions to have risen at the same rate as wages, this would have entailed expenditure more than SIT 5 billion higher last year, or 0.1% of GDP. Even though in the current system pension increases are slower than wage growth, in the last four years pensions have risen in real terms. Today the majority of OECD countries increase pensions in line with the consumer price index, thus merely preserving the real value, as more rapid growth in pensions would have undesirable long-term effects.

Additional pressure on growth in pension expenditure caused by the ageing of the population can be expected in the decades ahead (see Table). In this area Slovenia is facing challenges similar to those faced by other EU countries; according to forecasts, the age dependency of the population[1] will have more than doubled in Slovenia by 2050, while the extremely low birth rates seen over several decades will see the population, and in particular the population in active work, begin to diminish in the future.

Table: Long-term sustainability of general government finances – expenditure as percentage of GDP

	2005	2010	2020	2030	2040	2050
Pensions	13.3	12.4	13.2	14.9	16.9	18.2
Health	6.7	6.9	7.2	7.9	8.9	9.6
Total	20.0	19.3	20.4	22.8	25.8	27.8

Source: Supplement to the Convergence Programme, January 2005

The trend of a worsening ratio of pensioners to insured persons, which has been present for some time now, will continue for the aforementioned reasons, while the problems of funding pensions will escalate. These problems must be resolved promptly, and the pension reform made in 2000 is a step in the right direction. Delaying the necessary measures would demand more comprehensive changes, in the sense of a more decisive cut in pensions, a rise in the level of contributions and/or changes to other parameters of the pension system. Along with the enactment of pension reform, another factor of key importance remains the creation of additional sources of income for the post-retirement period. In Slovenia currently more than half of all those covered by the mandatory pension system are also included in the voluntary supplementary pension insurance system.

[1] Age dependency is defined as the ratio of the population of those aged over 65 to the population aged between 20 and 64 (the so-called working population).

Exchange rate criterion

Exchange rate stability has been secured since ERM II entry

In practical terms the exchange rate has been entirely stable since ERM II entry. Slovenia joined the ERM II on 28 June 2004, with the central rate being set at SIT 239.640 to the euro, with a standard band of fluctuation of 15% either side of this. During Slovenia's first nine months in the ERM II, the tolar's deviations from the central rate were minor, and there were no major pressures on the movement of the exchange rate.

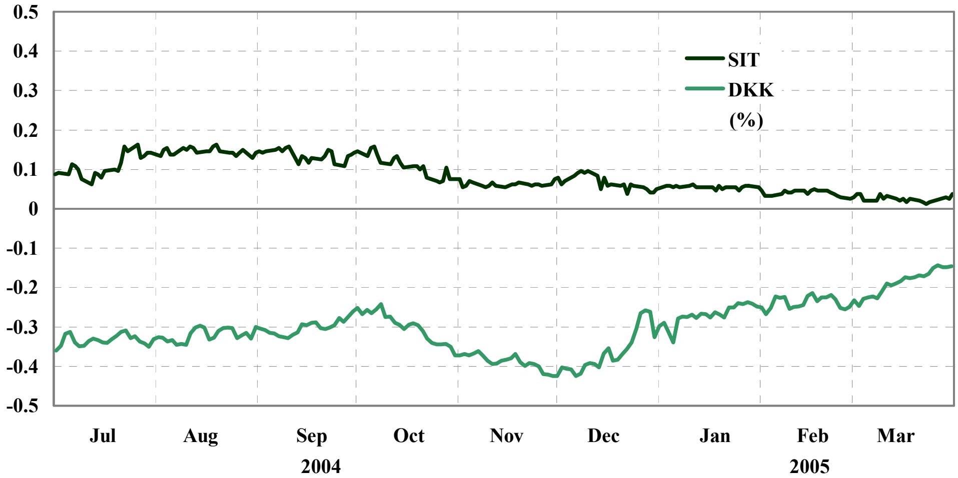
The risks to the exchange rate stability criterion are minor

The risks related to exchange rate stability are limited. This is primarily a result of the equilibrium in the exchange rate, which also reflects the relatively balanced current account position. The Bank of Slovenia also has appropriate monetary policy instruments and sufficient foreign exchange reserves to be able to guarantee exchange rate stability.

The short-term interest rate differential is relatively small, and reflects the Bank of Slovenia's decision to maintain interest rates at the highest possible level that still ensures stability on the money market. Since ERM II entry interest rate policy has been subordinate to maintaining the stability of the exchange rate, and is thus dependent on short-term interest rates in the eurozone. The deviation of 2 percentage points from the ECB interest rate allows for the market premium, which primarily reflects exchange rate and liquidity risk. The differential also reflects the relations, which are still tolerated by markets at the given structure of monetary policy instruments and their interest rates. In practice, since ERM II entry the interest rate differential has not been conditioned by a need to maintain exchange rate stability.

The interest rate differential is relatively small

Figure 5.3: Deviations from central rate – Danish krona and Slovenian tolar



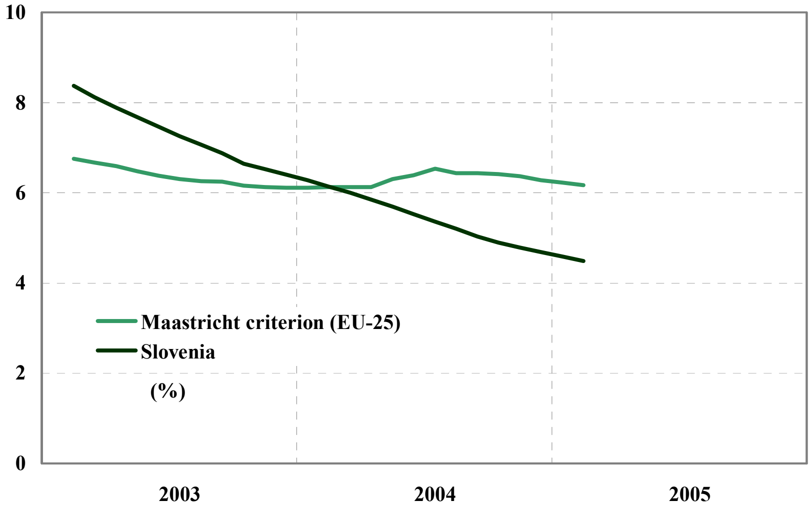
Source: ECB

Long-term interest rates criterion

Slovenia also meets the criterion for long-term nominal interest rates. The twelve-monthly average long-term nominal interest rates on government securities had fallen below the reference value by March 2004, and the falling trend is still continuing. Given that the current long-term interest rate has fluctuated around 4% in recent months, the average can be expected to fall by approximately a further half a percentage point by the end of the year.

Slovenia meets the long-term interest rates criterion…

Figure 5.4: Long-term interest rates criterion



Source: Eurostat

… which indicates financial markets' confidence in the credibility of economic policy

Long-term interest rates are an indicator of financial markets' confidence in the credibility of macroeconomic policy and the maintenance of macroeconomic equilibria in the future. They reflect long-term inflation expectations and expectations of the sustainability of the general government deficit. Low risk premiums confirm the credibility of macroeconomic policy in Slovenia in attaining low inflation and high fiscal stability.

5.3 Macroeconomic policy management

Meeting the Maastricht criteria is primarily associated with risks of…

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 our projections indicate that Slovenia will also meet the price stability criterion within the period envisaged for verifying the criteria, our aim is to use simulations of some likely macroeconomic shocks to examine the possibility of deviations in the trends in the principal macroeconomic indicators.

… excessive wage growth, …

Slower wage growth will be of key importance in reducing inflationary pressures of a cost nature. According to the simulations, wage growth 1 percentage point in excess of the baseline scenario would increase inflation by 0.3 percentage points in the second year after the shock occurs.

… excessive government spending, …

Formulating a restrictive fiscal policy will be a major factor in meeting the price stability criterion. A rise in government spending of 2 percentage points from the baseline scenario would cause a rise in inflation of 0.2 percentage points in the first year after the shock, and 0.3 percentage points in the second year.

… household spending …

A possible strengthening in domestic demand would cause faster closing of the output gap and additional inflationary pressures. Stronger domestic demand could be brought about by a decline in saving, even faster lending growth or higher wage growth. With faster household spending, inflation would rise by 0.3 percentage points in the year of the shock and 0.5 percentage points in the year after the shock for every percentage point increase in growth in household spending.

Table 5.1: Definition of simulations

Simulation	Shock (change)	Shock period
a) Foreign environment		
1. Oil price	up 5 USD per barrel on baseline	Q105-Q406
2. Commodities price	up 10% on baseline	Q105-Q406
3. Foreign demand	up 1% on baseline	Q105-Q406
b) Domestic environment		
4. Wage growth	up 1 percentage point on baseline	Q105-Q406
5. Household spending	up 1 percentage point on baseline	Q105-Q406
6. Government spending	up 1 percentage point on baseline	Q105-Q406
7. Administered prices	same as baseline increase in free prices	Q105-Q406

… and high oil prices

External factors also represent a significant risk to the price stability criterion being met, in particular rises in the prices of refined petroleum products. Prices of refined petroleum products have an asymmetric effect in inflation, which means that a rise in these prices causes a larger increase in inflation in Slovenia than in certain other EU member-states. Our forecasts are that a rise in oil prices of just USD 5 per barrel from the baseline scenario would increase inflation by approximately 0.3 percentage points and 0.6 percentage points in the first two years. With higher oil prices the current account balance would also worsen sharply. Each rise in oil prices of USD 1 per barrel would worsen the current account balance by approximately 0.1% of GDP. A positive effect on inflation is expected from higher commodity prices, but significantly less than the effect of the higher oil prices, while the impact on the worsening in the current account is rather high.

Table 5.2: Response of macroeconomic variables to simulated shocks

	GDP			Inflation			Current account		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Forecast - basline scenario	3.9	4.0	4.0	2.5	2.5	2.6	-1.6	-1.3	-1.2
Alternative scenarios									
a) Foreign environment									
1. Oil price	3.8	3.9	3.8	2.8	3.1	2.6	-1.9	-1.8	-1.9
2. Commodities price	4.0	4.0	4.0	2.7	2.6	2.7	-1.9	-1.7	-1.6
3. Foreign demand	4.3	4.3	4.1	2.6	2.6	2.8	-1.3	-0.9	-0.9
b) Domestic environment									
4. Wage growth	4.1	4.3	4.3	2.7	2.9	3.0	-1.8	-1.6	-1.5
5. Household spending	4.2	4.7	4.6	2.8	3.0	3.2	-1.8	-1.7	-1.7
6. Government spending	4.1	4.2	4.3	2.7	2.8	2.9	-1.7	-1.4	-1.4
7. Administered prices	3.9	4.0	4.0	2.3	2.6	2.9	-1.6	-1.3	-1.3

Source: ARC forecasts

Coordination of all economic policies will be the key to meeting the conditions for adopting the euro

Given the risks described and the results of the simulations, of key importance to meeting the conditions for adopting the euro is effective and credible coordination of all macroeconomic policy. The central task of monetary policy will be maintaining exchange rate stability, while fiscal policy assumes the burden of ensuring price stability and managing economic activity. Incomes policy will have to limit the cost pressures on inflation through wage growth that lags sufficiently behind productivity growth. Structural reforms, in particular on the labour market, should be focused on increasing the flexibility of the economy and maintaining its competitiveness.

Monetary policy must ensure exchange rate stability…

Since ERM II entry monetary policy has maintained the stability of the nominal exchange rate. Maintaining a stable exchange rate makes the Bank of Slovenia interest rate policy subordinate to factors that are independent of the bank, in particular interest rates in the eurozone.

… while fiscal policy restrains inflationary pressures

Fiscal policy will therefore play a central role in controlling inflationary pressures. The restrictiveness of fiscal policy is reflected simultaneously in lower inflationary pressures on the demand side and in greater stability in the general government deficit. Restricting general government expenditure would be particularly necessary in the event of demand rising above the supply potential. The latter would be reflected in higher economic activity, and would thus ensure higher general government revenues, but from the point of view of the price stability criterion it would be vital to reduce expenditure and the structural general government deficit. Slower economic growth would cause general government revenues to fall, and fiscal policy must therefore secure sufficient budgetary reserves to avoid the threat of a failure to meet the general government deficit criterion.[14] In order to respond to potential asymmetric macroeconomic shocks, which will also be a task for fiscal policy after the euro is adopted, an increase in the flexibility of general government expenditures is vital.

Growth in administered prices cannot exceed growth in free prices

Growth in administered prices cannot be higher than the anticipated growth in free prices. Here it is particularly important that more moderate growth in administered prices is recorded by all components. Scenarios in which lower growth in certain administered prices would compensate for higher growth in other administered prices would lead unnecessarily to higher inflation, and would encourage inflationary expectations in other sectors. A special place

[14] An example of such action is Denmark, which in the period between 1995 and 2001 made use of relatively good economic circumstances to promote fiscal consolidation. An improvement in the general government budget balance from a deficit of 3.1% of GDP in 1995 to a surplus of 3.2% of GDP in 2001 allowed Denmark to adjust to the economic downturn in 2002 and 2003, when the functioning of automatic stabilisers caused the budget balance to worsen by 2 percentage points. Denmark’s budget surplus policy will also ease its transition to the eurozone when it decides to adopt the euro.

among administered prices is held by refined petroleum products, prices of which are influenced by external factors, and can therefore rise faster than other prices in unfavourable circumstances.

Box 5.2: The need for an appropriate response from fiscal policy

The cases of certain eurozone countries can be informative when it comes to the response of fiscal policy to macroeconomic shocks that also represent the main risks to Slovenia. During the introduction of the euro, interest rate convergence meant that monetary policy in Ireland became less and less restrictive. Consequently there was a rapid growth in lending to the private sector and a rise in real estate prices. In addition there was a sharp rise in inflation, which reached 5.3% in 2000, 3 percentage points higher than inflation in the eurozone at the time. Given that in the monetary union the sole instrument for managing macroeconomic shocks is fiscal policy, Ireland increased its general government surplus by 2 percentage points of GDP with the aim of reducing aggregate demand and cooling economic growth. Ireland's recent economic growth, unemployment and inflation figures show that this response was successful.

Table: Key macroeconomic indicators for Ireland

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Economic growth (%)	9.8	8.1	10.8	8.9	11.1	9.9	6.0	6.1	3.7	4.9
Fiscal balance (% GDP)	-2.1	-0.1	1.1	2.4	2.4	4.4	0.9	-0.4	0.2	1.3
Inflation (HICP; %)	n.p.	2.2	1.2	2.1	2.5	5.3	4.0	4.7	4.0	2.3
Unemployment (%)	12.3	11.7	9.9	7.5	5.6	4.3	3.9	4.3	4.6	4.5

Source: Eurostat

Portugal was also faced with similar macroeconomic circumstances after 1999. Interest rate convergence also triggered credit expansion and higher spending on the part of consumers and companies. However in Portugal neither fiscal policy nor incomes policy acted in a restrictive manner, but were pro-cyclical. Fiscal policy exploited the higher tax revenues under increased economic growth and the lower expenditure brought by smaller debt financing costs as a result of the fall in interest rates to further increase employment and wages in the public sector. Growth in the average nominal wage between 1995 and 2000 was double that in the rest of the eurozone, and was based on corresponding growth in productivity. As a consequence the competitiveness of the Portuguese economy fell, which was also reflected in a higher current account deficit. By the end of 2002 Portugal had fallen into recession, and unemployment was on the rise. Despite low economic growth inflation remained above the eurozone average. The general government deficit rose to 4.4%, which forced the government to take measures to reduce the deficit to below the reference value in the Stability and Growth Pact.

Table: Key macroeconomic indicators for Portugal

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Economic growth (%)	4.3	3.5	4.0	4.6	3.8	3.4	1.7	0.4	-1.1	1.0
Fiscal balance (% GDP)	-4.5	-4.0	-3.0	-2.6	-2.8	-2.8	-4.4	-2.7	-2.9	-2.9
Inflation (HICP; %)	4.0	2.9	1.9	2.2	2.2	2.8	4.4	3.7	3.3	2.5
Unemployment (%)	7.3	7.3	6.8	5.1	4.5	4.1	4.0	5.0	6.3	6.7

Source: Eurostat

These case studies show that the maintenance of macroeconomic equilibria and a successful response to any shocks by fiscal policy are the key to a successful transition to monetary union. The restrictiveness of fiscal policy and incomes policy will also be of central importance to Slovenia meeting the conditions for adopting the euro and its subsequent involvement in the monetary union.

Sources: The Portuguese economy after the boom, European Commission, 2004;
Backe et al: The acceding countries' strategies towards ERM II and the adoption of the euro, ECB, 2004

Incomes policy must adhere to the social agreement

Incomes policy must ensure that in line with the social agreement wage growth in all sectors is at least a percentage point lower than productivity growth. Although this target was met in Slovenia last year for the whole economy, in certain sectors there were undesirable discrepancies (See Box 2.2). Consistent application of the social agreement would restrict price pressures on companies, and in this manner would partly or fully ensure that the price stability criterion is met. Keeping wages behind productivity is also vital to maintaining the employment trend in Slovenia. Further restricting wage growth in the public sector could have a signalling effect on wage growth in the economy as a whole.

Financial supervision will ensure the stability of the financial system

In the future financial supervision will also have to ensure that there is no deterioration in banks' credit portfolios, and in this manner ensure that the stability of the financial system is maintained. Although financial supervision cannot directly limit credit expansion by banks, it can ensure that during conditions of high economic growth banks do not underestimate the risks associated with the ability to repay lending, which could have negative consequences for the entire financial system during the turnaround in the economic cycle.