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1 SUMMARY AND BANK OF SLOVENIA POSITION

Favourable inflationary trends continued in accordance with the spring forecasts of the Bank of Slovenia and the average inflation of 2005 is currently forecasted at 2.6%. The lowest inflation registered so far reflects mainly macroeconomic developments, in particular the lag of demand behind supply capacities and the moderate growth of unit labour costs. Despite the considerably high growth of wages, the growth of labour costs was moderate and was achieved through the slow growth of other payments from the labour income and the reduced payroll taxes. Inflation was additionally lowered by some structural factors that hindered the growth in prices of food, clothing and footwear. The increased inflation in the second half of this year was mostly under the influence of price increases in refined oil products that followed developments on global markets and accounted for over half of the total inflation. The year-on-year growth in core inflation that excludes the impacts of refined oil products, tax rate increases and seasonal food prices floats just below 1%. Inflation would have been even lower, if administered prices on which crude oil prices in world markets do not have a direct influence had also not on average overrun the inflation of non-administered prices by 3.3 percentage points. Low inflation has been achieved in a sustainable manner, keeping both the fiscal balance and the balance of current account, i.e. core macroeconomic equilibria.

According to the macroeconomic forecasts of the Bank of Slovenia, Slovenia is going to meet the Maastricht criterion of price stability at the beginning of the next year and is going to have economic growth of approximately 4%. Regarding the inflation rate, the forecasts show that it should settle at 2.5% in the next two years. However, the continuation of the currently relatively high growth of nominal wages could cause tendencies towards price increases. In addition, the movements of administered prices should be more harmonised with those of non-administered prices and the contribution of energy prices to inflation is expected to be gradually reduced, given the assumption of crude oil prices. With economic growth being at a level close to the potential one, the contribution of external trade is, unlike this year, expected to decrease while the domestic expenditure is expected to increase in the next years. Therefore, the highest medium-term risk to macroeconomic and price stability continues to be a possibility of excessive aggregate demand, mainly in combination with the increased household income. Nevertheless, the Governing Board of the Bank of Slovenia estimates that the mentioned risk is manageable provided the proper response of fiscal policy. Therefore, the forecasted economic developments imply the sustainability of macroeconomic equilibria within the span of forecasts and a stable, low level of inflation, consistent with the euro adoption in 2007.

The Governing Board of the Bank of Slovenia emphasises the importance of the Programme for ERM II Entry and Adoption of the Euro as a guide for economic policies until and after the euro adoption. A commitment of fiscal policy to counter-act inflationary pressures stemming from aggregate demand was one of the conditions for the entry into ERM II and will be a condition for a successful functioning in the Eurosystem. Although there are yet no signs of aggregate demand exceeding the available supply capacity of economy, the expected full convergence of interest rates before the adoption of the euro requires the responsiveness in the fiscal policy. The Bank of Slovenia pays special attention to the risk of overheated economy, since in the regime of a stable exchange rate or in the monetary union the realisation of this risk results in the real appreciation, a loss of competitiveness, temporarily sluggish economic growth and increased unemployment.

The Governing Board of the Bank of Slovenia supports a renewal of the process of structural reforms, a commitment made in the joint declaration upon entry into ERM II. Increased flexibility and adaptability of the labour market should provide more rapid and less painful reallocation of workforce from less perspective sectors to the more perspective ones. By reducing fiscal expenditures tax burden of economy could be decreased. However, it is necessary to consider economic consequences and to assess an impact on the welfare of those affected by such reductions in expenditures.

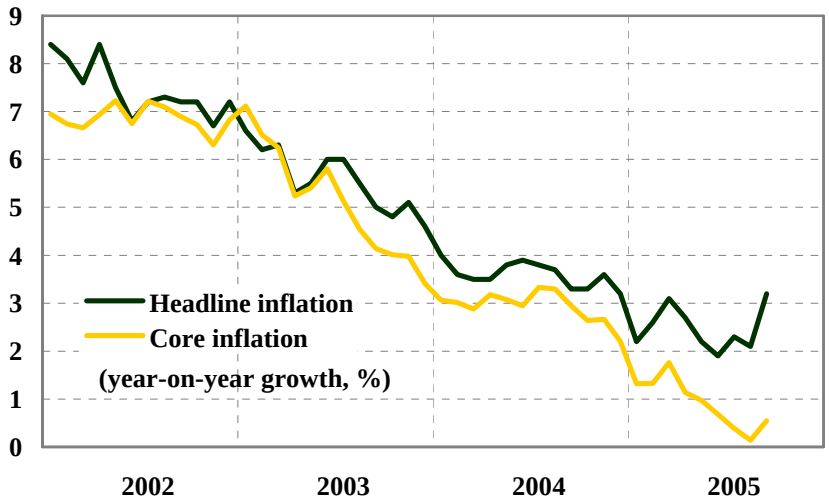
The implementation of structural reforms should not impede fiscal consolidation efforts and compliance with the provisions of the reformed Stability and Growth Pact. Cutting budget revenues may take place only together with the simultaneous and sustainable cutting in expenditures. In addition, the current and expected favourable macroeconomic environment offers an ideal opportunity to remove the structural deficit in public finance and create a safety margin with respect to requirements of the Stability and Growth Pact. In this way, the room for manoeuvre would be extended for a successful implementation of both macroeconomic and structural policies.

2 ECONOMIC TRENDS AND INFLATION

Continuing fall in inflation in 2005…

The disinflation process has continued in 2005, taking Slovenia closer to meeting the Maastricht price stability criterion. Between January and September inflation averaged just 2.5%, down 1.2 percentage points from the same period last year.

Figure 2.1: Headline inflation and core inflation



Source: SORS, ARC calculations

…enabled by appropriate economic policies, favourable macroeconomic environment and structural factors

The fall in the inflation rate to around 2.5% also saw it reach the lower threshold of price rises sustainable in the long-term in the context of the ongoing process of real convergence. Despite strong price pressures from abroad, the right economic policies, coupled with the macroeconomic environment and structural factors this year allowed for a fall in inflation, and as a result brought a further increase in the gap between headline inflation and core inflation. The rise in consumer prices was just 0.5% year-on-year in September, excluding the effects of taxes, energy and food.

2.2 Macroeconomic Trends

Unfavourable trends in the international environment and trends in line with expectations in the domestic environment

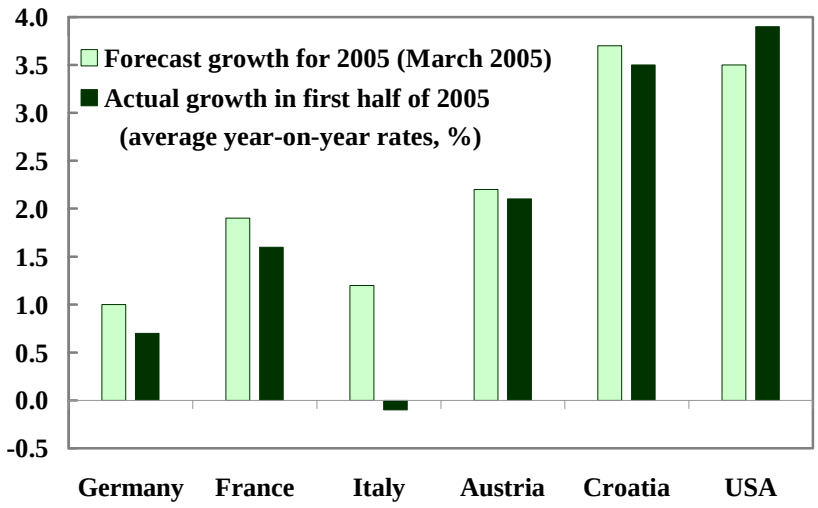
The macroeconomic trends in the first half of the year did not deviate significantly from the preliminary forecasts. However, it could be said that trends in the international environment were considerably more unfavourable than expected, with oil prices particularly prominent in this. Growth in domestic economic activity was in line with expectations, but contrary to expectations net exports contributed significantly more to economic growth than domestic demand. Employment and wages moved in line with the favourable economic developments, while there were divergent movements in the different components of labour costs, which were partly the result of methodological changes and partly the result of taxation and structural changes. The relatively low growth in investment and a reduction of inventories restricted growth in imports. With export movements favourable, the current account went into surplus at the start of the second half of the year, while there was a net inflow in the financial account, owing primarily to high borrowing from abroad by banks.

International Environment

Foreign demand lower than expected…

This year has been marked by the continuation of relatively slow economic growth abroad and by strong price pressures on the supply side. Economic growth in the most important EU trading partners was below expectations in the first half of the year, while exports were the most important engine of growth in these countries. The most important factors in this were the weaker euro and strong demand, particularly from the USA, and developing countries in Asia. The euro averaged USD 1.27 in the first eight months of the year, almost 5% lower than our previous assumption. Domestic demand in rest of the world remained low, primarily as a result of low growth in household consumption. Low household consumption in the most important EU trading partners was primarily the result of the highly restrictive incomes policy in recent years, high oil prices and uncertainties on the labour market related to relatively high unemployment, which additionally shook consumer confidence.

Figure 2.2: Forecast and actual GDP growth in selected trading partners in the first half of the year



Source: Eurostat, Consensus Forecasts

…in the light of high energy prices…

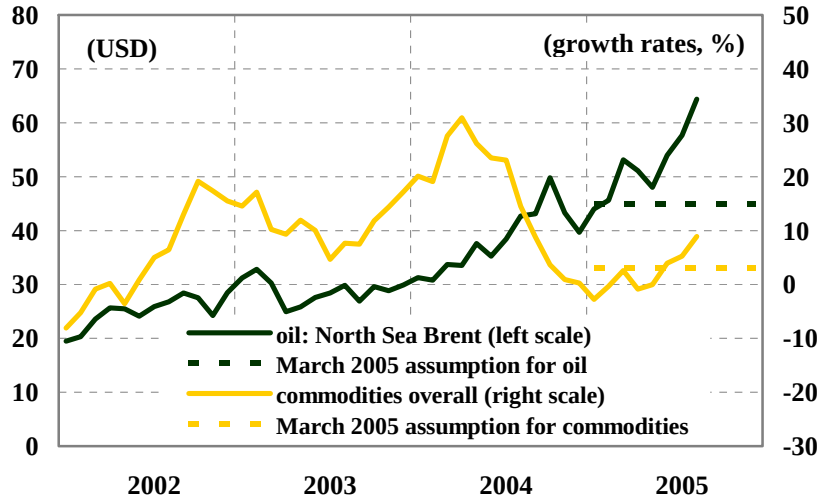
Prices in the rest of the world significantly outstripped the assumptions in our previous forecasts. The most prominent in this were oil prices and prices of other commodities, with the result that consumer price indices in the rest of the world were also higher. The average oil price over the first eight months of the year exceeded our year-end forecast by more than USD 7 per barrel, owing to disruptions in supply, to persistent high demand and partly to speculation on oil markets. In particular, the bad weather conditions in the Gulf of Mexico and the associated problems with diminished refining capacity meant that the annual average of our forecasts will be approximately USD 11 per barrel, i.e. almost one-quarter higher than our assumptions. Prices of other commodities expressed in US dollars were also up 5% year-on-year on average over the first eight months of the year, slightly more than our annual average assumption of 3%. The fastest rise of approximately 9% was recorded by prices of metals, thanks to strong demand, while rises in food prices were slightly slower.

…which were also reflected in higher consumer prices and producer prices abroad

The relatively rapid growth in consumer prices and producer prices in the rest of the world also reflected the high energy prices and prices of other commodities. Growth in consumer prices in the eurozone exceeded 2% in almost all months of the year, and was thus above the upper limit set by the ECB as the target for its monetary policy. However core inflation fell in conditions of weak demand. The inflationary pressures caused by high energy prices have not yet begun to be built into prices of other products, which can be attributed above all to the uncertain conditions on the labour market and the associated low growth in

labour costs. Growth in producer prices was even higher than expected, owing to high energy prices. The highest growth in producer prices was recorded in energy production, while for the moment there is no sign of these prices being transmitted to prices of manufactured consumer goods. The most important factors in this were the appreciation of the euro and the re-emergence of low growth in unit labour costs.

Figure 2.3: Oil prices and commodities prices: March 2005 assumptions and actual



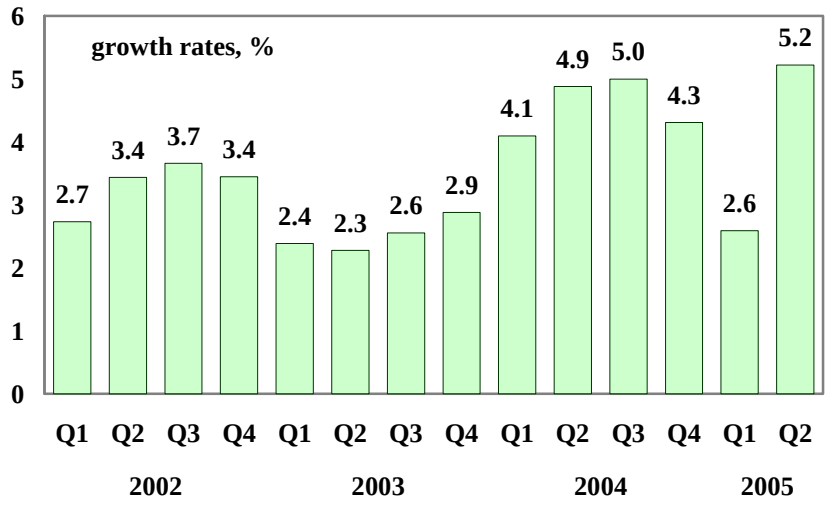
Sources: Reuters, The Economist; ARC calculation

Economic Activity

Domestic economic activity in the first half of the year was in line with expectations

The current rate of growth in aggregate economic activity on average in the first half of the year was in line with forecasts, although developments in certain components of GDP differed from the previous forecasts. After low growth in the first quarter, growth in economic activity strongly accelerated in the second quarter, taking GDP growth to 3.9% in the first half of the year. The current rate of growth in the second quarter strengthened for the second successive quarter to 1.3%, or more than 5% annualised.

Figure 2.4: Quarterly GDP growth, annualised



Sources: SORS, ARC calculations

Owing to the rapid growth in the second quarter the output gap closed quickly but remains negative, with aggregate demand not yet triggering inflationary pressures, in line with our forecasts.

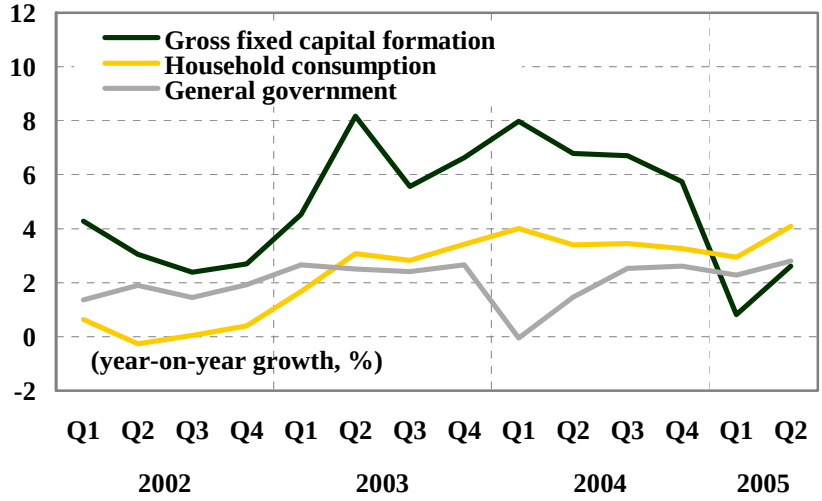
High contribution by net exports in the context of relatively strong domestic spending…

The largest contribution to favourable GDP growth came from net exports, i.e. an increase in the gap between growth in exports of goods and services and growth in imports. Apart from the pace of investment, it was also the contribution of net exports to economic growth that in the first half of the year saw the largest deviations from our forecasts. While we forecast that the contribution to economic growth made by net exports would be negative on average over the whole year at approximately –0.5 percentage points, net exports accounted for 2.8 percentage points or 70% of total economic growth in the first half of the year. Despite the assumption of relatively pessimistic conditions in the most important trading partners, growth in exports of goods and services strongly exceeded our expectations, while growth in imports of goods and services was significantly slower than we had forecast. The main factor in the slow dynamic of imports of goods was low growth in investment spending and the reduction of inventories.

…despite weaker investment activity…

The movement in gross investments was significantly contrary to our forecasts, which to a great extent was also the reason for the excessive forecast for growth in imports. Our previous forecast for average annual growth in investments was 7%, but gross investments actually fell by 4.1% in the first half of the year. After the high investment seen prior to Slovenia joining the EU, gross investments in fixed assets recorded reduced growth of just 1.7% year-on-year, with investments in inventories slowing even more. These fell after almost two years of strengthening, and made a negative contribution of 1.7 percentage points to economic growth. Notwithstanding the low year-on-year growth, the figures for current rates of growth in the second quarter point to an improvement in investment activity.

Figure 2.5: Components of GDP spending by quarter



Sources: SORS, ARC calculations

…and in the context of robust final consumption

Final consumption, household consumption and government spending were much more in line with the forecasts. In both cases the projected average annual growth rate and the actual growth in the first half of the year were almost equal. Our forecast for household consumption was 3.5% growth on average over the year, and this was the rate recorded in the first half of the year. The relatively strong household consumption in the first half of the year was partly financed by loans, and was thus encouraged by high lending activity. Although the statistics point to a rather high growth in wages, total household income did not rise to such an extent that household consumption would increase excessively. Here it is necessary to consider the significant decline in other earnings from employment

that was brought about by changes in tax legislation. The average growth in government spending of 2.5% in the first two quarters showed almost no deviation from the forecast of 2.4%. Nevertheless the current rate of growth in both components of final consumption had accelerated significantly in the second quarter from the slow rates seen at the end of last year.

Box 2.1: The transition to calculating GDP in the previous year's prices and the chain index

In September the Statistical Office of the Republic of Slovenia published its revised annual figures in constant prices for GDP from 1995 onwards. Under the new methodology aggregates in the national accounts are measured on the basis of the previous year's prices, which entails a change from the previous calculation with a fixed annual basis (1995 and 2000 to date). The transition to the Lespeyres chain index is also currently being introduced by other EU member-states in accordance with Commission Decision No. 98/715, while numerous other countries are already using similar methods.

Changes in the values of economic aggregates are distinguished by two factors: changes in prices and changes in volume. In order to calculate the size of GDP it is therefore necessary to eliminate the effect deriving from changes in the prices of individual aggregates. This was previously accomplished by setting a year (the base year, usually set for a period of five years) in whose prices the volumes of the aggregates in all other years were defined. In this method the weightings of the various components of GDP deriving from the relative prices are equal to the weightings for the base year throughout the period. This procedure therefore does not reflect that the relative prices and thus the weightings of GDP components actually change.

The new methodology of annual chaining ensures that the base year changes each year. The changes in volume are thus calculated using the relative prices (and weightings) of the previous year. Under the new methodology a reference year is set, and this is the point of departure for the index or aggregates of the national accounts for all other periods. Unlike the base year, the choice of reference year is of no great significance, which means that it can be changed without any consequences for real GDP growth rates.

One of the fundamental concepts of economic theory is the substitution effect, which presumes that the consumption of a product A rises proportionately if its relative price falls in comparison with product B. The fixed base year method fails to take account of this, which means that it overestimates the value of those components whose relative prices fall. If larger volumes of components therefore tend to coincide with lower prices for the same components, the fixed base year method overestimates economic growth more as it gets further from the base year. For this reason it is necessary to change the base year more often. The revised GDP growth figures in the majority of EU countries are not producing any significant discrepancies, although the much more dynamic international economic environment and the associated rapid fluctuations in relative prices also argue for methodological changes in Europe. The largest discrepancy between 2000 and 2004 in Slovenia was recorded in 2004, when GDP growth was 4.2%, some 0.4 percentage points lower than that measured at fixed prices.

The biggest problem with the chain index is the loss of summation in the various components insofar as the current year differs from the reference by more than one year. The GDP components expressed in the prices of the reference years do not sum to the total GDP expressed in the same prices. They can only be summed after adjusting for inflation for all components, for which it is necessary to know the GDP deflator for the previous year, and also the price index of the previous year for all the components.

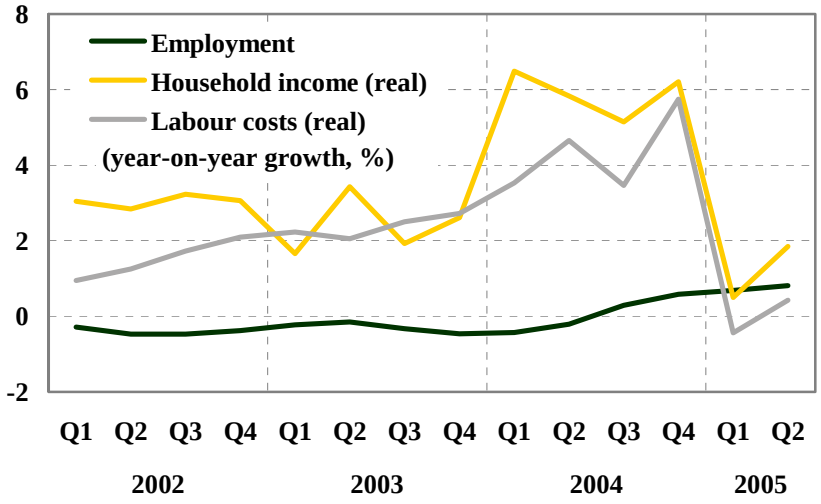
In the use of the chain index inconsistencies can also arise with regard to the chaining of quarterly figures. The European Commission does not prescribe any specific model for member-states, but advises application based on the average of the previous year's prices. Of the three possible methods the SORS opted for the annual overlap method, which guarantees consistent calculation of quarterly growth rates from the second to the final quarter, but slightly distorts the rates in the first quarter and all the annual rates between one quarter and the same quarter a year later. The methodology selected also guarantees that it will be possible to sum the quarterly rates into an annual rate in the future.

The Labour Market

Favourable trends on the labour market…

Developments on the labour market reflected trends in economic activity to a great extent. Employment in the first half of the year rose by 0.8% according to figures from the national accounts, with labour costs per hour worked rising by 5.5% in real terms. While employment growth was very similar to our forecasts for the annual average of 0.6%, wage growth significantly outstripped our forecasts, although growth in total labour costs per employee remained rather low. The reasonably high growth in employment was primarily the result of job creation in service activities. The employment trend in the basic industrial sectors, which account for most of the export-oriented companies, was rather less favourable, despite the rapid export growth.

Figure 2.6: Employment, household income and labour costs



Sources: SORS, ARC calculations

…marked by a rise in employment…

The fastest year-on-year growth in employment in service activities in the first half of the year was recorded by real estate, leasing and business services (6.3%), financial intermediation (3.9%) and construction (3.8%). The largest falls in employment were recorded by mining (3.8%) and manufacturing (1.8%). While the rapid growth in employment in service activities primarily reflects the favourable trend in value added, the contraction of employment in manufacturing is the result of the ongoing structural changes in the economy, which this year in particular were reflected in certain labour-intensive sectors.

…and relatively moderate growth of labour costs, with significant variation in the development of individual components

Growth in labour costs this year remains rather low, despite the strong rise in wages. Although figures from various sources point to diverging movements in components of labour costs, growth in total labour costs per employee is actually falling, in the context of the improving dynamic of economic activity. As such it is acting to maintain price stability and has an encouraging effect on the competitiveness of companies. Labour costs per employee, which include gross wages, other earnings from employment and all taxes not included in gross wages, rose by 4.4% on average in the first half of this year, or by 2.0% in real terms. Meanwhile average gross wages increased by 6.6% on average over the first eight months of the year, or by 4.2% in real terms. The fastest average growth in gross wages over the first eight months of the year was recorded by real estate and intermediation services (8.9% year-on-year), electricity, gas and water supply (7.2%) and retail (7.1%). Net wages rose by even more, and were up 8.1% or 5.7% in real terms. Our previous forecast was for a rise of just 2.5% in real net wages on average in 2005, with the current rate of growth in wages at the beginning of the second half of the year pointing to a slowdown in the relatively rapid growth seen earlier in the year.

Box 2.2: Methodological, tax and structural changes, and wages and labour costs in 2005

A new methodology for collecting data on wages entered into force in 2005, while at the same time data on the movement of wages and components of labour costs this year is also reflecting certain changes to tax legislation and structural changes in the economy.

The new methodology for collecting data on wages entails a break from the old time series, as in addition to the change in methodology it involves a different way of incorporating data and different statistical treatment of the data. Statistical research into the wage developments now also includes private sector legal entities with one or two employees, while since January 2005 the Agency for Public Records and Related Services has been collecting the data, and the SORS has been statistically processing it. The SORS has already published recalculated data on wages prior to 2005, and the year-on-year growth rates in this year are therefore calculated on the basis of the data obtained under the new methodology..

The changes in tax legislation that had a significant impact this year on the diverging movements in individual components of labour costs were changes to income tax, the change in taxation of contract-based work and the effective cut in payroll tax. The difference between growth in gross wages and net wages was negligible in previous years, but averaged 1.5 percentage points over the first eight months of this year. A large proportion of the difference between growth in gross wages and net wages can be attributed to changes in income tax, where there was an increase in the general relief from 11% of average gross wages to approximately 17% of average gross wages.

The increase in general income tax relief introduced at the beginning of this year will have a direct effect, via smaller income tax prepayments, with higher growth in net wages than in gross wages. The change in the taxation of contract-based work, in the sense of the higher effective taxation with the cut in the allowance rate for normalised costs, caused a shift in the structure of household income away from payments on a contractual basis to payments via wages. For this reason too there was year-on-year decline of 5.8% on average over the first eight months of the year in other earnings from employment, while earnings in the form of wages rose by 8.6% on average over the first eight months of the year, with the two components together rising by 4.5% or 2.1% in real terms. The rise in the lower threshold at which employers are obliged to pay payroll tax from SIT 130,000 to SIT 165,000 in September 2004 entails lower costs for employers. Estimates are that the savings to employers resulting from these tax changes will amount to SIT 3.5 billion in 2004 and SIT 6.5 billion in 2005.

In the context of the structural changes in the economy, owing to which there is a decline taking place in the number of low-wage employees, statistically the average wage of employees is rising. Our estimate is that the average gross wage has risen by almost 0.3% this year merely as a result of the decline in employment in the textile and footwear industries, where wages are approximately 60% of the average. In this extent the rise in the average wage does not therefore reflect growth in wages or labour costs per employee, but merely a change in the structure of employment.

Balance of Payments

The current account deficit is in line with expectations…

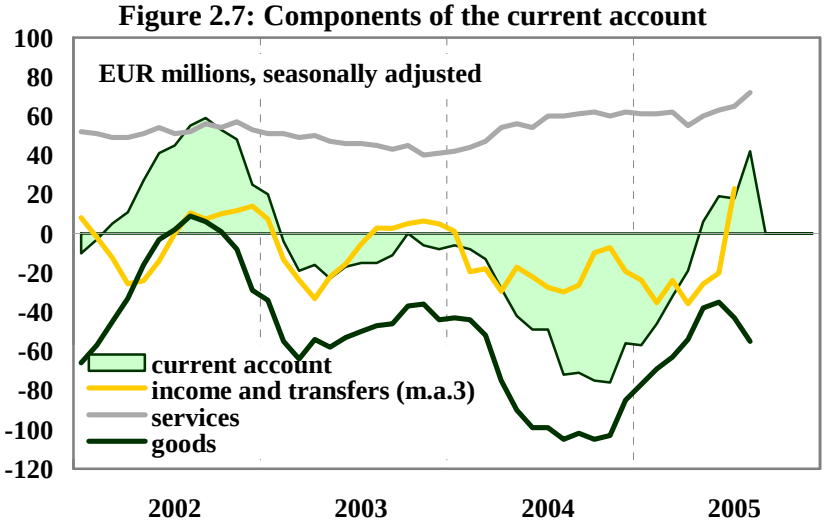
Figures on the movement of the current account show the deficit in the first half of the year to have been reasonably similar to the forecasts. The cumulative current account deficit in the year to July amounted to EUR 290 million, while the forecast deficit for the whole of 2005 stood at EUR 440 million.

…with trade in goods favourable…

Trade in goods was the largest factor in the decline in the current account deficit this year. With the balance of trade in goods and services improving by EUR 300 million, there was an improvement of EUR 250 million in the balance of trade in goods, and an improvement of EUR 50 million in the balance of trade in services. Exports of goods grew significantly faster than forecast, while imports of goods rose more slowly than predicted in the previous forecasts. The rapid growth in exports of goods occurred despite the relatively low growth abroad, primarily as a result of a strong impetus in exports by the car industry. The fastest growth was recorded by exports of goods to France, Italy and Austria,

while exports of goods to the USA declined. Although some imports of goods are related to exports, and thus part of the growth in imports – in particular imports of intermediate goods used to manufacture products with high value added – is conditioned by the rapid growth in exports, in comparison with 2004 this year saw significantly fewer major one-off deals on the import side that would contribute to strong import demand.

Figure 2.7: Components of the current account



Sources: SORS, ARC calculations

…and major outflows in the transfers balance

In the income balance, both labour income and capital income, there has been no significant change this year from last year. The deviations from our previous forecasts have also been virtually negligible. There were slightly larger deviations in the transfer balance, with transfers this year slightly lower than both last year's results and the previous forecasts. The majority of the deviation in this area can be attributed to the decline in official transfers, in particular those from the EU.

Increased private sector saving

Given the developments described in the components of domestic consumption and of the current account, the main factor in the closing of the savings-investment gap in the first half of this year was the increase in private sector saving. This holds despite the slight rise in investments in comparison with the 2004 average. General government saving fell slightly less than general government investments. The general government deficit thus rose slightly in the first half of the year, and made a negative contribution to the savings-investment balance.

Terms of Financing

Economic activity supported by high financial inflows…

The main features of the economic trends that affected the national economy's terms of financing this year were relatively strong economic activity and the increase in the volume of flows with the rest of the world. The net financial flow in the first seven months of the year was positive at approximately 3% of GDP, primarily owing to increased borrowing by the private sector. While the outflow via direct investment abroad was almost unchanged in comparison with last year, this year saw a significant decline in the inflow from FDI to Slovenia. Among the most important items of the outflows in the financial account this year were investments by residents in foreign securities, while the repayment of eurobonds by the government also contributed to the increase in outflows over 2004.

…and high domestic lending activity

Domestic lending has grown relatively rapidly this year, at year-on-year rates close to 20%, while the volume of lending taken abroad has also increased. In the latter this year has seen a shift from companies financing themselves directly

with loans from abroad to companies financing themselves primarily via domestic foreign currency loans from commercial banks. At the same time there has been strong growth in borrowing abroad by banks this year. Total year-on-year growth in domestic and foreign loans averaged more than 18% over the first eight months of the year. Almost one-half of the total flow can be attributed to domestic foreign currency loans to companies, while new foreign currency loans accounted just one-third of total lending on average in 2004. The volume of new loans taken abroad by companies in the first seven months of the year was unchanged from last year at approximately EUR 250 million, but loans taken abroad by banks almost tripled from EUR 350 million to EUR 1,015 million. Among domestic lending, long-term loans grew significantly more rapidly than short-term loans, in both the corporate and household sectors.

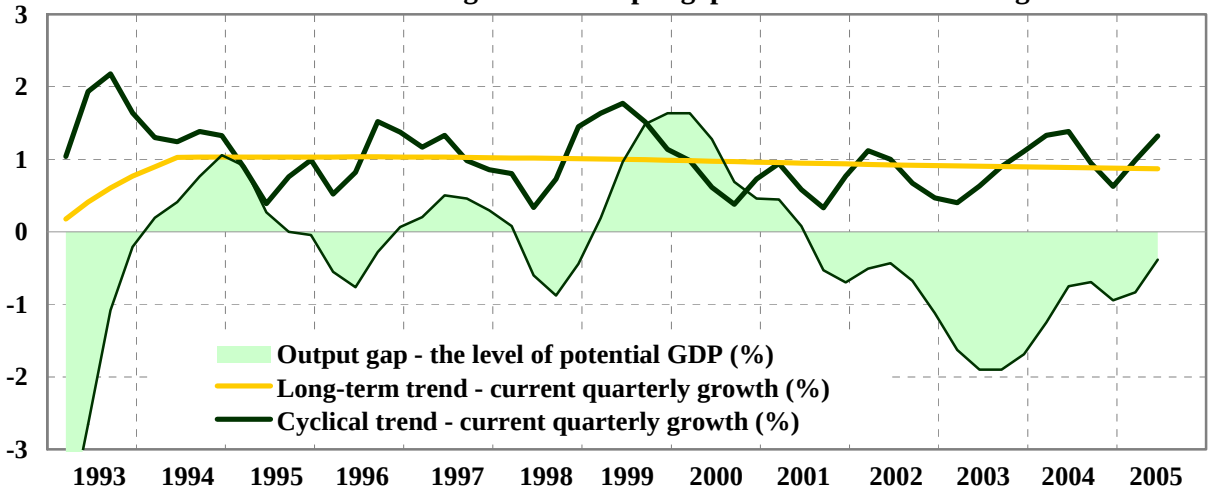
2.3 Inflation Factors

Convergence with the Maastricht criterion continued in 2005

In the first half of 2005 inflation reached its lowest rate since it has been measured by the consumer price index. Between January and September inflation averaged just 2.5%, down 1.2 percentage points from the same period last year. Slovenia thus continued to get closer to meeting the Maastricht price stability criterion, with the September figures showing it to be exceeded by just 0.3 percentage points. With inflation having fallen to 2.5%, Slovenia is also at the lower edge of the band in which the real convergence process means that a level of price growth is maintained over the longer term.

In line with expectations, the main factors contributing to low inflation were the macroeconomic environment, the negative output gap and limited growth in labour costs, and the direction of macroeconomic policies. The effects of the strong disinflation factors were mostly nullified by unfavourable factors in the international environment, in particular the rapid growth in oil prices and other energy prices. An additional effect can be attributed to the effects of competition on certain prices of tradable goods when Slovenia joined the EU. As a result, the gap between headline inflation and core inflation further widened. The level of consumer prices in September was just 0.5% higher than last year, excluding the effects of taxes, energy prices and food prices.

Figure 2.8: Output gap and current economic growth



Sources: ARC forecasts

The negative output gap acted to curb inflation

The output gap remains negative, although it is closing gradually. The current rate of economic activity rose sharply in the second quarter in particular, having further closed the output gap, which remains negative at approximately 0.5%

GDP. In line with our expectations aggregate demand remains behind potential supply, thus restricting the opportunity to raise prices.

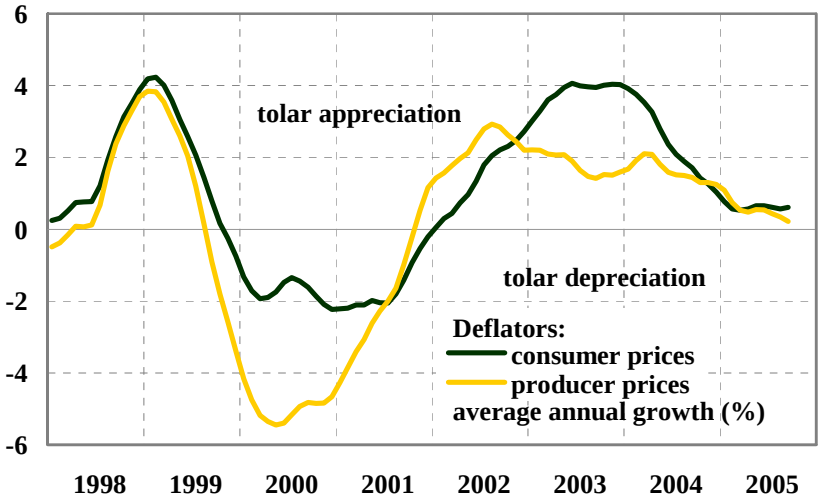
Real growth in labour costs remains behind productivity growth in most sectors

Supply-side indicators also point to the absence of inflationary pressures. As seen in the previous section, real growth in labour costs remains rather low this year (2.0% in real terms) despite strong increases in wages, and is acting towards maintaining price stability. With labour costs growing more slowly than labour productivity, manufacturers have been able to raise their prices less in a competitive environment than they would otherwise have to. Despite faster growth in gross wages, the rate in the first half of the year remained behind productivity growth in the majority of economic sectors. For the most part growth in gross wages only outstripped productivity growth in sectors that are less under the influence of competition and partly have a monopoly or oligopoly position. Despite this, this year's faster growth in gross wages also partly reflects the changes in tax legislation and the methodological changes examined in Box 2.2.

The balanced real tolar exchange rate has not has an impact on inflation or competitiveness

The moderate real appreciation of the domestic currency, which has been close to balanced in recent years, is therefore not giving rise to any significant pressures on inflation or to deterioration in competitiveness. The real effective exchange rate as measured both via consumer prices and via producer prices shows a decline in the rate of real appreciation, primarily owing to low growth in domestic prices. The real appreciation of the tolar between 2001 and 2003 was partly the result of the euro's appreciation against the dollar, and partly the result of effects connected with the difference in productivity between the tradable and the non-tradable sector, the Balassa-Samuelson effect. In the light of the current trend in productivity growth, this effect, estimated at 1 to 1.5 percentage points of inflation annually, represents a rate of appreciation, which is in line with the process of catching up with wealthier countries price levels, and is not causing a decline in competitiveness. Higher real appreciation entails a deterioration in competitiveness for export-oriented companies and a need for the partial sale of excess goods on the domestic market, where excess supply means additional pressure to lower domestic prices, and consequently lower inflation. By contrast, depreciation of the domestic currency causes an increase in competitiveness and pressures for rising inflation. Deviations from balanced rate of appreciation have been extremely minor in recent years. Together with the external equilibria, this indicates that the real (and nominal) tolar exchange rate is in equilibrium.

Figure 2.9: Real effective exchange rate



Source: ARC forecasts

Adverse factors in the international environment gave rise to most inflationary pressures this year

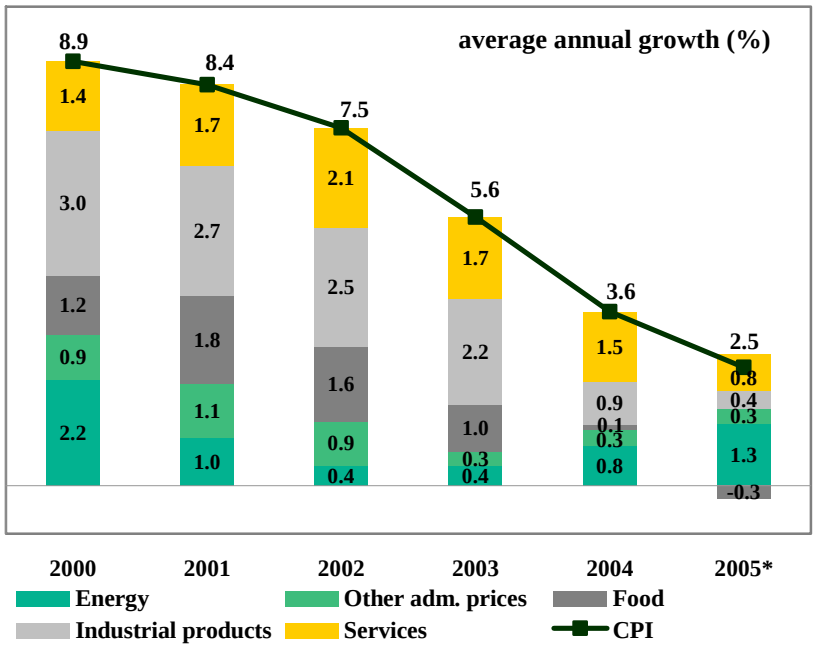
As in previous years, this year it is factors from the international environment that are causing most pressure on inflation. In addition to the rapid growth in oil prices, which have risen by approximately 62% this year alone, this year has also

seen a rise of approximately 12% in the dollar exchange rate, which in previous years mitigated the effects of rapid growth in oil prices on world markets. The extremely high growth in energy prices accounts for more than one-half of total inflation, and will probably be temporary in nature. The August year-on-year inflation rate, excluding the effects of refined petroleum products and measured by the HICP, was the fourth-lowest in the EU. A significantly more favourable inflation factor this year has been foreign competition, which further strengthened certain favourable trends seen last year, in particular regarding food products, but also regarding textiles and footwear.

Changes in the structure of inflation are only reflecting temporary effects

Changes in the structure of inflation mostly reflect temporary effects within individual price groups. This year the slower growth in free prices more than compensated for the faster growth in energy prices. The contribution made to inflation by rises in free prices more than halved. Growth in food prices fell further this year, and was negative on average over the first nine months of the year, which lowered average inflation by approximately 0.3 percentage points. An additional factor acting to lower inflation was slower growth in prices of other industrial goods, the contribution of which was approximately 0.5 percentage points less this year. The main factor in this was slower growth in prices of clothing and footwear, which was the result of excess supply, of cheaper Chinese textiles in particular. The slower growth in prices of goods was accompanied by slower growth in prices of services, whose contribution fell from 1.5 to 0.8 percentage points. Unlike the slower growth in prices of package holidays, which this year came particularly under the influence of temporary factors, the slower growth in prices of other services was probably of a more sustained nature and in line with the macroeconomic environment.

Figure 2.10: Structure of inflation – contributions by components



Note: * average growth for first three quarters of 2005
Sources: SORS, ARC calculations

High growth in prices of refined petroleum products again overshadowed growth in other prices this year

Growth in prices of refined petroleum products was the strongest factor of growth in administered prices. In the year to September prices of refined petroleum products rose on average by 25%, with 95 octane petrol recording the lowest rise of approximately 20% and heating oil the largest rise of approximately 38%. As in the previous two years, the government again mitigated the effects within the monthly fluctuations by adjusting excise duties on refined petroleum products. This policy has proved successful in the last two years in mitigating the fluctuations, without retarding the trend of growth in

prices of refined petroleum products dictated by the world market. However since August 2005, when there was again a large rise in oil prices in the world market, it has no longer been possible to adjust excise duties, as the level of excise duty on all refined products is already at the minimum set by the European directive. In addition the transmission of rises in foreign oil prices into domestic prices was lower owing to the proportion of the retail price accounted for by tax, which in Slovenia is approximately 53%, compared with just 20% in the USA.

Table 2.1: Transmission of foreign prices of refined petroleum products into domestic prices

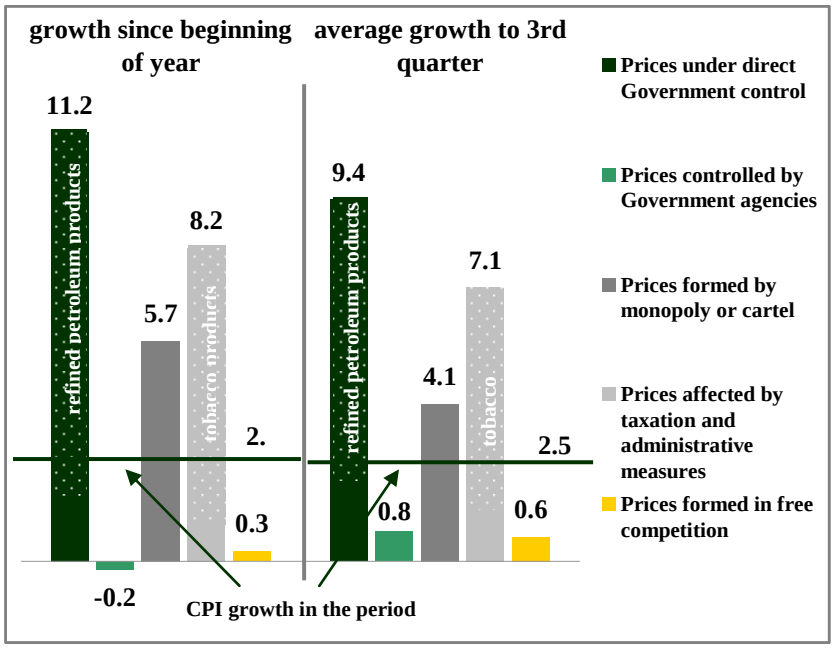
Year-on-year (Sep 05 / Sep 04) growth (%)	95 unl. petrol	98 unl. petrol	D2 diesel	heating oil
World price of refined petroleum (USD)	58.7	62.5	51.3	53.0
Exchange rate (SIT/USD)	-0.8	-0.8	-0.8	-0.8
World price of refined petroleum (SIT)	57.5	61.2	50.2	51.8
Domestic price of refined petroleum (SIT)	19.5	21.8	24.0	38.0
Transmission of foreign to domestic prices[1]	34%	36%	48%	73%

Note: [1] Calculated as domestic tolar prices / foreign tolar prices
Source: ARC estimate.

A rise in excise duties is necessary to harmonise with the European directive

As in previous years, the adjustment of excise duties on tobacco because of the European directive requirements raised inflation this year. This year to September the rise in prices of tobacco products averaged 7.5% from the same period last year, and accounted for just over 0.2 percentage points of inflation. January's and July's price rises were the result of the rise in excise duties in accordance with the Excise Duty Act, which envisages three further rises by 2008. Despite having been adopted by the Slovenian government, the Excise Duty Act (at least in this part) represents the implementation of the European directives setting out adjustment to the minimum duty level by 2008. Although the gradual adjustment of excise duties brings a certain sustained element to inflation, it also reduces the need for one-off price rises in the future.

Figure 2.11: Consumer price rises

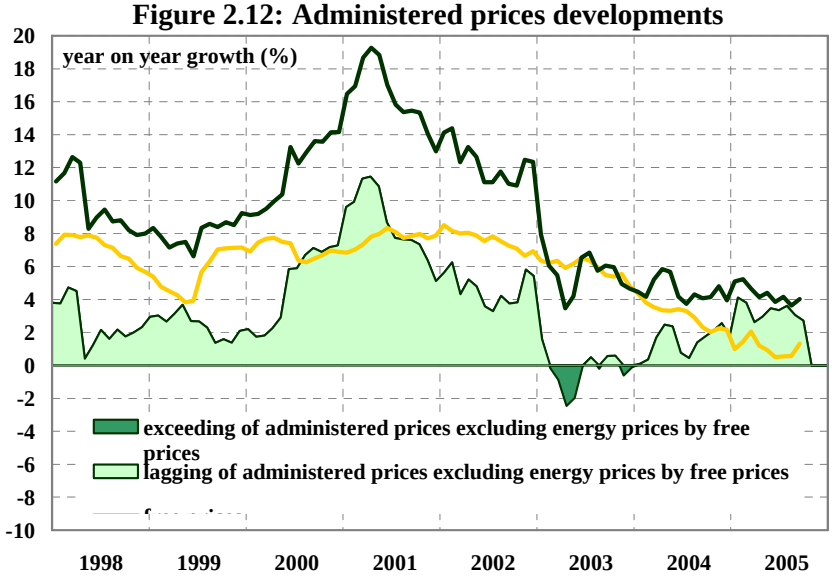


Source: ARC

Growth in administered prices excluding energy prices again outstripped growth in free prices

As in 2004, growth in administered prices excluding energy prices has again exceeded growth in free prices in 2005. The divergence between growth in administered prices excluding energy prices and growth in free prices continued in 2005. In the year to September the gap widened to approximately 3.0 percentage points. The reason for a gap of this size lies primarily in the more pronounced slowdown in the growth in free prices, which was not followed by the growth in administered prices excluding energy prices. After the relatively high growth in administered prices excluding energy prices between 1998 and 2002, the rate was at the same level as the growth in free prices in 2003, before stalling at approximately 4%, even while the growth in free prices continued to decline.

Figure 2.12: Administered prices developments

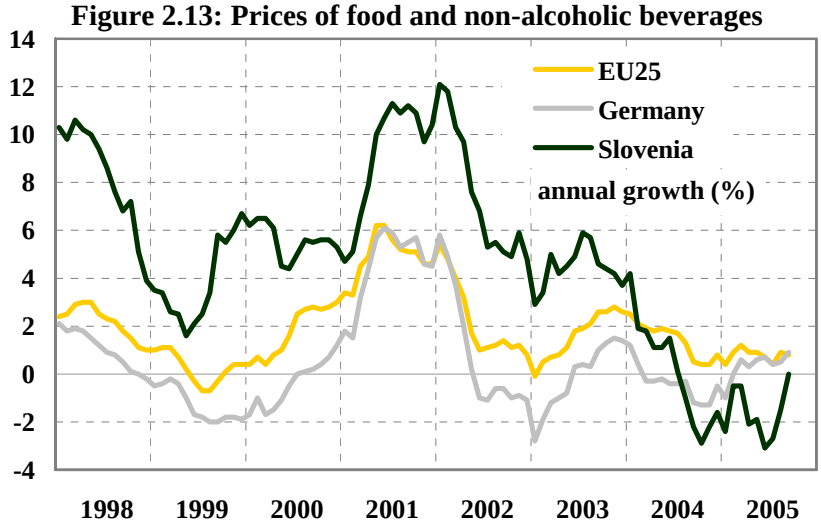


Source: ARC

Growth in free prices came primarily under the influence of temporary factors

This year growth in free prices has been low, which is partly the result of certain temporary effects in food prices and clothing and footwear prices. Given last year's fall in food prices, which was primarily of a one-off nature and the result of price adjustments after Slovenia joined the EU and the abolition of customs duties, the rise in year-on-year rates of growth that occurred in September and that will probably continue towards the end of the year was expected. Comparing growth in food prices in Slovenia and the rest of the EU, growth in food prices in

Figure 2.13: Prices of food and non-alcoholic beverages



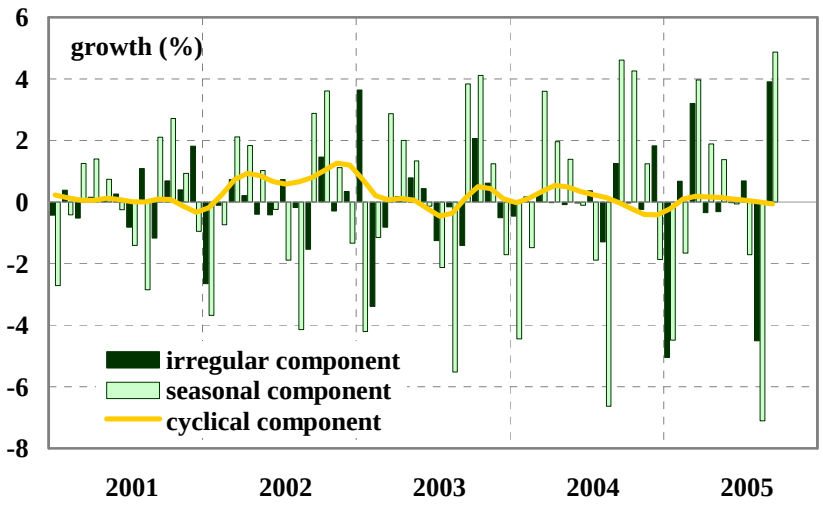
Source: ARC

Slovenia in recent years was always above that in the EU, and only in the last year has there been an easing of the prices following the abolition of customs duties. Despite the history of faster growth, growth in food prices can be expected to be more in line with that in the EU thanks to increased competition. Although the competition existed before the abolition of customs duties, it increased further when they were removed, as this lowered the price level of companies that could previously exploit their market position more excessively.

Competition from China made clothing and footwear cheaper

Similar one-off effects on prices were seen this year in clothing and footwear, prices of which fell by an average of approximately 0.9% to September. This fall can mostly be attributed to increased competition in the EU market after the relaxation of terms of textile imports from China that occurred at the beginning of the year, and also partly to the statistical effects caused by the change in the seasons between individual months. Both effects can be identified through individual components of seasonal adjustment. The effect of increased competition because of higher imports from China can be seen in the relatively slow growth in the current trend component, while the change in seasons can be seen in the irregular component. With the shift in the starting date for winter sales, they are now included in January, while increased competition is forcing retailers into the early purchase of new collections, which took place in March and September. In addition the excess supply of goods is bringing about an expansion in the range and depth of sales, a feature of this August. Despite this year's effects on the prices of clothing and footwear being temporary, the reverse effects will most probably be slower and will depend to a great extent on the EU's trade policy towards China.

Figure 2.14: Clothing and footwear prices



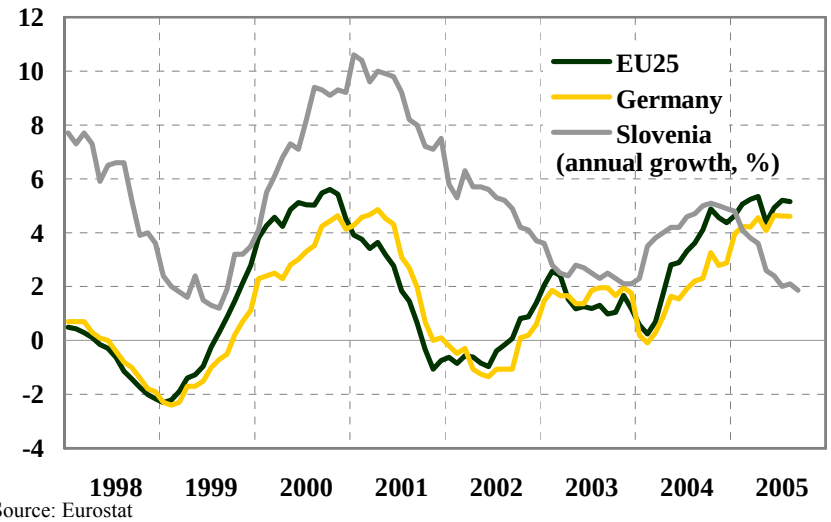
Sources: SORS, ARC calculations (X12 seasonal adjustment)

Growth in producer prices has slowed to 2.0%

After last year's high rate, growth in producer prices of manufactured goods slowed this year and is again more in line with inflation. After a temporary rise in year-on-year growth rate of producer prices last year, it declined again this year to the level seen in 2003 of approximately 2.0%. 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. A comparison of producer prices developments in Slovenia with those in the EU and in Germany points to a probable high level of convergence in prices of these products. 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. Although this year's growth in producer prices in the EU is significantly faster than the growth rate of domestic producer prices, this is primarily the result of the faster growth in energy prices in the EU (19% year-on-year) and the slower growth in these prices in Slovenia (1.6% year-on-year). Price developments of other intermediate goods, capital goods and consumer

goods have again been in line in both Slovenia and the EU this year. The slower growth in energy prices in Slovenia could be a result of the liberalisation of the electricity market and adjustments in the level of the prices to the EU average. Recent figures indicate that both the production and consumption of electricity is within the projected frameworks, and that they have not deviated from the average, although Slovenia was even a net exporter of electricity in July. Business in the energy sector has been smooth, despite the slower growth in prices.

Figure 2.15: Comparison of producer prices of manufactured goods

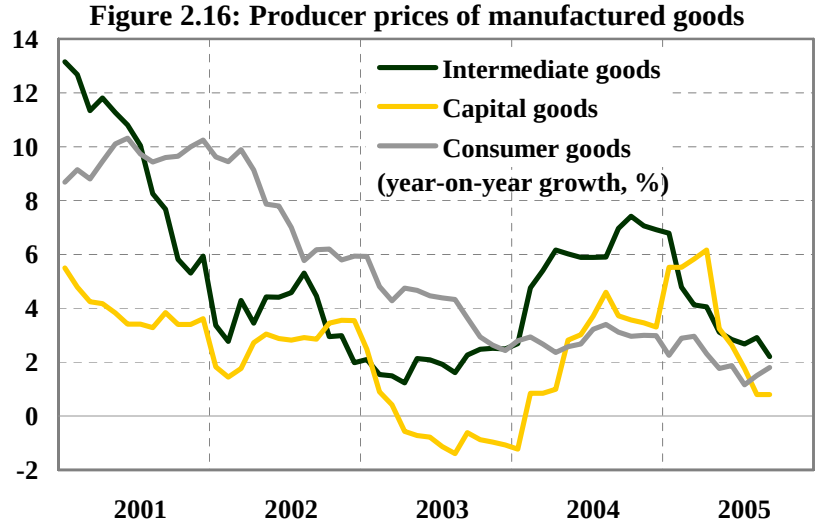


Source: Eurostat

The slowdown in growth in producer prices is the result of a slowdown in growth in these prices in all sub-categories

Developments in individual groups of producer prices indicate a sustained decline in producer prices aggregate to 2.0%. On the side of final consumption competition is preventing the faster transmission of rises in prices of intermediate goods into rises in prices of consumer goods, and consequently into the consumer price index. Growth in producer prices of consumer goods has fluctuated between 2.0% and 3.0% since the end of 2003, but this year has fallen below 2.0%. The slow movement of these prices further indicates the absence of inflationary pressures on the producer side. This is also confirmed by the growth in prices of intermediate goods, which after a temporary rise owing to last year's one-off rise in metals prices has again fallen to 2.0% this year. There has also been a fall in the rate of growth in prices of capital goods, which having been extremely low in 2003 and a little higher in the beginning of this year is now returning to a more sustainable level.

Figure 2.16: Producer prices of manufactured goods



Sources: SORS, ARC calculations

3 MONETARY POLICY

Monetary policy has been conducted in line with the adoption of the euro at the beginning of 2007 as the goal of the Bank of Slovenia and the Slovenian government, on the basis of the Programme for ERM II Entry and Adoption of the Euro.[1] Within the framework of the limitations imposed on it by participation in the ERM II, the Bank of Slovenia uses its monetary policy and exchange rate policy to create the conditions for its participation in the ERM II to be as short as possible. The basic objective of monetary policy is price stability. With inflation stable and low, and monetary and macroeconomic movements in line with forecasts, the stance of monetary policy has remained unchanged.

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

2.1 Monetary Policy and Macroeconomic Trends

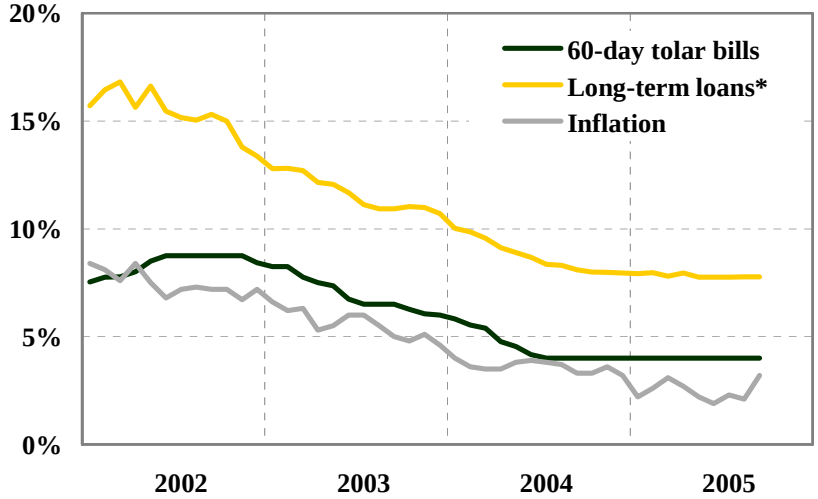
Slovenia entered the ERM II, one of the conditions for introducing the euro, on 28 June 2004. The central rate was set at SIT 239.640 to the euro in agreement with the relevant European institutions. The nominal exchange rate is allowed to fluctuate within a standard band of 15%.

ERM II entry as one of the pre-requisites for introducing the euro

Within the framework of the limitations imposed by the ERM II, the Bank of Slovenia has held interest rates at the highest possible level that still maintains exchange rate stability. The Bank of Slovenia has thereby attempted to prevent inflationary pressures that could trigger excessive lending or consumption. The year-on-year inflation rate fell from 3.6% in the third quarter of 2004 to 2.5% in the third quarter of 2005, while the Bank of Slovenia's nominal interest rates remained unchanged.

Within the limitations the Bank of Slovenia keeps real interest rates as high as possible…

Figure 3.1: Maintenance of real interest rates



* Long-term corporate loans for capital expenditure. Includes loans with a TOM (base rate) clause until October 2002, and nominal interest rates alone since November 2002
Source: Bank of Slovenia

By maintaining interest rates at the highest possible level the Bank of Slovenia is encouraging saving and restricting spending. The effect on spending works via both lending and deposit rates. Higher lending rates reduce the demand for credit

…thereby encouraging saving and restricting consumption

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

and broad money, while higher deposit rates increase banks' time deposits, increase the average maturity of deposits, and reduce the volume of transaction money, all of which restricts spending.

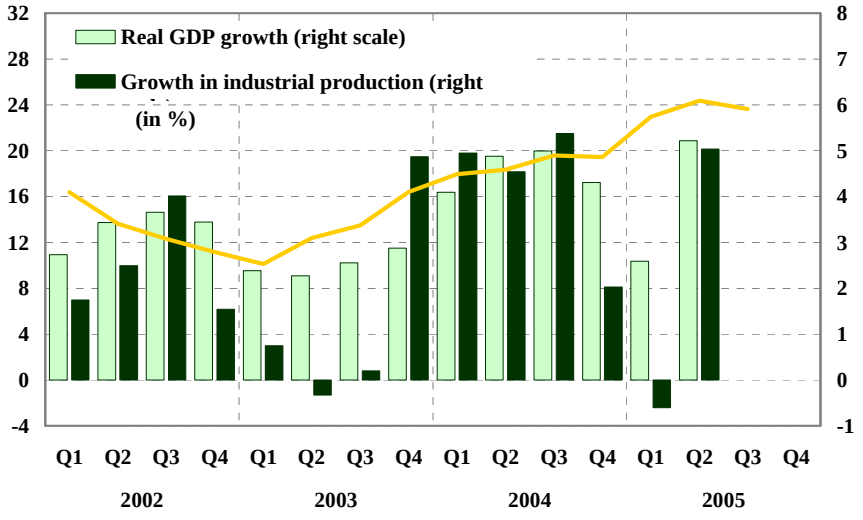
Reduced influence of monetary policy

Despite the euroisation process and the conditions of free movement of capital, the tolar part of the banking sector's balance sheet is still of such an extent that tolar interest rates have an effect on spending. However, the foreign currency part of the banking sector's balance sheet is expanding. The proportion of total lending accounted for by foreign currency lending rose from 25% in September 2004 to 33% in September 2005. In the same period the proportion of broad money accounted for by foreign currency deposits remained unchanged at approximately 31%, although the proportion of banks' total assets accounted for by foreign currency deposits and loans from abroad rose from 19% to 27%. Conversion costs and payment transactions act to slow the euroisation process, and thus increase the effect that tolar interest rates have on spending.

The ability to maintain a differential between domestic and foreign interest rates thanks to low exchange rate risk and the costs of obtaining tolar liquidity

The differential between interest rates in Slovenia and interest rates in the eurozone is sustainable owing to the low risk of short-term exchange rate fluctuations and the costs of obtaining tolar liquidity via foreign exchange swaps. In addition it is necessary to consider the possibility of investments in countries where despite a stable exchange rate interest rates are higher than in Slovenia. Although the tolar exchange rate is stable, the short-term fluctuation around the central rate is very limited and a source of a certain risk in investing in short-term securities such as Bank of Slovenia tolar bills. The foreign exchange swap is the main instrument for obtaining short-term tolar liquidity for banks, and the price for converting foreign currency into tolars is currently 1.5%. Higher interest rates under the conditions of a stable exchange rate and the free movement of capital could give rise to financial inflows, which would be likely to bring about appreciation of the domestic currency or demand further cuts in interest rates. The moderate net financial flow into Slovenia is an indication that the interest rates in certain comparable countries are higher, given the exchange rate risk, and that they are thus more attractive to capital. These elements are allowing the Bank of Slovenia some manoeuvring room in administering its monetary policy, and allow for a gap between its short-term interest rates and those of the ECB. The gap therefore reflects the current need to influence macroeconomic trends, as the Bank of Slovenia could achieve the mere maintenance of exchange rate stability with interest rates closer to those of the ECB.

Figure 3.2: Lending and economic activity



Source: Bank of Slovenia

Increased lending activity is primarily the result of stronger economic activity

The increase in lending activity is to a great extent connected to stronger economic growth.[2] Figure 3.2 clearly shows that real GDP growth exceeded 4% year-on-year throughout 2004. At the beginning of 2005 real GDP growth temporarily declined to 2.7% year-on-year, before exceeding 5% in the second quarter. The movement in industrial production was similar, if a little more volatile. The year-on-year rates of growth in lending to the private sector have gradually risen since the beginning of 2003. The rate stood at 10.1% in the first quarter of 2003, to reach 19.6% in the third quarter of 2004. A temporary stalling at the end of 2004 was followed by acceleration at the beginning of 2005 to a rate of more than 23% year-on-year. Growth in lending to the private sector remained at this level until September.

Box 3.1: Factors of increase in lending

Bank lending has been gradually strengthening since the beginning of 2003. The year-on-year rate of growth in lending to the private sector was below 10% at the beginning of 2003, but is almost 25% in 2005, exceeding the record growth seen in 1999. The depth of financial intermediation is increasing, with lending to the private sector having been equivalent to approximately 40% of GDP at the end of 2002 but passing 53% in the middle of 2005.

The depth of financial intermediation as measured by private sector lending as a proportion of GDP is relatively low in Slovenia. The depth of financial intermediation is to a great extent connected to the level of economic development. Therefore it is thus much lower in the new EU member-states than in the EU15. Per capita GDP at purchasing power parity in the new members is one-half that in the EU15, as is private sector lending as a proportion of GDP. The ratio of private sector lending to GDP in the new members averages around 50%, while it exceeds 100% in the EU15. In 2004 Slovenia's per capita GDP at purchasing power parity was 78% of the EU25 average, placing it immediately behind Cyprus (82%) among the new members in terms of this indicator. Private sector lending as a proportion of GDP is higher in Slovenia than in Lithuania, Poland, Slovakia and the Czech Republic, lower than in Malta, Cyprus and Estonia, and similar to the levels in Hungary and Latvia.

Lending in Slovenia has been dynamic in the recent period.[i] The average year-on-year real growth in lending was less than 10% between 2000 and the end of 2003, since when it has exceeded 10%, and is currently 15.7% (or 21.2% for lending to the private sector). Between 2000 and 2003 real growth in lending was between two and three times real GDP growth, but since 2004 it has been more than three times real GDP growth.

In part the high growth in lending can be attributed to the process of deepening financial intermediation in order to catch up with more developed economies in the EU, and to interest rate convergence.[ii] There is strong growth in lending in both the household sector and the corporate sector. The stock of household lending rose by SIT 66.4 billion in 2003, by SIT 136.0 billion in 2004 and by SIT 127.6 billion in 2005 to August. The main reasons for the increase in household lending are:

- Relatively strong growth in household consumption and the gradual convergence of interest rates. Growth in household consumption was just 1.3% in 2002, but has exceeded 3% since the middle of 2003, passing 4% in the second quarter of 2005. Declared nominal interest rates on short-term consumer loans were still more than 12% in 2002, but had fallen to below 8% by the end of 2004 and have remained at this level in 2005.

- Disbursement of housing loans on the basis of the National Housing Saving Scheme (NHSS). Two generations of the NHSS matured in 2004 and 2005, which was reflected in an increase in housing loans and consumer loans.[iii] The increase in housing loans was just over SIT 30 billion in 2003, but during the second half of 2004 and the first half of 2005 the increase in housing loans amounted to more than SIT 70 billion.

- Competition on the lending market has increased, restrictions on foreign currency lending have been removed, loan procedures have been simplified and costs have been cut.

- The relatively low level of indebtedness. The level of indebtedness as measured by the ratio

[2] See Box 3.1 (Factors of increase in lending)

of household lending to monthly income has increased from 2.8 to 3.2 in the last two years, but is still low compared with more developed countries.

- Increasing credit activity is not necessarily reflected in an increase of domestic spending. Decrease in interest rates enables increasing borrowing, but these funds are to a large extent spent to redistribute the existing stock of wealth portfolio, especially in terms of real estate. Part of these funds is also reflected in increased savings – in the circumstances of low interest rates primarily as investment into alternative saving possibilities, and most significantly into mutual funds. Because of risk diversification mutual funds invest part of their assets abroad. Additionally, part of funds is spent for purchases of real estate abroad.

The stock of corporate lending rose by SIT 279.1 billion in 2003, by SIT 375.3 billion in 2004 and by SIT 296.6 billion in 2005 to August. The main reasons for this increase are:

- Strong economic activity. Real GDP growth stood at 2.7% in 2003, and 4.2% in 2004, and has remained at this level in 2005.
- The corporate sector is replacing foreign sources of finance with domestic sources, which is partly the result of interest rate convergence. The proportion of corporate financing accounted for by foreign sources was slightly more than 30% in 2003 and 2004, but had fallen to less than 20% by July 2005. While interest rates on loans abroad have remained relatively unchanged in the last two years, nominal interest rates on domestic loans have fallen. Declared nominal interest rates on long-term corporate loans stood at 12.6% in 2003, at 8.5% in 2004, and at 6.5% in the middle of 2005.

[i] Honohan (1997) classifies real credit growth of more than 10% annually as a credit boom. According to Caprio and Klingebiel (1996) normal growth in real credit is between double and triple growth in real GDP

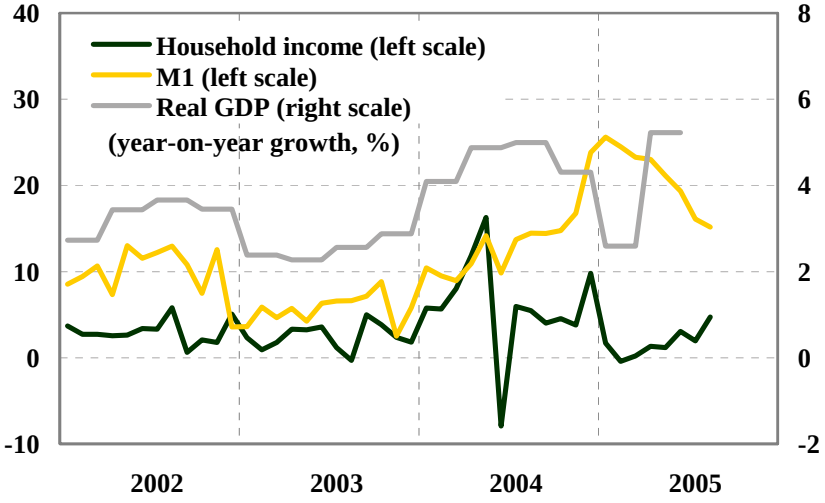
[ii] The reasons for the strong lending in Slovenia and certain other new EU members are analysed in detail in the IMF paper *A credit boom without a demand boom* (http://www.imf.org/external/pubs/ft/scr/2005/cr05254.pdf)

[iii] During the saving period for the NHSS lending terms improved significantly and the majority of NHSS savers therefore opted not to take housing loans based on the NHSS, but rather opted for ordinary housing loans or even consumer loans

Lower growth in M1

The movement of M1 is in line with the movement of economic activity and household income. As Figure 3.3 reveals, the rapid growth in M1 in 2004 can be attributed to the recovery of the economy. At the beginning of 2003 year-on-year growth in real GDP was less than 2.5%, but it gradually rose to reach 4.3% at the end of 2004. In the same period real year-on-year growth in M1 rose from just under 4% to almost 25%. The rapid growth in M1 at the end of 2004 and the beginning of 2005 can be attributed to the significant growth in household income, which was primarily a result of higher wage supplements such as allowances, annual bonuses and other earnings. Growth in M1 has decreased this year, as a result of the slight decline in economic growth in the first quarter, and is in line with the normalisation of the high growth in household income.

Figure 3.3: M1, economic activity and household income

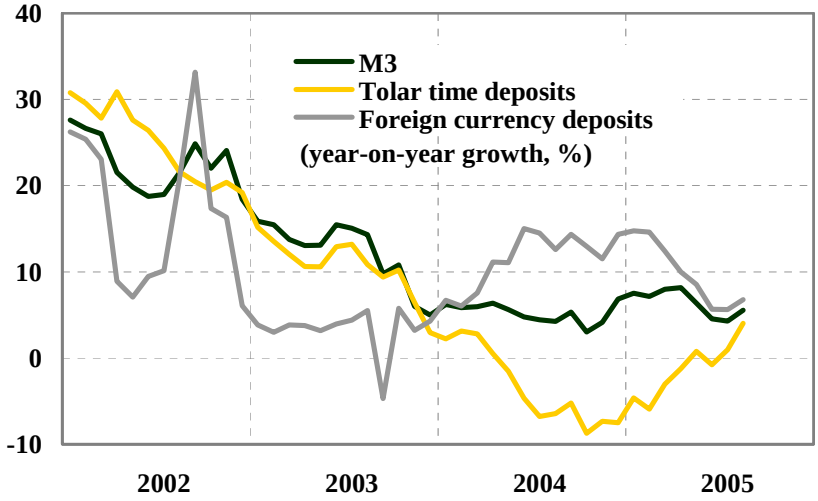


Source: Bank of Slovenia

Growth in tolar time deposits is increasing, while growth in foreign currency deposits is declining

In 2005 growth in tolar time deposits has increased, growth in foreign currency deposits has slowed and the average maturity of deposits has remained unchanged. The increased growth in foreign currency deposits in 2004 was the result of uncertainty regarding the setting of the central rate when Slovenia joined the ERM II, uncertainty regarding the movement of the exchange rate during its participation in the ERM II and the decline in tolar deposit rates. Figure 3.4 shows the restructuring from tolar time deposits to foreign currency deposits for the aforementioned reasons. This trend gradually turned round towards the end of 2004: year-on-year growth in tolar time deposits rose from –7.2% in December 2004 to 4.0% in August 2005, while that of foreign currency deposits fell from 14.4% to 6.8%. The proportion of broad money accounted for by foreign currency deposits rose from 28.3% in December 2003 to 30.2% in December 2004, and has remained between 30% and 31% in 2005. M1 as a proportion of M2 rose by 6.7 percentage points, while the proportion of M2 accounted for by long-term tolar deposits fell by 5.2 percentage points. Between the end of 2004 and August 2005, M1 as a proportion of M2 rose by just 1.1 percentage points (to 38.5%), while the proportion of M2 accounted for by long-term tolar deposits fell by 0.8 percentage points (to 10.4%).

Figure 3.4: Components of broad money



Source: Bank of Slovenia

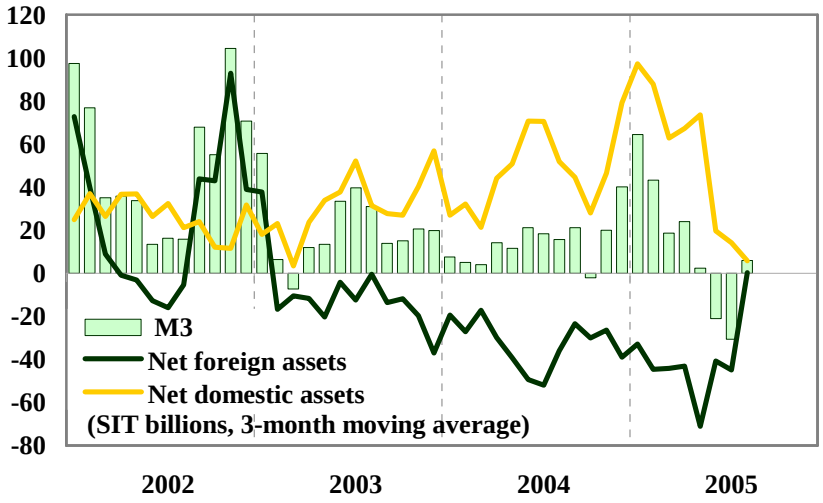
Balance of payments movements are not excessively increasing broad money…

Balance of payments movements are not giving rise to excessive growth in broad money. Net foreign assets, which indicate the contribution of balance of payments flows to broad money growth, fell by SIT 387.5 billion in 2004, and by SIT 277.2 billion this year to May. Net foreign assets remained unchanged between June and August, thanks in part to the effect of the season. Because the contribution of net foreign assets to broad money growth has recently been negative or very low, broad money growth remains low, despite relatively strong lending activity. Year-on-year growth in M3 averaged 7.4% this year to May, but 4.8% between June and August.

…while investments in alternative forms are slowing

Because investments in alternative forms of assets are easing, broad money growth is also no longer declining. In 2004 household investments in domestic securities rose by SIT 197 billion, in mutual funds by SIT 107 billion and in supplementary pension and life insurance by SIT 100 billion. In total this is equivalent to more than 10% of M3, and more than 6% of annual GDP. This year these investments have slowed, with the exception of investments in domestic securities. Investments in mutual funds amounted to just SIT 26 billion in the first half of the year. This can be attributed to the reasonably stable deposit rates and low returns on mutual funds, which is a result of the decline in securities prices on the domestic financial market.

Figure 3.5: Supply of M3

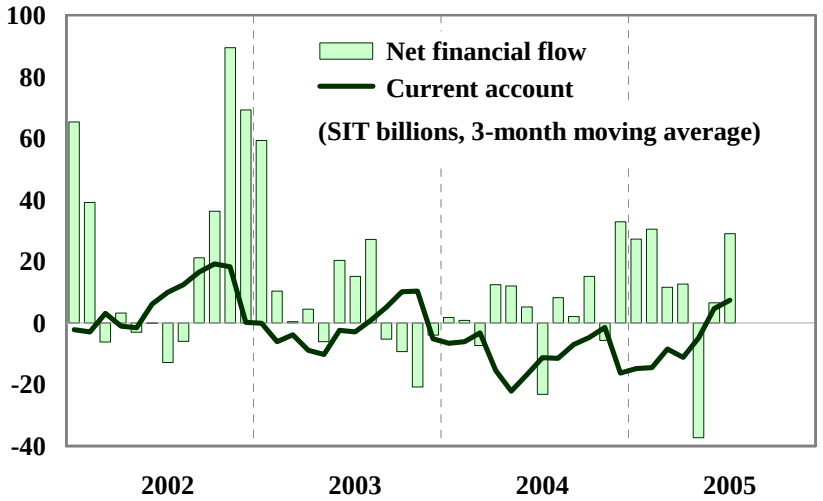


Source: Bank of Slovenia

No pressure on he exchange rate thanks to equilibrium in the balance of payments

Balance of payments movements are not giving rise to any major imbalances on the foreign exchange markets, pressures on the exchange rate or excessive growth in monetary aggregates. The current account was in deficit in the first half of 2005, but the deficit was financed in full by net financial inflows from abroad. Since June there has been a slight surplus in the current account, while net financial flows remain in influx. This is also partly reflected in the slight excess supply of foreign exchange on the foreign exchange markets and the neutral effect of flows with the rest of the world on growth in money. The main financial inflows were foreign loans and deposits in banks, while the main outflows were portfolio investments.

Figure 3.6: Current account and financial account



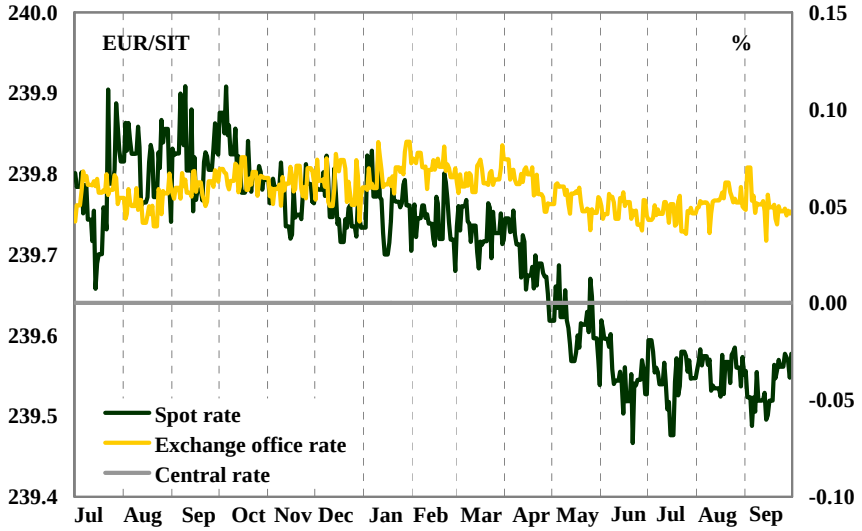
Source: Bank of Slovenia

3.2 Monetary Policy Instruments in the ERM II

Market exchange rates' deviations from the central rate are negligible

Since ERM II entry, the Bank of Slovenia's monetary policy has focused on the stability of the nominal exchange rate. The differentials between the central rate and the market rate during the participation to date in the ERM II have been negligible. Between ERM II entry at the end of June 2004 and the end of September 2005, the maximum differentials in the exchange rate on the spot market[3] were 0.11% above and 0.07% below the central rate. The differentials in the exchange office rate, which was between 0.03% and 0.08% above the central rate, were even smaller.

Figure 3.7: Market exchange rates and differential from central rate



Source: Bank of Slovenia

The foreign exchange markets are in long-term equilibrium

There has been no major excess supply of or demand for foreign exchange on the markets since Slovenia joined the ERM II, which indicates that the central rate is sustainable in the long term. Despite short-term fluctuations in foreign exchange supply and demand, the total excess supply of foreign exchange on the markets amounted to just SIT 186.8 billion between July 2004 and September 2005, less than 3% of annual GDP. This period can be broken down into three sub-periods: excess demand from July 2004 to September 2004 (monthly average of SIT 34.4 billion), balance between October 2004 and March 2005 (average monthly excess supply of SIT 12.2 billion), and excess supply from April to September 2005 (monthly average of SIT 36.0 billion). 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.

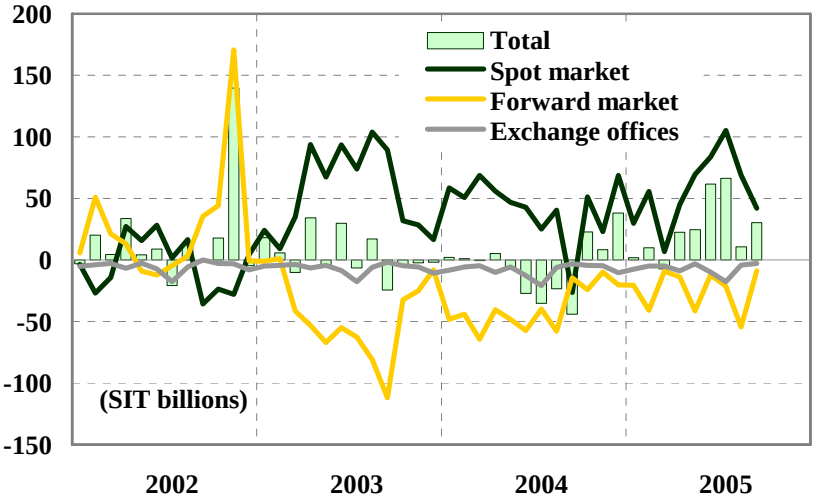
Given the small size of market exchange rates' deviations from the central rate, there was no need for exchange rate

The minor imbalances on the foreign exchange markets were reflected in the movement of the tolar exchange rate, with very small differentials from the central rate, and Bank of Slovenia intervention was not required. The tolar slowly depreciated on the spot market between July 2004 and September 2004, was stable between October 2004 and March 2005, and then appreciated between April 2005 and June 2005. Since June the exchange rate has been stable on the strong side of the central rate. The Bank of Slovenia last exerted an active influence on the exchange rate in July 2004, when immediately after ERM II entry it intervened indirectly on the foreign exchange markets for three days by setting the base exchange rate. In the same month it raised the reverse foreign

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

exchange swap rate and directly intervened on the interbank foreign exchange market by selling foreign currency to banks outright. These measures eased the temporary depreciation pressures and signalled the Bank of Slovenia's intention to maintain the nominal tolar exchange rate close to the central rate.

Figure 3.8: Excess supply/demand on foreign exchange markets



Source: Bank of Slovenia

Foreign exchange swaps and reverse foreign exchange swaps as instruments to reduce exchange rate volatility

Bank of Slovenia foreign exchange swaps allow banks to swap foreign exchange for tolar liquidity (and vice-versa). These instruments thereby reduce fluctuations in the exchange rate and increase the stability of the financial system in the short term. The short-term smoothing of the exchange rate does not prevent it from gradually crawling with regard to conditions on the foreign exchange market. The medium-term movements in the nominal tolar exchange rate thus depend on foreign exchange flows and on the macroeconomic balances.

Subordination of interest rate policy to exchange rate stability

Maintaining a stable exchange rate mostly 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 and the risk premium. Interest rates in the eurozone are essentially formed on the basis of the ECB's monetary policy, while the risk premium is formed by foreign investors' views of country risk, currency risk and liquidity risk.

No change in the Bank of Slovenia's key interest rates

Given that the aforementioned factors have not changed since Slovenia joined the ERM II, the Bank of Slovenia has made no change to its key interest rates. The ECB refinancing rate has remained unchanged since June 2003 at 2.0%. Neither is there any indication from balance of payments movements or movements on the foreign exchange markets that Slovenia's risk premium has significantly changed since it joined the ERM II.

The only changes in the Bank of Slovenia's main instruments occured in December 2004 and April 2005, when the Bank of Slovenia raised the price of the foreign exchange swap 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.

The interest rates on the Bank of Slovenia's instruments in the middle of October 2005 were as follows: refinancing rate 3.5%, foreign exchange swap 1.5%, reverse foreign exchange swap 1.0%, lombard loan 5.0%, 60-day tolar bills 4.0% and overnight deposit 2.25%. The differential between the 60-day tolar bill interest rate and the key ECB interest rate has remained unchanged since ERM II entry at 2 percentage points.

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 to monetary policy instruments 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, restrictions in the liquidity ladder, the level of swapped foreign exchange, and the system of required reserves.

Long-term deposits as an instrument for sterilising foreign currency inflows from the past

In 2005 the Bank of Slovenia again offered long-term tolar deposits with the aim of sterilising the excess liquidity from the maturity of the 270-day tolar bills issued during the takeover of Lek at the end of 2002. The interest rate offered on the long-term tolar deposits was 0.2 percentage points higher than the interest rates on 60-day tolar bills, while the maturity date stretches past the time planned for the adoption of the euro. Between July 2004, when the first offer was made, and December 2004, the Bank of Slovenia withdrew SIT 156.7 billion through this instrument, and a further SIT 46.8 billion of base money in the first nine months of 2005. From the point of view of the effect on base money, the operation of replacing 270-day tolar bills with long-term tolar deposits was almost neutral, as between July 2004 and September 2005 the stock of 270-day bills fell by SIT 186.5 billion.

Relaxation of the minimum prescribed foreign currency liquidity and replacment of swaps with ourtright purchases of foreign currency

In order to increase banks' flexibility in transacting on foreign exchange markets, the Bank of Slovenia gradually relaxed the minimum prescribed foreign currency liquidity, and offered to replace foreign exchange swaps with outright purchases. In 2004 the Bank of Slovenia reduced the minimum requirement for liquid assets in foreign currency from 80% to 70% of short-term foreign currency liabilities, and left it unchanged in 2005. The level of compulsory subscription to foreign currency bills was reduced from 45% of liquid foreign currency assets to 35% in 2004, and further to 25% in 2005. Compulsory subscription to foreign currency bills was finally abolished in July 2005. The stock of foreign currency bills therefore fell from SIT 512.7 billion at the end of June to SIT 426.8 billion at the end of August. In 2005 the Bank of Slovenia again offered banks the opportunity of the outright sale of foreign exchange from the cumulative Bank of Slovenia foreign exchange swaps. Via this offer the Bank of Slovenia made an outright purchase of SIT 331.8 billion of foreign exchange from banks in 2004, and SIT 319.0 billion in the first nine months of this year.

Adaptation of the prudential control rating instrument of the liquidity ladder…

The Bank of Slovenia is gradually adjusting the liquidity ladder instrument to the eurosystem regulations. The possibility of including tolar lending with an A credit rating and a maturity of more than 180 days when meeting the liquidity coefficients in the first category (maturity up to 30 days) was abolished, and a weighting for household and corporate sector sight deposits of 85% in the first category and 60% in the second category (maturity up to 180 days) was established. Banks have been able to operate under the new system since July, and will be obliged to switch to the new system by 1 January 2006.

…and of required reserves to the regulations in the eurozone

The Bank of Slovenia continued to adjust the required reserve instrument to the ECB standards. In March 2005 it lowered the level of required reserves for tolar liabilities falling due in up to 90 days from 4.5% to 2%. Thus the level of required reserves for all liabilities falling due in 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 aimed to delay the liquidity effect of this change until after the euro has been adopted. Banks and savings banks were therefore 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. The interest rate paid on the reserves at the Bank of Slovenia is 1%, less than the interest rate paid at the ECB (currently around 2%). However it should be borne in mind that in addition to investments in required reserves and other instruments of monetary policy banks also hold investments in long-term deposits at the Bank of Slovenia. Investments in long-term deposits stood at SIT 203 billion at the end of September, the interest rate being 4.2%. The weighted interest rate on banks' investments in required reserves and long-term deposits is 3.3%, which means that banks' terms of operation in Slovenia in relations with the central bank are better than those in the eurozone.

Box 3.2: Diary of Bank of Slovenia measures since ERM II entry

28 June 2004

- The Bank of Slovenia enters the ERM II. The central rate is set at SIT 239.640 to the euro, with a lower intervention point of SIT 203.694 and an upper point of SIT 275.586 to the euro (15% above or below the central rate).
- The Bank of Slovenia cuts the 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.

2 July 2004

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

20 July 2004

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

27 July 2004

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

30 July 2004

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

27 October 2004

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

- 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

24 to 25 November 2004

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

3 to 10 December 2004

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

23 December 2004

The Bank of Slovenia raises the 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 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.

13 to 19 April 2005

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia

purchases SIT 70.6 billion of foreign currency from banks.

8 April 2005

The Bank of Slovenia raises the foreign exchange swap rate from 1.25% to 1.5%.

10 to 16 June 2005

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 46.9 billion of foreign currency from banks.

20 to 26 July 2005

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 83.9 billion of foreign currency from banks.

19 to 23 September 2005

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 117.7 billion of foreign currency from banks.

4 ECONOMIC OUTLOOK[4]

With the world economic climate gradually improving and domestic demand remaining at a reasonably high level, GDP growth will remain relatively high in the period to 2007. The forecasts are that prices will have risen by approximately 2.8% by the end of this year, and then price growth will stabilise at approximately 2.5% in the next two years, given the absence of new oil shocks. The first section of this chapter presents the anticipated trends in selected variables in the international environment. This is followed by an account of the projections of economic activity, employment and wages. The third section shows the trend in domestic demand broken down by components of spending. The external balance and terms of financing are analysed in the fourth and fifth sections. The final section presents forecast price movements. A summary of the forecasts and a comparison with the estimates from April 2005 are given in Table 4.8 at the end of the section.

4.1 The International Environment

Only a gradual recovery in the outlook abroad, and risks of supply-side price pressures

Growth in Slovenia's most important trading partners will be lower this year than last year. The recovery of domestic demand remains considerably uncertain in the eurozone trading partners in particular. Household consumption in these countries remains weak owing to slow wage growth, high oil prices, uncertainty on the labour market and consumer pessimism, while investment activity has been marked to a great extent by the an outflow of investments abroad. Economic growth will therefore be shaped to a significant degree on the basis of a positive contribution by net exports. In addition to the relatively low growth in domestic demand, price pressures in the eurozone will continue to be restricted by the rather unfavourable conditions on the labour market and slow wage growth, even apart from the anticipated tightening of monetary policy. Price pressures on the supply side abroad are also expected to be slightly lower than last year, as it is anticipated that the easing of commodities prices will be accompanied by an end to the rapid rise in oil prices. 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

				2005 Forecast		2006 Forecast		2007 Forecast	
	2002	2003	2004	Nov	Δ	Nov	Δ	Nov	Δ
Foreign demand*	1.9	3.7	5.3	4.5	-1.6	6.0	-0.9	6.0	-0.9
USD/EUR	0.94	1.13	1.24	1.25	-0.07	1.21	-0.11	1.21	-0.11
Oil (USD per barrel)	25	29	38	56	11	65	20	65	20
Commodities	4.6	11.3	16.0	5.0	2.0	3.0	0.0	3.0	0.0
Inflation in EMU (%)	2.2	2.1	2.1	2.2	0.4	1.9	0.2	1.9	0.2
PPI Germany (%)	-0.6	1.7	1.6	4.1	2.2	2.1	0.8	2.1	0.8
3-month Euribor (%)	3.3	2.3	2.3	2.2	-0.2	2.3	-0.5	2.5	-0.6

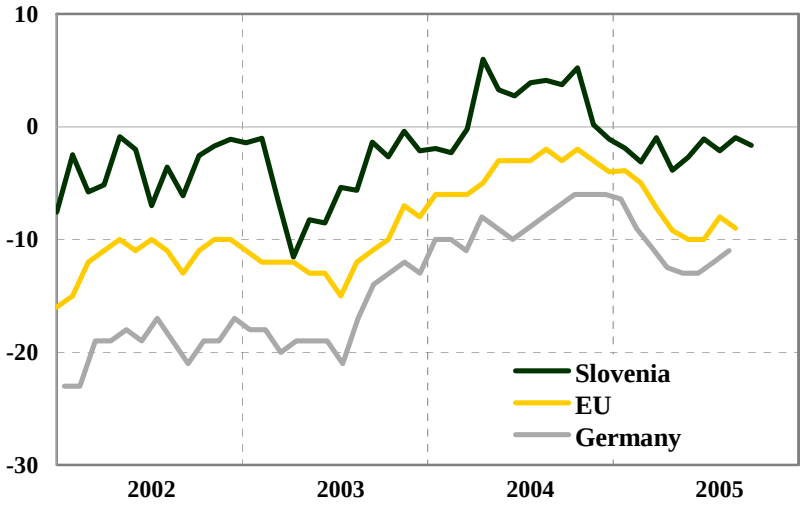
Sources: JP Morgan, Consensus Forecast, OECD Economic Outlook, IMF World Economic Outlook

[4] The forecasts were made on the basis of information available and the statistical methodology applicable on 30 September 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.

Modest domestic spending will in particular hinder the recovery of economic activity abroad

Current forecasts indicate that after stalling at the end of last year and recording limited growth in the first half of this year, foreign demand will begin to strengthen in the second half of this year. Although not all indicators of confidence in the most important trading partners point to this yet, figures for growth in industrial production and exports from the middle of the year do indicate this. Domestic spending remains rather weak in the eurozone partners. Household consumption is being held back by low wage growth and the uncertain conditions on the labour market, while thanks to low labour costs corporate profits should be strengthening and competitiveness increasing, owing to which exports in particular should rise in the future. Exports should be further encouraged by reasonably solid activity in the world economy and a slight fall in the value of euro. Demand from the countries of eastern and south-eastern Europe will remain relatively high, although growth will not be as pronounced as in previous years. The exception is Russia, where demand will remain strong while high oil prices persist.

Figure 4.1: Business confidence in Slovenia and abroad



Sources: SORS, ARC calculations

The dollar has risen against the euro this year…

The US dollar's rise against the euro throughout almost all of this year has been underpinned primarily by the better performance of the American economy compared with the European economy, the political uncertainty in Germany and the gradual increase in the differential between interest rates in the USA and those in the eurozone. Our forecasts employ a technical assumption of a constant value of USD 1.21 to the euro throughout the projection period, which corresponds to the actual average exchange rate in the last month and is also very close to the forecasts of foreign institutions.

…while high oil prices have brought a significant revision to the oil price assumed in the forecast…

This year growth in oil prices strongly exceeded the expectations of the majority of analysts. The main factors in this were tensions in individual oil exporters, unfavourable weather conditions, low stocks and probably speculative oil purchases on world markets. The increased demand this year was not the main factor in high oil prices. Demand for oil rose by 1.5 million barrels per day in the first half of the year, slightly less than on average in 2004, when demand rose by 2.7 million barrels per day from 2003. Developing countries accounted for the largest part of the increase in demand, with China recording the largest rise of 5%. In the aftermath of Hurricane Katrina the oil price rose to almost USD 70 per barrel at the end of August and beginning of September, before falling to between USD 60 and USD 65 per barrel. The majority of analysts nevertheless expect oil prices to remain high. Forward contracts point to oil remaining at around USD 65 per barrel, with prices rising slightly further until the middle of 2006 and then dropping back to a level of USD 65 per barrel. This assumption

entails a revision of USD 11 per barrel or 24% in 2005, and a revision of USD 20 per barrel or 44% in 2006 and 2007 compared with the previous forecasts.

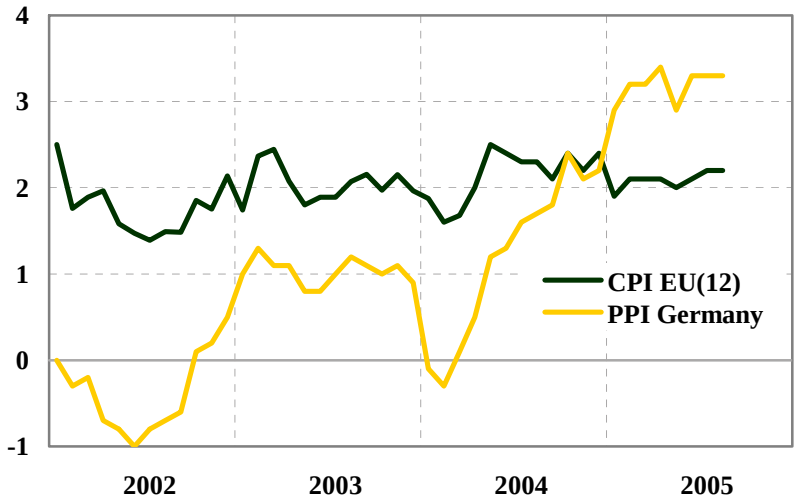
…as well as to commodities prices

After declining in the second half of last year, growth in commodities prices accelerated again this year, peaking in March, before prices then stalled at the high level reached. The level reached is just slightly behind that seen at the beginning of 2004. While the current rates of growth in food prices and metals prices having been negative at the end of last year, the monthly rates of growth were again very high in both cases in the middle of 2005, at around 1.5%. Given that the current rate of growth shows no sign yet of slowing, the assumed movements in commodities prices have been revised upwards slightly from the previous forecast. Contrary to our expectations half a year ago, the still rather low food prices will not fully compensate for high growth in metals' prices, where year-on-year growth averaged in excess of 15% in the first seven months of the year.

Higher inflation is also expected in the eurozone…

The rise to 2.2% in the inflation forecast for 2005 in the eurozone, up from the previous forecast, is mostly the result of the unexpectedly high growth in energy prices, particularly refined petroleum products. However the movement in core inflation has been favourable this year, with inflation in July excluding energy prices and unprocessed food falling from last year's average of 2.0% to 1.4%. The projected fall in inflation in 2006 is primarily the result of statistical effects connected with the proposed health reforms in the Netherlands, which are predicted to cut inflation in the eurozone by 0.2 percentage points. The movement of prices in the coming years will depend to a great extent on the possible transmission of high oil prices into prices of other products. Rapid growth in prices in the energy sector exerted a strong influence on the growth in producer prices of manufactured goods in Germany this year. Prices in other sectors rose slightly more slowly, and for the moment there is no sign of high energy prices being transmitted into prices of manufactured consumer goods, which is probably in part the result of the past appreciation of the euro and the moderate growth in unit labour costs.

Figure 4.2: CPI in eurozone and PPI in Germany



Source: Eurostat

…but interest rates are not likely to rise until the middle of 2006

The interest rates on the euro have remained practically unchanged since June 2003, averaging around 2.3%. The previous expectations of the ECB commencing interest rate rises have not come to pass. Analysts are forecasting that it will be the middle of 2006 before the ECB raises interest rates by 0.25 percentage points, and that it will do so again at the end of 2006, primarily as a result of expectations of a slow improvement in the economic climate in the eurozone.

4.2 Activity, Employment and Wages

Economic growth to remain around 4%

Forecasts for economic growth for the coming years remain as they were in the spring at approximately 4%. GDP growth will remain higher than the estimated growth of between 3.5% and 4% in potential output throughout the period of the projections. This growth will continue to facilitate the process of real convergence with the wealthier EU countries, with economic growth faster than the EU average, although with growth faster than the growth in potential output the output gap will close at the same time.

Table 4.2: Activity, employment and wages

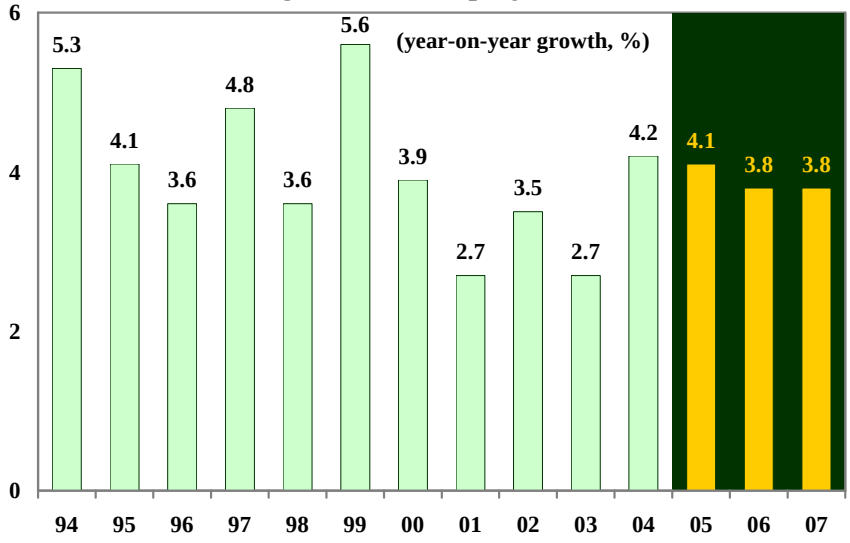
				2005 Forecast		2006 Forecast		2007 Forecast	
	2002	2003	2004	Nov	Δ	Nov	Δ	Nov	Δ
	real growth (%), unless stated otherwise								
Real GDP	3.5	2.7	4.2	**4.1**	**0.2**	**3.8**	**-0.2**	**3.8**	**-0.2**
Per capita GDP (EUR)	11,866	12,461	13,103	**13,829**	**22**	**15,144**	**432**	**16,394**	**694**
Employment	-0.4	-0.3	0.1	**0.7**	**0.1**	**0.3**	**0.0**	**0.5**	**0.0**
Net wages	2.1	1.8	2.1	**4.3**	**1.8**	**2.7**	**0.5**	**2.7**	**0.7**
Gross wages	2.3	1.9	1.6	**2.8**	**…**	**2.7**	**…**	**2.7**	**…**
Productivity	2.5	2.7	3.3	**3.4**	**0.1**	**3.5**	**-0.2**	**3.3**	**-0.2**

Source: ARC

Differing employment trends in the public and private sectors

The continuation of the positive dynamic in employment will primarily be the result of public sector jobs. The reasonably good general economic outlook was reflected this year in developments on the labour market, with the figures in the national accounts reporting that employment rose by 0.8% over the first half of the year on average, the general government sector having recorded a rise of 2.6% and the rest of the economy a rise of 0.4%. In the remainder of the year too a significant proportion of job creation can be expected to come in the public sector, where growth in employment is set to remain around 2% per year, as the structural shifts in the economy and resulting contraction of employment in traditional industrial labour-intensive sectors mean that growth in employment in the private sector will be modest.

Figure 4.3: GDP projections



Source: ARC

Wage growth expected to slow

Having been rapid this year, growth in net wages will stall in the next two years. The main factors in the high wage growth were tax reforms and methodological changes in the statistical monitoring of wages. The divergences in the components of labour costs seen this year will converge in the future. The wage adjustments for the next two years have not yet been agreed for either the private or the public sector. Given the projected growth of 1.6% in average real wages in the public sector in 2005, real wages are also expected to rise in the future on the basis of the budget documents proposed for the next two years. Public sector wages are set to rise by 1.8% in real terms in 2006, and by 2.0% in 2007. Given the favourable economic climate, wage growth in the private sector should outstrip that in the public sector by approximately 1.5 percentage points. According to these estimates the movement of total labour costs in the coming years will be in line with the expected movement in productivity, and will therefore not give rise to inflationary pressures of a cost nature. Should this not happen, a too rapid growth in the element representing the majority of costs at companies could be reflected in inflationary pressures, a decline in competitiveness and a slowdown in employment.

4.3 Components of Spending

The contribution of domestic and foreign components to GDP growth is expected to be more balanced…

After this year, when despite expectations to the contrary net exports generated a significant proportion of economic growth, the contribution of domestic and foreign components will be more similar in the next two years. There will be a revision in the contribution made to economic growth by domestic demand primarily because of acceleration in investment spending and the persistent high level of household consumption.

Table 4.3: Components of spending

	2002	2003	2004	2005 Forecast Nov	2005 Forecast Δ	2006 Forecast Nov	2006 Forecast Δ	2007 Forecast Nov	2007 Forecast Δ
	real growth (%)								
Domestic demand	2.4	4.7	4.6	**3.1**	**-1.2**	**4.1**	**0.3**	**3.6**	**-0.5**
Household consumption	1.3	3.5	3.3	**3.5**	**0.0**	**3.4**	**0.2**	**3.2**	**0.2**
General government	3.2	1.6	2.9	**2.5**	**0.1**	**2.5**	**0.4**	**2.5**	**0.5**
Gross capital formation	4.0	10.1	9.2	**2.6**	**-4.4**	**7.0**	**1.0**	**5.3**	**-1.9**

Source: ARC

…after the high contribution by net exports in 2005

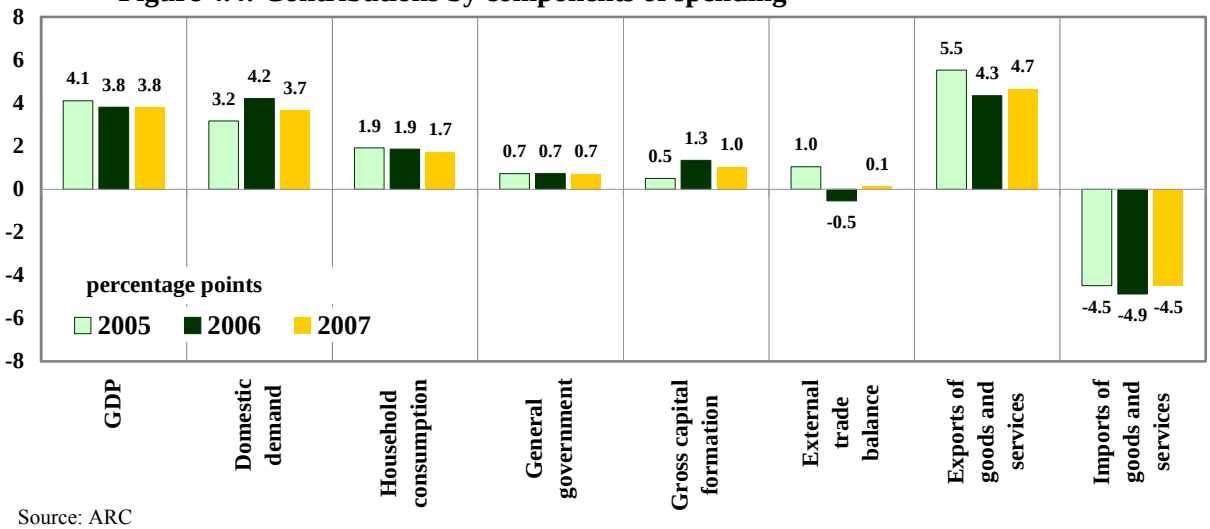
The contribution made to economic growth by net exports in 2005 will be larger than originally forecast. There was a rise in 2005 despite the expectations of slower growth in foreign demand, which reflects the pace of export growth compared with import growth. The contribution made to economic growth by net exports in 2006 and 2007 will be slightly lower than this year in the context of an improvement in the foreign economic climate and gradual growth in domestic demand. Therefore a further delay in the revival of activity in the most important trading partners could in particular lead to lower economic growth in Slovenia being lower than currently forecast in the projection period.

Household spending will remain solid…

Household consumption will remain reasonably high, the main factors in this being temporary high growth in net wages, the relatively favourable terms of financing and the positive outlook regarding employment. The wage policy agreements will probably restrict excessive increases in disposable income, while institutional changes in the area of pension insurance will encourage people to make use of more long-term forms of saving. The fact that the wage agreement for the period after 2005 has not yet been reached introduces uncertainty to the

forecast. Because pension rises have been tied to wages since the middle of this year, disposable income from pensions also represents a risk to the realisation of the household consumption forecast.

Figure 4.4: Contributions by components of spending

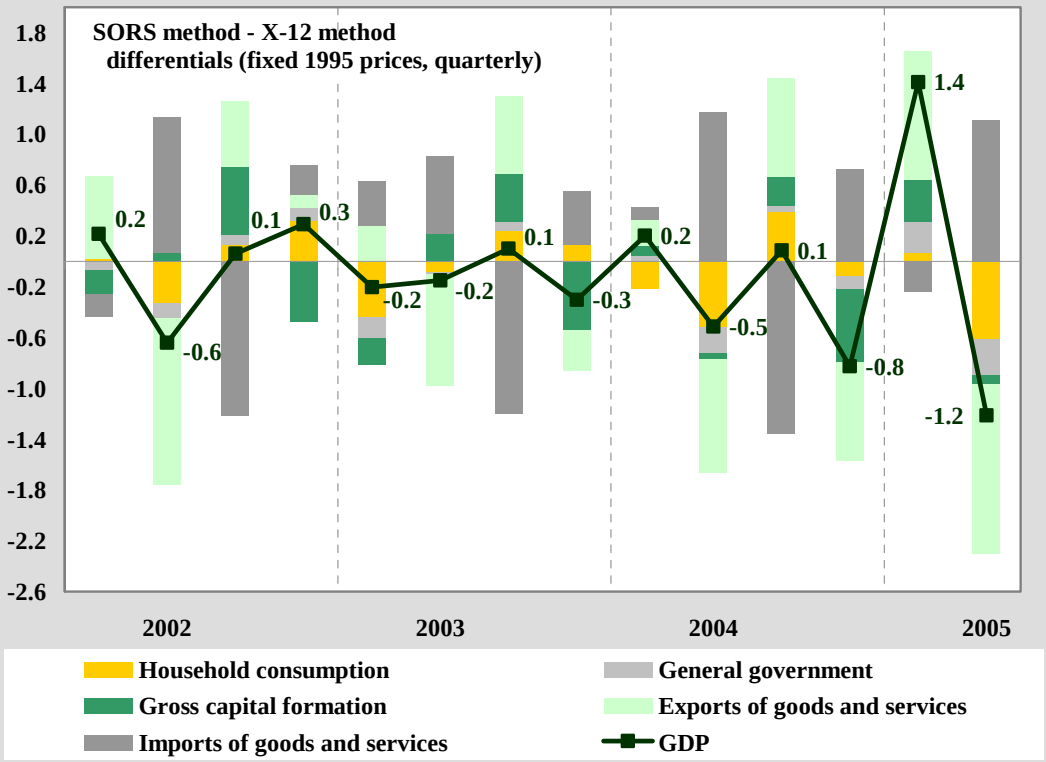


Source: ARC

Box 4.1: Differences in methods of seasonal adjustment

The quarterly current changes in GDP aggregates are the freshest data and therefore give key information about possible changes in the trends of economic activity. These figures contain a seasonal component, which needs to be excluded for a precise interpretation of the trend. The most common methods of seasonal adjustment are the Tramo-Seats and X-12 programs. Tramo-Seats takes a model approach, meaning that it first excludes foreign elements from the time series

Figure: Differential between seasonally adjusted current growth figures



Source: SORS, ARC calculation

using the ARIMA model, and then decomposes it into trend/cycle, the seasonally adjusted series and the non-regular component. The X-12 empirical method makes direct use of a package of filters that distinguish all three components of the time series.

The Statistical Office of the Republic of Slovenia (SORS) has opted to use the Tramo-Seats method, while the Bank of Slovenia's ARC uses X-12 for analytical purposes. The differences between these methods are insignificant over long and relatively regular time series. Large discrepancies can occasionally appear, and these need to be investigated and analysed.

In the final quarter of 2004 and in the first two quarters of 2005 in particular there were relatively large discrepancies between the seasonally adjusted figures for current GDP growth according to the X-12 method and those published by the SORS. The figure illustrates the discrepancies between the series measured as the proportions for GDP components. It clearly shows that the discrepancy in export growth is the key factor in the overall discrepancy.

Last year had an unusually high number of working days. The final quarter of 2004 had 65 working days, compared with the average of 62.8 for this quarter since 1995. The SORS figures seasonally adjusted using the Tramo-Seats method, which takes the total number of working days (not just the working days of the week) into consideration, recognise lower seasonal growth than that identified by the X-12 method. In terms of the number of working days the first quarter of 2005 did not differ from the average (62 compared with the average of 62.1), but failing to take account of the high number of working days in the previous quarter could see growth underestimated in the first quarter. The second quarter had 63 working days (compared with the average of 61.4), which had a positive effect on GDP and partly explains why the Bank of Slovenia's seasonally adjusted figures reveal higher growth than the SORS method.

The advantage of the Tramo-Seats method is that it directly estimates the effect of the number of working days, but it is also the case that it gives very different results from other methods, depending in particular on the parameters defined for the computer package. The two methods are of equal quality and are both reliable. For consistency of modelling it would be best to use one method of seasonal adjustment, but it makes sense to monitor other methods to identify and where possible adjust discrepancies, which should make forecasting as accurate as possible. We feel that in the future it will be necessary to focus most attention on fluctuations in seasonally adjusted figures for foreign trade, which are perhaps the result of Slovenia joining the EU, and the associated changes in the trend of import and export growth.

….investment activity will gradually strengthen…

Following low growth this year, investment activity will again accelerate in the next two years, thus contributing to 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 almost zero growth in investment expenditure in the first half of this year was the result of the high investment activity last year and the accumulation of inventories. Housebuilding is expected to continue recording high growth, while investments in equipment will grow slightly more slowly. 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 rather slow.

…while general government spending will remain reasonably stable

The contribution to economic growth made by general government spending this year will be slightly lower than last year. General government spending was the slowest-growing component of domestic demand in 2004. It is expected to remain so throughout the projection period, despite the recent increases in both the year-on-year and the current rates of growth in government spending. Despite the relatively low basis from 2004 and the transmission of wage growth in 2005, the public sector wage agreement having been taken into consideration, owing to the restrictive policy of expenditure on goods and services, government spending in 2005 will not strengthen from 2004, and the contribution made to economic growth by government spending will therefore decline. General government spending after 2005 should remain similar, and grow at close to 2.5% per year.

4.4 Balance of Payments

Current projections show no significant deviation from previous forecasts

The estimated current account deficit in the coming years will remain around 1.5% of GDP. It rose from 0.4% of GDP in 2003 to 2.1% of GDP in 2004. This projection does not represent any significant deviation from the previous forecasts. The main factors in the decline in the deficit in 2005 from the previous year will be the unexpected favourable export trend and the significantly slower growth recorded by imports, which is the result of slower growth in investments and a reduction of inventories. The growth dynamics of exports and imports will be roughly equal in the coming years, and the terms of trade can be expected to have a neutral effect on the current account.

Table 4.4: Current account

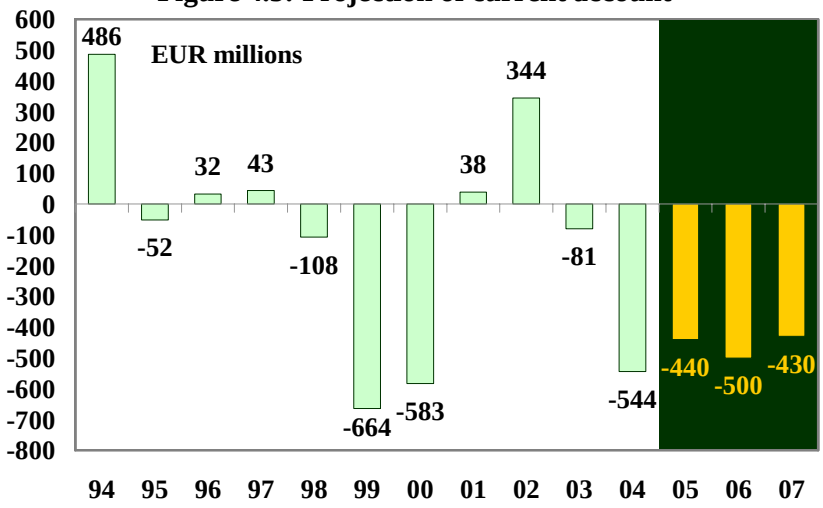
				2005 Forecast		2006 Forecast		2007 Forecast	
	2002	2003	2004	Nov	Δ	Nov	Δ	Nov	Δ
	real growth (%) unless stated								
Exports of goods and services	6.7	3.1	12.5	**8.5**	**1.8**	**6.4**	**-0.9**	**6.7**	**-0.6**
Imports of goods and services	4.8	6.7	13.2	**6.6**	**-0.6**	**7.0**	**0.2**	**6.3**	**-0.7**
Current account (EUR millions)	344	-81	-544	**-440**	**0**	**-500**	**-140**	**-430**	**-50**
(% of GDP)	1.5	-0.4	-2.1	**-1.6**	**0.0**	**-1.7**	**-0.4**	**-1.3**	**-0.1**
Terms of trade	0.5	1.3	-1.0	**-0.4**	**0.4**	**-0.1**	**0.0**	**0.1**	**-0.1**

Source: ARC

A current account deficit of around 1.5% of GDP in the future

The estimated current account deficit in 2005 will amount to 1.6% of GDP. The current account position will thus improve from the result in 2004. The deficit will fall from last year's figure of EUR 544 million to approximately EUR 440 million, or 1.6% of GDP. It will remain very similar in 2006, at around 1.7% of GDP. With foreign demand accelerating, the deficit will be reduced to around 1.3% of GDP in 2007.

Figure 4.5: Projection of current account



Source: ARC

The expected favourable movements in trade in goods are associated with considerable risks

The largest contribution to the improvement in the current account balance will be a decline in the deficit in trade in goods. An improvement in goods exports and a decline in goods imports will both contribute to the decline in the goods trade deficit. The faster growth in goods exports is primarily the result of above-average exports by the car industry, but the current dynamics will slow slightly

in the future. With domestic demand continuing to grow, the current rate of growth in imports will equalise with that in exports. There are several risks to the projection for the balance of trade in goods. The first is connected with the time delay and the size of the improvement in the foreign economic activity and the consequent movement in Slovenian exports. The second risk consists of further growth in domestic demand and the consequent movement in imports of goods. The third risk is the movement in the terms of trade, which is closely tied to the movement of commodities prices on world markets.

The terms of trade continued to exert a negative influence in 2005

The terms of trade will continue to have a slight negative impact on the current account in 2005, but a neutral effect over the remainder of the projection horizon. Increases in import prices will exceed growth in export prices by 0.4 percentage points in 2005, but rises in export and import prices will equalise in the next two years. Thus the terms of trade will bring a deterioration of approximately 0.2% of GDP in the current account deficit in 2005. The main factor in import prices growing faster than export prices is the rapid rise in oil prices and commodities prices, which is assumed to slow down in the future and will contribute to the more balanced growth in export and import prices. The assumptions of no change in oil prices and of slow growth in commodities prices represent the largest risk in the forecast of the terms of trade. Unfavourable shocks on world markets could bring deterioration in the terms of trade and the current account.

With the services balance and the income balance reasonably stable…

The balance of trade in services will move in line with the persistence of relatively low domestic demand and the recovery of economic activity abroad. The services balance will therefore improve slightly even in 2005. Net labour income will remain unchanged, while net capital income will deteriorate due to unfavourable movements in external debt on one side and because of reinvested earnings from non-residents' foreign direct investments in Slovenia on the other.

…the expected improvement in the transfers balance is associated with risks

With Slovenia having joined the EU, inward transfers are expected to increase slightly. They were lower than expected in the first half of the year, but the August figures indicate that a turnaround could occur in this area. Should there be a turnaround in the movement of official transfers, the current account position in 2005 could improve by just over EUR 100 million or 0.5% of GDP. Because disbursement of transfers is primarily connected to the ability to co-finance domestic projects from domestic sources, projected transfers remain a significant risk factor in the forecast for the current account.

4.5 Terms of Financing

Strong surplus in flows with the rest of the world…

The projected movement in the real sector and in the current account will be reflected in the volume and ways of financing the economy. The amount of financial transactions with the rest of the world is expected to continue to grow in the coming years. The volume of financial transactions with the rest of the world will increase in both directions. This is the result of Slovenia's increasing integration into the single European market, which is reducing risks for foreign investors, the small size of the domestic market and the total openness of capital flows. This allows residents to seek additional sources of financing or investments abroad. It is forecast that over the next three years the financial account will be reasonably strongly in surplus, with net financial inflows rising from approximately 2% of GDP in 2005 to around 3% of GDP in 2007. The main reason for the increase in net financial inflows in 2005 in comparison with previous projections is an increase in inflows via banks' borrowing abroad. The assumed increase in deposits by non-residents will also bring a net inflow in the coming years. Outflows via financial transactions will primarily be the result of net direct investments abroad by residents and outflows via investments in

foreign securities. The net outflow in 2005 will to a great extent also be the result of the matured government eurobonds.

Table 4.5: Financial flows with the rest of the world

	2002	2003	2004	2005 Forecast Nov	2005 Forecast Δ	2006 Forecast Nov	2006 Forecast Δ	2007 Forecast Nov	2007 Forecast Δ
Financial account (% of GDP)	4.9	0.6	-0.1	**1.9**	**3.9**	**2.4**	**1.7**	**3.1**	**2.0**
of which FDI	6.6	-0.5	0.9	**-0.5**	**-1.0**	**0.3**	**-0.9**	**-0.2**	**-1.2**
Foreign exchange reserves (EUR mio)	7,842	7,881	7,891	**7,981**	**658**	**8,221**	**654**	**8,811**	**792**
- % of BDP	34.1	32.7	31.1	**28.9**	**2.3**	**27.1**	**1.4**	**26.9**	**1.3**
External debt (EUR millions)	11,483	13,051	15,397	**17,945**	**1,327**	**20,196**	**1,918**	**22,616**	**2,728**
- % of BDP	49.9	54.1	59.5	**64.9**	**4.7**	**66.7**	**4.6**	**69.0**	**5.7**

Source: ARC

…in the context of favourable terms of financing

The terms of financing will remain relatively favourable. Together with Slovenia's low risk premium, low interest rates abroad will allow relatively cheap access to sources of financing.

Major fluctuation in net direct investments is expected

Net inflows via direct investment will fluctuate in the coming years between an outflow of EUR 150 million in 2005 and an inflow of EUR 100 million in 2006, while the net outflow via portfolio investments by the private sector will increase. With regard to direct investments, a rise is expected in both foreign investment in Slovenia and investments abroad by Slovenian companies. Major inflows from foreign direct investment are expected in the car industry. Given the numerous announcements by business figures concerning investments abroad that are intended or already underway, it is expected that in the coming years Slovenian investments abroad will also increase, particularly in the Balkans and in countries in transition. On the financial outflow side, portfolio investments abroad will continue to rise and will exceed those recorded last year. This year's lower returns on the domestic stock market will probably limit the number of new investors, while at the same time a greater proportion of investments will be directed abroad, in part to the higher-risk markets of eastern Europe.

A rise in foreign exchange reserves and in the external debt

With the deficit in the current account stable and net inflows in financial transactions with the rest of the world, foreign exchange reserves will rise in the coming years. The external debt will increase mainly as a result of private sector borrowing, and both its proportion to GDP and a proportion to exports of goods and services will be approximately 10 percentage points higher than in 2004.

An increase in loan activities with the rest of the world…

There will also be a slight increase in the volume of foreign loans received and loans made abroad, although the balance will remain at the level reached in 2004. With economic activity remaining high in 2005, banks will be forced by the low growth in domestic deposits to continue seeking some sources of financing abroad for their lending activities, while the volume of loans taken abroad by companies will halve from 2004. In part banks are set to continue borrowing abroad by issuing bonds abroad, as they did at the end of last year and also in 2005.

…will make a significant contribution to the high total volume of domestic and foreign financing

The total volume of domestic and foreign financing will remain relatively high in the coming years, although the borrowing dynamics will begin to gradually decline. These movements are in line with the continuation of relatively high economic activity and the high level of domestic spending. On account of the rise in banks' borrowing abroad and in foreign currency lending to companies, the proportion of corporate financing accounted for by foreign loans will decrease from approximately one-third of total lending in 2004 to less than one-fifth this year and in the next two years. In line with the ongoing restructuring of debt, government borrowing on the domestic market will also rise rapidly. With

banks borrowing heavily abroad, foreign currency lending will record the fastest growth among domestic lending. Given the large amount of bank borrowing from abroad this is understandable, as banks will thus bring the asset and liability sides of their balance sheets into line in terms of currency.

Heavier indebtedness on the part of companies and households

Relatively strong spending will also bring about an increase in corporate and household borrowing in the coming years, albeit with a slightly slower dynamics than last year. The trend of rapid growth in borrowing seen in the last year will slow slightly, particularly in the household sector. Net corporate borrowing as measured by the ratio of lending to deposits will increase a little further primarily because of the rapid growth in foreign currency lending taken at domestic banks, while net household borrowing will remain at the current level. Another feature of the growth in household borrowing up until the middle of 2005 was the release of savings from the National Housing Saving Scheme. Growth in borrowing will fall off by the end of the year and for the rest of the projection period. This is despite the release of savings from the second NHSS scheme at the end of 2005, owing to the relatively low volume of money saved, just one-third of the first scheme.

The trend of an increase in long-term borrowing at the expense of short-term borrowing will continue in the coming years. On the side of demand for long-term lending, the acceleration of investment expenditure will be the main factor in this.

Flows with the rest of the world will again make a positive contribution to the creation of broad money…

Broad money is expected to be generated both via domestic lending activity and via balance of payments flows. Because the net financial flow will exceed the current account deficit, the negative contribution made towards broad money growth by flows with the rest of the world seen in recent years will decline and will even become positive. Relatively high spending will mean that growth in domestic lending remains fairly high.

Table 4.6: Monetary system

				2005 Forecast		2006 Forecast		2007 Forecast	
	2002	2003	2004	Nov	Δ	Nov	Δ	Nov	Δ
	average annnual growth (%)								
M1	16.9	12.3	20.8	**20.2**	**2.7**	**14.4**	**1.0**	**13.2**	**1.1**
M3	23.5	14.1	5.3	**7.1**	**-0.7**	**9.8**	**2.2**	**11.8**	**4.0**
Total lending	17.3	11.8	18.2	**18.5**	**-3.3**	**17.3**	**-0.4**	**15.2**	**-0.3**

Source: ARC

…while the high current growth in narrow money is to slow

Owing to net inflows from the rest of the world and lower investments in alternative forms of saving, growth in the broad money aggregates will be slightly faster than previously forecast, but the year-on-year rates of growth will nevertheless not significantly exceed 10%. Narrow money growth will remain slightly higher, in line with the relatively strong economic activity and the high level of price stability achieved.

An increase in the share of short-term 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 interest rate yield curve is declining.

4.6 Inflation

Inflation of around 2.5% in the future

The disinflation process has come to an end this year, as the inflation reached around 2.5% on average to September, which is at the lower threshold of the long-term balance that can be expected in an economy still undergoing the process of real convergence. The inflation rate is expected to fluctuate around the long-term balance, with regard to the macroeconomic and structural shocks that could occur in the future. Taking exogenous variables and assumptions about economic policy into consideration, inflation will rise slightly in the final quarter of this year to average 2.6% over the year. A similar level of inflation can be expected in the next two years, with an average of 2.6% in 2006 and approximately 2.4% in 2007.

The Maastricht criteria are expected to be met by the beginning of 2006

The 12-month average of year-on-year inflation rates as measured by the harmonised index of consumer prices will continue to fall, and will stand at approximately 2.6% when the Maastricht criteria are measured, which is expected to take place in the first half of next year. Some forecasts place this slightly below the reference value for the Maastricht criterion. Thus Slovenia will also meet the price stability criterion on time, which will allow the euro to be adopted as planned in 2007.

Upward revisions in price rises in 2005 as a result of high oil prices

Comparing to the April forecasts revisions are primarily the result of the unexpected high growth in oil prices in the third quarter, which will also lead to inflation at the end of the year being higher than forecast back in April. The downward revisions for 2006 and 2007 are mainly connected with the projected slower growth in free prices, and consequently also with slower growth in other administered prices excluding energy prices. With economic activity growing slightly more slowly in the next two years, the positive output gap will also open slowly, thus making growth in free prices lower than forecast in April.

Table 4.7: Inflation

				2005 forecasts		2006 forecasts		2007 forecasts	
	2002	2003	2004	Nov.	Δ	Nov.	Δ	Nov.	Δ
	annual growth (%; final quarter)								
Consumer prices	7.2	4.8	3.4	2.8	0.4	2.3	-0.3	2.4	-0.4
Free prices	6.9	5.1	2.1	1.5	-0.7	2.6	-0.1	2.7	-0.3
Administered prices	8.8	3.7	9.5	8.5	4.9	1.1	-0.3	1.1	-0.3
	average annual growth (%)								
Consumer prices	7.5	5.6	3.6	2.6	0.1	2.6	0.1	2.4	-0.2
Free prices	7.6	5.9	3.0	1.2	-1.1	2.4	-0.2	2.7	-0.2
Administered prices	7.5	4.8	6.6	9.1	4.6	3.6	2.2	1.1	-0.3

Source: ARC

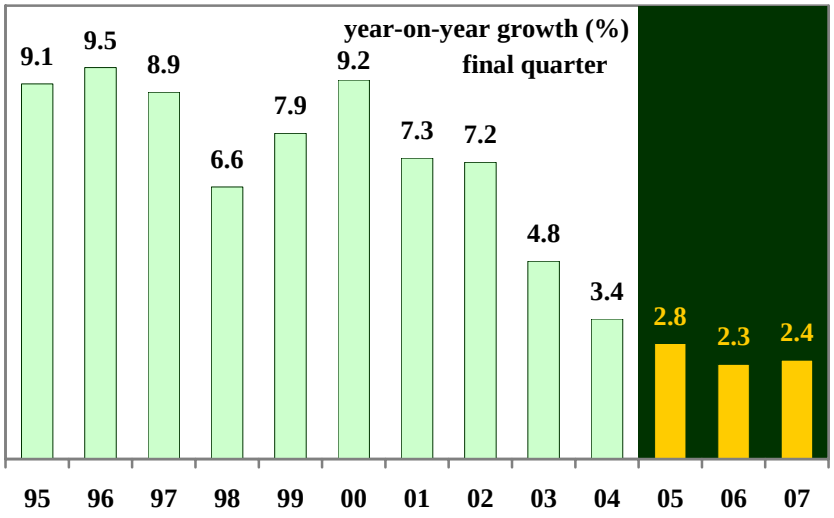
Growth in free prices will remain low…

After the extremely low rates recorded this year, growth in free prices will gradually increase. Our forecasts are for year-on-year growth in free prices of 1.5% in the final quarter of 2005, and then higher growth of 2.6% in the final quarter of 2006 and 2.7% in the final quarter of 2007. There are several factors primarily affecting growth in free prices in the future. The gradual closing of the output gap will end the pressures for lower inflation seen to date. A limited deferred transmission of high growth in energy prices into free prices can be expected to begin. Prices of food and non-alcoholic beverages, which recorded extremely low rates of growth this year, can be expected to rise slightly more quickly, in line with prices in EU trading partners.

…while administered prices will also contribute to maintaining the inflation level reached…

With free prices growing faster, the projected slowdown in the growth in administered prices, which is an implicit consequence of the assumption that energy prices will remain unchanged, is expected to compensate for higher growth in free prices and therefore contribute to lower inflation. According to our assumptions regarding developments in administered prices, energy prices will depend on the assumption of unchanged oil prices on the world markets, and hence prices of refined petroleum products on the domestic market will remain unchanged as well. At the same time it was assumed that all other administered prices will move in line with free prices determined by the macroeconomic model. Thus growth in administered prices overall will continue to exceed growth in free prices in 2005 and 2006, while in 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. Therefore, a major risk involved in these projections regards oil price developments, which in the event of significant deviation from our assumptions could prevent the projected fall in growth in administered prices.

Figure 4.6: Inflation projections



Source: ARC

…as will the projected slowdown in prices in the international environment

The exogenous assumptions from the international environment point to an easing of inflation pressures from abroad. After this year's faster rate of 2.2%, growth in consumer prices in the eurozone is expected to decline to 1.9% in the next two years. Growth in producer prices in Germany, Slovenia's biggest trading partner, should also decline. Despite the assumptions of recovery in world economic activity after 2005, with increasingly restrictive monetary policy abroad this should not entail any significant inflationary pressures.

Given the inflation risks of excess demand and excessive wage growth…

Elements of the domestic macroeconomic environment warn of a gradual rise in inflation of free prices towards the projected long-term path. The continuation of favourable economic activity will probably lead to the complete closure of the output gap in the future, which will gradually begin to heat the economy and increase inflationary pressures. Nevertheless, after the temporarily higher wage growth seen this year, the wage growth is expected to ease to 2.7% in the next two years, and will thus remain below productivity growth. The main risk regarding excessive wage growth is the failure to reach a wage agreement for 2006 and 2007 in either the private or the public sector. Given the projections of domestic and foreign price developments, the real effective exchange rate will remain in balance and will not have any noticeable effect on prices or competitiveness.

In the coming years, fiscal policy and administered prices policy will assume the decisive role in maintaining a sustainable level of inflation. In its adjustment of excise duties the government had already reached the minimum allowable level by August this year. Because of high oil prices the government has lowered excise duties this year to the minimum levels allowed by EU regulations. However, it was unable to entirely prevent increases in 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 prices of refined petroleum products will remain unchanged and that the government will leave excise duties unchanged. 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 estimates show that increases in indirect taxation will raise inflation by 0.2 percentage points in both 2005 and 2006.

…fiscal, incomes and administered prices policies will all play a key role in maintaining low price growth

Box 4.2: Forecasts and short-term effects of the tax system and labour market reforms

Slovenia is preparing for the introduction of structural reforms that could affect the potential supply of the economy, thus temporarily affecting economic growth. Here, in the light of making forecasts of economic developments, it is necessary to analyze the short-term effects of the reforms and possible responses of macroeconomic policy. This applies in particular to structural reforms of the labour market and adjustments to the tax system.

Many cases show that reforms of the labour market have a negative short-term effect on economic growth and employment, but over the long term positive effects prevail. In the short term reforms could lead to an increase in uncertainty and a decrease in confidence, thereby causing a temporary contraction in demand and lower economic activity. In addition the usual purpose of labour market reform is to increase the migration of workers from less-productive sectors to more prospective sectors. In the short term the loss of jobs in less productive sectors could be faster than job creation in more prospective sectors, which could cause at least a temporary rise in unemployment. The IMF conducted one of the rare empirical research projects on the dynamic effects of labour market reforms.[i] Analysis on the basis of the figures from 12 developed countries assesses the effects of indicators of wider reforms. For labour market reforms calculations show that they indeed have a negative short-term effect and positive long-term effect on economic activity and employment. Similar conclusions were reached by Salgado (2002), who additionally found that there was no direct short-term or long-term correlation between the rigidity of the labour market and the productivity of the economy.[ii] Reforms of the labour market thus represent a specific risk to short-term economic dynamics, while the actual effects of the reforms are also considerably dependent on the characteristics and current status of the domestic economy, and on the presentation of the reforms and their consequences to the public.

In the area of tax reforms, the potential raising of the reduced VAT rate would most likely bring an increase in inflation, at least temporarily, which has also been the experience in Slovakia. Before 2003 the upper VAT rate in Slovakia was 23%, and the reduced rate was 10%. The introduction of a flat VAT rate was done gradually, with a cut in the upper rate to 20% and a rise in the reduced rate to 14% in 2003, before final introduction of a flat rate of 19% in 2004. Despite the cut in the higher rate and negative growth in unit labour costs the gradual rise in the reduced VAT rate had a significant impact on inflation in Slovakia in 2003 and 2004, increasing it by approximately 1 percentage point.[iii] This is the expected outcome of an asymmetric rise in consumption tax rates, as changes in relative prices cause a rise in price levels owing to the short-term downward price rigidity. In the case of products and services with a low level of elasticity, such as food and public transport, this effect is greater. Analysis of the inflationary effects that result from a rise in consumption taxes is vital when preparing economic policy measures to prevent the occurrence of inflation-wage spirals, which could emerge from wage rises owing to rises in price levels. Similar effects were seen in Slovenia when VAT was introduced in 1999.

Detailed analysis of the risks associated with structural reforms is also necessary in order to optimise the actual process of carrying out the reforms. Some research shows that negative short-term economic trends within a wide package of

decisive reforms can trigger public reluctance to the reforms and thus a subsequent overturning of reform efforts.[iv] Reforms should therefore be made in a composition and tempo that not only ensures maximum long-term growth but also mitigates as far as possible any adverse short-term effects. Merlevede and Schoors (2005) also found that the experience of transition countries seems to be pointing to the advantage of a gradualist approach to reforms in comparison with shock therapies. Dewatripont and Roland (1995) additionally show that the gradualist approach is preferable to the big bang approach, when there exists uncertainty regarding the optimal set of reforms.[v] Because there are considerable differences in the structure of individual economies, in practice it is extremely difficult to determine what type of reform is the most appropriate for a particular country. The experimentation costs are lower in the case of gradualist reforms than in the case of radical reforms.

[i] IMF (2004), *World Economic Outlook, Ch.3, Fostering Structural Reforms in Industrial Countries*, April

[ii] Salgado, Ranil (2002), *Impact of Structural Reforms on Productivity Growth in Industrial Countries*, IMF Working Paper, October

[iii] Annual Report (2004), (2003), *National Bank of Slovakia.*

[iv] See for example Merlevede, Bruno, and Koen Schoors (2005), *On the Speed of Economic Reform: Tale of the Tortoise and the Hare*, BOFIT Discussion Papers, November

[v] Dewatripont, Mathias and Gerard Roland (1995), *The Design of Reform Packages under Uncertainty,* American Economic Review, vol. 85(5), pages 1207-23

Box 4.3: Forecasts of 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, although 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 smaller this time than in the previous round of forecasts, they still amount to 1.2 GDP percentage points in 2005 and 1.3 GDP percentage points in 2006. Almost all the institutions are forecasting that the deficit in 2005 will persist in 2006.

The inflation forecasts also differ. Forecasts of average annual inflation range from 2.5% to 2.6% for 2005, and from 2.0% to 2.6% for 2006. The differences between the inflation forecasts by domestic institutions and those by foreign institutions have also reduced significantly in the last half-year.

Table: Comparison of forecasts for Slovenia and change since previous forecast

	Publication of new/previous forecast	GDP annual growth (%)				Inflation annual average (%)				Current account % of GDP			
		2005		2006		2005		2006		2005		2006	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Nov 05 / Apr 05	**4.1**	0.2	**3.8**	-0.2	**2.6**	0.1	**2.6**	0.1	**-1.6**	0.0	**-1.7**	-0.4
EIPF	Sep 05 / Mar 05	**4.1**	0.3	**4.8**	0.4	**2.6**	-0.2	**2.0**	-0.2	**-1.9**	0.0	**-1.6**	0.0
IMAD	Oct 05 / Apr 05	**3.9**	0.1	**4.0**	-0.1	**2.5**	0.0	**2.5**	0.2	**-1.6**	-0.7	**-0.7**	-0.9
IMF	Oct 05	**3.9**	…	**4.0**	…	**2.6**	…	**2.5**	…	**-1.6**	…	**-0.8**	…
Consensus Forecasts	Oct 05 / Mar 05	**3.8**	0.0	**3.9**	0.0	**2.5**	-0.5	**2.4**	-0.4	**-0.4**	-0.3	**-0.4**	-0.3

Sources: Bank of Slovenia, UMAR, EIPF, European Commission Economic Forecasts, IMF World Economic Outlook, Consensus Economic Forecasts

Table 4.8: Selected main indicators

	2002	2003	2004	2005 Forecast Nov	2005 Forecast Δ	2006 Forecast Nov	2006 Forecast Δ	2007 Forecast Nov	2007 Forecast Δ
Activity, employment, wages	*real growth (%) unless stated*								
Real GDP	3.5	2.7	4.2	**4.1**	**0.2**	**3.8**	**-0.2**	**3.8**	**-0.2**
Per capita GDP (EUR)	11,866	12,461	13,103	**13,829**	**22**	**15,144**	**432**	**16,394**	**694**
Employment	-0.4	-0.3	0.1	**0.7**	**0.1**	**0.3**	**0.0**	**0.5**	**0.0**
Net wages	2.1	1.8	2.1	**4.3**	**1.8**	**2.7**	**0.5**	**2.7**	**0.7**
Productivity	2.5	2.7	3.3	**3.4**	**0.1**	**3.5**	**-0.2**	**3.3**	**-0.2**
Domestic demand	*real growth (%)*								
Domestic demand	2.4	4.7	4.6	**3.1**	**-1.2**	**4.1**	**0.3**	**3.6**	**-0.5**
Household consumption	1.3	3.5	3.3	**3.5**	**0.0**	**3.4**	**0.2**	**3.2**	**0.2**
General government	3.2	1.6	2.9	**2.5**	**0.1**	**2.5**	**0.4**	**2.5**	**0.5**
Gross capital formation	4.0	10.1	9.2	**2.6**	**-4.4**	**7.0**	**1.0**	**5.3**	**-1.9**
Balance of payments	*real growth (%) unless stated*								
Exports of goods and services	6.7	3.1	12.5	**8.5**	**1.8**	**6.4**	**-0.9**	**6.7**	**-0.6**
Imports of goods and services	4.8	6.7	13.2	**6.6**	**-0.6**	**7.0**	**0.2**	**6.3**	**-0.7**
Current account (EUR millions)	344	-81	-544	**-440**	**0**	**-500**	**-140**	**-430**	**-50**
(% of GDP)	1.5	-0.4	-2.1	**-1.6**	**0.0**	**-1.7**	**-0.4**	**-1.3**	**-0.1**
Terms of trade	0.5	1.3	-1.0	**-0.4**	**0.4**	**-0.1**	**0.0**	**0.1**	**-0.1**
Financial account (% of GDP)	4.9	0.6	-0.1	**1.9**	**3.9**	**2.4**	**1.7**	**3.1**	**2.0**
of which FDI	6.6	-0.5	0.9	**-0.5**	**-1.0**	**0.3**	**-0.9**	**-0.2**	**-1.2**
Foreign exchange reserves (EUR mio)	7,842	7,881	7,891	**7,981**	**658**	**8,221**	**654**	**8,811**	**792**
- % of BDP	34.1	32.7	31.1	**28.9**	**2.3**	**27.1**	**1.4**	**26.9**	**1.3**
External debt (EUR millions)	11,483	13,051	15,397	**17,945**	**1,327**	**20,196**	**1,918**	**22,616**	**2,728**
- % of BDP	49.9	54.1	59.5	**64.9**	**4.7**	**66.7**	**4.6**	**69.0**	**5.7**
Monetary system	*average annual growth (%)*								
M1	16.9	12.3	20.8	**20.2**	**2.7**	**14.4**	**1.0**	**13.2**	**1.1**
M3	23.5	14.1	5.3	**7.1**	**-0.7**	**9.8**	**2.2**	**11.8**	**4.0**
Total lending	17.3	11.8	18.2	**18.5**	**-3.3**	**17.3**	**-0.4**	**15.2**	**-0.3**
Prices	*annual growth(%; final quarter)*								
Consumer prices	7.2	4.8	3.4	**2.8**	**0.4**	**2.3**	**-0.3**	**2.4**	**-0.4**
Free prices	6.9	5.1	2.1	**1.5**	**-0.7**	**2.6**	**-0.1**	**2.7**	**-0.3**
Administered prices	8.8	3.7	9.5	**8.5**	**4.9**	**1.1**	**-0.3**	**1.1**	**-0.3**
	average annual growth (%)								
Consumer prices	7.6	5.6	3.7	**2.6**	**0.1**	**2.6**	**0.1**	**2.4**	**-0.2**
Free prices	7.61	5.9	3.0	**1.2**	**-1.1**	**2.4**	**-0.2**	**2.7**	**-0.2**
Administered prices	7.5	4.8	6.6	**9.1**	**4.6**	**3.6**	**2.2**	**1.1**	**-0.3**
International environment	*annual growth (%) unless stated*								
Foreign demand*	1.9	3.7	5.3	**4.5**	**-1.6**	**6.0**	**-0.9**	**6.0**	**-0.9**
USD/EUR	0.94	1.13	1.24	**1.25**	**-0.07**	**1.21**	**-0.11**	**1.21**	**-0.11**
Oil (USD per barrel)	25	29	38	**56**	**11**	**65**	**20**	**65**	**20**
Commodities	4.6	11.3	16.0	**5.0**	**2.0**	**3.0**	**0.0**	**3.0**	**0.0**
Inflation in EMU	2.2	2.1	2.1	**2.2**	**0.4**	**1.9**	**0.2**	**1.9**	**0.2**
PPI Germany	-0.6	1.7	1.6	**4.1**	**2.2**	**2.1**	**0.8**	**2.1**	**0.8**
3-month Euribor	3.3	2.3	2.3	**2.2**	**-0.2**	**2.3**	**-0.5**	**2.5**	**-0.6**

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

5 ECONOMIC POLICY IN LIGHT OF EURO ADOPTION

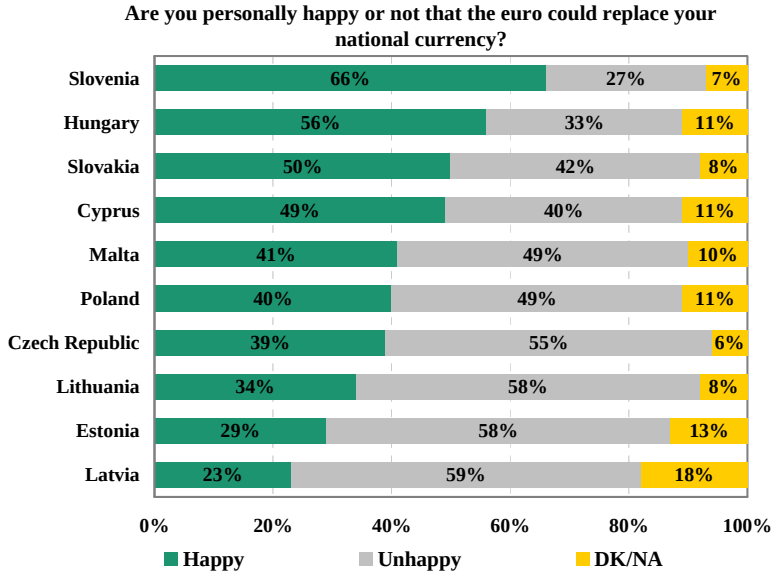
Adopting the euro is the main focus of economic policy in Sloveniain Slovenia

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, in which they committed themselves to creating the conditions to allow the euro to be introduced at the beginning of 2007.[5] In it they also emphasised the importance of the effective and credible coordination of economic policy. A coordinating committee for technical preparations for the introduction of the euro was created when the ERM II was joined, with the Bank of Slovenia and the Ministry of Finance jointly chairing. In January 2005 the Bank of Slovenia and the government presented the euro adoption plan, under which the euro is to be introduced in Slovenia under a big bang scenario.[6] The communication strategy in support of the introduction of the euro, which was drawn up in June 2005 by the Bank of Slovenia, government institutions, the SORS, the Bank Association of Slovenia, the Chamber of Commerce and Industry and the Consumer Association, reveals the methods and processes by which the public will be kept informed about the introduction of the euro.[7]

The euro enjoys high support

Public support for the introduction of the euro is high in Slovenia. Opinion polls show that the introduction of the euro is supported by two-thirds of people, the highest level among the new EU members.[8] The positive perception of the euro is also illustrated by the figures on expectations of consequences of the euro introduction, with 56% of those surveyed saying that the introduction of the euro will benefit Slovenia, and 51% saying that it will have benefits for them personally. A similar picture is presented by national opinion polls, in which the tolar, the euro and the Bank of Slovenia enjoy considerable trust and confidence among the public.

Figure 5.1: Opinions on the possible introduction of the euro



Source: Introduction of the Euro in the New Member States, European Commission and EOS Gallup Europe, October 2004

[5] http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf
[6] http://www.bsi.si/html/eng/publications/europe/Evro-masterplan_jan05-ang.pdf
[7] http://www.bsi.si/html/eng/publications/europe/Euro%20campaign.pdf
[8] Introduction of the Euro in the New Member States, European Commission & EOS Gallup Europe: http://europa.eu.int/comm/public_opinion/flash/flash165b_en.pdf

5.1 Achieving Nominal Convergence

Meeting the convergence criteria is a prerequisite for adoption of the euro

A high level of sustained convergence is a prerequisite for adpopting 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 budgetary position, exchange rate and long-term interest rate in October 2004 for the ten new member states and Sweden. In addition to meeting the aforementioned economic criteria, before introducing the euro a member state must also ensure compatibility between its national legislation and the Treaty and statute of the European System of Central Banks (ESCB). The individual economic convergence criteria are examined in detail below, together with projections of whether they will be met by Slovenia.

Price Stability Criterion

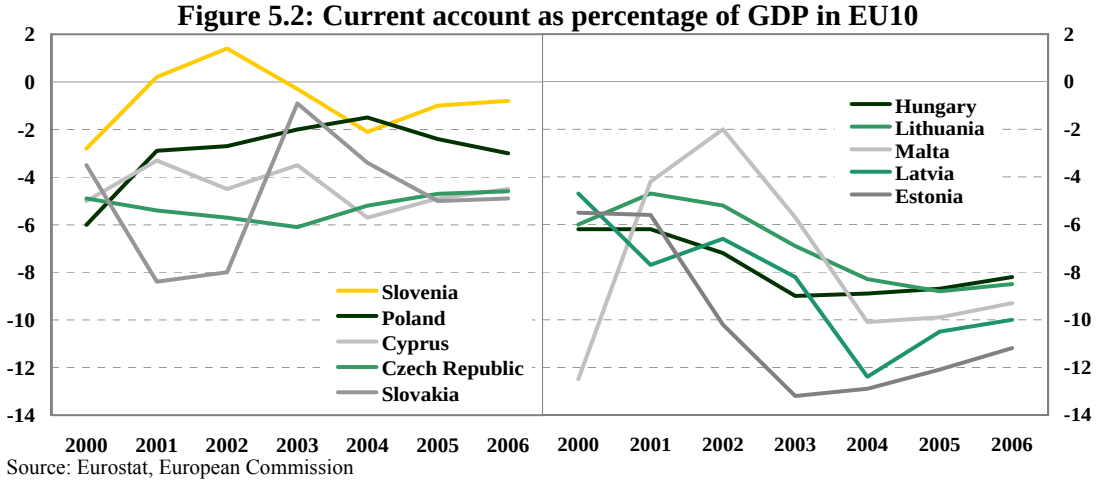
The disinflation process resumed in 2001 and continued while…

After the inflation shocks of 1999, the disinflation process resumed in Slovenia in 2001, and the inflation rate has fallen since then from just under 10% to around 2.5%. This process was the result of adjustments in economic policy, including the introduction of a new monetary policy framework,[9] the objective of which was to ensure that there was a gradual, but sustained fall in inflation. The maintenance of the current account equilibrium and the improvement in the public finance situation are testimony to the sustained nature of the disinflation throughout the process and so far there is no evidence of possible inflation shocks in the future.

…the current account remained in equilibrium…

Slovenia has had a relatively balanced current account throughout the last 12 years. The current account position has fluctuated between 4.0% of GDP (in 1994) and –3.3% of GDP (in 1999), and was thus significantly more stable than in other transition countries. The developments in this year and the forecasts for the coming years also point to a near balance position in the current account.

Figure 5.2: Current account as percentage of GDP in EU10



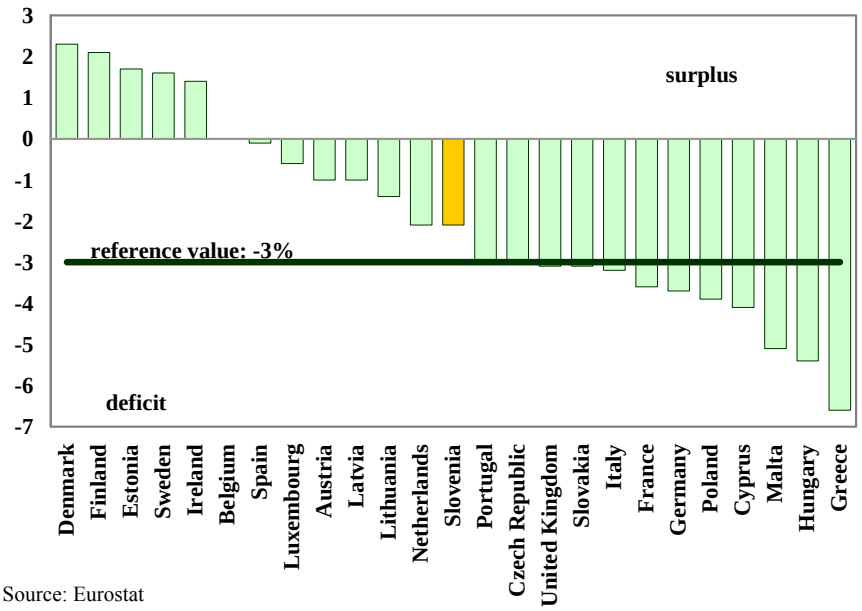
Source: Eurostat, European Commission

…and the public finance position improved

The second important macroeconomic equilibrium is the public finance position, which has improved throughout the disinflation process. The fiscal consolidation that has occurred since 2000 prevented the transmission of potential fiscal imbalances into inflationary pressures. The current public finance position in Slovenia is entirely comparable to those of countries in the eurozone, and is even more favourable in certain cases. Given the healthy state of public finances there is no need to raise taxes, which could reignite inflationary pressures.

[9] http://www.bsi.si/html/eng/publications/mon_policy/guidelines.pdf

Figure 5.3: General government balance as percentage of GDP in EU25 (2004)



Source: Eurostat

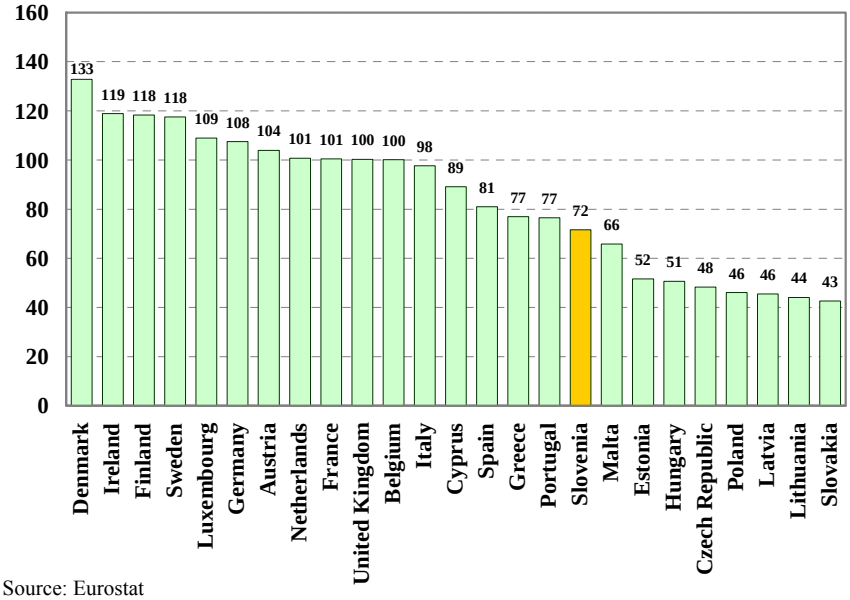
The disinflation process has been completed successfully in the last year

The disinflation process has been completed successfully in the last year. The harmonised index of consumer prices averaged 2.5% year-on-year over the first four months of the year, and in June the inflation rate as measured by the HICP fell below the 2% mark for the first time since independence, reaching 1.8%. Estimates of the structural rate of inflation in Slovenia indicate that in the medium term inflation will fluctuate around the rate reached this year.

Owing to real convergence the equilibrium inflation rate in Slovenia is higher than in the eurozone…

The catching-up process entails a higher equilibrium inflation rate in Slovenia. Balassa-Samuelson effects imply that due to real convergence the equilibrium inflation rate in Slovenia is 1 to 1.5 percentage points higher than in the more developed countries of the eurozone. The equilibrium inflation rate in Slovenia therefore lies in the range of 2.5% to 3.5%.[10] It should be stressed that Balassa-

Figure 5.4: Price levels in EU member-states (EU15=100) in 2003



Source: Eurostat

[10] See D Kozamernik: Achieving price stability in the ERM II and after the adoption of the euro, Bančni vestnik, July-August 2005, and references therein

Samuleson effect are part of an equilibrium process, and thus compatible within the framework of a well-functioning monetary union, because they have no bearing on the price competitiveness of the economy.

…as the general level of prices in Slovenia is lower than those in the eurozone

Balassa-Samuelson effects reflect the convergence in price levels that takes place in parallel with the convergence in economic development. The general price level in Slovenia is approximately one-quarter lower than the general price level in the eurozone. The smallest differentials between prices in Slovenia and those in the eurozone are recorded in groups clothing and footwear (approximately 10% behind) and food and non-alcoholic beverages (approximately 15% behind), while the largest differentials come in certain service sectors, where prices in Slovenia are even more than one-third lower than those in the eurozone.

Slovenia is expected to first meet the price stability criterion at the beginning of 2006

According to the Bank of Slovenia macroeconomic forecasts presented in Section 4, Slovenia will first meet the price stability criterion at the beginning of 2006. In September 2005 the average 12-month inflation rate as measured by the HICP stood at 2.7% in Slovenia, while the reference value for the price stability criterion was 2.4%. The forecasts indicate that average inflation in Slovenia will have fallen by the end of 2005 and will then remain around 2.5% in the medium term. The most recent forecasts by international institutions show that inflation in other eurozone countries is set to be up slightly by the end of the year and after, which is likely to bring a gradual rise in the reference value for the price stability criterion.

Sustainability of price developments is crucial when assessing price stability

In addition to the fall in the average inflation rate below the reference value, the sustainability of price movements is also of vital importance when assessing price stability. The calculation of the reference value for the price stability criterion rests on a relatively mechanical procedure. With the aim of ensuring economic interpretation of the criterion, the ECB and European Commission also check other indicators of inflation trends. They devote particular attention to the focus of monetary policy, the effects of the macroeconomic environment on inflation (unit labour costs and the output gap) and other important price indices (the national consumer price index, the GDP deflator, the index of producer prices of manufactured goods, import prices, etc.).

Price stabilisation has been accomplished sustainably in Slovenia…

In addition to the maintained macroeconomic equilibria, the indicators of inflation trends also show that price stabilisation has been accomplished sustainably in Slovenia. Other price indices, such as the national consumer price index, the GDP deflator and the index of producer prices of manufactured goods, have also decreased since 2000. The year-on-year CPI stood at 2.4% in the first half of the year, the GDP deflator recorded a year-on-year rise of 2.0% over the same period, while prices of manufactured goods were up 3.6%. Only the rise in import prices stood out to a certain extent, although this is mostly the effect of the rise in oil prices on world markets. The macroeconomic trends were similarly favourable, with the output gap still slightly negative and real growth in labour costs low in comparison with productivity growth.

Table 5.1: Inflation measures and price developments indicators

	2000	2001	2002	2003	2004	2005 (Jan-Jun)
HICP	8.9	8.6	7.5	5.7	3.7	2.5
CPI	8.9	8.4	7.5	5.6	3.6	2.4
GDP deflator	5.4	8.7	7.9	5.8	3.2	2.0
PPI	7.7	8.9	5.1	2.5	4.9	3.6
Import prices	18.9	8.6	2.9	2.5	3.7	8.5
Gross wage growth	10.6	11.9	9.8	7.5	5.3	6.7
ULC	8.1	8.4	5.9	4.5	4.0	-0.3
Output gap	1.0	-0.2	-0.7	-1.8	-0.9	-0.6

Notes: (year-on-year growth as %, or % of GDP for output gap)
Sources: SORS, Bank of Slovenia, ARC calculations

…as demonstrated also by the inflation forecasts of domestic and international institutions

The sustainability of the price stability achieved in Slovenia is also demonstrated by the inflation forecasts of domestic and international institutions. The Institute of Macroeconomic Analysis and Development is forecasting average inflation of 2.5% and 2.4% respectively in 2006 and 2007, while the IMF forecast for 2006 is 2.5%.

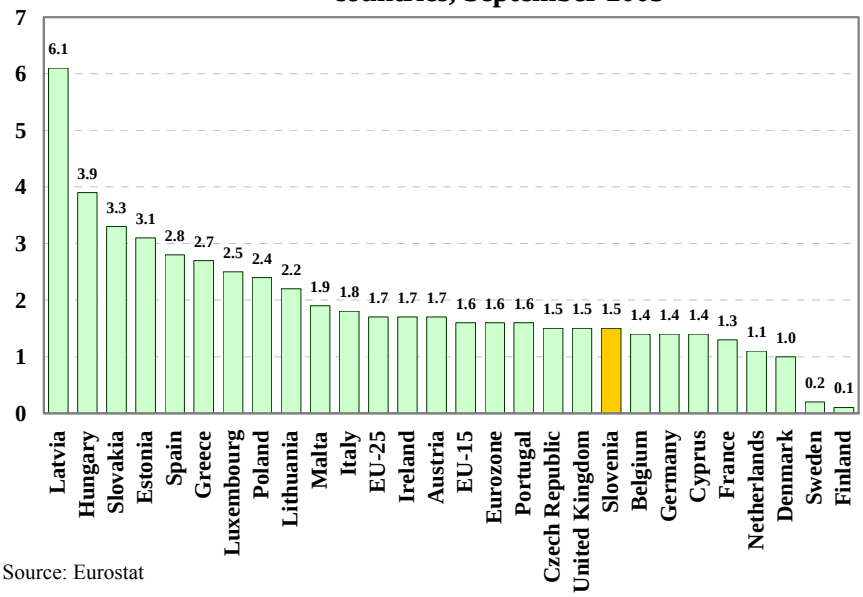
Changes in the prices of refined petroleum products have an above-average effect on inflation in Slovenia…

When assessing the level of price stability achieved it is necessary to take into account temporary effects, prime among which has recently been the rise in oil prices. A barrel of Brent crude cost USD 30 at the end of 2003, but the price had risen to USD 66 by this August. The rise in oil prices and thus in prices of refined petroleum products is of particular importance in Slovenia, as changes in prices of refined petroleum products have an above-average effect on inflation in Slovenia. The principal reason for this is the higher weights given to refined petroleum products in the calculation of the HICP (see Bank of Slovenia Bulletin, September 2005). Liquid fuels are given a weight of 2.1% in Slovenia, the highest in the EU, while the weight for fuels and lubricants for personal transport equipment is 6.0%, the third-highest in the EU. As a result refined petroleum products accounted for 1.9 percentage points of September's year-on-year inflation rate in Slovenia, but just 0.8 percentage points in the eurozone.

…which presents a technical risk of exceeding the reference value for the price stability criterion, but not a risk from the economic contents' point of view

The above-average inflationary effect of refined petroleum products in Slovenia presents a technical risk of exceeding the reference value for the price stability criterion, but that does not necessarily entail a failure to meet the price stability criterion interpreted as an economically meaningful benchmark. In particular, prices of refined petroleum products are an exogenous factor, as they are set on international commodity exchanges. Artificially delaying the transmission of higher prices on international exchanges into domestic prices of refined petroleum products would be undesirable and economically unjustified. In addition, it should be noted that the doubling of oil prices in the last year and a half is most likely of a temporary nature and the growth rate of oil prices should thus moderate in next years. However, economic policymakers should prevent a possible occurrence of second round effects and transmission of oil prices into other prices or wages, which would threaten price stability, at least temporarily.

Figure 5.5: 12-month average inflation rate excluding fuels in EU countries, September 2005



Source: Eurostat

Slovenia already meets the price stability criterion, once the asymmetric effects of rises in refined petroleum

Because the different HICP weights given to refined petroleum products imply an asymmetric effect on inflation of EU countries, it is economically meaningful to exclude the effect of changes in prices of refined petroleum products when assessing the level of price stability achieved. According to these assessments

Slovenia has already achieved the level of price stability required for the introduction of the euro. September's 12-month average inflation rate excluding fuels stood at 1.5% in Slovenia, while the modified reference value was 1.9%.

The divergence of inflation rates within the EU makes it more difficult to meet the price stability criterion

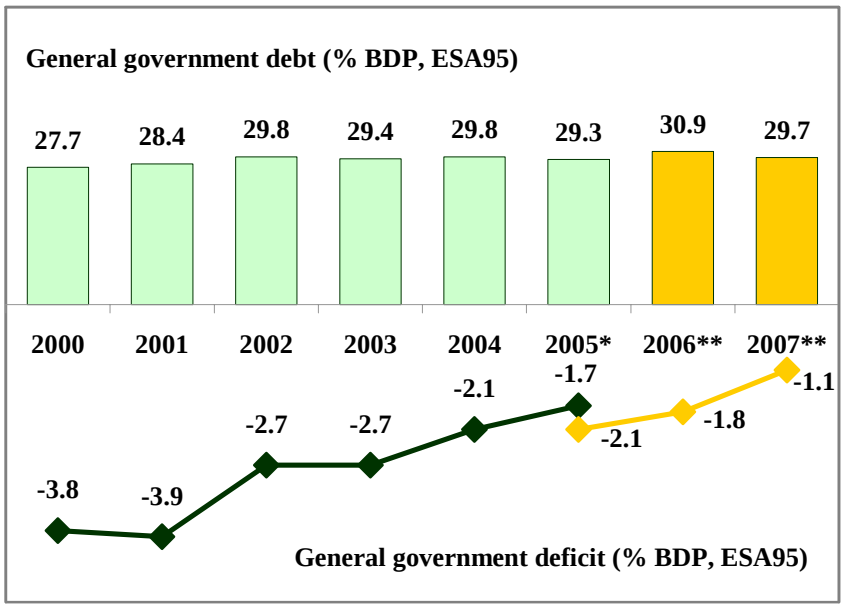
The divergence of inflation rates within EU countries since 1999 also has a significant influence on the assessment of the level of price stability achieved. During the nineties the inflation rates in EU countries converged. The April 1998 convergence report by the European Monetary Institute states that the inflation rates in 14 of the EU member-states ranged from 1.2% to 1.9% in 1997, and the convergence criterion (the 12-month average for February 1997 to January 1998) ranged from 1.1% to 1.9%. Only Greece stood out, not having achieved the required level of price stability at that time, with its inflation rate exceeding 5%. In September 2005 the 12-month average inflation rate in the EU15 ranged from 0.6% in Finland to 3.7% in Luxembourg, which is a range almost four times larger than when the EMI convergence report was issued (a similar picture is seen when the effect of refined petroleum products is excluded; see Figure 5.5). The divergence of inflation rates within the EU makes it more difficult to meet the mechanically calculated price stability criterion, as it increases the possibility that countries with low inflation rates will artificially lower the reference value for the price stability criterion.

Government Budgetary Position Criterion

Slovenia has met the government budgetary position criterion since 2002

Slovenia meets the government budgetary position criterion in terms of both the government deficit and general government debt. Figures in line with the ESA95 methodology show that Slovenia has met both aspects of this criterion since

Figure 5.6: Government budgetary position criterion



Note: the figures expressed as a percentage of GDP are taken directly from SORS, MoF and Eurostat publications. With the use of the revised GDP figures from this September, which differ from the previous figures primarily because of the way in which indirectly measured financial intermediation services are taken into account, the proportions of GDP are slightly lower: the estimated deficit in 2005 thus amounts to 1.6% of GDP for example.

* The forecasts for debt and the deficit for 2005 are taken from the General Government Deficit and Debt Report (SORS and MoF, September 2005)[11]

** The debt forecasts for 2006 and 2007 and the deficit forecasts for 2005 to 2007 (in orange) are taken from the updated Convergence Programme (MoF, January 2005)[12]

Sources: Eurostat, MoF, SORS

[11] http://www.gov.si/mf/slov/tekgib/por_prim_dolg_september_05.pdf
[12] http://www.gov.si/mf/angl/tekgib/conv_programme_2004_update.pdf

2002. General government debt as a proportion of GDP has been stable and slightly below 30%, while the reference value is 60%. The general government deficit has fallen significantly in recent times, from 3.8% of GDP in 2000 to the 1.7% of GDP projected this year, while the reference value is 3%.

Forecasts show that Slovenia will continue to meet the government budgetary position criterion in the future

Forecasts show that Slovenia will continue to meet the government budgetary position criterion in the future. According to the updated Convergence Programme (MoF, January 2005) the deficit as measured using the ESA95 methodology should amount to 1.8% in 2006 and 1.1% in 2007. A similar picture is revealed by the state budget proposals for 2006 and 2007, which were presented in the National Assembly at the beginning of this October. According to the budget proposals, the general government deficit as measured by national methodology should amount to 1.4% of GDP in 2006, thus unchanged from 2005, and to 1.2% in 2007.

Changes in legislation and the failure to approve the new EU financial perspective entail uncertainty while

Public finances movements in the coming years will come under the considerable influence of the tax reforms announced, while further uncertainty derives from the incomplete negotiations on the European financial perspective for the 2007 to 2013 period. Of the measures announced, the abolition of payroll tax will have the greatest impact on general government revenues. Payroll tax is to be cut by 20% in 2006 (a net cost of SIT 18 billion to public finances), then the tax should be gradually phased out by 2009. The decline in general government revenues next year owing to the cut in payroll tax should be neutralised by an appropriate reduction in general government expenditures, partly at the account of a proposed change in the way social transfers are adjusted and less money for sick benefits. An amendment to the VAT act that envisages VAT being charged on the paid realisation could cause a liquidity shortfall of SIT 5 to 7 billion in budget revenues in 2006. An amendment to the corporate income tax act envisaging relief for investment in research and development, under which companies could reduce their tax liabilities by 20% in the year of investment and then settle the reduction in tax over the next five tax periods, could also have a significant impact on general government revenues. A liquidity shortfall in revenues caused by this amendment is expected from 2007 onwards.

Box 5.1: The structural general government deficit and fiscal policy stance

The actual (headline) general government balance reflects the interplay of two factors: medium-term fluctuations in the business cycle, and discretionary fiscal policy measures. The structural general government balance, from which the effects of macroeconomic fluctuations on general government revenues and expenditures are excluded, is therefore usually calculated for a more detailed analysis of the fiscal policy measures and the fiscal policy stance.

Table: Actual and structural general government balance (% of GDP)

	2000	2001	2002	2003	2004	2005
Actual general government balance	-3.8	-3.9	-2.7	-2.7	-2.1	-1.7
Output gap	1.0	-0.2	-0.7	-1.8	-0.9	-0.5
Cyclical general government balance	0.5	-0.1	-0.3	-0.9	-0.4	-0.2
Structural general government balance	-4.3	-3.8	-2.4	-1.8	-1.7	-1.5

Sources: SORS, ARC calculations; the cyclical component of the general government balance is calculated as the product of the output gap and the estimated coefficient of general government balance sensitivity to the output gap (0.48)

The figures on the actual general government balance reveal a significant reduction of the deficit in Slovenia after 2000, with the deficit having fallen from 3.8% of GDP at that time to this year's projection of 1.7% of GDP (in certain years there is also a notable effect on the general government balance by one-off changes, such as the payment of claims for war damages to the public, which caused an increase of 0.8% of GDP in the deficit in 2001). As calculated, the structural general government balance shows that the fiscal consolidation between 2000 and 2003 took place in the context of a slowdown in economic activity, the actual deficit having fallen by 1.1% of GDP,

while the structural deficit fell by 2.5% of GDP. However, the improvement in the actual general government balance in the last two years from –2.7% of GDP to –1.7% of GDP has been almost entirely the result of the more favourable macroeconomic environment. The latter accounted for 0.7 percentage points of the reduction in the deficit, while the effect of actual fiscal consolidation in the last two years was merely 0.3 percentage points.

The reformed Stability and Growth Pact adopted this June stipulated that EU countries must pursue a medium-term target of a structural general government position between a deficit of 1% of GDP and balance or surplus. In addition, on the way to meeting the medium term target the eurozone countries and the members of the ERM II must achieve an average annual improvement in the structural balance of 0.5% of GDP, net of one-off effects and temporary measures. The reduction in the structural deficit should be greater in good economic times, which means that Slovenia should take advantage of the current favourable economic conditions for a further and faster fiscal consolidation.

A structural general government balance in line with the medium-term target of the reformed Stability and Growth Pact would also ensure an adequate safety margin with regard to the reference value of a 3% deficit. This would allow automatic fiscal stabilisers to act freely and symmetrically over the business cycle. Because of the operation of automatic fiscal stabilisers, general government balance typically worsens during a recession, as in that case the amount of tax collected generally decreases and expenditure on unemployment increases, while the reverse process occurs during a period of economic expansion. Automatic fiscal stabilisers bring economic benefits thanks to their smoothing of fluctuations in the business cycle and is therefore desirable. Potential fiscal policy measures that would offset the working of automatic fiscal stabilisers, such as a reduction in general government expenditure during a recession, would have negative economic effects, and fiscal policy in this case would be pro-cyclical.

Because fiscal policy has taken the main burden of managing short-term demand pressures after Slovenia joined the ERM II (but also after the euro will be adopted), it is necessary to ensure sufficient room for manoeuvre for it to respond appropriately to changes in the macroeconomic environment. In the event of a deterioration in the macroeconomic environment sufficient room for manoeuvre would allow for an expansive fiscal policy that would contribute to a successful economic recovery, and vice-versa in a period of overheated economic growth. In addition Slovenia will have to face a significant increase in general government expenditure as a result of the ageing population, which is another argument in favour of the earliest possible elimination of remaining fiscal imbalances.

Exchange Rate Criterion

Exchange rate stability has been secured since ERM II entry

The exchange rate of tolar has been 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 the central rate. During Slovenia's 16 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 of the exchange rate stability criterion not being met are low…

The risks related to exchange rate stability are limited. The stability of the market exchange rate is mainly the result of the credibly set central rate, which reflects the external macroeconomic equilibrium. The appropriateness of the chosen central rate is confirmed by the relatively balanced current account and by the absence of the inflationary pressures that could stem from a central rate set too high.

…as the Bank of Slovenia has appropriate monetary policy instruments and sufficient foreign exchange reserves at its disposal

The Bank of Slovenia has the appropriate monetary policy instruments and sufficient foreign exchange reserves at its disposal to ensure exchange rate stability. The central monetary policy instrument that the Bank of Slovenia uses to manage liquidity on the foreign exchange market and consequently to smooth out fluctuations in the exchange rate is the 7-day foreign exchange swap.

Figure 5.7: Deviations from the central rate: SIT and DKK

Source: ECB

The interest rate differential is relatively small

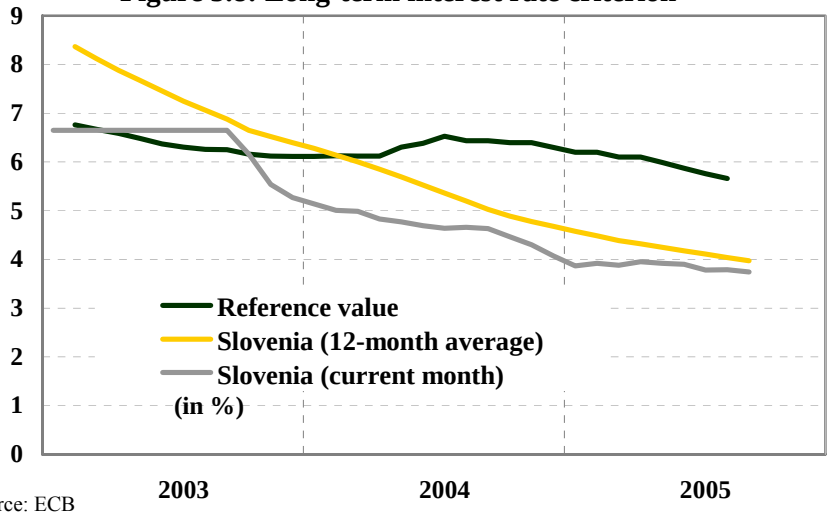
The short-term interest rate differential is relatively small, and reflects the Bank of Slovenia's decision to maintain interest rates at the highest possible level that still ensures exchange rate stability. Since ERM II entry interest rate policy has to a great extent been subordinate to maintaining the stability of the exchange rate, and is thus dependent on short-term interest rates in the eurozone. The differential of 2 percentage points with the main ECB interest rate allows for the market premium, which primarily reflects exchange rate and liquidity risk. In addition the differential reflects the conditions that markets still allow given the structure of the monetary policy instruments and interest rates. Since ERM II entry, the interest rate differential has reflected the Bank of Slovenia desire for a restrictive monetary policy.

Long-Term Interest Rate Criterion

Slovenia meets the long-term interest rate criterion…

Slovenia also meets the criterion for long-term nominal interest rate. The 12-month average long-term nominal interest rate on government securities had fallen below the reference value by March 2004. The falling trend is still continuing in average long-term interest rate, but has slowly been stopping in recent months. In September 2005 both current and average interest rates stood at less than 4%, while the reference value for the long-term interest rate criterion has averaged 6.2% in the last three years.

Figure 5.8: Long-term interest rate criterion

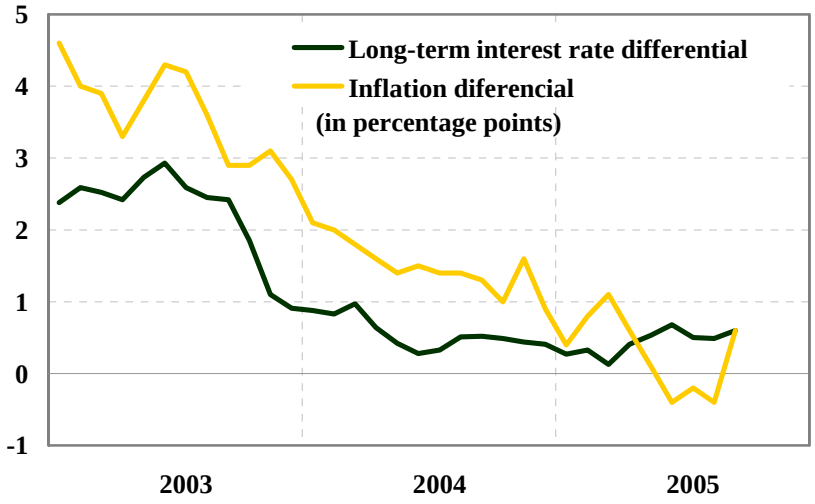


Source: ECB

Long-term interest rate is an indicator of financial markets' confidence in the credibility of macroeconomic policy and the expected maintenance of macroeconomic equilibria in the future. The differential between long-term interest rate in Slovenia and in the eurozone has been decreasing in line with the course of the disinflation process. The current low differential in long-term interest rate also reflects the favourable long-term inflation expectations and expectations of the sustainable level and stability of public finances. Low risk premiums confirm the credibility of macroeconomic policy in Slovenia in attaining low inflation and high fiscal stability.

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

Figure 5.9: Differential with the eurozone in long-term interest rate and the HICP



Sources: ECB, Eurostat

Box 5.2: The compatibility of national legislation

In addition to meeting the nominal convergence criteria, the first paragraph of Article 121 of the Treaty also cites the compatibility of national legislation among the conditions for adopting the euro, including the regulations governing central banks set out in Articles 108 and 109 of the Treaty and the statute of the European System of Central Banks and the ECB. In accordance with the second paragraph of Article 122 of the Treaty the European Commission and the ECB check whether the convergence criteria are met every two years or at the request of a member-state. In the convergence reports of October 2004, the European Commission and the ECB found certain areas of incompatibility with the Treaty in the Bank of Slovenia Act (Official Gazette of the Republic of Slovenia, Nos. 58/02 and 85/02; henceforth referred to as the ZBS-1). Because the compatibility of national legislation governing national banks is a formal prerequisite for the introduction of the euro, the ZBS-1 must be brought into line with the findings of the convergence reports of 2004 before the next convergence report, which will be drawn up by the European Commission and the ECB in 2006.

The European Commission and ECB convergence reports of 2004 cite the following areas of incompatibility with the Treaty in the ZBS-1:

- A requirement for consistent transposition of the wording of the statute of the ESCB and the ECB in the definition of the relationship between the primary aim of the ESCB (price stability) and the more expressly hierarchical subordination of the two secondary aims (support for economic policy and concern for the stability of the financial system).

- A requirement for strengthened financial and functional independence on the part of the central bank in managing official foreign exchange reserves.

- A requirement for consistent transposition of the wording of the statute of the ESCB and the ECB regarding the reasons for early termination of the term of office of a member of a decision-making body at the national central bank. *Consistent application of the statute and the introduction of the concept of*

a serious breach allows the European Court of Justice itself to formulate the standard of a serious breach by a member of a decision-making body of a central bank, thereby strengthening the legal position of members of decision-making bodies.

- A requirement for clear demarcation between the powers transferred by the Bank of Slovenia to the ECB when the euro is introduced, and the powers that it retains after the euro is introduced.

- A requirement for the adaptation of the central bank's instruments after the euro is introduced, and the regulation of the power to make decisions on action within the framework of international financial organisations and decisions on the supply of cash. This package also includes the provision on the cessation of the application of the title on monetary policy and the exchange rate after the euro is introduced.

- A requirement for strengthened personal independence on the part of members of the decision-making bodies of the central bank, *thereby eliminating from the system sanctioning under the prevention of corruption act, as this act sets out additional grounds for early termination of the term of office that are not in accordance with the statute of the ESCB and the ECB.*

5.2 Economic Policymaking

ERM II entry entailed a major change in the way economic policy is exercised in Slovenia

When Slovenia joined the ERM II appropriate adaptations had to be made to the previous framework for macroeconomic policymaking. While price stability used to be the concern of the Bank of Slovenia, which with its strategy of a gradual but sustained lowering of inflation while maintaining all important macroeconomic equilibria succeeded in hitting its primary objective, upon ERM II entry the main burden of managing economic activity and inflationary pressures on the side of aggregate demand was assumed by fiscal policy.[13] Under the conditions of the ERM II interest rate policy is subordinate to the maintenance of a stable exchange rate for the domestic currency, while it is fiscal policy that must respond to any inflationary pressures by maintaining the appropriate degree of restrictiveness.

The central exchange rate plays the role of an effective anchor for inflation expectations

The central exchange rate must play the role of an effective anchor for inflation expectations. Here it should be borne in mind that the stabilisation of the exchange rate alone is a very weak instrument for managing domestic demand. If domestic demand increases above the potential supply, inflationary pressures arise. If monetary policy is oriented towards maintaining exchange rate stability, interest rates cannot be adjusted to a level that would restrict excess demand. Therefore, the risk of a new cycle of inflation in the economy arises. Stabilising inflationary expectations lowers the degree to which inflation responds to shocks, thanks to the expectation that an appropriate reaction from macroeconomic policy will actually check the inflation shocks. The central exchange rate can therefore only be an effective anchor for inflation expectations if macroeconomic policy responds effectively and prevents the occurrence of inflation cycles.

Since Slovenia joined the EU the most important internal macroeconomic risk has been the possibility of a demand

Since Slovenia joined the EU the most important internal macroeconomic risk has been the possibility of a demand shock based on credit expansion. The risk stems above all from the gradual convergence of interest rates with those of the ECB, which for example caused a shock on the side of aggregate demand in Portugal after it joined the eurozone. Recently also Estonia has faced the risk of overheated economy. Economic growth in Estonia was 9.9% in the second quarter, which is significantly above its estimated medium-term potential growth of approximately 6%.[14] The overheating of the economy owing to rapid growth

[13] See http://www.ecb.int/press/pr/date/2004/html/pr040627.en.html
[14] IMF Country Report No. 04/358, November 2004

in domestic demand based on heavy borrowing, and wage growth that is outstripping productivity growth is already giving rise to inflationary pressures, with year-on-year inflation in Estonia reaching 4.9% in September.[15] As an appropriate response to the current economic conditions both the Estonian central bank and the IMF are recommending extra restrictiveness in fiscal policy, which in the last two years recorded a general government surplus of approximately 2% of GDP.

… which has not realised…

For now there is no sign of excessive growth in aggregate demand or the overheating of the Slovenian economy, which is partly the result of interest rates being maintained at the highest possible level allowed by the financial markets while keeping the exchange rate stable. Economic growth in the first half of the year was 3.9%, while growth in private spending was slightly lower at 3.5%.

…although the risk will remain

Nevertheless there remains a risk of a shock on the side of aggregate demand, as there will be further convergence in interest rates before Slovenia joins the eurozone. The figures also show that the relatively small decrease in real interest rates in the period leading up to ERM II entry caused a significant acceleration of growth in lending, and consequently in economic growth. The negative output gap shrank by just under a percentage point of potential GDP last year, and by an additional half a percentage point in the first half of this year. Given that the output gap will close over the timeframe of these forecasts, any further adjustment in interest rates will increase the likelihood of excess aggregate demand.

Table 5.2: Definition of simulations

simulation	shock (change)	period of shock
a) External environment		
1. Oil price	price up USD 5 per barrel	Q405-Q406
2. Commodities prices	prices up 10%	Q405-Q406
3. Foreign demand	up 1%	Q405-Q406
b) Domestic environment		
4. Wage growth	up 1 percentage point	Q405-Q406
5. Household spending	up 1 percentage point	Q405-Q406
6. General government spending	up 1 percentage point	Q405-Q406
7. Growth in administered prices	up 2 percentage points	Q405-Q406

Table 5.3: Response of macroeconomic variables to simulated shocks

simulation	GDP			inflation			current account		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Forecasts (baseline scenario)	4.2	3.8	3.8	2.6	2.6	2.4	-1.6	-1.7	-1.3
a) External environment									
1. Oil price	4.1	3.7	3.6	2.9	3.2	2.4	-1.9	-2.2	-2.0
2. Commodities prices	4.3	3.8	3.8	2.8	2.7	2.5	-1.9	-2.1	-1.7
3. Foreign demand	4.6	4.1	3.9	2.7	2.7	2.6	-1.3	-1.3	-1.0
b) Domestic environment									
4. Wages	4.4	4.1	4.1	2.8	3.0	2.8	-1.8	-2.0	-1.6
5. Household spending	4.5	4.5	4.4	2.9	3.1	3.0	-1.8	-2.1	-1.8
6. General government spending	4.4	4.0	4.1	2.8	2.9	2.7	-1.7	-1.8	-1.5
7. Administered prices	4.2	3.7	3.7	2.6	3.0	2.9	-1.6	-1.7	-1.4

Source: ARC forecasts

An appropriate fiscal policy response to any demand shock will be vital

In the event of excessive credit expansion and inflationary domestic demand, an appropriate fiscal policy response is vital. After the introduction of the euro and the complete loss of an independent monetary policy, fiscal policy will remain the sole instrument for the macroeconomic management of the economy. In the

[15] Quarterly Economic Policy Comment of Eesti Pank, September 2005

event of a shock it will be necessary to avoid spending the additional general government revenues resulting from excessive economic expansion, thus improving the general government balance. Through fiscal policy measures it is possible to reduce domestic demand to a sufficient degree that economic activity returns to its sustainable potential level. Such fiscal policy measures were successfully exercised in the past by both Denmark and Ireland, who thereby succeeded in offsetting inflationary pressures.

Incomes policy can prevent inflationary pressures and aid external price competitiveness

Incomes policy must play a key role in preventing inflationary pressures steming from increased labour costs. Controlling labour costs is of central importance to ensuring price competitiveness within the framework of monetary union. Unit labour costs declined in the last three years in the eurozone, where the cumulative fall between 2002 and 2004 was 1.5%, and even more among the new EU members, where the cumulative fall was 5.3% over the same period.[16] The possible abandonment of the moderate incomes policy in Slovenia, given continuing decline in unit labour costs abroad, could have considerable negative effects for the competitiveness of Slovenian companies, and could result in a reversal in the employment trend. Further restricting wage growth in the public sector could have a demonstration effect on wage growth in the economy as a whole.

The inflation effects of supply shocks, such as oil shocks, cannot be allowed to encourage wage growth

Labour costs growing in line with productivity means that nominal labour costs cannot adapt to the price rises that could be triggered by adverse supply shocks. Adverse supply shocks, such as a rise in prices of refined petroleum products, also appear as an additional cost factor for companies and reduce their production capacities. The latter is reflected in lower demand for labour. Although companies transmit part of the shock into prices, which can have an impact on inflation, labour income cannot be allowed to adapt to such price rises, as the lower demand for labour would entail a rise in unemployment, with economic activity falling further and the price competitiveness of the economy declining. Because labour costs are the most important costs for companies, they could strengthen inflationary pressures and the persistence of inflation at a higher level. Because of these effects, it is sensible to act in the direction of a gradual elimination of wage indexation to the inflation rate.

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.

Growth in administered prices cannot outstrip 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 among administered prices is held by refined petroleum products, prices of which are under the influence of external factors, and can therefore rise faster than other prices in unfavourable circumstances.

[16] Labour market and wage developments in 2004, European Commission, Special Report No.3, 2005

5.3 Structural Adjustments of the Economy

Flexibility of the economy ensures successful participation in monetary union

An important way to prevent the occurrence of asymmetric shocks is to ensure that the economy is flexible enough. Increasing flexibility is partly an autonomous process, one that has been unfolding in advanced economies in the last 20 years, primarily thanks to the effects of information technology, innovation and the creation of new financial instruments. However it is also possible to increase the flexibility of an economy using economic policy measures, in particular by supporting free competition, deregulating certain sectors and taking measures to increase labour market flexibility.

Slovenia has undertaken to carry out structural reforms

When joined the ERM II Slovenia committed to gradually carry out structural reforms in order to increase the flexibility and adaptability of the economy. Increasing the adaptability and flexibility of the labour market should allow for more efficient reallocation of workers from sectors in difficulties to more prospective sectors. Simplifications in administration can help to reduce costs for businesses and to reallocate resources more efficiently. Cuts in general government expenditure can reduce the tax burden on the economy, but it is also necessary to take into consideration the economic effects and the effects on the welfare of all those affected by the cuts in expenditure.

Macroeconomic policymaking should be coordinated with reforms

The key to successfully carrying out the reforms is to thoroughly explain the effects of the reforms to the public early on, including the short-term effects on economic activity and unemployment and the lasting consequences on the distribution of income. Given these risks, macroeconomic policies cannot be neglected during the implementation of structural reforms. When conceiving the structural reforms it therefore makes sense to work to establish as wide a consensus as possible, and to make the public aware of the prevalence of the long-term benefits of the reforms over the potential negative short-term effects.

The process of fiscal consolidation must continue

The structural reforms should be carried out in line with the necessary fiscal consolidation, with consideration given to the burdens placed on businesses and institutions by the introduction of the euro. In this context the reformed Stability and Growth Pact must be taken into consideration. A reduction in budgetary revenues can thus only proceed if there is a simultaneous assurance of a sustained reduction in expenditure. In addition the current and projected favourable macroeconomic environment offers an ideal opportunity to eliminate the structural deficit in public finances and to establish a security reserve for meeting the requirements of the Stability and Growth Pact. This would also increase the room for manoeuvre for the successful implementation of both macroeconomic and structural policies.