BANKA SLOVENIJE

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Table of contents

Figures, tables and boxes

Figures:

Tables:

Boxes:

Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
BLS	Bank Lending Survey
CPI	consumer price index
DARS	Motorway Company in the Republic of Slovenia
EC	European Commission
ECB	European Central Bank
EIPF	Faculty of Law Economic Institute
EMU	Economic and Monetary Union
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU	European Union
EU27	European Union (of 27 Member States)
EUR	euro
GBP	pound sterling
GDP	gross domestic product
HICP	harmonised index of consumer prices
IFS	International Financial Statistics (International Monetary Fund database)
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
MoF	Ministry of Finance of the Republic of Slovenia
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum-Exporting Countries
PSR	Price Stability Report
RS	Republic of Slovenia
SORS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar

Summary

The deepening of the financial turmoil since September 2008 has led to a global economic crisis of extraordinary proportions, significantly hampering opportunities for economic growth, while at the same time reducing the threat of inflation in Slovenia. The most significant risk is that to economic growth. A substantial decrease in GDP in 2009 can be expected, with economic growth of -2% forecast for this year. GDP growth is expected at 1.9% and 3% in 2010 and 2011 respectively, indicating the possibility of a relatively quick turnaround. In this regard the considerable base effect must be taken into account. Commodity prices have fallen due to the financial turmoil and economic crisis, resulting in a sharp drop in current inflation. Thus far core inflation has followed these changes relatively slowly. Although there may be several months of negative year-on-year growth in prices in Slovenia during the summer due primarily to falling energy prices and the corresponding base effects, inflation excluding energy prices is expected to fall only gradually during the period for which projections are being compiled from the current rate of 3% to between 1% and 2%. The temporary significant improvement in the terms of trade due to the fall in commodity prices will be the strongest factor in reducing the current account deficit in 2009 to approximately 3% of GDP, although the deficit is expected to increase again in the later years.

Uncertainties regarding future economic developments remain unusually high, although policy makers are striving to prevent a further deepening of the turmoil. There is a relatively high risk that a longer period of weak global demand could be seen. Slovenia's economic growth could slow further if this were to occur. Economic recovery would be slower as a result. It is therefore highly likely that economic growth will be lower than projected. Inflation factors are linked primarily to movements in commodity prices and wages, although inflationary risks are low in the context of a drop in economic growth. Despite expectation of negative year-on-year price growth in the middle of this year, the projections do not give any indication of possible deflation over the longer period of time. The expectations of negative price growth are mainly a result of a strong base effect.

* * *

Following the difficulties encountered by major international banks, and in particular after the bankruptcy of Lehman Brothers, the turmoil on the international financial markets had a very rapid and profound effect on the real sector in the final quarter of 2008. The entire international environment was affected by a significant drop in all types of demand and the volume of world trade. This translated to a rapid fall in the market values of most types of financial assets and real estate prices due to a lack of transparency with regard to risks in the financial system. The expectations of consumers and corporates were changed accordingly. The assumption for growth in imports of Slovenia's trading partners for 2009 was revised down by nearly 13 percentage points relative to the autumn projections, meaning a drop in foreign demand by more than 6% compared with 2008. According to available estimates, foreign demand is expected to remain unchanged in 2010. Sustained growth is not expected until 2011. In addition to the euro area, the main importers of goods and services of Slovenian companies are the markets of central, eastern and south-eastern Europe, where demand is likewise falling. The global economic climate has a significant impact on falling commodity prices, which are expected to drop by one-quarter on average this year, while the price of oil is expected to stabilise at USD 60 per barrel over the projection horizon, compared with the USD 120 per barrel foreseen by markets at the beginning of last September. The decrease in the lending activities of banks, driven in part by a drop in interbank lending, has pushed demand down further than would be otherwise expected as a consequence of the deterioration in the economic climate. This disruption and the contraction in bank lending represent banks' response to the lack of transparency regarding risks on global capital markets, which have significanly hurt the balance sheets of banks. A rapid response *from the competent authorities was necessary to stem the tide. In Europe this response was aimed at the following: a government deposit guarantee, the recapitalisation of affected banks, measures to maintain lending activity with the aid of government guarantee schemes and measures to stimulate demand. All of these measures are based on the principles of timeliness, targeting and temporality. The drop in activity and lower commodity prices have reduced the risks of inflationary pressures and created room for the stimulating orientation of macroeconomic policies. From October 2008 to March 2009 the ECB lowered its key interest rate five times by a total of 2.75 percentage points in response to economic conditions in the euro area, and responded to disruptions on the money market by providing unlimited liquidity. With its European Economic Recovery Programme, the European Commission committed EUR 200 billion or 1.5% of EU GDP in 2009 to stimulate demand, maintain employment and support structural reforms. To this end the Slovenian government also adopted a number of measures, including bank guarantees of EUR 12 billion and the issue of bonds in the amount of EUR 1 billion.*

GDP in Slovenia shrank significantly in the final quarter of last year. Average growth will again be negative this year, given expected developments in the international environment. Positive, but relatively moderate growth compared with recent years is expected in 2010 and 2011. Year-on-year growth in investments, which contributed most to economic growth in the first half of 2008, halved in the third quarter, and fell to -8.5% in the final quarter. Growth in private consumption since the third quarter of 2007, when it reached its peak at 7.4% in year-on-year terms, has fallen gradually, and stood at less than 1% in year-on-year terms in the second half of 2008. Growth in exports and imports of goods and services has halved in the context of falling domestic and foreign demand. The number of employees will fall by more than 2% this year due to the decline in output. Initially employment is expected to fall primarily on account of temporary employees, particularly in the construction and manufacturing sectors. The rise in the survey unemployment rate to more than 7% by 2010 will result in modest growth in consumption in the context of falling asset values, confidence and consumer expectations. A sharp decline in investment (expected to reach approximately -10% in 2009), coupled with weak growth in personal consumption (0.9%) in the context of a significant drop in exports (-7.0%), will temporarily result in a more rapid decline in imports than exports, while the contribution of net foreign trade to economic growth will be positive in 2009. Growth in gross investment is expected to turn positive again in 2010, although the level achieved in 2008 is not likely to be reached until 2011.

Current account projections indicate a temporary decrease in the deficit to approximately 3% of GDP in 2009, followed by an increase in 2010 and 2011, with price factors driving the majority of these changes. Lower commodity prices will primarily affect import prices, although export prices are also expected to grow very slowly. Lower foreign demand will drive down exports in 2009, which in turn will result in a decrease in imports. The latter will also be affected by domestic demand, primarily investment demand. The contribution of foreign trade to the current account is also expected to become positive in the context of a positive contribution to economic growth from net exports. In line with a lower current account deficit and in the context of expected lower interest rates, the trend of a rising negative contribution from factor income to the current account deficit is expected to end over the projection horizon. The increase in the deficit in 2010 and 2011 to between 4% and 5% of GDP is mainly a result of the gradual strengthening of domestic investment demand and probably less favourable price factors.

Average annual inflation could fall below 1% this year. According to expectations overall year-on-year price growth will be temporarily negative in the middle of the year due to base effects stemming from energy prices, and will afterwards return to a level of approximately 2%. Inflation excluding energy prices is expected to fall gradually from the current 3%, but is expected to remain between 1% and 2% over the projection horizon. The HICP rose by 5.5% on average in 2008, outstripping euro area inflation by 2.2 percentage points. Inflation has fallen very rapidly since the summer, primarily on account of a sharp drop in energy prices, the contribution of which fell from 2.3 percentage points in July 2008 to -0.4 percentage points this February. The contribution of food prices to inflation has also fallen by more than 1 percentage point since the summer. On the other hand, only a slow drop in core inflation excluding energy, food, alcohol and tobacco has been recorded due to significant nominal growth in labour costs, with year-on-year core inflation standing at 3.6% in December 2008, higher than the level recorded at the beginning of the same year. By March core inflation had fallen to 3.0%. Overall year-on-year growth in prices *stood at 1.8% in December then rose slightly to 2.2% in February, before falling again in March to 1.6%. Growth in private sector wages, which exceeded 9% in year-on-year terms in the third quarter of 2008, fell below 5% in the final quarter of last year. In contrast public sector wages have risen at a rate well above 10% in recent months due to the introduction of the new wage scheme in August. According to expectations, growth in the average gross wage will slow to between 2% and 3% in nominal terms this year under pressure from labour market conditions. Growth will then rise slightly to approximately 4%, with growth in public sector wages significantly outstripping growth in private sector wages. Reduced domestic demand and lower labour costs in the private sector will thus contribute to a more rapid and sharper decline in core inflation than envisaged in the October Price Stability Report, while the gap to average core inflation in the euro area is expected to close.*

The projections continue to be accompanied by a high degree of uncertainty. Risks regarding projections of economic growth are on the downside, while risks regarding projections of inflation are balanced. The possibility of price growth is limited by the expected contraction in economic activity. However, there are also risks that could be reflected in pressures for price growth. The latter are primarily linked to the possibility of a sharper fluctuation in commodity prices and to rigidity in the decline in labour costs. These risks are low in the period of the deep economic crisis. Risks are more significant with regard to projections of economic activity and positive economic growth by 2010, as the economic recovery may be considerably slower than expected. These risks are mainly linked to a sharper and more sustained slowdown in global economic growth, a stronger pass-through of the financial turmoil to the real sector and to the expected investment activity of private sector. Despite previously adopted measures, which decrease uncertainty with regard to secure financial funding of economic activity, the global drop in foreign trade and weak investment activity play a decisive role in banks' assessments of the related risks that they are prepared to accept. Furthermore, the process of deleveraging to the consequences of all risks in the financial system is not yet complete. Uncertainty remains as to when a reversal in the cycle of global activity will occur and how quickly the global economy will regain momentum. All of this raises uncertainty regarding projections of private consumption, which could fall further due to wealth effects linked to a sharp drop in the value of financial assets and real estate. Investments tied to government projects are also subject to uncertainties, as their implementation depends on government savings on other expenditures.

In global terms it is clear that interventions to support demand as a way to escape the economic crisis are insufficient. There is a general socialisation of risks and losses. The risks concentrated in the financial system as a result of innovation in financial markets in the period since 1990 are simply too large for their autonomous decomposition to be socially sustainable without government intervention. Moreover, the ultimate extent of these risks is unknown. Only governments and central banks, through globally coordinated action, can facilitate a gradual socially sustainable adjustment through intervention. A global environment for such action is possible in the scope of agreements between G7 and G20 countries. This process will entail the significant reshaping of the rules for the functioning of the financial system. The supervisory role of the state and its institutions will be strengthened with regard to the supervision of risks that are born out of the speed of innovation in the financial world and supported by the development of technology. This involves profound and complex structural changes in the system, which will arise over a longer period of time. Only a gradual easing of uncertainties will be seen in this process. Thus the effectiveness of macroeconomic policies will be objectively limited in the short term. Coordinated mechanisms aimed at preventing protectionism and self-benefiting decision-making will be very important. In this respect the European Union's coordinating mechanisms with regard to international harmonisation represent an important advantage, as these mechanisms are set out in the Treaty, together with the tools to implement decisions, and are tested in practice. A particularly important element of this coordination, in the context of a common monetary policy, is the Stability and Growth Pact, which represents the standard by which the financial markets assess the credibility of the public finance policy of individual, in particular smaller, EU Member States at a given point in time. In accordance with this standard, markets formulate their own assessment of the possibility of an individual Member State's access to funding for its needs and to the related costs.

Domestic fiscal policy measures are limited by the criteria set out in the Stability and Growth Pact. Manoeuvring room for the active functioning of fiscal policy is limited because public finance reserves or a relatively large budget surplus were not gener-

ated during the previous economic cycle. According to projections the functioning of automatic stabilisers themselves and previously adopted measures alone will temporarily lift the general government position above the permitted Maastricht criterion. Thus all the manoeuvring room of fiscal policy has already been spent. Additional effects can only be achieved by reallocating expenditure or through savings with regard to low-priority budget items. A more significant and sustained deviation from public finance stability and the Stability and Growth Pact could result in additional problems in the medium and long term, particularly when taking into account the increasing problem of the ageing population in the future. The diminishing credibility and sustainability of fiscal policy leads to higher interest rates on government borrowing and an increase in the debt servicing burden on the budget. Ultimately the government could face difficulties in financing the budget deficit. In the context of limited resources available in the scope of fiscal policy for interventions, it is important that measures are aimed at areas where possibilities for an autonomous recovery in economic activity are strengthening, based on economic entities' own risk assessments. Experiences from the European and international environments are also important when planning measures. The guarantee scheme for bank borrowing and direct government borrowing are aimed at bolstering available resources for credit supply in the banking sector. The guarantee scheme for corporates reduces uncertainty with regard to the use of this supply. Subsidies for the loss of income mitigate the consequences of the contraction in production. All of the aforementioned measures require a different degree of discretionary intervention by the government, the ability of which to manage this discretion could have a significant impact on the effectiveness of measures. This risk must therefore be the subject of particular attention when assessing the appropriateness of measures. Criteria for implementing measures must be simple, clear and understandable, while the outcome of measures must be efficiently verifiable.

Policies related to the labour market and policies that strengthen the long-term competitiveness of the economy are coming to the fore, due to the limited possibilities of implementing direct fiscal policy measures. In part these policies also involve the formation of a sustainable wage policy in line with long-term growth in productivity and a low non-inflationary unemployment rate. Measures stemming from an active policy on employment and the training of the unemployed could act to preserve or enhance human capital and facilitate a more rapid, sustainable and sharper drop in unemployment when economic conditions return to normal. In this context the current turmoil could be seen as the right time to introduce structural reforms that could strengthen the economy's competitiveness in the long-term.

							Projections					
							2009		2010		2011	
	2003	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
Activity, employment and wages	*real growth, %*											
GDP	2.8	4.3	4.3	5.9	6.8	3.5	**-2.0**	-5.5	**1.9**	-2.2	**3.0**	…
Employment	-0.4	0.3	-0.1	1.5	2.9	2.9	**-2.6**	-2.9	**-0.7**	-1.2	**0.5**	…
Disposable income*	1.7	4.3	2.7	4.4	5.5	5.9	**-0.5**	-4.4	**1.1**	-2.7	**2.1**	…
Compensation per employee	7.9	7.8	5.3	5.5	6.3	8.6	**2.5**	-4.6	**3.7**	-2.5	**3.9**	…
Productivity	3.2	4.0	4.5	4.3	3.7	0.7	**0.6**	-2.7	**2.6**	-1.0	**2.5**	…
ULC (nominal)	4.5	3.7	0.8	1.1	2.5	7.9	**1.9**	-2.0	**1.1**	-1.5	**1.4**	…
Contribution to GDP growth	*percentage points*											
Domestic demand	4.7	4.8	2.2	5.7	8.1	3.7	**-2.9**	-6.3	**2.4**	-1.6	**3.3**	…
Net exports	-1.9	-0.5	2.2	0.2	-1.3	-0.2	**0.9**	0.8	**-0.5**	-0.6	**-0.3**	…
Domestic demand	*real growth, %*											
Domestic demand	4.8	4.8	2.1	5.7	8.0	3.7	**-2.8**	-6.1	**2.5**	-1.5	**3.4**	…
Private consumption	3.3	2.8	2.8	2.8	5.3	2.2	**0.9**	-2.5	**1.4**	-2.0	**2.0**	…
Government spending	2.2	3.4	3.3	4.1	2.5	3.7	**2.1**	0.2	**2.1**	0.3	**2.5**	…
Gross investment	8.1	5.6	3.8	10.4	11.9	6.2	**-10.2**	-14.2	**4.7**	-1.3	**6.7**	…
Balance of payments	*real growth, %, unless stated*											
Exports of goods and services	3.1	12.4	10.6	12.5	13.8	3.3	**-7.0**	-14.4	**1.5**	-5.9	**4.0**	…
Imports of goods and services	6.7	13.3	6.6	12.2	15.7	3.5	**-7.9**	-15.0	**2.1**	-5.0	**4.3**	…
Current account: EUR billion	-0.2	-0.7	-0.5	-0.8	-1.5	-2.1	**-1.2**	1.3	**-1.7**	0.8	**-1.9**	…
as % GDP	-0.8	-2.7	-1.7	-2.5	-4.2	-5.5	**-3.2**	3.0	**-4.4**	1.8	**-4.9**	…
Terms of trade**	0.8	-1.0	-2.1	-0.6	0.6	-2.1	**2.2**	2.1	**-1.0**	-1.1	**0.0**	…
Prices	*average annual growth, %*											
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	5.5	**0.4**	-3.1	**1.8**	-1.7	**2.3**	…
HICP excluding energy	6.0	3.2	1.2	1.7	3.8	4.9	**1.8**	-1.8	**1.2**	-2.4	**2.0**	…
HICP energy	3.4	7.0	11.9	8.5	3.4	9.4	**-8.2**	-11.5	**6.3**	3.0	**4.7**	…
International environment	*average annual growth, %, unless stated*											
Foreign demand***	5.4	9.2	7.5	10.2	7.2	3.3	**-6.4**	-12.6	**0.9**	-5.3	**4.1**	…
Oil (USD per barrel)	29	38	54	65	73	98	**50**	-70	**60**	-60	**60**	…
Non-oil commodities	11.0	22.5	11.6	29.0	17.1	9.7	**-25.0**	-25.0	**5.0**	5.0	**5.0**	…
EMU inflation	2.1	2.1	2.2	2.2	2.1	3.3	**0.7**	-1.8	**1.6**	-0.9	**2.0**	…
PPI Germany	1.7	1.6	4.6	5.5	2.0	6.0	**0.4**	-2.6	**1.9**	-1.1	**2.0**	…

* Net wages, other employment earnings and social benefits; HICP deflated

** Based on national accounts deflators

*** Weighted volume of imports of a basket of foreign trade partners

Δ: Difference between current projections and projections in October 2008 Price Stability Report

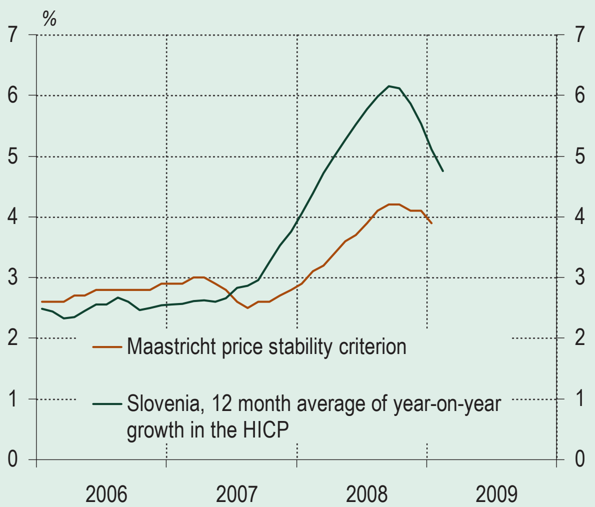
Sources: Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook

1 Recent Price Developments

Macroeconomic framework of price developments during the financial turmoil and economic crisis

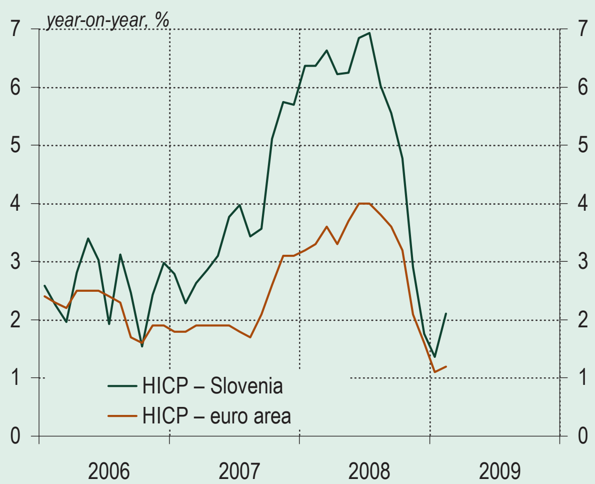
Economic developments in Slovenia over the last year have been characterised more than ever by the global factors in which a small and open economy operates. While the first half of the last year was marked by the gradual easing or normalisation of conditions on the financial markets, the picture deteriorated sharply in autumn. In July 2008 the ECB still assessed that inflation would exceed a level consistent with price stability over the longer-term. With the aim of keeping inflation expectations in check and preventing broadly based second-round effects, the ECB raised its main refinancing rate to 4.25%. Uncertainties in the environment increased significantly following the difficulties and collapse of several large investment banks in autumn 2008, resulting in the rapid and widespread transfer of the turmoil from the financial sector to the real sector. Demand fell sharply, and with it inflationary pressures. Policy makers responded to deteriorating economic conditions with relatively comprehensive measures. The ECB's key interest rate currently stands at 1.5%. It has already been seen that typical measures in the current turmoil are not sufficient, and that other less conventional monetary and fiscal policy measures are required. It has also been seen that profound and radical changes of a systemic nature are necessary to resolve the current conditions. At the beginning of the second half of last year, commodity prices began to fall rapidly due to the sharp deterioration in the macro-

Figure 1.1: Maastricht price stability criterion



Source: Eurostat, Bank of Slovenia calculations

Figure 1.2: Headline inflation



Source: Eurostat

economic environment, while falling commodity prices had the direct effect of significantly reducing inflationary pressures both abroad and in Slovenia. Alongside lower demand for products, this factor was the most significant reason for the rapid fall in inflation at the end of last year and the beginning of this year.

* * *

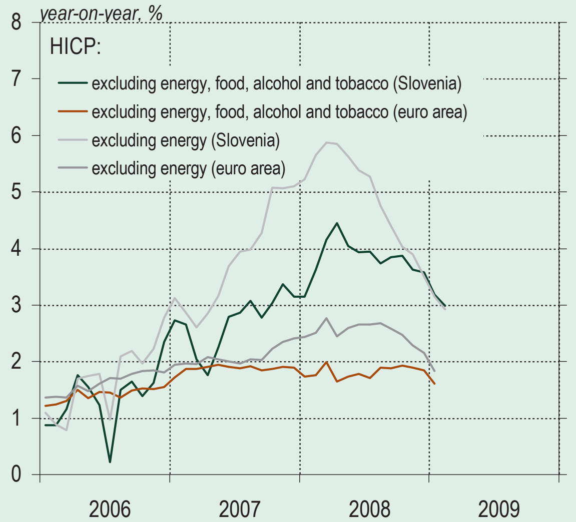
Average annual growth in consumer prices as measured by the HICP rose to 5.5% in 2008, an increase of 1.7 percentage points compared with 2007. Both domestic and foreign factors had an impact on the higher average annual inflation. Notable foreign factors included the accelerated growth in commodity prices, in particular of food and energy prices, in the first half of the year. Commodity prices eased rapidly in the second half of the year due to the global financial turmoil and economic crisis. Notable domestic factors in the first half of the year included high economic activity, growth in aggregate demand and rising nominal labour costs. Inflationary pressures linked to the domestic macroeconomic environment were seen in still relatively high core inflation, which began to fall in the second half of the year.

In 2008 average inflation exceeded the level consistent with sustainable real convergence, and increasingly deviated from the Maastricht price stability criterion during the first half of the year. This gap gradually closed in the second half of the year. The 12-month average growth in prices in Slovenia stood at 5.5% in December 2008, compared with the Maastricht criterion of 4.1%. The process of real convergence results in the catching up of prices with more developed economies, as seen in the higher average inflation rate and the real appreciation of the exchange rate under conditions of monetary union. The gap between average inflation rates in Slovenia and the euro area rose from 1.7 percentage points in 2007 to 2.2 percentage points on average in 2008. An analysis of macroeconomic indicators shows that the significant gap with the euro area is primarily linked to the trend of aggregate demand and economic activity in Slovenia, in the context of a higher weight of energy and food prices in the consumer basket. This type of development was mainly characteristic of the first half of last year when economic growth in Slovenia continued to outstrip supply potential, while economic activity in the euro area was at the level of supply potential.

Macroeconomic factors and core inflation indicators

Core inflation indicators in Slovenia began to fall gradually in the second half of the year, with these trends continuing at the beginning of 2009, and largely reflecting the slowdown in the rate of domestic economic growth. The high economic growth that characterised 2007 was also evident during the first half of last year. This was followed by a slowdown in growth. The latest national accounts figures also indicate a slowdown in household consumption, in line with a reduction in employment and lower wage growth. Growth in the HICP excluding energy and unprocessed food rose by 5.5% on average in the first half of last year, and by 4.4% in the second half of the year. Since this indicator includes the prices of processed food, which recorded high

Figure 1.3: Core inflation



Source: Eurostat, Bank of Slovenia calculations growth in the first half of the year, core inflation indicators excluding all food prices must also be compared. Growth in the harmonised price index excluding energy, food, alcohol and tobacco stood at 3.9% in the first half of last year, an increase of 1.5 percentage points on the previous year, and 3.8% in the second half of the year or 0.8 percentage points higher than a year earlier.

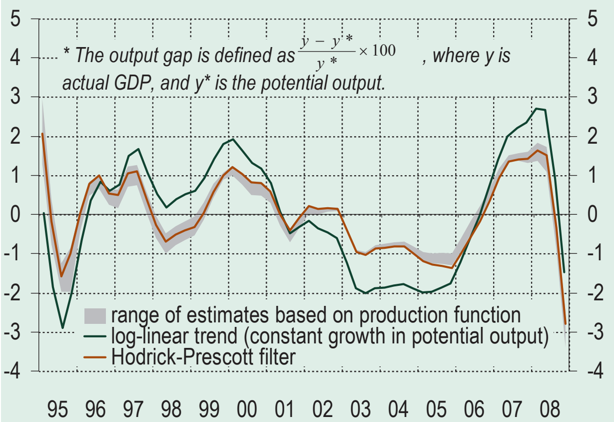
Growth in labour costs remained relatively high at the beginning of last year, and hindered the fall in core inflation during the second half of last year. Nominal growth in private sector labour costs has fallen in recent months, but current labour cost figures remain high due to the significant drop in productivity in the context of a rapid deterioration in the growth dynamics. Labour market trends over the last several months of 2008 indicate that the slowdown in economic activity is already resulting in gradually lower employment growth. High employment growth last year was still driven primarily by employment in construction (11.8% growth on average). However, employment growth slowed over the last two months of 2008 in line with slowing activity in this sector. The slowdown in employment growth has also been seen in a gradual rise in the registered unemployment rate, which stood at 6.9% at the end of the year and reached 6.7% on average for 2008. Private sector labour costs, measured by the average gross wage, rose by 7.9% on average last year or 1 percentage point more

Table 1.1: Structure of the HICP and price indicators

		average annual growth, %					year-on-year growth in quarter, %				
	weight	2004	2005	2006	2007	2008	07Q4	08Q1	08Q2	08Q3	08Q4
HICP	*100.0%*	3.7	2.5	2.5	3.8	5.5	5.5	6.5	6.4	6.2	3.1
Breakdown of HICP:											
Energy	*13.4%*	7.0	11.9	8.5	3.4	9.4	8.6	12.5	11.7	15.0	-1.2
Food	*22.5%*	1.3	0.2	2.7	7.1	8.1	10.7	11.3	9.9	7.5	4.1
processed	*14.9%*	2.7	0.6	2.5	6.3	9.9	10.6	13.0	12.7	8.9	5.5
unprocessed	*7.5%*	-1.4	-0.8	3.1	8.7	4.6	10.8	7.8	4.7	4.8	1.5
Other goods	*29.8%*	1.8	-0.3	-0.9	0.3	2.2	0.9	1.6	2.6	2.1	2.5
Services	*34.3%*	5.8	3.3	3.5	4.9	5.3	5.3	5.5	5.5	5.3	4.7
Core inflation indicators											
HICP excluding energy	*86.6%*	3.2	1.2	1.7	3.8	4.9	5.1	5.6	5.6	4.8	3.8
HICP excluding energy and unprocessed food	*79.1%*	3.7	1.3	1.5	3.4	5.0	4.5	5.4	5.7	4.8	4.0
HICP excluding energy, food, alcohol and tobacco	*64.2%*	3.9	1.5	1.3	2.7	3.8	3.2	3.6	4.1	3.8	3.7
Administered and non-administered prices:[1]											
Administered prices	*6.2%*	4.6	2.8	2.3	2.1	2.2	2.3	1.3	2.1	1.9	3.2
Non-administered prices	*93.8%*	3.5	2.4	2.6	3.9	5.8	5.7	6.8	6.7	6.4	3.1
Other price indicators:											
Industrial producer prices on domestic market		4.3	2.7	2.3	5.4	5.6	6.5	5.9	6.3	6.5	3.8
GDP deflator		3.4	1.6	2.0	4.1	4.0	4.6	5.3	4.4	3.6	3.0
Import prices[2]		4.1	5.0	3.3	2.3	4.0	1.9	3.5	3.9	6.0	2.5
Selected macroeconomic factors:											
Output gap (HP trend)		-0.9	-1.3	-0.3	1.3	0.0	1.4	1.6	1.5	-0.3	-2.8
Unit labour costs[3]		3.7	0.8	1.1	2.5	7.9	4.9	5.7	6.6	8.9	10.4
Labour costs per employee[3]		7.8	5.3	5.5	6.3	8.6	6.9	8.1	9.0	10.0	7.1
Productivity[3]		4.0	4.5	4.3	3.7	0.7	1.9	2.3	2.3	1.0	-2.9
Profit indicator[4]		-0.3	0.8	0.9	1.6	-3.5	-0.3	-0.4	-2.1	-4.8	-6.7

Notes: [1] ECB methodology, [2] National accounts figures, [3] National accounts data on compensation of employees is used for calculation of labour costs, [4] Calculated as the difference between the GDP deflator and unit labour costs.
Sources: SORS, Eurostat, Bank of Slovenia calculations

Figure 1.4: Range of estimates of output gap in Slovenia*



For more on the calculation of indicators see Box 1.1 in the October 2008 Price Stability Report. Current estimates of the output gap are very uncertain, as there could be a break in the growth trend of potential output in case of quick GDP growth reversal.
Source: SORS, Bank of Slovenia calculations

than the previous year. However, this growth rate began to fall sharply at the end of the year.

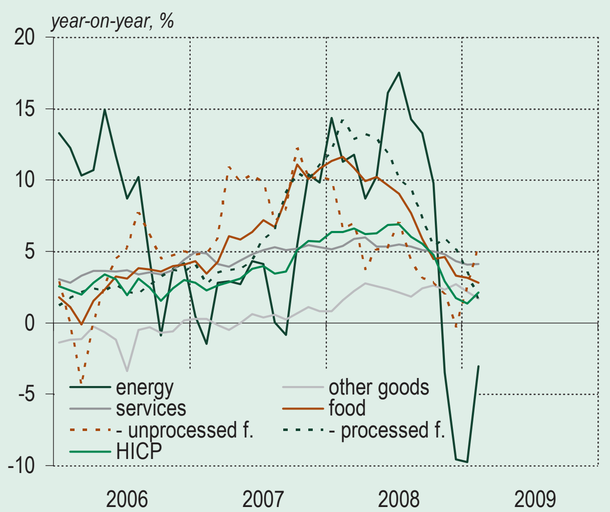
An important factor, which in part mitigated the adverse impacts on inflation, was the appreciation of the nominal effective exchange rate. The appreciation of the euro in the first half of the year contributed to the reduced pass-through of US dollar oil and food prices to the costs of euro area companies. The euro appreciated by an average of 7.3% last year against the US dollar, while US dollar oil prices were up 34.3% on average.

The turmoil affecting the financial markets and the economy resulted in a tightening of financing conditions in Slovenia as well, while the drop in lending activity and the tightening of monetary indicators is reducing longer-term inflationary risks. Rising real interest rates at the end of last year, primarily due to falling inflation, further reduced demand. Despite the gradual rise in nominal interest rates, financing conditions for non-financial corporations and households remained favourable until the final quarter of last year. During this period, real interest rates in Slovenia were lower than the euro area rates due to somewhat higher inflation, which stimulated lending. Real interest rate rose in the final quarter as a result of falling inflation, despite the fact that nominal interest rates were down. This, in addition to the financial turmoil and associated uncertainties, resulted in a further drop in lending activity, both in Slovenia and the euro area.

Microeconomic factors and the structure of inflation

Energy and food prices recorded the most rapid decline in the second half of last year. Following the rise at the end of 2007, energy prices continued to grow over the first half of last year, followed by a drop, which was most notable in the final quarter. Year-on-year growth in energy prices reached its peak in July at 17.5%, while growth had turned negative (-9.5%) by the end of last year. Average year-on-year growth in energy prices stood at 9.5% last year, up 6.1 percentage points on the previous year. Record global oil prices, which exceeded USD 140 per barrel in the middle of the year, contributed most to the growth in energy prices in the first six months of the year. Growth in oil prices began to fall in the second half of the year, with a particularly sharp drop in growth seen in the final quarter due to the deepening global economic crisis and financial turmoil. The average price of a barrel of oil on global markets stood at USD 98 last year, an increase of USD 25 from a

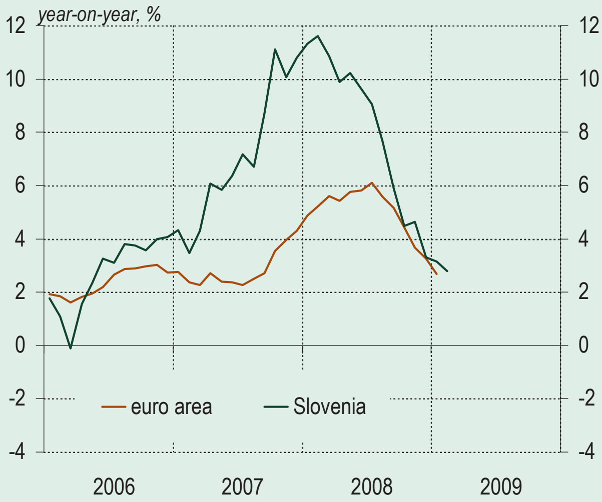
Figure 1.5: Individual price categories



Source: SORS, Bank of Slovenia calculations year earlier. Also contributing to the path of energy prices were base effects from 2007 when the growth in energy prices was relatively low over the first ten months of the year, while prices began to rise in the last two months. Year-on-year growth in energy prices in the first two months of 2009 was up on the end of last year, and stood at -3.0% in February, as a result of the government's decision at the end of December 2008 to raise excise duties on energy products in order to mend the budget deficit in the context of falling prices on global markets. Average annual growth in energy prices in euro area stood at 10.4 % in 2008, an increase of 7.8 percentage points from the previous year.

Food prices have begun to ease, primarily since October 2008, in part due to a drop in food and commodity prices in the context of the global economic crisis and financial turmoil, and also as a result of a decline in domestic demand. Average annual growth in food prices stood at 8.2% in 2008, up 1.1 percentage points on the previous year and 3.1 percentage points higher than in the euro area. The high growth in food prices present since April 2007 continued during the first half of last year, while growth slowed in the second half of the year to stand at just 3.3% in year-on-year terms at the end of December. Growth fell by an additional 0.5 percentage points in the first two months of this year to 2.8%. The fastest growing food prices with respect to the previous year were processed food prices. Despite the fact that processed food prices rose by 10.0% on average last year, or 3.7 percentage points more than in 2007, growth in the final quarter and at the beginning of 2009 began to slow, and stood at 1.6% in February. In contrast growth in the prices of unprocessed food fell by 4 percentage points in 2008 compared with the previous year to 4.7%. Growth in prices was up slightly again at the beginning of this year, and stood at 5.4% in February. As in 2007 the high growth in food prices can in part be attributed to higher food prices in the international environment, where the average year-on-year growth in US dollar food prices stood at 35% in 2008, an increase of 9

Figure 1.6: Food prices in Slovenia and the euro area

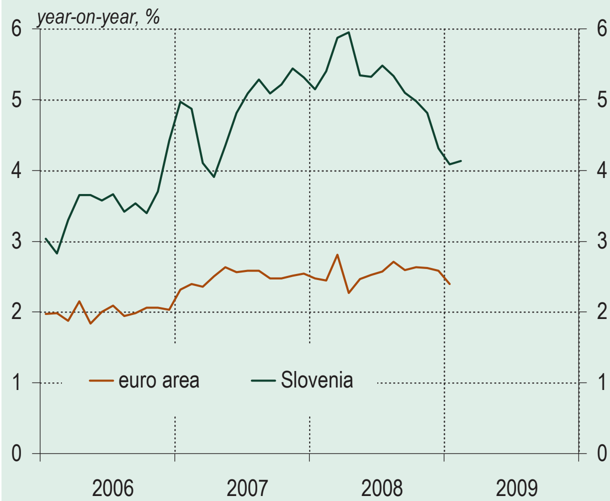


Source: Eurostat, Bank of Slovenia calculations

percentage points on the previous year, and partly to the trend of domestic demand and cost factors. In order to collect additional budget revenues, the government passed a decision to increase excise duties on alcohol and alcoholic beverages by 31.1%, which will enter into force on 1 March 2009. Excise duties on tobacco products are also expected to be raised as of 1 May 2009 from EUR 64 to EUR 69 per 1,000 cigarettes.

Services prices followed the trends of aggregate demand and labour costs, and thus deviated from

Figure 1.7: Prices of services in Slovenia and the euro area

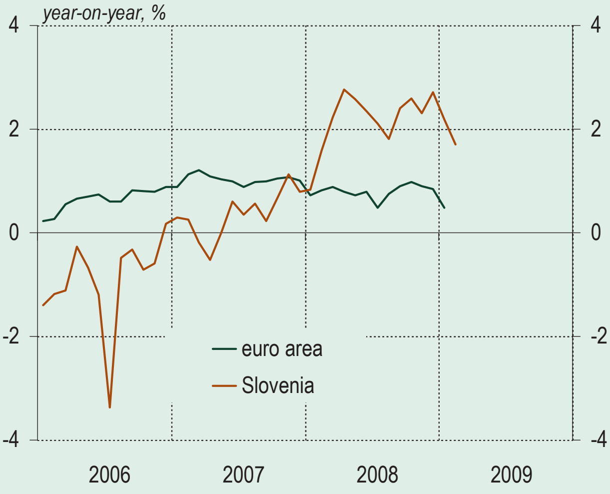


Source: Eurostat, Bank of Slovenia calculations

growth in services prices in the euro area. That gap, however, was halved over the last three quarters. Average growth in services prices stood at 5.3% last year, up 0.4 percentage points on the previous year. However, the deterioration in the economic situation and the resulting decline in demand led to a drop in the growth in services prices in the final months of last year and at the beginning of this year, with growth standing at 4.1% in February. Growth in euro area services prices remained virtually unchanged from the previous year at 2.6%. Among services, the most notable growth was recorded by prices of hospital services, which was up 5.6 percentage points at 7.8%. Growth in the prices of catering and accommodation services was up 2.3 percentage points at 9.6%, while growth in the prices of holiday packages was up 0.9 percentage points at 7%. Following a drop in 2007, the prices of municipal services rose by an average of 0.7% last year.

The prices of non-energy industrial goods were also up in 2008 compared with the previous year. Year-on-year growth in prices rose from the end of 2007, when it still stood at around 1%, to 2.7% at the end of last year, significantly outstripping euro area price growth. Average annual growth in the prices of non-energy industrial goods stood at 2.2% last year, an increase of 1.9 percentage points on the previous year and 1.4 percentage points higher than in the euro area. Similar to services, price growth was down at the beginning of this year, and stood at 1.7% in February. This category's contribution to headline inflation rose from 0.2 percentage points in 2007 to 0.7 percentage points in 2008. The largest contribution to the higher growth in prices came from prices of clothing and footwear, which rose by 4.3% on average last year. Last year average growth in the prices of non-energy industrial goods in the euro area stood at 0.8%, down 0.2 percentage points on the previous year. Higher growth in the prices of this sub-category in Slovenia compared with the euro area is primarily a reflection of internal macroeconomic factors. However, the gap is smaller than that recorded by services due to the higher level of international competition in this category of goods.

Figure 1.8: Prices of non-energy industrial goods



Source: Eurostat, Bank of Slovenia calculations

Administered prices

Administered prices excluding energy rose by 1.1% on average in 2008, contributing approximately 0.1 percentage points to headline inflation. The prices of district heating rose by 12.3% last year. The prices of passenger railway services within Slovenia rose by 3.0% in 2008, while the prices of municipal services were up 0.5%. The government has approved a maximum of 2.8% increase in the prices of domestic passenger railway services, effective as of March 2009.

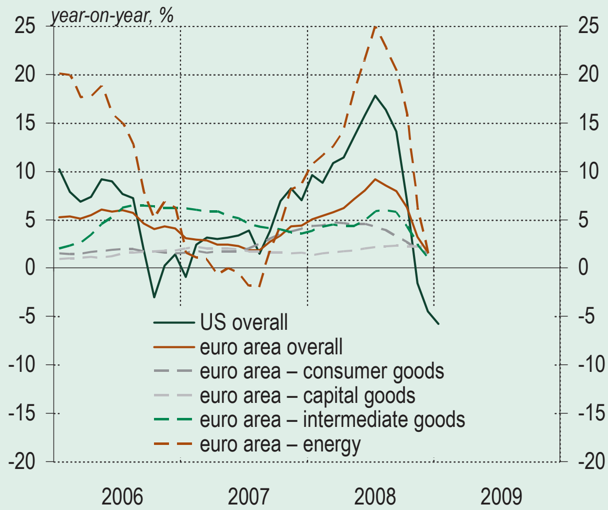
Producer prices

Industrial producer prices on the domestic market rose by an average of 5.6% last year, while these prices were up 3.3% in the euro area over the same period. Growth in industrial producer prices eased considerably at the end of last year and the beginning of this year, in part due to the fall in energy prices. Despite higher average growth, year-on-year price growth has slowed since September 2008, and

Figure 1.9: Industrial producer prices on the domestic market

Source: SORS, Bank of Slovenia calculations

Figure 1.10: Industrial producer prices on the domestic market for the US and the euro area



Source: Eurostat, Federal Reserve Bank of St. Louis, Bank of Slovenia calculations

stood at 2.3% in January of this year. Prices of energy output recorded the highest growth (7.6%) last year, as a result of high growth in energy prices on world markets. The impact of metal prices, which rose by an average of around 2%, on the 5.3% growth in prices of intermediate goods was considerably lower than the previous year. Lower year-on-year growth in metal prices was primarily a result of a slowing demand from major world economies. Moreover, average growth in the prices of capital goods rose from 0.9% in 2007 to 3.6% in 2008, as did the growth in prices of consumer goods, from 3.2% in 2007 to 5.6% in 2008. Higher growth in industrial producer prices in the euro area compared with a year earlier was primarily a result of higher growth in energy prices. Last year growth in industrial producer prices in the US was up 5.1 percentage points to 9.9%. A slowdown in growth in industrial producer prices at the end of last year and the beginning of this year is characteristic for both of the aforementioned economies. Average price growth fell from 6.2% in 2008 to -0.5% in January in the euro area, and from 9.9% to -5.7% in the US.

2 International Environment and Projection Assumptions[1]

The financial turmoil, which has gradually spread to the real sector, deepened considerably during the second half of last year, and continues in the beginning of 2009. Many major world economies have slid into recession. Forecasts of economic growth in Slovenia's most important trading partners for 2009 have been revised downwards accordingly, significantly affecting projections of economic activity in Slovenia. The euro area economy has been faced with negative quarterly growth rates since the third quarter of last year. According to initial estimates, euro area growth was a modest 0.8% in 2008. The US economy grew by 1.1% last year, while the year-on-year drop in economic activity of 0.8% in the final quarter was worse than analysts' forecasts. A high level of uncertainty, which in part is reflected in considerable downward revisions to economic growth forecasts (see Box 2.1), and weak consumer confidence at the beginning of 2009 point to a significant global economic downturn. Even the economies of developing countries and the countries of south-eastern Europe,

Table 2.1: Assumptions regarding factors from the international environment

						Projections					
						2009		2010		2011	
	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
	annual growth, %, unless stated										
Foreign demand*	9.2	7.5	10.2	7.2	3.3	**-6.4**	-12.6	**0.9**	-5.3	**4.1**	…
Oil (USD/barrel)	38	54	65	73	98	**50**	-70	**60**	-60	**60**	…
Non-oil commodities	22.5	11.6	29.0	17.1	9.7	**-25.0**	-25.0	**5.0**	5.0	**5.0**	…
EMU inflation	2.1	2.2	2.2	2.1	3.3	**0.7**	-1.8	**1.6**	-0.9	**2.0**	…
PPI Germany	1.6	4.6	5.5	2	6.0	**0.4**	-2.6	**1.9**	-1.1	**2.0**	…

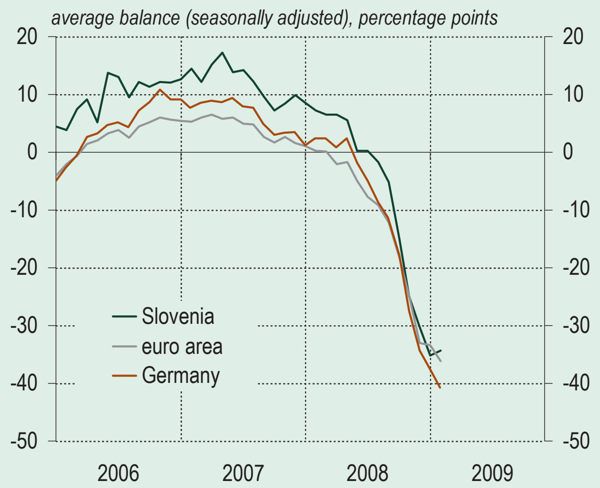
* *Weighted volume of imports of a basket of foreign trade partners*
Δ: Difference between current projections and projections in April 2008 Price Stability Report
Sources: Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook

[1] The projections were made on the basis of the data available and the statistical methodology applicable on 9 March 2009. The projections of macroeconomic factors presented in the Price Stability Report are based on assumptions regarding the movement of variables in the international environment and certain domestic factors dependent on economic policy decisions. The assumptions regarding the movement of variables in the international environment are taken from the Consensus Forecasts (February 2009), JP Morgan (Global Data Watch, 6 March 2009), the OECD Outlook (December 2008), the IMF World Economic Outlook Update (January 2009) and the European Commission Economic Forecast Update (January 2009), and from the value of futures contracts as at 2 March 2009. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumed values used in the projections are not the same as those used in its projections by the ESCB. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex in the April 2008 Price Stability Report.

where significant downward revisions to forecasts of future economic growth have been made, will be affected. In their latest forecasts, the majority of institutions are projecting negative economic growth in 2009 for the major global economies. According to Consensus's February forecasts, economic activity in the euro area, the US and Japan is expected to contract by 2.0%, 2.1% and 3.8% respectively in 2009. ECB forecasts from March point to an even greater contraction in economic activity in the euro area, where it is expected to be between 2.2% and 3.2% in 2009. The World Bank and IMF are forecasting the first contraction in the global economy since the end of 1945. Governments are attempting to compensate for the drop in household final consumption and mitigate the effects of the financial turmoil through fiscal stimulus. The budget deficit in the US, where fiscal stimulus is greatest, is expected to be between 8% and 12% of GDP for the next fiscal year. Higher budget deficits this year are also foreseen for euro area countries. This will trigger procedures set out in the Stability and Growth Pact for identifying an excessive deficit. The increased needs of euro area countries for financing are also reflected in the high balance of payments deficits of certain countries, which are triggering the setting of high premiums for the financing of government debt.

Following several years of strong economic growth in Slovenia's most important trading partners, a significant drop in foreign import demand can be expected this year, while further deterioration in conditions in south-eastern Europe could result in an additional downward deviation. Recent news of economic conditions in Slovenia's most important trading partners points to a major slowdown in economic activity. In February Consensus forecast a contraction in economic activity this year for nearly all of Slovenia's most important external trading partners. Economic activity in Germany, Italy and France is expected to contract by 2.5%, 2.3% and 1.4% respectively. The economic outlook for trading partners outside the euro area is also bleak. According to Consensus's February forecast, Croatia and Russia can

Figure 2.1: Business confidence in Slovenia and abroad



Source: Eurostat

expect a drop in aggregate output of 0.6% of GDP, while economic growth of 1% is forecast for Serbia, which has received IMF assistance. The Russian and Croatian central banks intervened on the foreign exchange market several times last year and at the beginning of this year to mitigate falls in their domestic currencies. The Baltic States and several countries from south-eastern Europe have incurred high current account deficits in past years, where a large portion of the debt of the private and public sectors was denominated in a foreign currency. Depreciation or devaluation of the currencies in the aforementioned countries therefore increases the risk of default on raised loans. Rating agencies have downgraded several countries both within and outside the euro area, or issued warnings of future downgradings. For these reasons, the assumption regarding foreign demand, which is expected to fall by 6.4% this year and rise by 0.9% in 2010, has been revised downwards significantly.

Recent figures, which point to a drop in output in the euro area and the US, and weak consumer confidence indicators further dampen this year's outlook. Euro area industrial production has fallen for several months in succession and fell by 17.3% in year-on-year terms in January 2009. The number of new industrial orders has also fallen for several consecutive months.

Box 2.1: Across-the-board cuts in economic growth forecasts for 2009

Massive downward revisions to economic growth forecasts were made in the second half of last year and at the beginning of this year. This box illustrates the movements in economic growth forecasts for the euro area, the US and eastern Europe* for 2009, as published by the International Monetary Fund (IMF), the European Commission, the Organisation for Economic Cooperation and Development (OECD) and Consensus, which compiles monthly averages of forecasting experts. The cumulative downward revision, from the middle of last year until February 2009, in Consensus's average forecast for GDP growth is 3.3 percentage points for the euro area and 3.7 percentage points for the US.

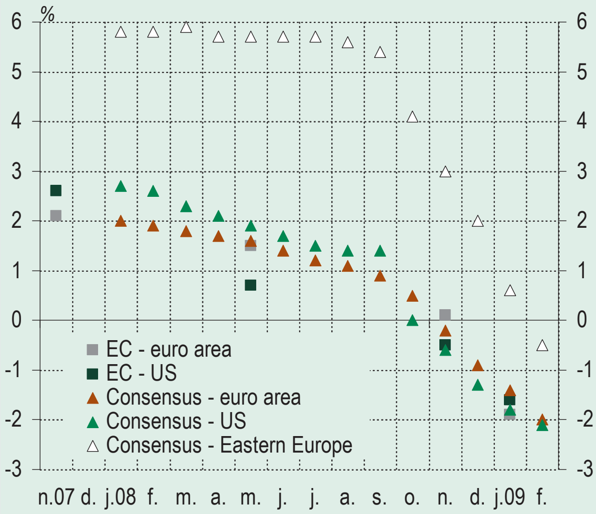
The first forecasts of economic growth for 2009 drawn up by the aforementioned institutions were published in the middle of 2007. The European Commission's autumn 2007 forecast projected GDP growth in 2009 of 2.1% for the euro area and 2.6% for the US. In its forecast published in December 2007, the OECD projected GDP growth in 2009 of 2.0% for the euro area and 2.2% in the US. In January 2008 Consensus likewise forecast robust growth in the major economies: 2.0% for the euro area and 2.7% for the US. In January 2008 Consensus also forecast exceptionally high growth for the countries of eastern Europe, where economic growth was expected to be 5.8%.

The first major revisions to forecasts of economic growth were made in April 2008, when the IMF cut its economic growth forecast for 2008 and 2009 significantly. The April forecast projected economic growth in 2009 of 1.2% for the euro area and 0.6% for the US. The European Commission followed suit with downward revisions in its spring forecast, which projected economic growth of 1.5% in the euro area and 0.7% in the US. In June 2008 the OECD followed the IMF and the European Commission and revised its forecasts for 2009 downwards to 1.4% in the euro area and 1.1% in the US. Consensus's June forecast of economic growth for the euro area was the same as the OECD forecasts, while the forecast for the US stood at 1.7%. At this time Consensus continued to forecast high economic growth of 5.7% for the countries of eastern Europe.

The IMF again revised its forecasts downwards in October 2008, following the collapse of Lehman Brothers investment bank, which deepened the financial turmoil. It forecast economic growth in 2009 of 0.2% for the euro area and 0.1% for the US. The European Commission’s autumn forecast was similar, projecting 0.1% economic growth for the euro area and a contraction in US economic activity of 0.5%. In October 2008 Consensus's economic growth forecast for 2009 stood at 0.5% for the euro area and 0.0% for the US. In October Consensus made a significant downward revision to its economic growth forecast for eastern Europe, to 4.1%. In December the OECD once again revised its forecasts for economic growth in the two most important economies downwards. According to the OECD's December forecasts, economic growth is expected to be -0.6% in the euro area and -0.9% in the US. Consensus followed the OECD and cut its 2009 economic growth forecasts significantly for practically all the observed economies. It forecast a contraction in economic activity in the euro area of 0.9% and a 1.3% drop in GDP in the US. It also significantly cut forecasts of economic growth in the countries of eastern Europe, where December's forecast stood at 2.0% for the entire region.

In January 2009 the European Commission and IMF published revised economic growth forecasts for 2009 in their interim reports. The European Commission and IMF forecast

Figure: Changes in forecasts of economic growth for 2009



Source: Consensus, European Commission

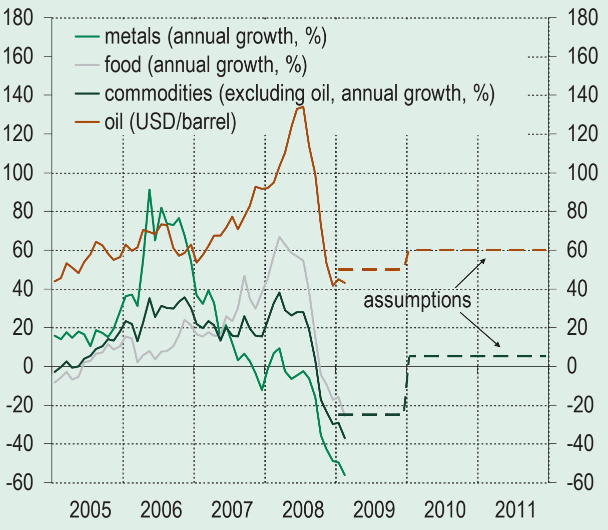
* The countries of eastern Europe are taken from Consensus's classification which includes Bulgaria, the Czech Republic, Croatia, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Russia, Slovakia, Slovenia, Turkey, Ukraine, Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Cyprus, Georgia, Kazakhstan, Macedonia, Moldova, Serbia, Turkmenistan and Uzbekistan.

contractions in euro area economic activity of 1.9% and 2.0% respectively. In January both institutions forecast a 1.6% drop in US economic activity. In February 2009 Consensus made further downward revisions to its economic growth forecasts. Economic growth is expected to be -2.0% in the euro area and -2.1% in the US, while 0.5% economic growth is forecast for eastern Europe.

Consumer confidence indicators remain at low levels in both the euro area and US. The Ifo confidence indicator for the euro area, measured on a quarterly basis, has fallen for six consecutive periods, and reached its all-time low in the first quarter of 2009. The University of Michigan Consumer Sentiment Index has risen slightly in recent months falling sharp drops at the end of 2008, but remains extremely low. Figures from the US and euro area labour markets have deteriorated over the last six months. The unemployment rate in the US non-farm sector stood at 8.1% in February, up 3.3 percentage points on February 2008, while euro area unemployment was up 1 percentage point from January 2008 at 8.2% in January of this year.

Oil prices fell sharply in the second half of 2008 and at the beginning of this year due to weak economic activity and concerns over the depth and duration of the recession in major economies. This has resulted in considerable downward revisions of oil price assumptions for the next two years. Oil prices reached their peak in the middle of 2008, with the price for a barrel (159 litres) of Brent crude reaching nearly USD 135 in July. The second half of the year initially saw a moderate drop in prices, while oil prices fell sharply in the final months of last year, which even OPEC decisions to cut pumping could not prevent. In 2008 the average price for a barrel of Brent crude was USD 98 or EUR 66. Oil prices continued to fall in the first two months of this year; however, the drop in prices was less notable. The average price for a barrel of Brent crude was USD 44 in the first two months of 2009, while forward contracts point to somewhat higher prices in the second half of the year. The movement of oil prices will be affected on the one hand by future decisions of crude oil producing nations to cut pumping, while the duration of the recession and the pace of recovery in major global economies could have a negative impact on oil prices on the other hand.

Figures 2.2: Prices on world commodity markets



Source: The Economist, Bloomberg, Bank of Slovenia assumptions

The prices of other commodities have also fallen sharply since autumn, while market participants expect moderate growth in commodity prices in the future. Commodity prices were up 30% on average in the first half of 2008, while there was a sharp drop in price growth in the second half of the year, in line with the downward revisions regarding economic growth in the major economies. US dollar commodity prices rose by 9.7% on average in 2008, while euro prices were up 1.6% due to the currency's appreciation against the US dollar. The high basis achieved in the first half of 2008 and slowing global economic activity are the reasons for the expected year-on-year fall in commodity prices in 2009. These prices fell 37% on average in February in year-on-year terms. Metal prices, which fell 56% year-on-year in February, recorded the most significant drop among commodities. Food prices, which were down 26% year-on-year, recorded the smallest fall. An average drop of 25% in US dollar commodity prices in 2009 is assumed in the forecasts.

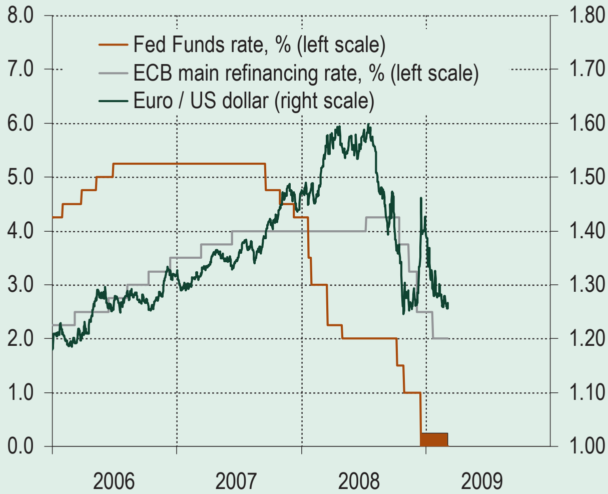
In the second half of last year inflation in the euro area and US fell sharply from the high rates recorded in the first six months due to the fall in energy prices and weak economic activity. Risks of inflationary pressures in the euro area are balanced over the projection horizon. The drop in commodity prices and the slowdown in economic activity had the greatest impact on the significant downward revision of the assumption regarding inflation in the euro area and the US for this year. Average growth in the HICP in 2008 stood at 3.3% and 3.8% in the euro area and the US respectively. The largest contribution to general price growth came from the high growth in energy prices, which stood at 10.3% on average in the euro area and 13.9% in the US. A slowing in general price growth was seen in second half of last year, which intensified at the beginning of 2009. The main reason for this was lower oil and other energy prices. In February year-on-year inflation stood at 1.2% in the euro area and 0.2% in the US. Energy prices recorded the largest year-on-year fall in February, dropping 4.9% in the euro area and 18.5% in the US. Transport prices, which were up 2.7% on average, also contributed to the lower growth in the euro area general price index in February. Core inflation has eased in both economies. Core inflation (measured as the consumer price index excluding energy and unprocessed food) in the euro area stood at 1.7% in February in year-on-year terms, while core inflation (measured as the consumer price index excluding energy and food) in the US was 2.2% in the same period. Last year average core inflation stood at 2.4% in the euro area and 2.3% in the US. Growth of 0.7% in the HICP in the euro area is forecast for this year. An average fall in the consumer price index of 0.9% is expected in the US.

Growth in industrial producer prices is falling in line with the drop in the general price level. Euro area industrial producer prices rose by 6.2% on average last year, primarily due to high energy prices, which rose rapidly during the first half of the year in particular. German industrial producer prices were up 6.0% on average, with a notable slowdown in growth seen in the second half of the year. Growth in industrial producer prices was highest in July when year-on-year growth stood at 8.9%. Year-on-year growth in industrial producer prices was even higher in some euro area countries, while month-on-month drops in the same prices were exceptionally high in these countries. German industrial producer prices are expected to rise by 0.4% on average in 2009. Weak domestic and foreign demand will contribute further to the low growth in industrial producer prices.

In response to the easing of inflationary pressures and the deepening of the economic crisis, central banks have cut their key interest rates significantly. These now stand at all-time lows. Tightened conditions on the financial markets call for an active role by the central banks, which have responded in part to the limited functioning of the money market by expanding the range of securities accepted as loan collateral and by aggressively cutting interest rates. Among the steps taken by the central banks in the second half of 2008 was coordinated action to drastically cut interest rates. The ECB left its key interest rate unchanged at 4.00% during the first six months, and raised it to 4.25% in July. The ECB began cutting its key interest rate in October, reaching a level of 1.50% in March 2009. The Federal Reserve has been cutting its key interest rate since August 2007, when the rate stood at 5.25%. The aggressive cutting of interest rates continued until December, when the Federal Reserve defined a target interval for its key interest rate of between zero and 0.25%, where the rate stood in March. In March the Bank of England cut its key interest to 0.50%, the lowest value in its history. The Bank of Japan also cut its key interest rate in December to 0.10%, where it currently stands. The standard assumption that interest rates will be aligned with the current expectations of financial markets has been applied in the projections.

The euro appreciated against the US dollar during the first half of last year, but depreciated in the second

Figure 2.3: Euro / US dollar exchange rate and central bank interest rates



Source : ECB, Federal Reserve

half of 2008 and at the beginning of this year. Despite the drop in the euro's value since the middle of 2008, the currency appreciated by 7.3% on average against the US dollar in year-on-year terms. The average EUR/USD exchange rate stood at 1.4707. Following a brief period of the euro appreciating against the US dollar at the end of last year, the US dollar continued to appreciate against the euro at the beginning of 2009. A EUR/USD exchange rate of 1.25, the level seen at the beginning of March 2009, is taken into account in the assumptions.

3 Economic Trends and the Labour Market

Slovenia's real GDP rose by 3.5% in 2008, down one-half on the exceptional 6.8% growth recorded in 2007. Projections for this year indicate negative economic growth, while the risk of continued weak economic growth over the entire projection horizon is increasing. While economic growth in the first half of the year stood at 5.6% year-on-year, it slowed significantly in the second half of the year. The contraction of economic activity by 4.1% in the final quarter of 2008 relative to the previous quarter reflects further deepening of the international financial turmoil, which has passed through to the broader economy and primarily affected investment activity, which will contract significantly in 2009 as well. Uncertainties regarding economic developments remain high, mainly due to the slowdown in economic activity in the euro area and eastern Europe and the lasting global credit crunch. According to the projections, on average, the economic growth is expected to lag significantly behind the estimated potential output over the entire projection horizon, and stand at about -2% in 2009.

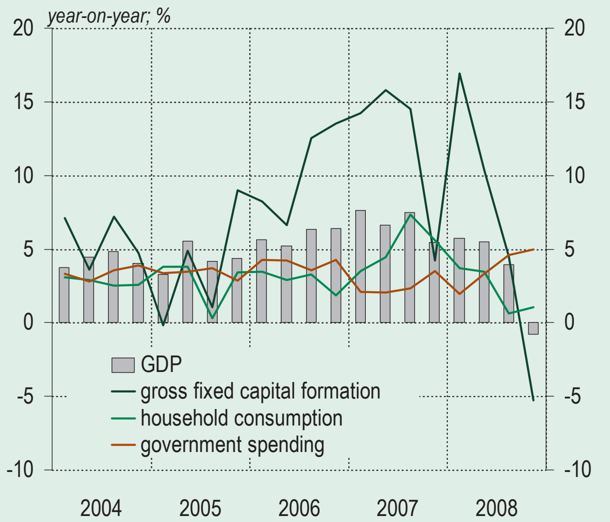
The structure of value-added growth remained largely unchanged with regard to last year. As in 2007 the greatest contribution to growth in value-added last year came from construction, financial intermediation and retail. A considerably more negative picture is presented by value-added in manufacturing, which was up 2.4% in year-on-year terms in the first half of the year, and was followed by a significant drop in the second half of the year. The 10.5% decline in the final quarter helped drive value-added in manufacturing down

Table 3.1: Activity, employment and wages

						Projections					
						2009		2010		2011	
	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
	real growth, %										
GDP	4.3	4.3	5.9	6.8	3.5	**-2.0**	-5.5	**1.9**	-2.2	**3.0**	…
Employment	0.3	-0.1	1.5	2.9	2.9	**-2.6**	-2.9	**-0.7**	-1.2	**0.5**	…
Disposable income*	4.3	2.7	4.4	5.5	4.8	**-0.5**	-4.4	**1.1**	-2.7	**2.1**	…
Average employee compensation	7.8	5.3	5.5	6.3	7.4	**2.5**	-4.6	**3.7**	-2.5	**3.9**	…
Productivity	3.9	4.5	4.3	3.7	0.6	**0.6**	-2.7	**2.6**	-1.0	**2.5**	…
ULC (nominal)	3.7	0.8	1.1	2.5	6.8	**1.9**	-2.0	**1.1**	-1.5	**1.4**	…
Contribution to GDP growth	*percentage points*										
Domestic demand	4.8	2.2	5.7	8.1	3.7	**-2.9**	-6.3	**2.4**	-1.6	**3.3**	…
Net exports	-0.5	2.2	0.2	-1.3	-0.2	**0.9**	0.8	**-0.5**	-0.6	**-0.3**	…

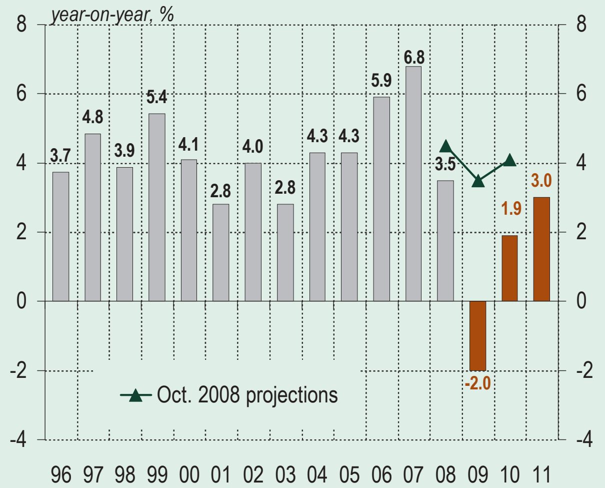
** Net wages, other employment earnings and social benefits; HICP deflated*
Δ: Difference between current projections and projections in October 2008 Price Stability Report
Sources: SORS, Bank of Slovenia

Figure 3.1: Domestic demand and GDP



Source: SORS, Bank of Slovenia calculations

Figure 3.2: GDP growth projections



Source: SORS, Bank of Slovenia projections

1.5% on average for the year. According to expectations this contraction or slowdown will continue in 2009 due to low economic growth in the most important trading partners. Industrial production had also slowed significantly by the end of last year: in November alone, industrial production was down 12.8% on October, and fell an additional 4% in December. These figures are in line with the industrial production dynamics in the euro area, where industrial production was down 1.7% in 2008 with the most significant slowdown seen at the end of last year, when industrial production in December fell by 2.6% on November.

In the context of slowing economic activity in the euro area and in other important trading partners, new manufacturing orders from both, the foreign and domestic markets were down and the same can be expected this year. The value of new manufacturing orders fell sharply in the second half of last year in Slovenia: a double-digit contraction in both current and year-on-year terms was recorded in October and November, so that the value of new manufacturing orders at the end of December 2008 was down 34.3% on the same period in 2007. In line with the increasing drop in orders from the rest of the world at the end of last year, confidence indicators have deteriorated over the last several months. In

Table 3.2: GDP and components of demand in Slovenia and the rest of the world

	GDP 2008				Private consumption 2008				Government spending 2008				Gross investment 2008				Exports 2008				Imports 2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	year-on-year change, %, seasonally adjusted and adjusted for number of working days																							
Euro area*	2.1	1.4	0.6	-1.3	1.6	0.8	0.4	-0.7	1.6	2.2	2.5	1.7	3.3	2.0	0.4	-3.3	5.5	4.4	2.5	-5.6	4.3	3.2	2.5	-3.2
EU**	2.4	1.7	0.7	-1.3	2.3	1.5	0.8	-0.4	1.9	2.2	2.5	1.9	3.5	2.4	0.1	-3.7	6.0	5.0	2.7	-5.2	5.3	4.3	2.5	-3.4
US	2.5	2.1	0.7	-0.8	1.5	1.3	-0.2	-1.5	2.6	2.4	2.9	3.3	-1.7	-2.4	-3.2	-6.7	10.1	11.0	6.1	-1.8	-1.0	-1.9	-3.5	-7.1
Japan	1.4	0.6	-0.2	-4.6	1.4	0.2	0.6	-0.1	2.7	0.2	0.5	-0.1	-4.4	-3.3	-4.5	-7.2	10.9	6.1	4.2	-12.8	2.7	-1.6	0.4	2.9
Slovenia	5.9	5.0	3.7	-0.9	3.8	3.5	0.6	1.1	2.0	3.3	4.6	5.0	16.5	13.1	6.0	-8.5	7.6	8.0	4.2	-6.2	9.7	9.2	3.0	-6.6

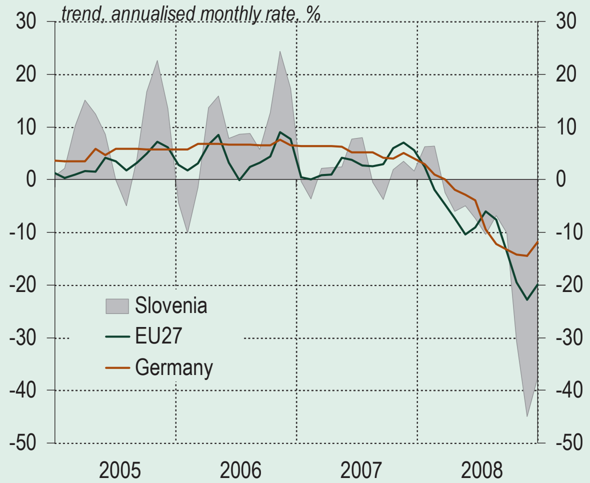
**15 countries, ** 27 countries*
Sources: Eurostat, SORS

the first months of this year manufacturing expectations dropped to record lows.

A slowdown is also expected in the service sectors and construction. Expectations in construction and services have also been deteriorating for several consecutive months. The value-added in the construction sector grew by just 3.1% in year-on-year terms in the final quarter of last year. This is significantly less than the 14.2% growth recorded in the previous quarter and the 20.5% growth from the first half of the year. Slowing growth in value-added in the second half of 2008 was recorded by companies that are dependent on domestic demand as well as those that produce primarily for foreign markets. Growth in value-added in retail also slowed considerably in the second half of last year, with growth of just 1.7% recorded in the final quarter, down sharply from the 7.1% growth in the first half of the year. Despite the financial turmoil, the value-added in financial intermediation grew in the second half of the year at a similar pace to the first half of 2008, the year-on-year growth rates standing at 11.9% and 13.8% respectively. According to expectations the sharp drop in growth in value-added seen at the end of last year will continue in 2009, not only in manufacturing, but also in construction and other sectors that are less exposed to international competition.

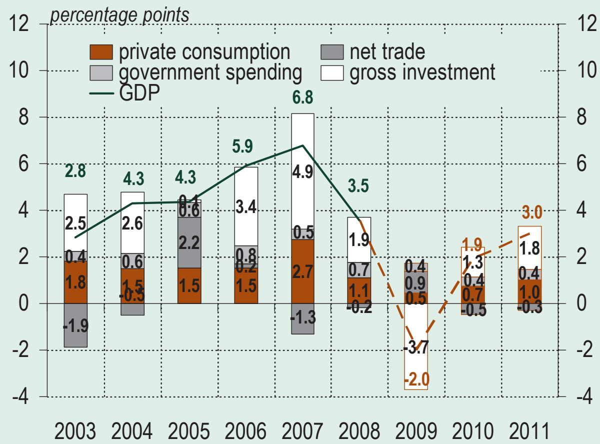
According to the expenditure breakdown of GDP, domestic demand is expected to fall in real terms compared with 2008. It will then again be the main

Figure 3.3: Total industrial production excluding construction



Source: Eurostat, Bank of Slovenia calculations

Figure 3.4: Contributions to GDP growth by components of spending



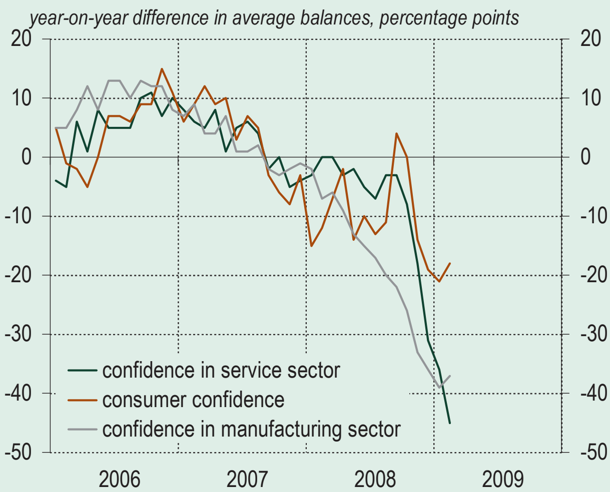
Source: SORS, Bank of Slovenia projections
Note: The sum of components may differ from aggregate amounts due to rounding and use of chain indices.

Table 3.3: Components of domestic demand

						Projections					
						2009		2010		2011	
	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
	real growth, %										
Domestic demand	4.8	2.1	5.7	8.0	3.7	**-2.8**	-6.1	**2.5**	-1.5	**3.4**	...
Private consumption	2.8	2.8	2.8	5.3	2.2	**0.9**	-2.5	**1.4**	-2.0	**2.0**	...
Government spending	3.4	3.3	4.1	2.5	3.7	**2.1**	0.2	**2.1**	0.3	**2.5**	...
Gross investment	5.6	3.8	10.4	11.9	6.2	**-10.2**	-14.2	**4.7**	-1.3	**6.7**	...

Δ: Difference between current projections and projections in October 2008 Price Stability Report
Sources: SORS, Bank of Slovenia

Figure 3.5: Seasonally adjusted confidence indicators



Source: SORS, Bank of Slovenia calculations

factor in moderate GDP growth. Although private consumption and government spending will achieve positive growth in 2009, investment will contract significantly over the same period, by an estimated 10%. This will occur primarily as result of a cooling in the external and domestic economic growth, which is being reflected in a significant deterioration of expectations. Tighter financing conditions could additionally contribute to this, as they are deteriorating due to the uncertainties in the international financial markets and the consequent rise in premiums on lending rates. The contribution of foreign trade is expected to be marginally positive in 2009, as in the context of lower domestic demand, the growth in imports will be slower than growth in exports. The domestic demand will, according to the estimates, once again account for the majority of aggregate demand in both 2010 and 2011.

Household consumption rose by an average of 2.2% last year in real terms. Following solid growth in the first half of the year, household consumption slowed sharply in the second half of 2008, and stood at just 1.1% in year-on-year terms in the final quarter. This year's growth in household consumption is expected to be less than 1%, but could rise gradually to approximately 2% over the projection horizon. Important factors in slowing growth in household consumption this year include slowing growth in private sector wages, a delay in the public sector wage adjustment and a significant deterioration in conditions on the labour market. Accordingly, consumer confidence indicators also fell sharply at the end of 2008 and at the beginning of this year, most notably those that indicate outlooks regarding unemployment and the appropriateness of timing for major purchases. Other consumer expectations regarding future economic trends have also deteriorated. Tighter lending conditions may also slow this year's household consumption. Household lending slowed last year, while bank deposits increased gradually. Despite the favourable effect of rapidly slowing inflation on the consumer purchasing power, real disposable household income, which contributes most to the consumption growth, will contract further due to deteriorating conditions in the labour market and lower or limited growth in wages.

Real disposable income is expected to record moderate growth in the future, contracting by approximately 0.5% this year, while gradually rising over the next two years at a rate of between 1% and 2%. Given that employment in recent years has risen fastest in the construction sector, largely on account of the employment of non-residents, a reversal with regard to the employment of non-residents will not be reflected in overall household consumption, as foreign labourers typically send a large portion of earnings to their home countries. A drop in employment in the manufacturing sector, which accounts for nearly one-third of all employees in Slovenia, has a greater adverse impact on disposable income and domestic private consumption. A drop in employment in this sector and the cutting of working hours as well as a consequent decrease or easing in private sector wage growth will result in significantly lower growth in real disposable income in 2009, while easing in price growth over the projection horizon will have a positive effect on real disposable income. Growth in total net wages, which represent the majority of disposable household income, will ease by the end of the year. According to the estimates, particularly transfers to the unemployed will rise

Box 3.1: The impact of the wealth effect on economic activity

The wealth effect indicates the impact of the real estate prices and financial assets of households on their spending. Changes in the value of assets affect household consumption in various[1] ways, namely via expectations regarding future income from wages, financial assets or rising real estate prices. These expectations are reflected in the behaviour of households so that they spend more when real estate prices rise sharply, as they believe their wealth has increased. The current financial turmoil underlines the importance of understanding how households respond to wealth shocks, and how and to what extent this response is based on their income, demographic characteristics and the level of indebtedness. In recent years of a favourable economic climate, euro area households borrowed extensively, primarily on the basis of favourable financing conditions and financial innovations, which have facilitated borrowing based on the ownership of current or future real estate or other forms of assets, looser lending standards, high growth of real estate and equity prices and a stable macroeconomic environment.

Significant changes in the prices of assets, particularly real estate prices, could have far-reaching consequences on the aggregate consumption dynamics. This was experienced in the 1990s in Finland, Sweden and the United Kingdom. Initially a fall in real estate prices reduces the demand of households. Since real estate represents the largest proportion of total wealth for most households, fluctuations in real estate prices and interest rates result in lower expectations regarding future income. This could be followed by uncertainty regarding the extent and duration of a correctionof real estate prices, which is followed by a drop in consumer confidence and a negative wealth effect, as household consumption and investment in residential construction fall. As economic climate deteriorates, banks tighten lending standards and with the falling value of loans' collateral, the need for additional capital arises due to the deterioration of the quality of the portfolio. This leads to a further contraction in economic activity, rising unemployment and a further restriction of growth in lending. Similarly, changes in equity prices have a significant impact on household consumption.

Most international studies of the wealth effect in developed countries[2] indicate that real estate prices have a greater impact on household consumption than the prices of financial assets. In some developed European countries the elasticity of household consumption in relation to the prices of residential property ranges from 0.01 to 0.16, while the elasticity to growth in the prices of financial assets ranges from 0 to 0.06. The wealth effects for the euro area are estimated to be lower (e.g. Slacalek, 2006).

Assessments based on currently available figures for Slovenia indicate that the overall effect of residential property and financial assets on household consumption could be moderate. The proportion of Slovenian households that own their own real estate is very high, and stood at around 82% in 2007. However, the effect of residential property on final household consumption is not wholly dependent on the proportion of housing ownership, but also on the economic, institutional and financial environment, and on the structure of the real estate market as well as the disposable income of households. The findings of some studies indicate that the high growth in real estate prices in Slovenia in recent years, particularly in 2006 and 2007, which exceeded 15% could have resulted in higher household consumption in that preceding period. According to some estimates for countries comparable with Slovenia, the elasticity of the wealth effect of residential property on household consumption is approximately 0.069. With the growth in real estate prices, the development of the financial infrastructure, and in particular the market and financial integration in the EU and EMU in years of high economic growth, it was easier to borrow on the basis of current or future residential property also in Slovenia. Financial liberalisation, globalisation, financial innovations, favourable interest rates and the perception of loose lending standards played a significant role in this respect.

[1] Global Financial Stability Report, Financial Stress and Deleveraging, Macro-Financial Implications and Policy, IMF, World Economic and Financial Surveys, Washington, October 2008.

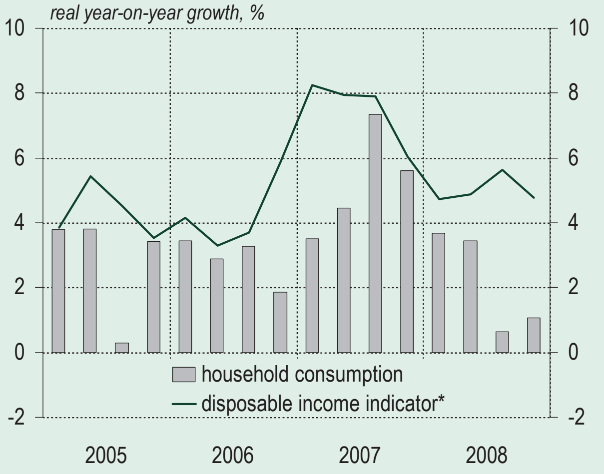
[2] Altissimo et al (2005): "Wealth and Asset Price Effects on Economic Activity", European Central Bank, Occasional paper series, no. 29.

Sierminska & Takhtamanova (2007): "Wealth Effects out of Financial and Housing Wealth: Cross Country and Age Group Comparisons", Federal Reserve Bank of San Francisco, Working Paper 2007-1.

Juster, Lupton, Smith & Stafford (2004): "The Decline in Household Saving and the Wealth Effect", University of Michigan, Board of Governors of the Federal Reserve System.

Davis & Palumbo (2001): "A Primer on the Economics and Time Series Econometrics of Wealth Effects", Federal Reserve Board.

Figure 3.6: Household consumption and disposable income



** Net wages, other earnings from employment and social benefits. Adjusted by HICP deflator.*
Source: SORS, AJPES, Bank of Slovenia calculations

relatively quickly, after having risen by nearly one-third in January this year, after recording a 6% year-on-year decline last year. Expenditure on pensions also rose sharply last year, while the number of pension recipients was up approximately 1.4%, out of which the number of old age pensioners rose by 3.1% in year-on-year terms. Together with the growth in pensions linked to wage growth, a delay in the public sector wage adjustment will result in slower growth in real disposable income in 2009 and over the projection horizon.

Negative wealth effects linked to the fall in real estate prices and those resulting from the significant drop in prices on securities markets could also have a partial effect on the level of consumption. Last year growth in real estate prices came to a near standstill following growth of approximately 22% recorded in 2007, while the prices of shares and securities on the Ljubljana Stock Exchange were down about two-thirds last year. In recent years household investments in shares and other securities recorded explosive growth due to exceptionally high returns, with some households even raising loans for the purpose of buying shares and securities. Huge losses in the value of these shares and securities in the second half of the year were followed by further negative corrections in the first months of 2009. This type of a drop has not been observed for housing prices yet, however, a sharp decline in the number of real estate transactions has been seen in the context of a stagnation or easing of prices.

According to estimates the contribution made to aggregate demand by real government spending is expected to be lower than the average of the last several years over the entire projection horizon. Final government spending was up 5% in year-on-year terms in the final quarter, while growth stood at 3.7% overall in 2008. According to estimates government spending is expected to be lower over the projection horizon, primarily on account of a restrictive employment policy, in line with the government guidelines. Estimated growth in government spending for 2009 with regard to the previous estimate was revised upwards by 0.2 percentage to 2.1%. Similar growth is projected for 2010, while in the final year of the projection horizon the government spending would rise by 2.5% in the context of a continuing restrictive employment policy. Compensation of employees will remain the fastest growing component of government spending, despite this year's adoption of a public sector wage agreement due to changing macroeconomic conditions for 2009 and 2010. According to the latest available estimates public sector wages are expected to rise by 7.1% on average this year, while slightly higher growth can be expected next year. Public sector wage growth in both years is expected to outstrip growth in productivity.

In the tightened conditions fiscal measures are being taken by increasing the general government deficit in order to curb the drop in aggregate demand. However, the manoeuvring room for such measures is limited due to the absence of the appropriate consolidation of public finances in the previous period. In its latest fiscal position forecast[2] the European Commission

[2] European Commission, Interim Forecast, January 2009. The Statistical Office is scheduled to publish the government sector accounts on 31 March 2009. The Ministry of Finance has not yet published the update to the Stability Programme giving the estimates for 2008 and the projections for 2009 to 2011. Publication is expected shortly after the adoption of the revision to the state budget for 2009.

Box 3.2: Fiscal policy measures to mitigate the effects of the financial turmoil and economic crisis

Last year the financial turmoil and economic crisis affected European Union Member States to a greater extent and also affected economic activity in Slovenia at the end of the year. The Slovenian government responded with a broad range of measures to mitigate the effects of the turmoil. The measures are aimed at ensuring the smooth functioning of the financial system and at strengthening confidence. They are also aimed at reviving the economy, in accordance with the European Economic Recovery Programme.[1]

I. Measures related to the financial sector

The Slovenian government adopted the first package of measures in the final quarter of last year. This package of measures included an unlimited guarantee on bank deposits of individuals until 31 December 2010. At the same time the Act Amending the Public Finance Act was passed to improve the economic stability of banks. This act stipulates that the government may seek additional borrowing for the purpose of granting loans and for capital investments in the credit institutions set out in the Banking Act and in insurance companies, reinsurance companies and pension companies with a registered office in Slovenia. The government may also borrow for the government guarantees for the refinancing of credit institutions with a registered office in Slovenia, up to the total amount of EUR 12 billion.

The government passed a second package of measures in February 2009 aimed at stimulating bank lending and improving corporate liquidity. The most important measure is a guarantee scheme aimed at banks for general corporate lending of up to EUR 1 billion, thus reducing the credit risk of banks, which must share at least 20% of the risk. The next measure involves individual government guarantees for corporate borrowing in the amount of EUR 500 million in the case of loans for investment and working capital, where the guarantee may not exceed 50% of the loan. In a new *de minimis* aid scheme, EUR 20 million will be available to corporates. The co-financing of strategic investments in clean and technologically advanced industries is also envisaged. The aim of this measure is for companies to maintain or improve their competitive position in the global market via investments and research and development.

II. Measures related to other sectors

The most important measure is the partial subsidisation of full-time employment, intended to maintain the number of jobs and ensure the social security of the population. Subsidies have been available to employers since February. Employers that shorten working hours from 40 to 36 hours a week are entitled to a subsidy of EUR 60 and an additional subsidy of EUR 15 for each additional hour, to a limit of 32 hours a week. Subsidies may be received for a maximum of six months, while the application for subsidisation must be submitted no later than 30 September 2009. While receiving subsidies employers must pay wages and social contributions for those workers for whom they receive subsidisation, and may not dismiss employees for business reasons, order overtime work or pay bonuses to management or supervisory bodies during the fiscal year. EUR 230 million was earmarked for this measure in the revision to the state budget for 2009. Among other measures aimed at improving the state of the economy is a significant increase in tax relief for investments in equipment and intangible fixed assets (valid for investments made in 2008) and a change to the method of determining corporate income tax prepayments.

The government has also adopted measures to limit growth in the general government deficit, opting for a policy of raising excise duties to offset the drop in other revenues. According to estimates by the Ministry of Finance, previously implemented rises in excise duties on energy products should result in an increase in annual revenues of approximately EUR 300 million. Higher excise duties on alcohol and tobacco will increase annual revenues by more than EUR 40 million. Another important measure relates to the agreement signed with public sector unions to reduce the expected wage growth this year, with respect to the previous agreement.

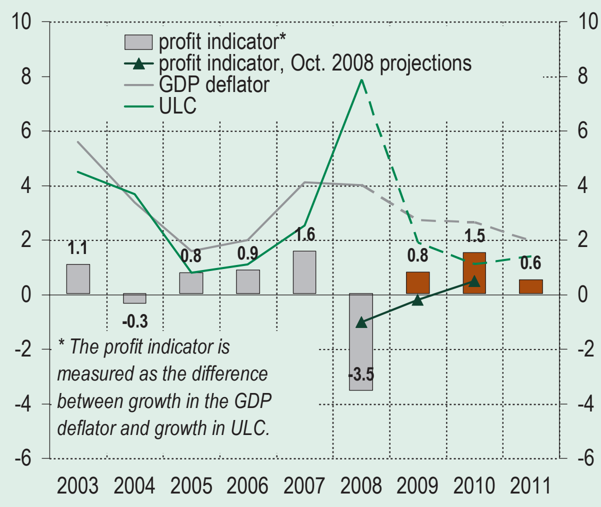
At the conclusion of its visit to Slovenia, the IMF mission assessed that the government's previous measures to shore up liquidity and its fiscal measures were for the most part prompt and appropriately targeted. For the purpose of stimulating demand, it recommended that more funds be earmarked for infrastructure projects that could also be financed from EU funds. The IMF also noted that procedures must be transparent, particularly those related to the measure to facilitate corporate lending (the possibility of a moral hazard) and the measure to subsidise full-time employment. Members of the mission called for reforms aimed at raising the economy's growth potential and ensuring fiscal sustainability to complement previously adopted measures. These include reforms in the labour, product and financial markets, as well as the reform of the pension system.

[1] A European Economic Recovery Programme, 26. November 2008. http://ec.europa.eu/economy_finance/publications/publication13504_en.pdf.

estimated that Slovenia's deficit stood at 0.9% of GDP last year, compared with a surplus of 0.5% of GDP in 2007. The deterioration in the general government position will continue this year. The sharp slowdown in economic growth at the end of last year and the beginning of this year was reflected in a notable drop in revenue growth. Conversely, measures to mitigate the effects of the turmoil (see Box 3.2) will hasten expenditures' growth. The proposed revision to the state budget for 2009 envisages a deficit of 2.9% of GDP, while the local government and health sub-sectors are also expected to be in deficit, and the general government deficit, which also includes the Pension and Disability Insurance Institute, is expected to exceed 3% of GDP.

The average year-on-year growth in gross investment stood at just over 6% in 2008, while year-on-year growth in the final quarter was markedly negative at -8.5%. Average growth in gross investment in the first half of the year stood at 14.8% in year-on-year terms, with growth slowing primarily in the final quarter to average 6.1% for the year overall. Following strong investment activity in 2007, which carried over to the first half of last year, investment in non-residential and housing construction recorded the fastest growth. In line with deteriorating financing conditions and falling demand, investment in housing construction fell by 2.7% year-on-year in the final quarter, following growth of 22.9% in the first half of the year. Likewise investment in non-residential construction grew by just 0.1% year-on-year in the final quarter of 2008. A similar dynamic can be seen in investment in transport equipment, which was up 10.9% in the first half of the year, but fell by 0.4% in year-on-year terms in the final quarter. Investment in machinery and equipment rose 5.3% on average in year-on-year terms in 2008, however, their growth in the final quarter stood at -5.0%, following the more than 11% year-on-year growth achieved in the first quarter of 2008.

Figure 3.7: Profit indicator

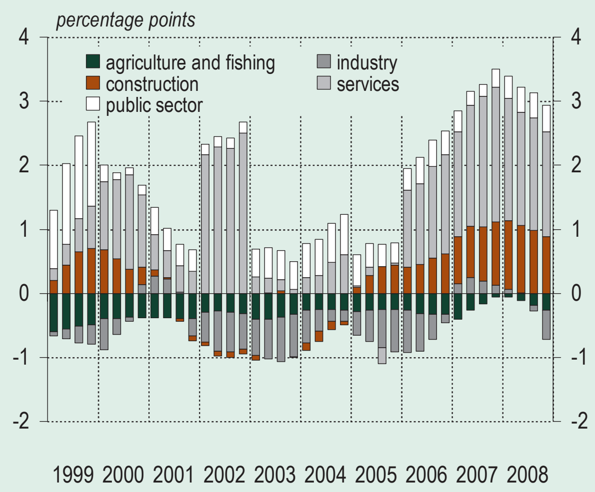


Source: SORS, Bank of Slovenia calculations

Gross investment is expected to fall by nearly 10% this year. The downward revision with respect to the previous projections is mainly due to the increasingly bleak expectations regarding the domestic and international economic growth, and in part on account of difficultly in accessing resources to finance projects. The high growth in investment in non-residential construction last year, driven in part by motorway construction, will slow this year and in the coming years. The high growth in investment in housing construction last year, particularly on account of continued high demand for housing in the first half of the year, will also slow this year, as the number of building permits issued is gradually falling, the decline standing at 4% year-on-year in the final quarter. Investment in machinery and equipment, which recorded moderate growth last year, will slow in the coming years in line with the deteriorating economic climate in the major trading partners and the tighter financing conditions, as access to sufficient financing is of key importance for long-term investment in the private sector. Expectations regarding a slowdown in growth in investment in machinery and equipment are also in line with the decrease in the value of the indicator of excess production capacity. Private sector investment will be stimulated primarily by the gradual cut in the corporate income tax rate, which will reach 20% in 2010, down from 25% in 2006. This could mean higher corporate profits, and thus more available funds for reinvestment. However, the effect of this measure remains highly questionable in the current conditions. Growth in government investment and investment by government-controlled companies, particularly DARS, is expected to slow gradually in the coming years.

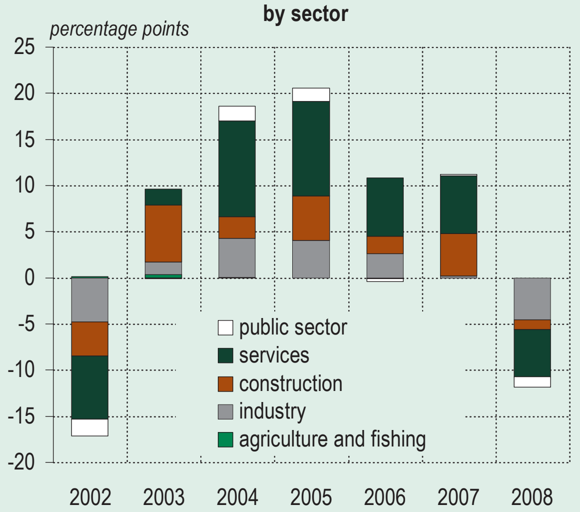
Although changes in economic activity are typically reflected in the labour market with a delay, the effects of the economic crisis have been evident in the current rate of employment growth since November. The economic crisis is particularly evident in the most export-oriented manufacturing activities, where the number of employees began falling in the second half of 2008. That number had risen since the beginning of 2007 in the context of a favourable economic cycle, following five consecutive years of decline. At the end of 2008 employment was up in most sectors from the final quarter of 2007, the year-on-year growth in overall employment standing at 2.2%. Growth was particularly strong in the construction sector, where it reached 10.2% year-on-year in the final quarter and contributed 0.9 percentage points to total employment growth. In addition to the construction sector, employment also grew rapidly in real estate, renting and business activities (by 6.7%) in the final quarter of 2008 and in financial intermediation where 6.5% year-on-year growth was recorded. At the end of the year the current growth rate fluctuated in line with year-on-year rates, with the only notable contraction in employment seen in manufacturing. The greatest impact of the decline in economic activity can currently be seen in the number of hours worked, as this is the fastest way for employers to

Figure 3.8: Contributions to employment growth by sector



Source: SORS (national accounts), Bank of Slovenia calculations

Figure 3.9: Contributions to growth in job vacancies by sector

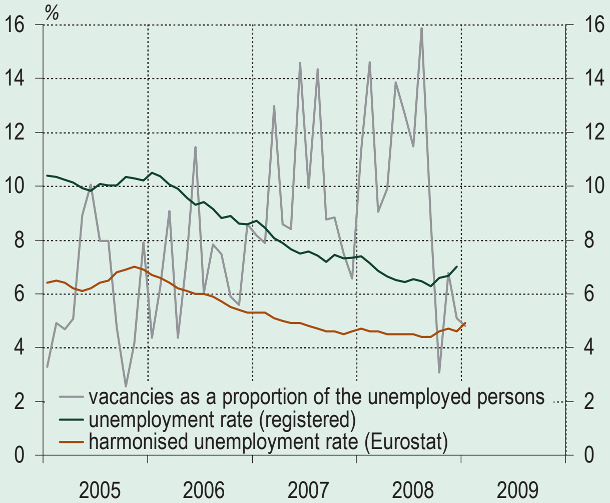


Source: SORS, Bank of Slovenia calculations

respond to changing demand. This indicator of developments on the labour market fell in year-on-year terms in December 2008 for the first time since January 2005.

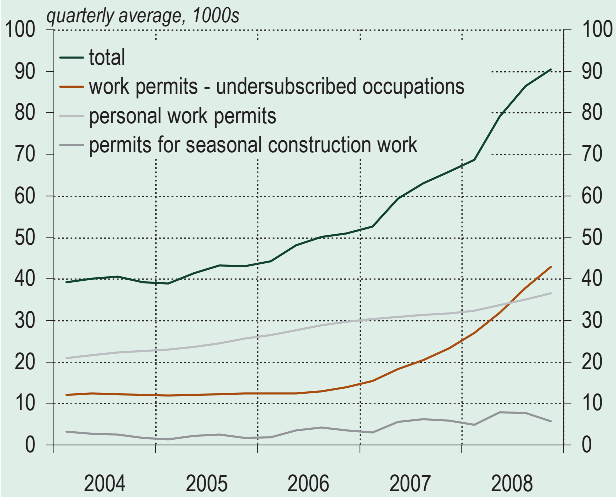
In 2008 the slowdown in economic growth was strongly reflected in a drop in the number of advertised job vacancies, and in a decline in the number of unfilled job vacancies at the end of the year. In the context of high economic growth the number of job vacancies rose sharply between 2003 and 2007, with the highest year-on-year growth achieved in 2005, when the

Figure 3.10: Unemployment and vacancy rates



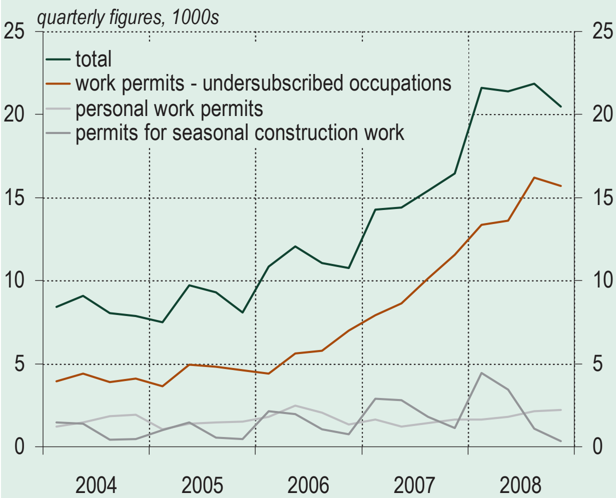
Source: Eurostat, SORS, Employment Service of Slovenia

Figure 3.11: Valid work permits for non-residents



Source: Employment Service of Slovenia

Figure 3.12: Work permits issued to non-residents



Source: Employment Service of Slovenia

number of advertised job vacancies was up 20.6% on the previous year. The highest number of new vacancies was recorded in the service and construction sectors in this period. The drop in the number of job vacancies in manufacturing contributed significantly to the overall decline in vacancies in 2008. The previous trend of a growing number of job vacancies measured as the difference between new employees and newly registered vacancies also reversed in the final quarter.

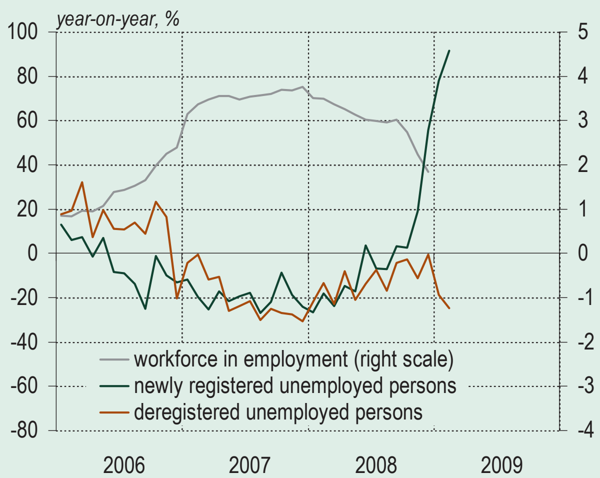
In the context of unfavourable economic developments, employment is expected to contract sharply in 2009 and 2010, by more than 3% on a cumulative basis. The most significant decline in employment is expected in manufacturing, which is especially exposed to the slowdown in economic activity in the international environment, and in construction where employment has risen most in recent years in the context of high economic activity. The drop in employment at the start of the projection horizon is expected to be driven by a decrease in the number of employees with fixed-term contracts, where non-residents represent a relatively high proportion of workers. The projections envisage a drop in employment of 2.6% in 2009 and 0.7% in 2010.

Lay-offs of temporarily employed non-residents, who represented more than half of employment growth over the last three years, are expected to account for the majority of the decline in employment next year. From the beginning of 2005 until the end of 2008, employment rose by 9.4% or 86,000 workers, while the number of valid work permits rose by 54,000 over the same period. At the end of 2008 there were 91,000 valid work permits for non-residents. Of these, approximately 37,000 or 41% are personal permits that are not tied to labour market conditions or limited by quotas set by the government. Approximately 8,000 or 9% are work permits relating to seasonal work, the majority of seasonal workers being employed in the construction sector. The majority of the remaining permits (45,000 or 50%) are work permits tied to a specific job or employer. On this basis it is possible to determine that more than half, or 50,000 permits, could be terminated in the context of less favourable labour market conditions. These non-residents represent approximately 5% of employment, which could limit the rise in unemployment in the context of a drop in employment in the coming years. Its should be noted that EU citizens, including citizens of new EU Member States, have not been included in the number of valid work permits since May 2004, as they do not require a work permit for employment in Slovenia. Nevertheless, their number has remained relatively small since Slovenia joined the EU.

A trend of rising unemployment, which could last until 2010, began in the final quarter of 2008, in line with the reversal in the economic cycle. In the final quarter of 2008 the registered unemployment rate rose for the first time in two and a half years, by 0.3 percentage points with regard to the previous quarter to stand at 6.8%. The unemployment rate measured by the Labour Force Survey also rose slightly in the final quarter of 2008, from 4.1% to 4.3%. According to Eurostat's calculation, the increase in the harmonised unemployment rate was even sharper, from 4.1% to 4.8%. Despite this increase the survey unemployment rate remains relatively low by international standards, as it was more than 3 percentage points below the euro area average of 8.0% in the final quarter. According to projections, the survey unemployment rate is expected to exceed 6% this year, and could rise to over 7% in 2010 in the context of a sustained unfavourable economic climate.

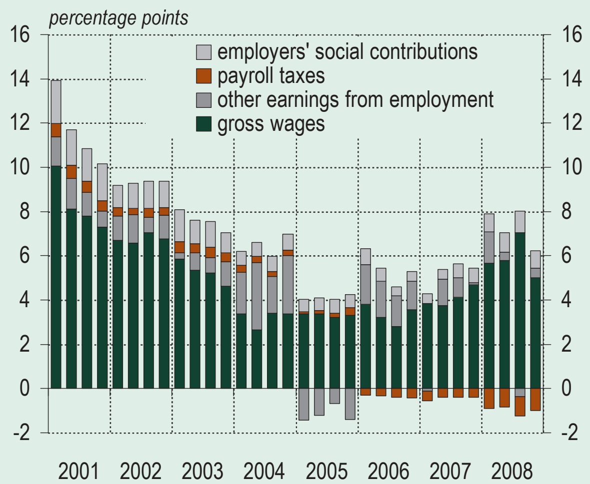
Rising growth in unit labour costs represents one of the risks outlined in previous Price Stability Reports. The baseline scenario indicates that wage movements and growth in productivity will align over the projection horizon. Although growth in average labour costs fell at the end of 2008, it remains relatively high

Figure 3.13: Labour market



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

Figure 3.14: Contributions to growth in labour costs per employee



Source: SORS, AJPES, MoF, Bank of Slovenia calculations

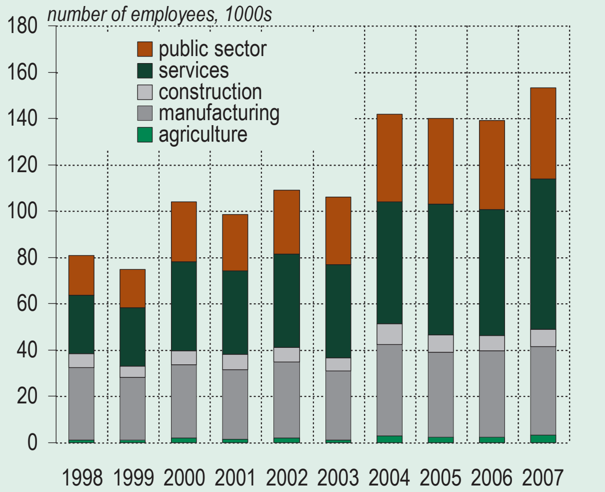
given the sharp drop in productivity. Year-on-year growth in average gross wages in the private sector fell from 9.3% to a still high 4.9% in the final quarter of 2008, while growth in the manufacturing sector fell from 9.3% to 3.5%. Despite the sharp decline, growth in private sector gross wages in the final quarter fell to a level comparable with average growth in the last four years of 5.7%. However, growth in overall productivity in the final quarter was -2.9%, with the manufacturing sector recording negative productivity growth since the third quarter of 2008. This

Box 3.3: Temporary employment and the flexibility of the labour market

According to expectations, the drop in employment will also have a significant impact of temporary employees, primarily comprising workers on fixed-term contracts, non-resident workers (other than non-residents with personal work permits) and workers employed via student services. Lay-off costs are considerably lower in these worker groups than those relating to lay-offs of full-time employees. The sharp growth in the number of temporary employees as a proportion of total employees following the implementation of the new Employment Relationship Act in 2003 will make restructuring and reducing the volume of output easier for companies in the context of falling demand.

A review of temporary employees by length of contract indicates that most of these workers have short contracts, so that employers can reduce the number of employees relatively quickly should the need arise. In Slovenia 6.3% of workers have a fixed-term contract of less than three months, representing approximately 60,000 employees. This proportion is considerably higher then in the EU27, where the figure is 3.3% of workers. In this context, such a difference puts Slovenian companies in a more competitive position.

Figure 1: Temporary employment by sector, Slovenia, 1998-2007



Source: Eurostat

Figure 2: Temporary employment by contract duration, Slovenia, 1999-2008

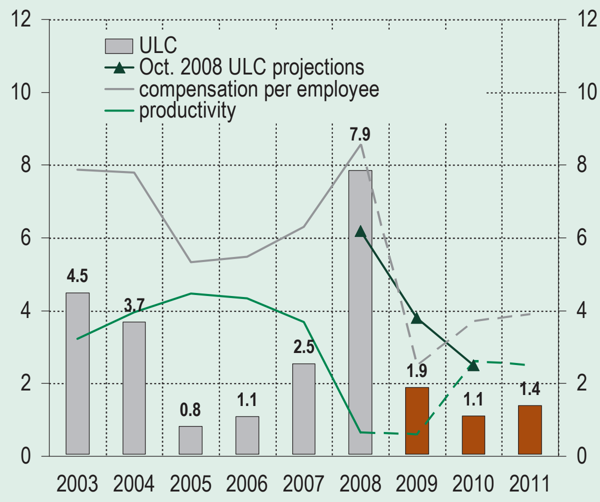
Source: Eurostat

Table: Comparison of the share of temporary employees, Slovenia and EU27, 2008

Length of contract	Number of temporary employees in Slovenia (1000s)	Share of temporary employees in Slovenia (%)	Share of temporary employees in EU27 (%)
less than 1 month	15.6	1.7%	0.7%
1 to 3 months	43.1	4.6%	2.6%
4 to 6 months	27.5	2.9%	2.4%
7 to 12 months	46.8	5.0%	3.6%
more than 1 year	30.3	3.2%	4.0%
Total	163.3	17.5%	15.4%

Source: Eurostat

Figure 3.15: Unit labour costs



Source: SORS, Bank of Slovenia calculations

has led to rising growth in gross wages per unit of output, which reached 10.3% in the final quarter, the average growth having stood at just 2.2% over the previous five years. Growth in gross wages per unit of output reached 13.5% in the manufacturing sector, while the average of the last five years stood at 1.3%. The gradual phasing-out of payroll tax has partially limited growth in labour costs, which has lagged behind the accelerated growth of gross wages. In 2006 and 2007 growth in unit labour costs fell by approximately 0.4 percentage points due to the phasing-out of this tax, and by around 0.9 percentage points in 2008. An even greater drop in year-on-year growth in labour costs (of at least 1 percentage point) can be expected this year, as payroll tax has now been completely phased-out. This labour cost indicator is not en-

Table 3.4: Labour cost indicators

	2004	2005	2006	2007	2008	Q407	Q108	Q208	Q308	Q408
	nominal year-on-year growth, %									
Gross wage	4.6	4.9	4.8	5.9	8.4	6.8	7.8	8.6	9.9	7.1
Gross wage in private sector	5.3	5.4	5.4	6.8	8.0	8.0	8.2	9.4	9.3	4.9
Gross wage in public sector	2.7	3.3	3.4	4.1	9.7	3.8	7.1	7.0	11.7	12.8
Gross wage in manufacturing	6.6	5.9	5.5	6.8	7.7	8.4	8.2	9.6	9.3	3.5
Labour costs per employee[1]	6.4	2.9	5.0	4.7	6.3	5.0	7.0	6.2	6.8	5.2
Other employment earnings per employee	14.3	-7.0	10.1	2.9	3.2	0.5	10.4	1.9	-2.4	2.8
Gross wage per unit of output	0.6	0.4	0.4	2.1	7.7	4.7	5.4	6.2	8.8	10.3
Gross wage per unit of output (trend)[3]	1.4	1.6	1.6	2.7	5.1	3.5	4.6	5.4	6.7	3.9
Gross wage in manufacturing per unit of output	1.2	0.1	-3.4	-0.2	8.8	3.2	6.9	6.1	9.6	13.5
Gross wage in manufacturing per unit of output (trend)3	0.8	0.0	-0.3	0.9	1.8	2.6	2.4	3.8	3.5	-2.3
Unit labour costs[1]	2.4	-1.5	0.7	1.0	5.6	3.1	4.6	3.8	5.7	8.4
Unit labour costs (trend)[1,3]	3.2	-0.3	1.8	1.5	3.1	1.8	3.8	3.0	3.6	2.0
Compensation of employees per unit of output[2]	3.7	0.8	1.1	2.5	7.9	4.9	5.7	6.6	8.9	10.4
Output per employee	4.0	4.5	4.3	3.7	0.7	1.9	2.3	2.3	1.0	-2.9
Output per employee (manufacturing)	5.4	5.8	9.2	6.9	-1.0	5.1	1.3	3.4	-0.2	-8.8
HICP	3.7	2.5	2.5	3.7	5.5	5.5	6.5	6.4	6.2	3.1
GDP deflator	3.4	1.6	2.0	4.1	4.0	4.6	5.3	4.4	3.6	3.0

[1] Labour costs include gross wages (SORS), other employment earnings (AJPES), and social contributions and payroll tax (MoF)
[2] National accounts
[3] Output per employee, average over last 10 years: 3.2%
Output per employee in manufacturing, average over last 10 years: 5.8%
Sources: SORS, AJPES, Ministry of Finance; Bank of Slovenia calculations

tirely relevant for analysing trends, primarily due to the high volatility of other employment earnings: in the second quarter of 2006 other employment earnings contributed 3.6 percentage points to the growth in unit labour costs, compared with -0.4 percentage points in the third quarter of 2008.

A comparison of growth in unit labour costs with the GDP deflator indicates that labour costs have also had an impact on the higher average rate of core inflation in the last year. Growth in unit labour costs actually outstripped growth in the GDP deflator by nearly 4 percentage points in 2008, after lagging behind growth in the GDP deflator by approximately 1 percentage point between 2005 and 2007. A comparison of growth in nominal labour costs per employee and growth in average ten-year productivity in Table 3.4 is shown for the purpose of stripping out the effects of the economic cycle on the productivity estimate and the effects of fluctuations in deflators. This indicator points to the inflationary effect of labour costs if economic growth were close to the long-term average. The gap between growth in nominal labour costs per employee and growth in long-term productivity indicates a slight improvement in the final quarter of 2008 with regard to the previous three quarters, as the indicator fell from 3.5% to 2.0%, but remained 1 percentage point higher than the average of the previous three years. Taking into account the growth rate of gross wages suggests a less favourable picture, as this indicator's growth rate of 3.9% is 1.9 percentage points higher than the average of the last three years.

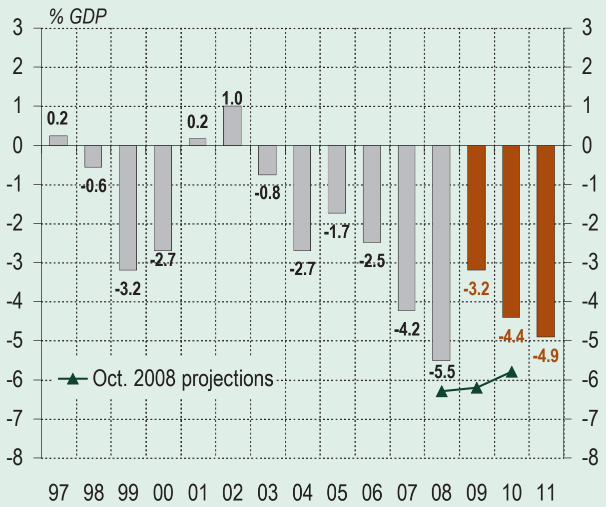
On average public sector wage growth will outstrip private sector wage growth by approximately 4 percentage points over the projection horizon, largely due to the new public sector wage system adopted in August 2008. The assumption in the projections is for public sector wage growth of 7.1%, 9.2% and 4.0% in 2009, 2010 and 2011 respectively. The assumption regarding growth in the nominal average gross wage in the public sector for 2009, 2010 and 2011 takes into account further wage adjustments, and the elimination of wage discrepancies by the newly envisaged deadlines. The first two phases of the changeover to the new wage system were completed in September 2008 and January 2009. An increase in the average gross wage of slightly less than 4% is planned in each phase. The public sector wage agreement due to changing macroeconomic conditions, which was signed by the government and public sector unions in February 2009, also impacts on growth in public sector wages. The parties agreed to postpone the third phase of the changeover to the new wage system from 1 September 2009 to 1 January 2010, while the final phase is still planned for 1 March 2010. Nevertheless, some uncertainty remains regarding the final form of the new wage system, as not all interest groups are in favour thereof.

In the context of expected macroeconomic developments, growth in private sector wages over the projection horizon should slow rapidly, followed by a period of moderate wage growth. Unfavourable economic conditions will act to slow and limit wage growth, while provisions regarding wage increases set out in collective agreements are not expected to have any significant effect. The reason is that, given the relatively high private sector wage increases in 2008, many companies have, according to assessments, already consented to minimum increases for 2009 as set out in collective agreements. The private sector collective agreement (collective agreement on an extraordinary wage adjustment in 2007 and wage adjustments, reimbursement of work-related expenses and other personal earnings for 2008 and 2009) signed in May 2008 envisages specific increases of the lowest bases, namely the basic wage, in January and August 2009 and January 2010. The January 2009 increase is set at 1.15%, and represents the difference between the average growth in the CPI for 2008 and the agreed threshold of 4.55%. A 2.3% increase in the basic wage is planned for August 2009, while a further increase is planned in January 2010 if inflation exceeds 2.7% in 2009. Given the baseline scenario of projections, this is not expected to happen. Private sector wages are expected to rise by less than 2% in 2009 and by just slightly more than 2% in 2010. According to expectations companies will also reduce expenditure on employees during this period by cutting other employment earnings, such as the allowance for annual leave, from previous levels to the legal minimum. In an extreme case private sector collective agreements include a provision that permits a temporary reduction in wages in agreement with the union, if such a reduction contributes to maintaining the number of jobs. Several unions at companies that have submitted a request for partial subsidies for full-time employment have already agreed to such reductions.

4 External Balance and Competitiveness

In light of the forecast macroeconomic factors in the international environment and the projections for domestic economic trends, this year's current account deficit could be half of that recorded last year at around 3% of GDP, but will then widen again to in excess of 4% of GDP. Slovenia's current account deficit has been growing since 2003, and has increased by an average of 1.5 percentage points of GDP per year over the last two years. The current account deficit in 2008 stood at EUR 2,055 million, or 5.5% of GDP, 1.3 percentage points of GDP wider than in 2007, and the largest figure since Slovenia gained independence. The global financial turmoil since August 2007 and its transformation into a global economic crisis in the second half of 2008 are also being reflected in Slovenia's economic and balance of payments projections. The projections show that the trend of a widening current account deficit seen in recent years could temporarily cease this year. The forecasts point to the deficit narrowing to around 3% of GDP, and then widening gradually over the next two years, to finish the projection horizon at around 4.9% of GDP. The

Figure 4.1: Current account projections



Source: Bank of Slovenia

Table 4.1: Current account

						Projections					
						2009		2010		2011	
	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
	real growth, %, unless stated										
Exports of goods and services	12.4	10.6	12.5	13.8	3.3	**-7.0**	-14.4	**1.5**	-5.9	**4.0**	…
Imports of goods and services	13.3	6.6	12.2	15.7	3.5	**-7.9**	-15.0	**2.1**	-5.0	**4.3**	…
Current account: EUR billion	-0.7	-0.5	-0.8	-1.5	-2.1	**-1.2**	1.3	**-1.7**	0.8	**-1.9**	…
as % GDP	-2.7	-1.7	-2.5	-4.2	-5.5	**-3.2**	3.0	**-4.4**	1.8	**-4.9**	…
Terms of trade*	-1.0	-2.1	-0.6	0.6	-2.1	**2.2**	2.1	**-1.0**	-1.1	**0.0**	…

** Based on national accounts deflators*
Δ : Difference between current projections and projections in October 2008 Price Stability Report
Source: SORS, Bank of Slovenia.

current account deficit should decline from EUR 2.1 billion in 2008 to approximately EUR 1.2 billion this year. The main factors in the narrowing of the deficit compared with the previous year and compared with the previous projections are the more favourable terms of trade, the faster decline in imports than exports, and the possible improvement in the factor income and transfers position. The growth forecast for the volume of imports and exports in 2009 and 2010 has been revised sharply downwards from the previous projections, in line with the rapid decline in import demand and trade in the international environment. It is not until 2011 that growth in the volume of imports and exports is expected to pick up again.

The largest revisions from the most recent projections of October 2008 are estimated to occur this year, as foreign demand is expected to decline sharply as a result of the recession, while year-on-year growth in trade is expected to become strongly negative. Export growth is estimated to be just over 14 percentage points down, and import growth 15 percentage points down, while the changes in 2010 will be smaller, at between 6 and 7 percentage points. Price factors will also act to reduce the trade deficit and the current account deficit. According to the forecasts, falls in prices of energy, food and other commodities will bring an improvement over the projection horizon of more than 1 percentage point in the terms of trade, which recorded a year-on-year deterioration of more than 2 percentage points last year. In light of the uncertainties on global markets, in particular the movement of energy prices, this forecast for the terms of trade is exposed to a high level of risk, as is the forecast for net factor income, which is primarily subject to developments on global financial markets.

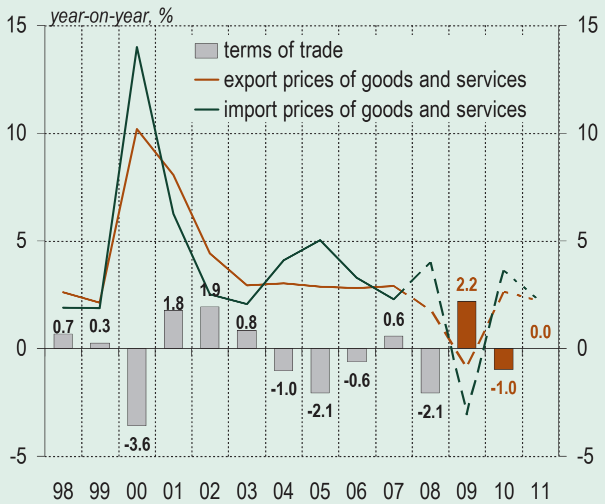
The dynamics in trade of goods and services is expected to slow sharply this year, the year-on-year rates falling below zero. Growth in imports and exports is expected to gradually increase over the next two years, but is only expected to reach the levels seen in 2008 in the final year of the projections. The deepening of the global financial turmoil and its transformation into an economic crisis at the end of 2008 were the most important factors in the decline in demand for Slovenian products from the rest of the world, which was also strongly reflected in exports and in domestic economic activity in the second half of the year, the final quarter in particular. Real sales revenues in industry in the final quarter were down 2.1% in year-on-year terms, real sales revenues declining by 2.6% on the domestic market, and by 1.8% on foreign markets. The global financial turmoil and economic crisis had the fastest and deepest impact on transactions with euro area countries, real sales revenues in industry recording an above-average year-on-year decline of 3.8%. Only transactions with non-euro-area countries recorded positive real growth in sales revenues on foreign markets, both those with other EU Member States and those with the rest of the world. Real growth in from these countries reached 1.1% overall in the final quarter. Only real sales revenues for consumer goods increased in year-on-year terms, by 4.1%, primarily as a result of an increase of 10.3% in sales of consumer non-durables. Sales revenues for capital goods were down 1.5%, but the largest decline of 4.2% was recorded by sales revenues for intermediate goods, an additional indication of the decline in economic activity in Slovenia's major trading partners.

The estimated growth of foreign demand in 2009 and 2010 are down just under 13 percentage points and 6 percentage points respectively on the those made in last October's projections. The revised assumption of lower demand from the rest of the world derives primarily from the forecast for lower demand from the euro area, which has technically been in recession since the final quarter of 2008. Similar trends in foreign demand are expected in other EU Member States and in non-EU countries.

The goods trade deficit is expected to narrow slightly this year and next year compared with 2008, and then to gradually widen. The merchandise trade deficit is forecast to narrow by just over EUR 1.0 billion compared with 2008 to reach EUR 1.6 billion or 4.3% of GDP in 2009. The improvement is expected to come primarily as a result of more favourable terms of trade, and also as a result of a relatively larger year-on-year decline in the pace of real imports than real exports of goods. In the coming years growth in goods trade is expected to gradually increase in line with the anticipated improvement in the international climate, exports keeping pace with growth in foreign demand. In addition to lower growth in exports of goods,[3] another factor in the slowdown in growth in imports of goods will be the projected slowdown in domestic consumption, particularly investment spending, which was the most dynamic domestic component of GDP growth in 2007 and 2008.

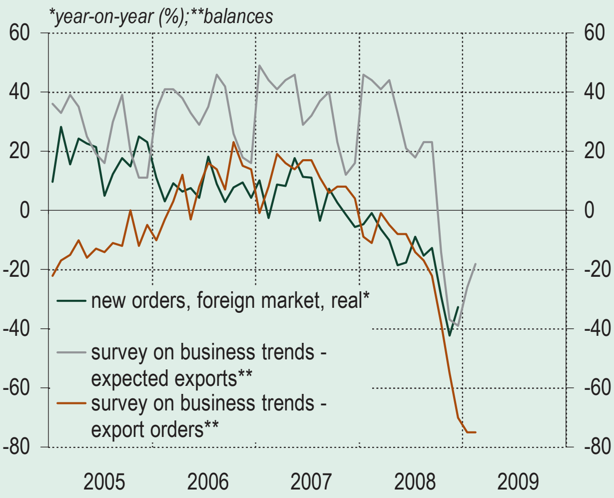
Alongside the falling costs of financing, the largest factor in the decline in the current account deficit is expected to be the improvement in the terms of trade compared with 2008, which is primarily a reflection of the fall in prices of oil, food and other commodities on global markets. This year's average euro oil prices are expected to be 60% lower than last year's, with import prices expected to fall by 3.1% and export prices by 0.9% on the basis of this assumption and the assumptions regarding a fall in commodity prices and inflation in the euro area. The estimated positive effect of the terms of trade in goods and services on the current account position is expected to amount to just over EUR 0.6 billion in 2009, which accounts for more than half of the narrowing of the current account deficit compared with 2008. The nominal current account deficit is expected to gradually increase in the following years to reach EUR 1.9 billion in 2011. In the context of the anticipated increase in energy and commodity prices, the terms of trade are expected to deteriorate by about 1% in 2010, and to remain almost neutral in 2011. Growth in imports and exports of goods is expected to gradually rise from 2009, and in the next two years is expected to range between 3% and 4% for imports, and between 2% and 4% for exports.

Figure 4.2: Terms of trade



Source: SORS National Accounts, Bank of Slovenia calculations

Figure 4.3: Export orders



Sources: SORS

The surplus of trade in services is expected to remain the most important factor acting to reduce the current account deficit over the projection horizon, even if growth in both imports and exports of services temporarily declines this year. Growth in imports and exports of services is subject to similar factors as trade in goods. Over the projection horizon, the decline in economic activity and lower foreign demand will have the greatest indirect impact on services that are closely related to trade in goods. The prime examples are transport

[3] Production for export depends strongly on imports, each unit of additional exports requiring an estimated 0.7 units of imports on average.

services and business and technical services. The most noteworthy of the latter services are foreign trade intermediation, services related to the handling of merchandise (unloading, forwarding and warehousing), and other services related to the promotion of trade in goods. Owing to a significant slowdown in growth in investment in the construction sector, particularly in civil engineering work, revenues and, in particular, expenditure from investment work in Slovenia are expected to decline in the coming years. The financial turmoil and economic crisis and the anticipated decline in household purchasing power in Slovenia's most important trading partners will probably also result in a decline in tourism revenues. Because the crisis is rapidly spreading to Slovenia, and is profoundly increasing uncertainty and reducing disposable income in the context of a simultaneous fall in employment, tourism expenditure is also likely to decline this year. Given all these factors, this year's growth in imports and exports of services is expected to be down significantly on previous years. The decline on the export side could be around 3%, which is still a significantly smaller decline than the corresponding rate for merchandise trade. The growth forecasts for 2009 and 2010 are down 4 percentage points and 5 percentage points respectively on the October 2008 projections for services imports, and down 11 percentage points and 7 percentage points respectively for services exports. After stalling in 2009, growth in trade in services is expected to be favourable in the coming years, and with the strengthening of investment both at home and in the rest of the world it should again outpace growth in merchandise trade by 2010. A beneficial impact on the surplus of trade in services is expected to come from the anticipated faster growth in export prices than import prices, i.e. an improvement in the terms of trade of 1.6% in 2009 and just over 0.5% in the next two years. In the context of such trends, the surplus of trade in services, which reached a record 4.6% of GDP in 2008, is forecast to decline to 4% of GDP this year, and will remain at this level until the end of the projection horizon.

The deficit in factor income has widened at a faster pace in the last few years. In the context of a slower increase in net borrowing and the assumed decline in financing costs on global financial markets, the deficit in factor income is estimated to narrow this year, and then gradually increase in 2010 and 2011. The deficit in factor income stood at EUR 300 million in 2005, but by 2008 had more than tripled to EUR 1,026 million or 2.8% of GDP. The deficit in factor income is expected to decline by just over a tenth in 2009 to EUR 900 million or 2.4% of GDP. The deficit in factor income should gradually increase again in the next two years, ending the projection horizon at around 2.7% of GDP. Net inflows of labour income have been declining for several years in the context of rising employment of foreign workers in Slovenia. In 2007 they were down more than half on the previous year, and by 2008 there was a net outflow of EUR 25 million. The adverse climate at home and in the rest of the world will also have an impact on net labour income, forecasts of which for the next two years are down on those made in last October's projections. The bad economic climate means that companies in Slovenia have begun to release foreign workers, who to a great extent are employed in the construction sector and at companies primarily manufacturing export products. These trends will have an impact on labour income, which will decline on the outflow side. The economic crisis, particularly in the euro area, will also impact on labour income inflows. Among the individual factor income items in the current account, net outflows of capital income have increased in recent years under the influence of FDI, increased borrowing in the rest of the world and rising interest rates on global financial markets, until the final quarter of last year. The deficit in capital income widened by EUR 214 million from 2007 to reach EUR 1,001 million. Interest payments to the rest of the world recorded the largest increase on the outflow side. The relatively rapid change from net claims of EUR 0.9 billion at the end of 2005 to a net external debt of EUR 9.5 billion at the end of 2008, and the rise in interest rates on global financial markets until the beginning of 2008 were the main factors in the increase in net interest payments during this period. Interest payments for loans raised in the rest of the world were up EUR 334 million in year-on-year terms in 2008 at EUR 1,186 million, in the context of an increase in the gross external debt in the last two years and rising interest rates on global financial markets. The repatriation of earnings to parent companies in the rest of the world has also increased since 2005. Of their EUR 540 million of earnings from equity, companies under foreign ownership reinvested just EUR 16.1 million into companies in Slovenia, transferring the remainder to parent companies in the rest of the world. In the capital income account, income from investments in securities was up 12.7%, while expenditure was up 4.3%. As a result of these trends the net inflow of income from these investments was up EUR 40 million in year-on-year terms to EUR 262 million in 2008. The largest increase on the inflow side was bank income from bonds and notes.

In the context of the deficit in labour income, the decline in the net deficit in equity income and outward interest payments are forecast to contribute most to the narrowing of the deficit in factor income over the projection horizon. The main factors in the deficit in capital income are expected to be the decline in interest paid and expenditure on dividends and reinvested earnings. The main factor in the decline in net interest payments, despite the projected growth in the net external debt, which is expected to be significantly slower than the average of recent years, is the assumed gradual decline in financing costs, i.e. falling interest rates on global financial markets. Both inward and outward FDI are expected to decline sharply as a result of the global financial turmoil and economic crisis. The decline in economic activity will also be reflected in the returns on FDI, and net outflows of income from FDI will therefore decline from EUR 472 million in 2008 to around EUR 380 million this year, before increasing again to around EUR 450 million by the end of the projection horizon. The current trends of repatriation of dividends and profit distributions from outward FDI are expected to continue until the end of the projection horizon. Despite the expected lower returns both to date and in the future, income from investments in foreign debt securities will act to reduce the deficit in factor income. The stock of these as at the end of last year was more than two times the stock of foreign investments in domestic currency debt securities.

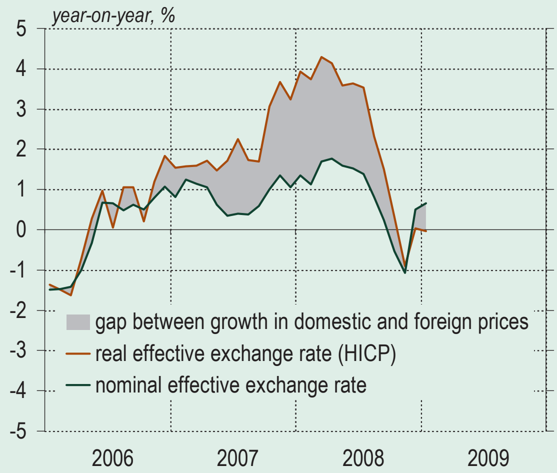
Net current transfers to the rest of the world in 2008 were down just over a third on 2007, and accounted for less than 10% of the current account deficit last year. The largest year-on-year improvement in 2008 was recorded by private transfers (a net improvement of EUR 45 million). The main factor in the improvement in private transfers was the surplus in taxes and social contributions on the gross earnings of workers, which increased from EUR 62 million to EUR 80 million in 2008. There was also a slightly smaller improvement in official transfers in 2008, the deficit narrowing by EUR 39 million in year-on-year terms to EUR 183 million. The majority of official transfers relate to payments of taxes and contributions to the rest of the world, insurance premiums and other transfers. Receipts from the EU budget amounted to 46.4% of the planned value, while expenditure was 114.0% of the planned value. On the expenditure side, there was an above-average increase last year in the liabilities from traditional funds (customs duties), expenditure arising from VAT and expenditure arising from gross national income. Compared with 2007, when it was almost in balance, Slovenia's net government position against the EU budget deteriorated sharply in 2008, accounting for EUR 64.7 million of the deficit in official transfers. The forecasting of the net position with the EU budget makes use of the figures from the budget memoranda for 2008 and 2009, which envisage receipts of 1.56% of GDP and expenditure of 1.13% of GDP, which in light of the GDP forecast entails an annual surplus of approximately EUR 150 million. This surplus, given the previous experience of realisation, particularly on the receipt side, was correspondingly reduced so that, according to estimates, the position of receipts and expenditure related to the EU budget will also show a small deficit over the projection horizon. The relative deficit in transfers narrowed to 0.5% of GDP in 2008, and is expected to remain around this level during the coming years.

Given the assumptions made for import and export prices, changes in exchange rates and trends in commodity and energy prices, the terms of trade are expected to improve sharply this year, and thus represent the most significant factor in the relative improvement in the current account position. The overall terms of trade in goods and services deteriorated by 2.1% in year-on-year terms in 2008. Export prices were up 1.8% in year-on-year terms overall, while import prices were up 4.0%. This trend in import and export prices was significantly less favourable than in 2007, when the terms of trade were actually positive in the amount of 0.5%. Import and export prices are expected to fall in 2009, with import prices recording a significantly larger decline of 3.1% than the 0.9% decline in export prices. In the context of these movements the terms of trade with the rest of the world are expected to improve by 2.2% in year-on-year terms in 2009, thereby becoming a major factor in the narrowing of the current account deficit this year. The positive effect of the terms of trade is expected to account for more than EUR 600 million of this year's narrowing of the current account deficit, equivalent to 1.6% of GDP. As a result of the projected renewed growth in energy and commodity prices, the terms of trade are expected to deteriorate by more than 1% in 2010, but will remain roughly neutral after this as a result of the projected stalling of commodity prices. The movement of the euro exchange rate against other global currencies, the US dollar in particular, has a major impact on the terms of trade, and thus on the current account position. In the event of a hypothetical depreciation in the euro of 20% against the US dollar, the positive terms of trade of 2.2% from the baseline scenario would decline to 0.5%, which would also entail a short-term deterioration of just over 1 percentage point in the current account position.

The harmonised competitiveness indicator as measured by the nominal effective exchange rate averaged an appreciation of 0.9% in 2008, having recorded a significant appreciation in the first half of the year and then a significant depreciation. The nominal effective exchange rate reached its high for 2008 in April, when it was up 1.8% in year-on-year terms, and its low in November, when it was down 1.1% in year-on-year terms. Last year the euro gained most against the pound sterling (18.1%), while it fell against the US dollar (13.3%), the yen (25.1%) and the Swiss franc (7.3%). The euro exceeded the USD 1.50 mark at the end of February 2008, approaching USD 1.60 by the middle of July, before falling to below USD 1.30 in early February 2009. The euro stood at GBP 0.74 at the beginning of the year, and then slowly rose, peaking at GBP 0.98 at the end of December. It is currently fluctuating around GBP 0.90. The fall in the nominal effective exchange rate in the second half of the year had a direct impact on the competitive position of the euro area countries. The competitiveness of euro area countries thus rose on both the US and the Asian markets, but the financial turmoil and the resulting economic crisis meant that it was impossible to exploit these advantages in full.

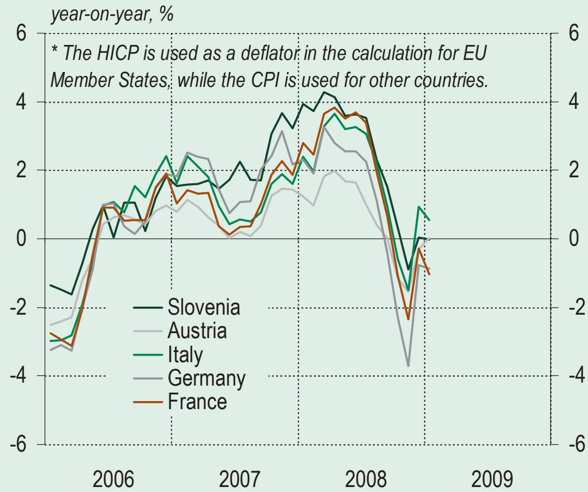
The majority of the real effective exchange rate indicators appreciated between the final quarter of 2005 and the first quarter of 2008, when the trend then reversed. An exception was the real effective exchange rate as measured by unit labour costs in manufacturing, which after appreciating in 2007 then depreciated until the third quarter of 2008. After a sharp appreciation in 2007, the real effective exchange rate as measured by consumer prices (the HICP) peaked in the first quarter of 2008, recording a year-on-year increase of 4.2%. Despite a depreciation in the second half of the year, the exchange rate averaged a year-on-year appreciation of 2.5% over 2008. The appreciation was primarily the result of faster growth in domestic prices than in the basket of foreign prices. The price competitiveness indicator has continued to decline since the second quarter,

Figure 4.4: Harmonised national competitiveness indicators (for 41 countries and 15 euro area countries)



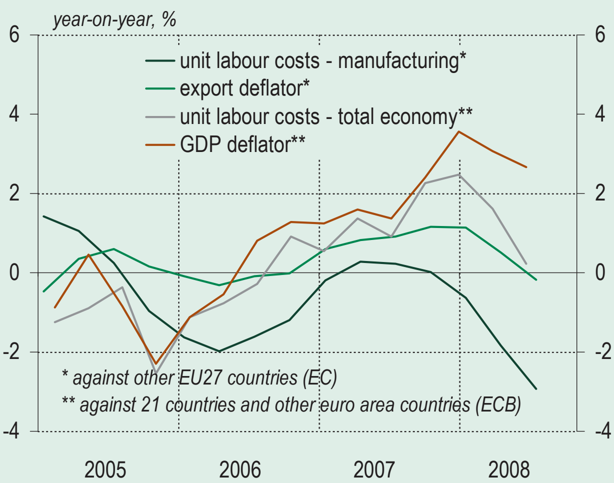
Source: ECB

Figure 4.5: Harmonised price competitiveness indicator (for 41 countries and 15 euro area countries)



Source: ECB

Figure 4.6: Competitiveness indicators



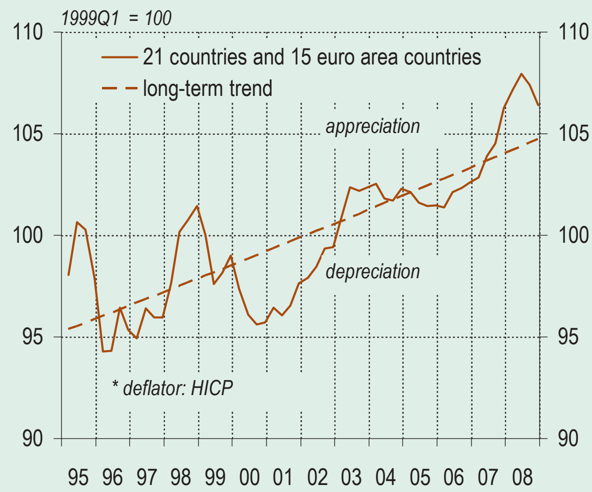
Source: European Commission, ECB

most notably in the final quarter of 2008. The real effective exchange rate as measured by unit labour costs in the economy as a whole appreciated by 2.5% in year-on-year terms in the first quarter, but by just 0.2% in the third quarter. Given the reversal in the productivity trend and the increase in labour costs per employee, this indicator can be expected to have appreciated sharply again in the final quarter. By contrast, the real effective exchange rate as measured by unit labour costs in manufacturing depreciated in 2008, the year-on-year depreciation averaging 1.6% over the first two quarters of the year. After a two-year trend of increase in the real effective exchange rate as measured by the GDP deflator, the trend ceased in the second quarter of 2008, and the indicator began improving. The year-on-year appreciation in the competitiveness indicator, which stood at 3.6% in the first quarter of last year, had declined to 2.7% by the third quarter. The main factor in the improvement in this competitiveness indicator was the decline in year-on-year growth in Slovenia's GDP deflator from 6.2% in the first quarter to 3.3% in the third quarter of last year. The real effective exchange rate as measured by the EU export prices deflator averaged an appreciation of 0.5% in 2008, down 0.4 percentage points on 2007. In this case an appreciation does not necessarily entail a deterioration in the competitiveness of the export sector, but can also reflect changes in the structure of Slovenian exports.

As a result of inflation falling faster in Slovenia than in its most important euro area trading partners, Slovenia's price competitiveness indicator in 2008 reveals an improvement in competitiveness. The indicator of price competitiveness against euro area countries appreciated rapidly between the second quarter of 2007 and the first quarter of 2008 as a result of the high inflation in Slovenia. This put Slovenia bottom in terms of price competitiveness among the euro area countries, but the indicator depreciated in the second half of the year. Although the competitiveness indicators at the end of the year point to convergence with the average of Slovenia's most important euro area trading partners, its competitive position remains relatively unfavourable.

The effects of long-term real convergence can also be seen in the movement of price competitiveness indicators, but these are neutral so far as a decline in competitiveness is concerned. These effects have been moderate in Slovenia, given the long-term trend of appreciation in the real effective exchange rate since 1995. The same assessments are shown by analysis based on the trends in intersectoral relative prices and productivity illustrated in last October's PSR. The deviations from the long-term trend reveal that there was a downturn in 2007, with appreciation outpacing the rate that could be tied to the process of balanced long-term real convergence. In 2008 the indicator again approached its long-term trend.

Figure 4.7: Harmonised competitiveness indicator



Source: ECB, Bank of Slovenia calculations

5 Financing Conditions

The widening of the savings-investment gap in Slovenia in recent years has coincided with relatively strong borrowing in the rest of the world and an increase in the net external debt. The savings-investment gap ceased to widen in the second half of 2008, primarily as a result of lower investment. The main financial intermediaries are the banks, which borrow in the rest of the world to finance other domestic sectors. As a result of the financial turmoil, banks have been primarily funding themselves since the final quarter of 2008 by reducing their investments in the rest of the world and by borrowing from the Eurosystem. After increasing rapidly in 2007, lending to the domestic private sector[4] slowed relatively sharply in 2008, which was primarily related to the significant slowdown in economic activity, in particular the decline in investment, tighter financial conditions, and the slowdown in prices and trading on the real estate market.

Figure 5.1: Savings-investment gap

Source: SORS, Bank of Slovenia calculations

** The public sector savings-investment gap is defined as the deficit in the consolidated public sector position according to the ESA 95 methodology. The private sector savings-investment gap is the difference between the current account position and the public sector savings-investment gap .*

Financial flows with the rest of the world and external debt

The private sector's savings-investment gap increased rapidly between the middle of 2006 and the second quarter of 2008, remaining at the high level reached until the end of the year. Because the net saving of the public sector was insufficient, the deficit in domestic saving has been financed by borrowing in the rest of the world. National saving increased by 2.1 percentage points over the preceding two years to 27.4% of GDP in 2007, while gross investment increased by 4.3 percentage points during the same period to 31.4% of GDP. The savings-investment gap, i.e. the difference between domestic saving and investment, thereby widened by 2.2 percentage points to 4.0% of GDP in 2007, and, as is evident from Figure 5.1, widened further in the first half of 2008. In the second half of the year the savings-investment gap remained at a level just below 6% of GDP. The public sector's savings-

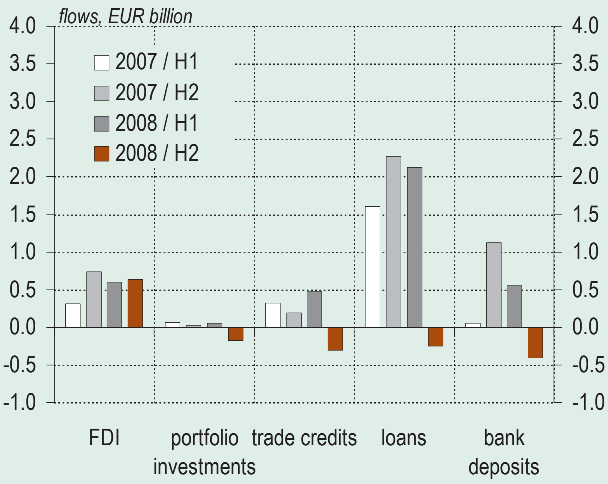
[4] The domestic private sector includes non-financial corporations, households and non-monetary financial institutions.

investment gap was slightly positive at the end of 2007, but then turned negative once again in the second half of 2008. The private sector's savings-investment gap gradually widened from the beginning of 2003, and after a temporary reversal widened continuously between the middle of 2005 and the middle of 2008.

As a result of the relatively high negative savings-investment gap, the net financial inflow in the balance of payments[5] remained significantly large in 2008. The net financial inflow increased from EUR 1.1 billion in 2006 to EUR 1.7 billion in 2007. It increased to EUR 1.2 billion in the first half of 2008, and remained roughly at this level in the second half of the year, thereby standing at around 6% of GDP. In 2008 two-thirds of this inflow was into the private sector, and one-third into the government sector. The net financial inflow into the government sector was primarily the result of the release of government bonds in the amount of EUR 1.0 billion in February 2008.

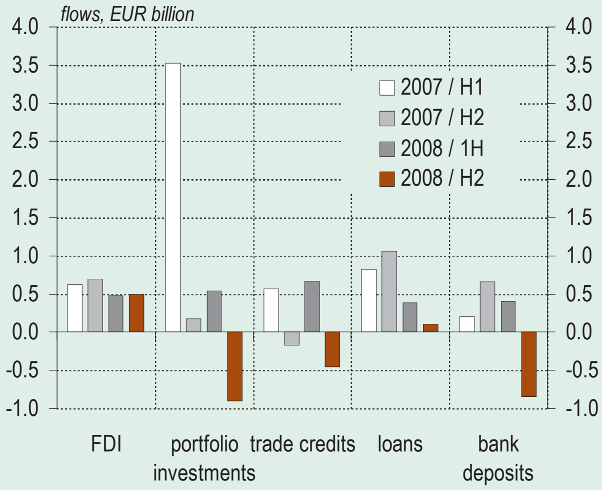
The private sector's financial inflows and financial outflows in the first half of 2008 remained at the high level of the preceding period, but there was a downturn in the second half of the year as a result of the economic slowdown and, in particular, the deepening of financial turmoil, which made access to foreign financial resources more difficult. The private sector's inflows via external liabilities amounted to EUR 4.5 billion in the second half of 2007, but to EUR 3.9 billion in the first half of 2008, while the outflows via external claims amounted to EUR 3.0 billion and EUR 3.2 billion respectively during the same periods. In the second half of the year the cooling economy reduced the need for financing from the rest of the world, and also reduced the money available for outward investments. The deepening of the financial turmoil after September also made it more difficult to access financing in the rest of the world,[6] while simultaneously raising the risk of investing in the rest of the world. The private sector's external liabilities and claims therefore both declined in the second half of 2008, by EUR 0.4 billion and EUR 0.9 billion respectively. Financing during this period thus proceeded primarily via a reduction in investments, and not via borrowing in the rest of the world.

Figure 5.2: Financial inflows from the rest of the world



Source: Bank of Slovenia

Figure 5.3: Financial outflows to the rest of the world



Source: Bank of Slovenia

[5] The net financial inflow represents the position of the financial account of the balance of payments, excluding statistical errors.
[6] Euro area banks surveyed in the Bank Lending Survey were among those reporting greater difficulty in accessing funding. For more, see the ECB Monthly Bulletin, February 2009, Box 3, p 22.
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

Loans to banks from the rest of the world and bank deposits by non-residents, which actually recorded a net outflow in the second half of 2008, were again prevalent among the private sector's financial liabilities in the first half of the year. Of the total financial inflow into the private sector of EUR 3.9 billion in the first half of 2008, loans to banks from the rest of the world accounted for EUR 1.9 billion, while bank deposits by non-residents accounted for EUR 0.6 billion. These inflows were unchanged from the second half of 2007. With the decline in credit demand from domestic sectors, and the corresponding smaller need for bank funding from the rest of the world, and in particular with the deepening of the financial turmoil, these flows reversed to become outflows[7] in the second half of 2008. FDI in the second half of 2008 remained at its level of the first half of the year at around 3.5% of GDP. Corporate borrowing in the rest of the world in the second half of the year was almost two times that in the first half of the year at EUR 0.4 billion, while inward portfolio investments remained negligible.

Among the private sector financial claims, all types of investment continued to record outflows in the first half of 2008, while all types of investment other than FDI recorded inflows in the second half of the year, primarily as a result of the financial turmoil. This reversal was most evident for portfolio investments, which recorded an outflow of EUR 0.5 billion in the first half of the year, but an inflow of EUR 0.9 billion in the second half of the year as a result of disinvestment from foreign securities, and in bank deposits in the rest of the world, which recorded an outflow of EUR 0.4 billion and an inflow of EUR 0.8 billion over the same periods.[8] As expected there was no such reversal in FDI, which remained stable at around 3.5% of GDP.

Financial flows with the rest of the world are highly uncertain[9] over the projection horizon as a result of the financial turmoil and its consequences. Even in the event of gradual normalisation on the financial markets, inflows of loans from the rest of the world can be expected to continue slowing as a result of the significant decline in economic growth forecasts and the high level of past financial flows. Inflows arising from FDI are expected to remain at a level similar to previous years, but will depend to a great extent on the realisation of government plans for selling off state assets. On the outflow side, loans and FDI are also expected to gradually slow. Inflows and outflows of portfolio investments are expected to remain negligible in the future.

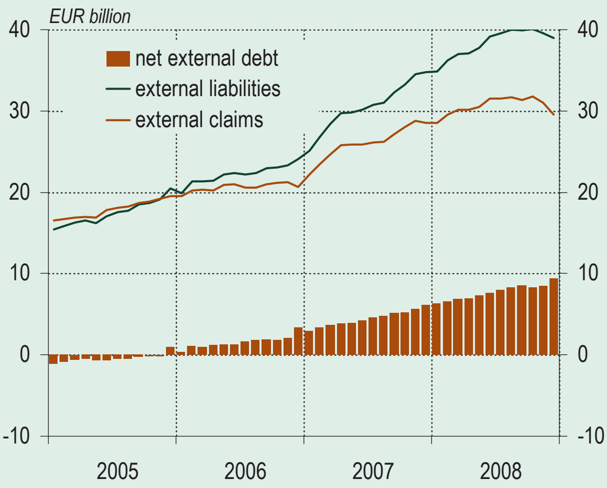
The continuation of relatively strong flows with the rest of the world until August 2008, in which debt instruments were prevalent, was reflected in an increase in gross external claims and liabilities, but gross external claims and liabilities both declined from September on, primarily as a result of the financial turmoil. Slovenia's gross external claims increased from EUR 28.6 billion at the end of 2007 to EUR 31.7 billion at the end of August 2008, while its gross external debt increased from EUR 34.8 billion to EUR 40.0 billion over the same period. Slovenia's gross external claims and gross external debt declined from September, reaching EUR 29.6 billion and EUR 39.1 billion respectively by the end of December 2008. The increase in the gross external claims and gross external debt is expected to be lower than forecast before September's deepening of the

[7] In the euro area both financial inflows and outflows other than FDI have been declining since the second half of 2007, primarily as a result of the uncertainty on financial markets. These flows strengthened again towards the end of the year. For more, see the ECB Monthly Bulletin, August 2008, Box 7, p 67 and the ECB Monthly Bulletin, February 2009, p 66.
http://www.ecb.int/pub/pdf/mobu/mb200808en.pdf
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

[8] The increased financial inflow into the Bank of Slovenia and the outflow of portfolio investments from the private sector in the first half of 2007 was primarily the result of the repayment of Bank of Slovenia bills and the placement of these assets of domestic banks in foreign securities in early 2007. For more, see the Price Stability Report, October 2007, p 48, Box: Adjustment of certain balance of payments categories following the introduction of the euro.
http://www.bsi.si/en/publications.asp?MapaId=786

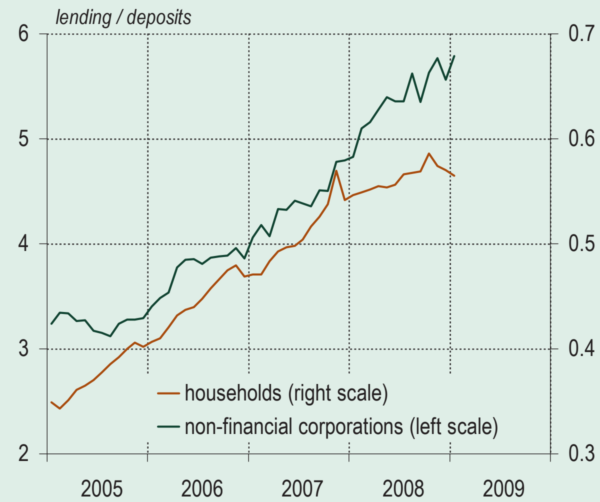
[9] The uncertainty in the forecasting of financial flows with the rest of the world is best illustrated by the reversal of trends in the second half compared with the first half of 2008.

Figure 5.4: External debt



Source: Bank of Slovenia

Figure 5.5: Net indebtedness at banks



Source: ECB, Bank of Slovenia

financial turmoil, in line with the projected slightly lower financial flows with the rest of the world.

As a result of the prevalent net financing from the rest of the world via debt instruments, the net external debt is increasing, and financing this will lead to further deterioration in the current account because of the increase in net interest payments. The slightly lower forecast for the current account deficit means that a slightly lower net financial inflow can be expected in the future, and thus a slower pace of increase in the net external debt. The net external debt increased by EUR 2.8 billion in 2007, and by EUR 3.3 billion in 2008. The net external debt amounted to EUR 9.5 billion at the end of last year. An increase in the net external debt also increases the burden of financing, which leads to additional deterioration in the current account. The net outflow of capital income thereby increased from EUR 0.7 billion in 2007 to EUR 1.0 billion in 2008. The current account deficit is expected to narrow slightly over the projection horizon, and the pace of increase in the net external debt and the costs of financing the debt are expected to slow, given the assumed dynamic of interest rate. The current account deficit is expected to remain financed primarily via debt instruments.

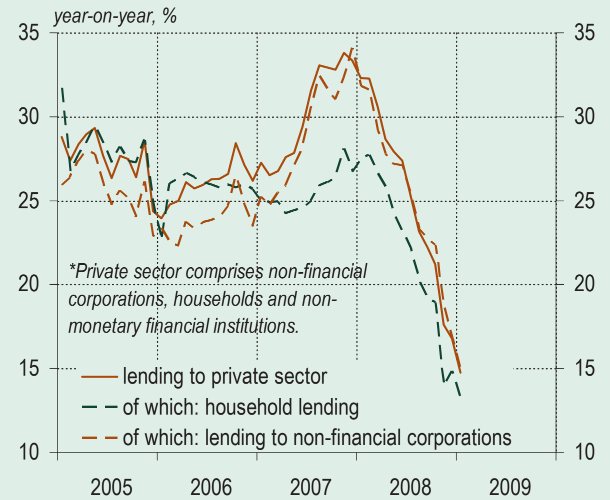
Lending activity and financing conditions

Given insufficient domestic funding, in the first half of 2008 banks continued to fund the domestic private sector's reduced credit demand by borrowing in the rest of the world. As a result of the further decline in credit demand and, above all, the financial turmoil, banks funded themselves in the second half of the year, the final quarter in particular, by reducing outward investments and borrowing from the Eurosystem. The flow of loans to banks from the rest of the world and the flow of deposits by non-residents amounted to EUR 4.5 billion in 2007, and to EUR 2.5 billion in the first half of 2008, while the flow of lending to domestic sectors amounted to EUR 6.8 billion in 2007 and EUR 2.9 billion in the first half of 2008. This means that up to the first half of 2008 banks funded an increasing proportion of their lending via borrowing in the rest of the world. In the second half of 2008 banks actually made net repayments to the rest of the world of EUR 1.1 billion in the form of borrowing and deposits by non-residents. They also reduced their investments in the form of lending and deposits in the rest of the world by EUR 0.8 billion and borrowed EUR 1.1 billion from the Eurosystem. The slight decline in funding is also partly the result of the decline in credit demand, as the flow of lending to the domestic private sector in the second half of 2008 was just EUR 1.6 billion. These trends are also evident from the indicators of the net indebtedness of non-financial corporations and households, defined as the ratio of the individual sector's lending to its deposits. This ratio began to rise noticeably in 2005. Until then the ratios had been just over 3.0 for non-financial corporations, and just over 0.35 for households. By the middle of 2008 the ratios had reached more than 5.5 for non-financial corporations, and almost 0.6 for households. The ratios remained unchanged for both non-financial corporations and households in the second half of 2008.

Growth in bank lending to the private sector, which stood at almost 35% in year-on-year terms at the end of 2007, declined rapidly in 2008, and now stands at just 15% in year-on-year terms. Growth in lending to the private sector increased by 10 percentage points in 2007, but declined by 20 percentage points in 2008. As is evident from Figure 5.6, lending to both non-financial corporations and households began to increase in the second quarter of 2007, increasing very sharply until the end of the year, since which it has slowed relatively sharply. Growth in lending to non-financial corporations outpaced growth in lending to households during the last two years.

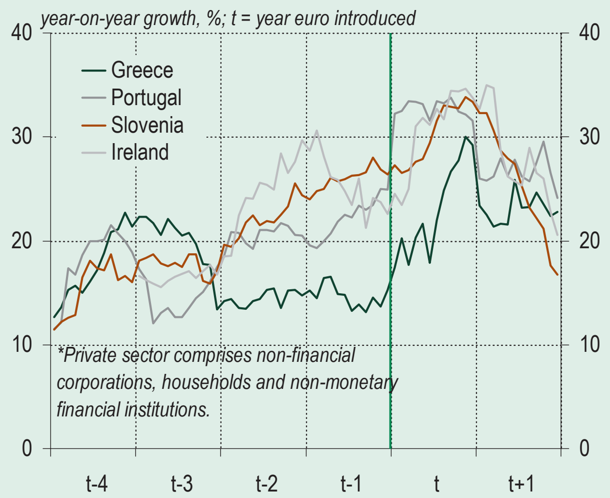
The relatively rapid slowdown in lending to the private sector in 2008 was primarily the result of the cooling economy and the deepening of the financial turmoil since September. Another factor in the relatively rapid slowdown was normalisation after rapid growth in the depth of financial intermediation and the reaching of long-term equilibrium in 2007.[10] An increase in the level of borrowing is partly an expected part of the process of real convergence to the more developed EU Member States. The depth of financial intermediation in Slovenia as measured by the ratio of private sector lending to GDP has increased by around 10 percentage points each year in recent years, reaching almost 80% at the end of 2008. The gap in the depth of financial intermediation measured in this manner between the euro area and Slovenia narrowed from 60 percentage points in 2003 to just over 50 percentage points in 2008. It is clear from Figure 5.7 that a similar acceleration in lending has been seen by other less-developed countries after they joined the euro area. In these countries too growth in lending leapt upwards in the first year after joining the euro, and then slowed relatively sharply in the following year, as in Slovenia.

Figure 5.6: Lending to the domestic private sector



Source: Bank of Slovenia

Figure 5.7: Growth in lending to the private sector and the introduction of the euro*



Source: IFS.

[10] The effects on lending of reaching long-term equilibrium and the financial turmoil are discussed in detail in Box 5.1.

Box 5.1: Lending and economic activity in Slovenia

In Slovenia credit growth was in line with economic growth until 2004, but after 2004 it significantly outpaced economic growth, which was reflected in an increase in the ratio of lending to GDP. The ratio of lending to GDP increased from 40% in 2004 to 80% in 2008, gradually moving towards the average in the euro area, where it is almost 140%. This rapid growth in lending entailed a deepening of financial intermediation, and is to a certain extent an equilibrium process of real long-term convergence. An excessively fast or slow increase in lending and/or an excessive or insufficient volume of lending in the economy, i.e. a level not in balance with the macroeconomic fundamentals, could give rise to imbalances, increasing the country's financial vulnerability.

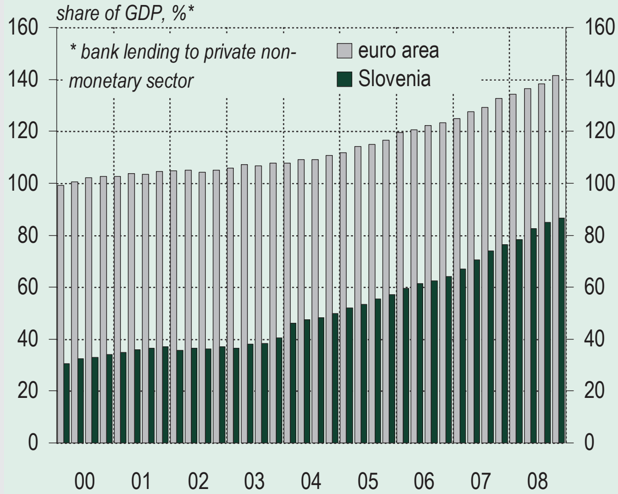
The ratio of private sector lending to GDP increased in recent years in circumstances of high economic activity. Because a significant slowdown in economic growth is expected over the projection horizon, bank lending to the private sector could also be expected to slow correspondingly, particularly if it is assumed that the level of lending in Slovenia in 2008 had already approached the estimated equilibrium level.[1] This means that average annual growth in lending of between 0% and 5% over the projection horizon would be in line with the economic growth forecast for Slovenia, and would entail the maintenance of the equilibrium level of lending reached in the economy, while faster growth in lending would entail a further increase in the depth of financial intermediation.[2]

Supply-side limits on lending have not been taken into consideration in the above lending growth forecast. One of the consequences of the financial turmoil can be seen in banks' increased preference for liquidity and in banks' refinancing difficulties, which could reduce the supply of lending. A decline in credit supply that is of greater magnitude than the decline in credit demand occurring because of cyclical factors or the decline in clients' borrowing capacity, and that is the result of limits in refinancing is known as a credit crunch.[3]

Private sector lending declined significantly over the three months after November 2008. The monthly increase in the stock of private sector lending averaged EUR 458 million over the first ten months of 2008, but just EUR 63 million between November 2008 and January 2009, the stock of private sector lending actually declining in November.[4] Here it should be noted that private sector lending in the two years preceding October 2008 was very strong, and most likely excessive with regard to the equilibrium macroeconomic needs, and that part of the slowdown since November 2008 can probably be attributed to a "normalisation" of lending activity.

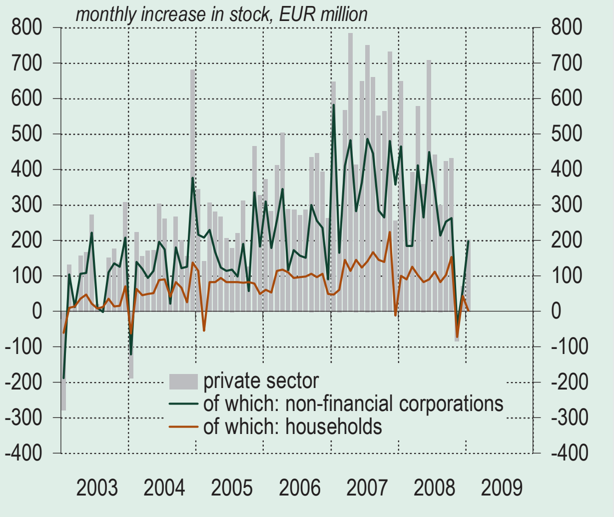
Despite the significant decline in private sector lending in recent months, it is still difficult to determine to what extent this decline is the result of a decline in credit demand and to what extent it is a credit crunch. All these factors on the part of both non-financial corporations and households point to a significant decline in credit demand (declines in economic

Figure 1: Lending to the private sector in Slovenia and the euro area



Source: Bank of Slovenia, ECB

Figure 2: Lending to the private sector



Source: Bank of Slovenia

activity, investment and private consumption, declining volume and prices on the real estate market).[5] Furthermore, the BLS[6] reveals that corporate credit demand increased only slightly in the final quarter of 2008, while demand for consumer and housing lending declined significantly. By contrast, credit standards and loan terms for corporates, which can primarily be treated as factors of credit supply, underwent their most pronounced tightening to date in the final quarter of 2008, having already been tightened significantly for consumer and housing lending in the third quarter and remaining at that level in the final quarter. In addition, banks are reporting that accessing funding is more difficult, part of the evidence for which is the change in the movement of banks' financial flows with the rest of the world, borrowing in the rest of the world having been banks' most important source of funding in recent years.[7] The indicators therefore reveal that the decline in private sector lending in late 2008 and early 2009 was to a great extent the result of a decline in credit demand, but was also partly the result of a decline in credit supply.

A sharper decline in lending, say as the result of a credit crunch, would entail limits for economic activity. Simulation of restricted credit supply using the Bank of Slovenia's macroeconomic model shows that GDP growth could decline significant in the event of a contraction in credit supply. According to this forecast, in the three years following a decline of 10 percentage points in private sector lending, GDP could decline by between 0.6 and 2.4 percentage points, depending on the reaction of imports to the slowdown in domestic demand. The range of the effects is tied to the model reaction of imports at the first boundary condition, and to unchanged imports at the second boundary condition. The largest response to lending limitations comes from investment, which could record a cumulative decline of between 2 percentage points and just over 4 percentage points. The response of household consumption would be slightly smaller, while prices would also respond with a delay as a result of reduced demand-side pressures and the gradual adaptation of wages. These forecasts of the effect of loans on economic trends are relatively similar to those for the euro area,[8] which cite a value for the current ratio of around 0.15 (which corresponds to a cumulative effect on GDP of around 1.8 percentage points over three years). The European Commission forecasts[9] point to an even greater impact of lending on economic activity in the euro area, with a ratio of 0.37, in a rather wide confidence interval of 0.02 to 0.72.

[1] Found by a study by P Backe, M Eller, B Egert and T Žumer. The preliminary version of the study was presented at the Eleventh Conference of the ECB-CFS Research Network on "The Market for Retail Financial Services: Development, Integration and Economic Effects", October 2008, Prague. http://www.eu-financial-system.org/index.php?id=93.

[2] The higher lending forecast estimated by Jašovič and Košak (The effects of the crisis on the Slovenian banking system, proceedings from the Global Crisis and the Slovenian Economy conference, December 2008) was primarily the result of older, and thus more optimistic macroeconomic forecasts.
http://www.ef.uni-lj.si/dogodki/datoteke/konferencazbornik.pdf

[3] The definition is taken from the article entitled "Are There Signs of a Credit Crunch in Austria" (Oesterreichische Nationalbank, Monetary Policy & the Economy, Q4/08). A similar definition also appears in ECB material, where a credit crunch is defined as a limit in credit supply above the customary economic cycle, which is seen in a sharp tightening of credit standards and/or loan terms.

[4] A similar trend can be seen throughout the euro area. In December the stock of lending to non-financial corporations actually declined for the first time during the financial turmoil (for more, see the ECB Monthly Bulletin, February 2009).

[5] For more about these indicators see other sections of the Price Stability Report, in particular Economic Trends and the Labour Market. The real estate market will be discussed in detail in the Financial Stability Review (May 2009).

Table: Simulation of the shock of a decrease in lending to the private sector by 10 percentage points in 2009

	2009	2010	2011	cumulative
GDP	-0.2 to -1.0	-0.3 to -0.8	-0.2 to -0.6	-0.6 to -2.4
HICP	0.0	0 to -0.3	-0.1 to -0.5	-0.2 to -0.8
Household consumption	-0.8 to -0.9	-0.5 to -0.6	-0.6 to -0.7	-2.0 to -2.2
Investment	-1.3 to -1.6	-0.3 to -1.8	-0.3 to -0.9	-1.9 to -4.3

Deviation from baseline scenario in percentage points. Minimum and maximum values are shown for the response in variables based on various assumptions for import behaviour (endogenous or exogenous).
Source: Bank of Slovenia

[6] The Bank Lending Survey is based on the responses of euro area banks to survey questions. In Slovenia five banks participate in the survey. Methodological limitations mean that a direct comparison of the results between Slovenia and the euro area as a whole is not entirely appropriate. More about the BLS has been and will be published in the Financial Stability Reviews (May 2008, May 2009).

[7] Bank borrowing in the rest of the world increased relatively rapidly over the first eight months of the year, but has been declining since September. For more, see the Financial Flows with the Rest of the World and External Debt section.

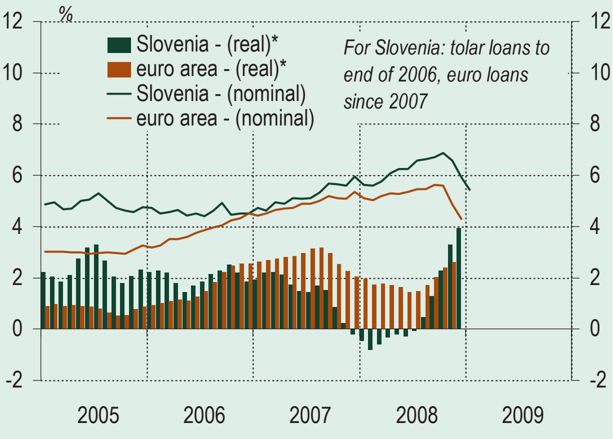
[8] IMF (2008), Euro Area Policies: Selected Issues. IMF Country Report 08/283.

[9] European Commission (2008), Quarterly Report on the Euro Area. Vol 7 No 4.

The rapid slowdown in borrowing by non-financial corporations in 2008 was primarily cyclical in nature, and is related to the slowdown in economic growth.[11] High borrowing by non-financial corporations, particularly in the second half of 2007, was to a great extent related to the high economic growth, and above all to investment, the large demand for financing for corporate acquisitions, and the reinforcement and expansion of positions on external markets, the western Balkans in particular. Since the final quarter of 2007, and in the second half of 2008 in particular, year-on-year real growth in GDP and investment has been declining or even negative, and this has coincided with a slowdown in lending to non-financial corporations. Other factors in the decline in lending to non-financial corporations in the second half of the year were the significant deterioration in the outlook for economic growth, and the financial turmoil.[12]

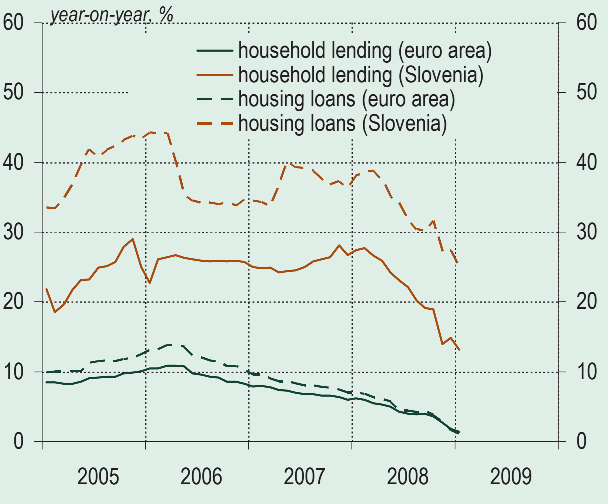
The real financing conditions for non-financial corporations remained favourable until the middle of 2008, despite the gradual rise in nominal interest rates, but deteriorated in the second half of the year despite the fall in nominal interest rates as a result of the fall in inflation. Figure 5.8 shows that from the end of 2006 the movement and level of nominal interest rates on loans to non-financial corporations in Slovenia was comparable to those in the euro area, an indication of the Slovenian financial system's considerable level of integration with

Figure 5.8: Interest rates on loans of more than EUR 1 million to non-financial corporations



** Real interest rates, allowing for past inflation (3-month moving average).*
Source: ECB, Bank of Slovenia

Figure 5.9: Breakdown of household lending



Source: ECB, Bank of Slovenia

[11] Lending to non-financial corporations has also been declining in the euro area, the year-on-year rate reaching 9.4% in December 2008. The ECB attributes the slowdown in lending to non-financial corporations in the euro area primarily to a decline in demand for reason of the deterioration in the economic growth outlook and tighter credit standards and financing conditions. (ECB, Monthly Bulletin, February 2009).
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

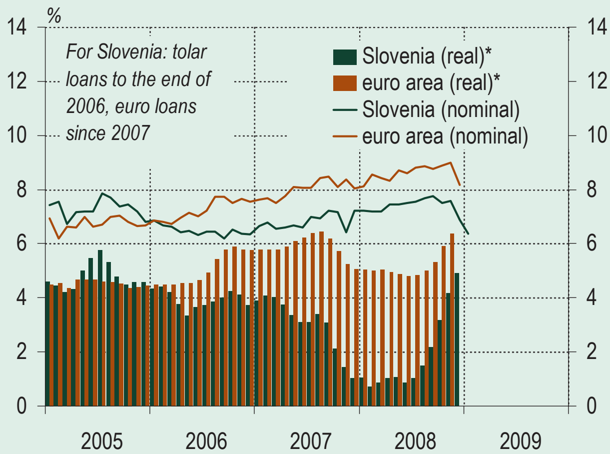
[12] The financial turmoil has also seen certain limitations arise on the credit supply side, which are being reflected in the very rapid tightening of credit standards and financing conditions (ECB, Monthly Bulletin, February 2009, Box 3: The results of the January 2009 Bank Lending Survey for the euro area).
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

the euro area. Between the middle of 2007 and the middle of 2008, taking just short-term inflation movements into consideration, real interest rates in Slovenia were lower than in the euro area, primarily as a result of slightly higher inflation in Slovenia. Since the middle of 2008 real interest rates in both Slovenia and the euro area have been gradually rising, which has further acted to curb the pace of lending to non-financial corporations.[13]

The expected continued slowdown in economic activity and investment and also the current trends point to a continued decline in year-on-year growth in lending to non-financial corporations. The economic projections point to negative economic growth in 2009, and a gradual recovery in the following years, more evidently for investment. Year-on-year growth in lending to non-financial corporations can therefore be expected to continue declining from the current rate of around 15% to between 5% and 10% in 2009, before gradually increasing in the following years. The financial turmoil and its consequences mean that these forecasts are highly uncertain.[14]

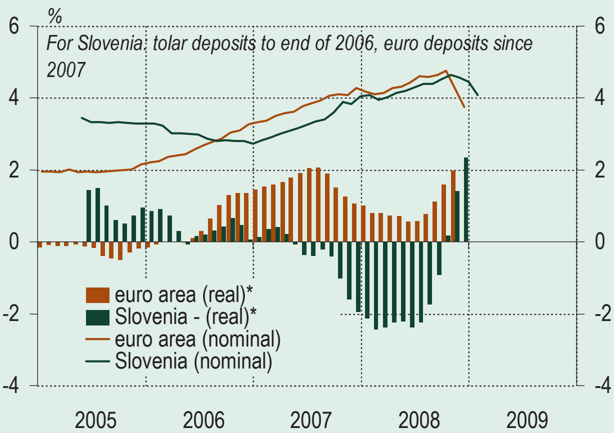
The relatively rapid slowdown in household lending in 2008 was the result of both a gradual decline in housing lending and a decline in consumer lending.[15] The breakdown of household lending shows that year-on-year growth in housing lending declined from almost 40% at the end of 2007 to below 30% at the beginning of 2009. Here it should be noted that the high growth in housing lending is also a consequence of the relatively low level of these loans. The proportion of total household lending accounted for by housing lending increased over the last three years from approximately 30% to almost 45% at the beginning of 2009. Year-on-year growth in consumer lending declined from almost 30% at the end of 2007 to around 15% at the beginning of 2009.

Figure 5.10: Interest rates on consumer loans to households



* Real interest rates, allowing for past inflation (3-month moving average).
Source: ECB, Bank of Slovenia

Figure 5.11: Interest rates on household deposits of up to 1 year



* Real interest rates, allowing for past inflation (3-month moving average).
Source: ECB, Bank of Slovenia

Growth in housing lending is slowing in conjunction with a decline in growth in real estate prices, and a significant decline in the volume of trading on the

[13] In addition to rising interest rates, non-price factors of financing such as credit standards and financing conditions are also tightening (ECB, Monthly Bulletin, February 2009, Box 3: The results of the January 2009 Bank Lending Survey for the euro area).
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

[14] See Box 5.1.

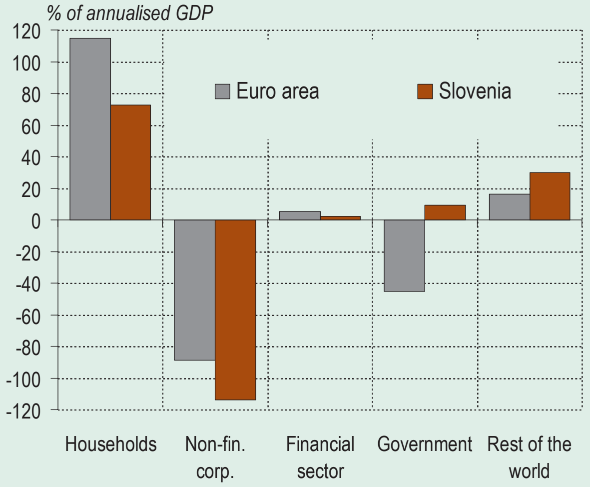
[15] Lending to households in the euro area has been declining since the middle of 2006, the year-on-year rate reaching 10.8% in December 2008. The ECB attributes the decline in household lending in the euro area primarily to poor expectations regarding economic activity and the real estate market, and to tighter financing conditions (ECB, Monthly Bulletin, January 2009).
http://www.ecb.int/pub/pdf/mobu/mb200901en.pdf

Box 5.2: Indebtedness of households and non-financial corporations

Compared with the euro area, non-financial corporations in Slovenia are more indebted, while households hold smaller net claims.[1] At the same time financing from the rest of the world in Slovenia is greater than the euro area average. Figure 1 shows that for both economies households are the sector that provide the majority of savings, while non-financial corporations are the sector that to the greatest extent uses the savings of other sectors. The difference between Slovenia and the euro area is in the order of size, as the net indebtedness of non-financial corporations in Slovenia is around 115% of GDP, compared with 90% in the euro area, while the net claims of households in Slovenia stand at around 70% of GDP, compared with around 115% in the euro area. Here it should be noted that the claims and debts of both sectors in Slovenia as a proportion of GDP are significantly lower than the corresponding proportions in the euro area, which to a great extent is related to the lower depth of financial intermediation in Slovenia, and is therefore also a consequence of the lower level of economic development. Household claims and debts in Slovenia amount to 103% and 30% of GDP respectively (compared with 183% and 68% of GDP in the euro area), while non-financial corporations' claims and debts amount to 57% and 170% of GDP respectively (compared with 157% and 246% of GDP in the euro area). The government sector holds net claims in Slovenia, but net debts in the euro area. The net credit position of the government sector in Slovenia is primarily the result of its greater corporate ownership. In both Slovenia and the euro area the financial system is of greatest importance in transferring savings from deficit sectors to surplus sectors, and its net claims are negligible.

Between 2004 and 2008 households' net claims as a proportion of GDP remained more or less unchanged in Slovenia, while non-financial corporations' net indebtedness increased. While households' net claims remained between 75% and 80% of GDP during the aforementioned period, the net debts of non-financial corporations increased from around 100% to around 120% of GDP. Both households' net claims and non-financial corporations' net indebtedness increased relative to the euro area. The gap between households' net claims in Slovenia and the euro area narrowed from around 90 GDP percentage points in 2004 to around 40 GDP percentage points in the third quarter of 2008. Non-financial corporations' net indebtedness was around 10 GDP percentage points lower in Slovenia than in the euro area, but by the third quarter of 2008 it was more than 20 GDP percentage points higher. Net saving by households thus increased in Slovenia relative to the euro area over the aforementioned period, while net saving by non-financial corporations declined.

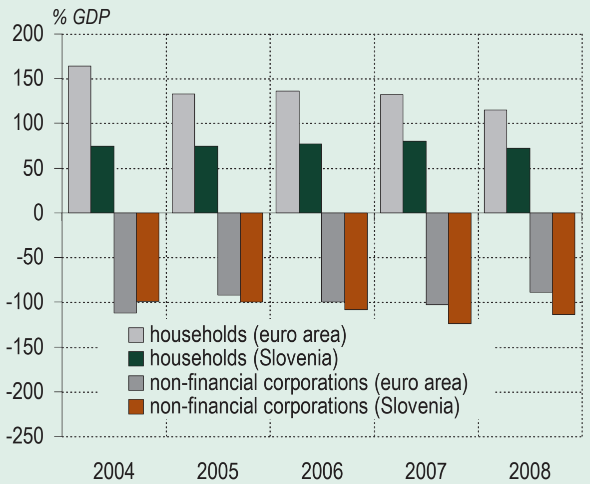
Figure 1: Net financial position at the end of Q3 2008



Source: Bank of Slovenia, ECB

Given no change in other assumptions, the increase in net corporate indebtedness is increasing the burden of financing, which is increasing corporate vulnerability to changes in financing conditions. Additional borrowing by non-financial

Figure 2: Net indebtedness of households and non-financial corporations*



** Includes figures until the end of Q3 2008.*
Source: Bank of Slovenia, ECB

corporations alone of around 15 GDP percentage points during the period in question at an interest rate that currently stands at around 6% would increase the burden of financing by almost 1% of GDP. This is increasing costs, which could result in price rises and a deterioration in competitiveness and/or cuts in other expenditure such as investment, which in the long term would entail lower output. The effect on economic activity could be significantly less were the indebtedness of other sectors such as households to be reduced as the indebtedness of non-financial corporations increases, as households can increase aggregate demand for this reason. However, in Slovenia the rising indebtedness of non-financial corporations has recently come at the expense of greater indebtedness to the rest of the world, as evidenced by the increase in the external debt. As households' net claims decline, so household income declines, which could reduce aggregate demand and economic activity. Household income from claims is lower in Slovenia than in the euro area, because claims are proportionately lower.

An increase (decline) in the value of households' financial assets could increase (reduce) consumption via the wealth effect (see Box 3.1).[2] This effect is probably greater at higher values of net financial assets. Because both households' claims and debts as a proportion of GDP in Slovenia are lower relative to the euro area, the wealth effect on household consumption is also smaller, as expected. Of course, this effect also depends on other factors: the development of the financial markets, the types of financial instruments held by sectors in their portfolios, institutional arrangements, etc.

[1] Net indebtedness is defined as the surplus of financial claims over debts, and is therefore positive when the sector discloses a surplus of financial claims over debts (net claims), or negative when financial debts are greater than claims (net debts).
[2] During a time of financial turmoil, this effect is of great importance. A rapid fall in securities prices has a very large impact on the value of financial assets.

real estate market.[16] **The slowdown in consumer lending is in line with the movement of private consumption.** Growth in real estate prices has been gradually declining since the middle of 2007, while the volume of trading has been declining significantly since the second quarter of 2008. Year-on-year growth in housing prices declined from around 25% in the first half of 2007 to less than 5% in the third quarter of 2008. The number of transactions (sales/purchases) in housing declined from almost 1,500 in the first quarter of 2008 to less than 1,000 in the third quarter of 2008.[17] The decline in year-on-year growth in consumer lending in 2008 is in line with the movement of domestic private consumption, which increased by 3.1% in real terms in 2007, but by just 2.2% in 2008, with the slowdown particularly evident in the second half of the year.

The financing conditions for household consumption have been more favourable in Slovenia than in the euro area since the middle of 2006. It is evident from Figure 5.10 that nominal interest rates, and to an even greater extent, real interest rates on consumer loans have been lower in Slovenia than in the euro area since the beginning of 2006. The gradual rise in nominal interest rates, and in real interest rates in the second half of 2008, is probably one of the main factors in the gradual slowdown in consumer lending in 2008, which can also be attributed in part to lower household borrowing capacity.[18]

Real interest rates on household deposits, taking short-term inflation movements into consideration, have again been positive since the final quarter of 2008, after nearly a year and a half. The movement of

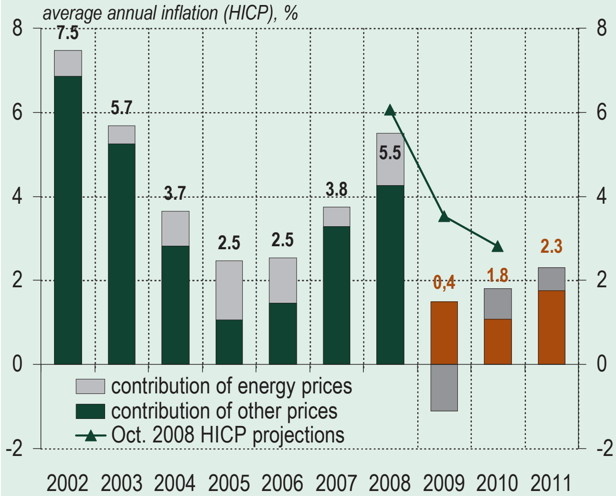
[16] The trends on the real estate market are discussed thoroughly in the May 2008 Financial Stability Review.
http://www.bsi.si/en/publications.asp?MapaId=784
[17] Source: SORS.
http://www.stat.si/eng/novica_prikazi.aspx?id=2070
[18] In addition to rising interest rates, non-price factors of financing such as credit standards and financing conditions are also tightening for both non-financial corporations and for households (ECB, Monthly Bulletin, February 2009, Box 3: The results of the January 2009 Bank Lending Survey for the euro area).
http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf

nominal interest rates on household deposits since the end of 2006 shows the high level of integration with the euro area, whereby nominal interest rates and, more so, real interest rates on household deposits of up to 1 year were lower in Slovenia than in the euro area until the end of 2008. Real interest rates were actually negative between the end of 2007 and the final quarter of 2008. Since then nominal and real interest rates have been higher in Slovenia than in the euro area. The past migration from bank deposits to higher-risk investments increased household sensitivity to any fluctuations on the financial markets. Household deposits have increased recently, primarily as a result of the financial turmoil and certain measures to mitigate its consequences, most notably the unlimited government guarantee for all deposits.

6 Price Projections and Risks

The projections of macroeconomic factors form the basis for the sharp fall in inflation over the projection horizon, which will be notable also compared with the projections from October's Price Stability Report. Average annual inflation as measured by the HICP is forecast at 0.4% for 2009, the lowest figure to date. Inflation in expected to rise to 1.8% in the following year, and to 2.3% in 2011. Compared with the October 2008 projections, this is a downward revision in inflation of 3.1 percentage points for 2009 and 1.0 percentage point for 2010. The low inflation projection for this year is partly the result of the significantly lower assumption for oil prices and other commodity prices, and partly the result of a significant decline in both domestic and foreign demand. As a result of strong base effects, the contribution made

Figure 6.1: Inflation projections



Source: SORS, Bank of Slovenia projections

Table 6.1: Inflation

						Projections					
						2009		2010		2011	
	2004	2005	2006	2007	2008	**Mar**	Δ	**Mar**	Δ	**Mar**	Δ
			average annual growth, %								
Consumer prices (HICP)	3.7	2.5	2.5	3.8	5.5	**0.4**	-3.1	**1.8**	-1.0	**2.3**	...
food	1.3	0.2	2.7	7.1	8.1	**2.2**	-2.4	**1.4**	-2.3	**2.6**	...
energy	7.0	11.9	8.5	3.4	9.4	**-8.2**	-11.4	**6.3**	4.0	**4.7**	...
other goods	1.8	-0.3	-0.9	0.3	2.2	**0.5**	-0.8	**-0.1**	-1.5	**0.9**	...
services	5.8	3.3	3.5	4.9	5.3	**2.6**	-2.1	**2.0**	-1.6	**2.4**	...
Core inflation indicators (HICP)											
excluding energy prices	3.2	1.2	1.7	3.8	4.9	**1.8**	-1.7	**1.2**	-1.7	**2.0**	...
excluding energy and unprocessed food prices	3.7	1.3	1.5	3.4	5.0	**1.7**	-1.7	**1.3**	-1.5	**2.0**	...
excluding energy, food, alcohol and tobacco prices	3.9	1.5	1.3	2.7	3.8	**1.6**	-1.6	**1.1**	-1.5	**1.8**	...

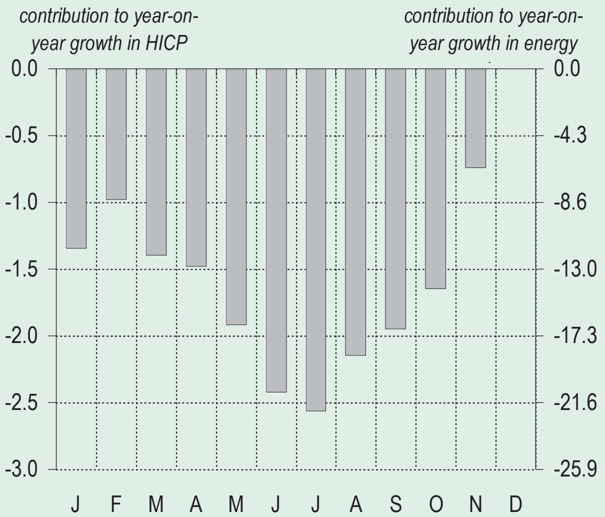
Δ: Difference between current projections and projections in October 2008 Price Stability Report
Source: Bank of Slovenia

Box 6.1: The base effect of developments in energy prices and year-on-year inflation dynamics in 2009

Inflation in Slovenia rose rapidly in the first half of 2008, and then began to gradually fall in the second half of the year (Figure 1.2). Such development in inflation was to a considerable extent the result of the movement in energy prices on global markets, but the high fluctuation of energy prices in 2008 will also have a major impact on the behaviour of year-on-year inflation rates this year via the base effect.

From a statistical point of view, the base effect is defined as the contribution to changes in the year-on-year inflation rate made by unusual changes in price indices in the base period (i.e. the period, usually the specific month, used as the basis for calculating the annual rates). If the price changes in the base period are of a one-off nature, they are usually not repeated in the observation period, and therefore drop out of the calculation of the year-on-year inflation rate. It therefore makes sense to evaluate the base effect, as it is necessary to determine when price movements are the result merely of temporary and one-off factors. Base effects can usually be evaluated by assessing the effects of exogenous factors that affect the general development of inflation, but arise from the movements of specific components of the HICP. Examples of such factors are the tax effect on prices of tobacco products, a sharp rise in certain food prices as a result of the effect of weather conditions on yields, and shifts between months or year-on-year variations in seasonal discounts during sales of clothing and footwear. Base effects thus arise when unusual price fluctuations occur, and can help to explain to what extent the monthly changes in year-on-year inflation rates are the result of past movements that have dropped out of the calculation of year-on-year inflation. The base effect of energy prices, where movements are subject to the greatest extent to exogenous factors, on the 2009 year-on-year inflation path is assessed below.

Figure: Impact of the base effect of energy prices in 2009



Source: Eurostat, Bank of Slovenia calculations

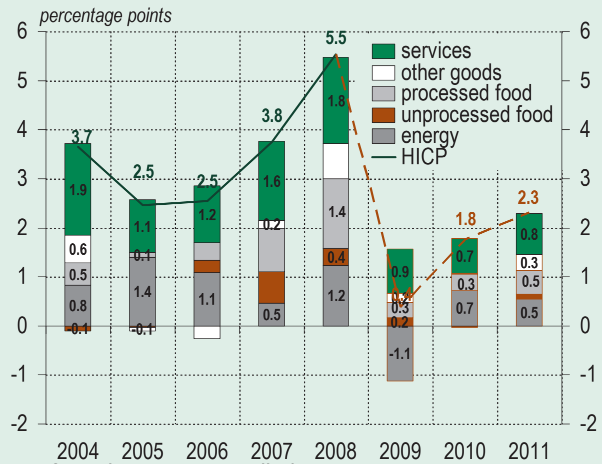
The base effect is evaluated as the contribution to the change in year-on-year inflation resulting from the changes in energy prices last year, which in this illustration is assumed to be entirely dependent on exogenous factors. The changes in year-on-year inflation in an individual month are an illustration of both the effect of the change in prices in the current month, and the change in prices in the base month, i.e. 12 months before. For the evaluation of the base effect, energy prices in 2009 have been assumed to remain at the level of December 2008.

The contribution of energy price base effects to the fall in year-on-year inflation will be extremely large as a result of the exceptionally high growth in energy prices in the first half of 2008. The base effect could reach around -1 percentage point in the first half of 2009, and could increase in magnitude to -2.5 percentage points by the middle of the year. The base effects will gradually fade away over the remainder of the year, as a reflection of the fall in energy prices during the same period last year.

by growth in energy prices will be negative this year, and slightly positive in the next two years. Growth in other prices is expected to decline to 1.8%, only reaching its low next year, when it is expected to stand at 1.2%. After a gradual recovery in domestic and foreign demand, inflation is expected to rise again in 2011 to a level in line with the price stability target.

Alongside low growth in commodity prices, other factors in this year's easing of inflationary pressures are expected to be the slowdown in economic activity both at home and in the rest of the world, and a decline in consumer purchasing power. The effects of

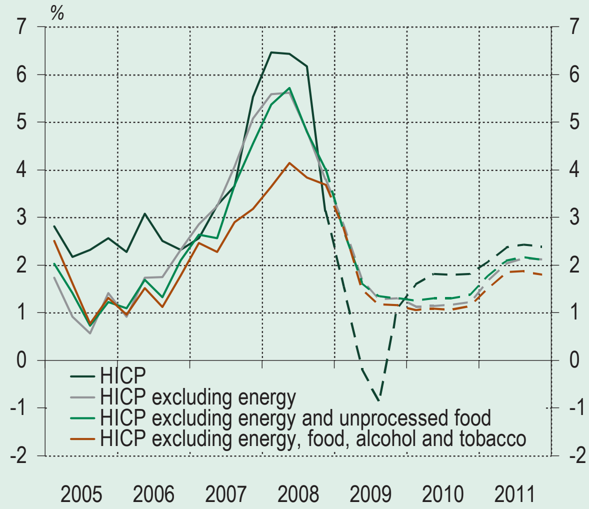
Figure 6.2: Contributions of components to inflation



Note: Sums of components may differ from aggregates values due to rounding.

Source: SORS, Bank of Slovenia projections

Figure 6.3: HICP and core inflation



Source: Eurostat, Bank of Slovenia projections

the stalling of corporate lending and economic activity were already being passed through to the real sector at the end of last year, and are only expected to reach full extent this year. As a result of an excessive production and the consequent build-up of inventories in previous years, a decline in inventories is expected to occur this year, which will act to reduce prices further in the context of reduced demand. Because the private sector is adapting to the crisis in part by reducing working hours and by lay-offs, growth in disposable household income is expected to slow significantly, which will further reduce domestic demand. Wage growth is also expected to slow in line with the trend in employment, particularly in the private sector. Growth in total earnings per employee this year is expected to be down just under 5 percentage points on last year at 2.5%. The pressures on domestic prices will therefore probably ease, first in the goods sectors where competition is most intensive, followed by service sectors, and last in trade in food products and the energy sector, as the price elasticity of demand is lowest for these products.

In line with trends in the domestic macroeconomic environment, core inflation is also expected to fall significantly. The core inflation indicators point to the rate falling again this year and in the following years to a level that would allow the sustainable achievement of price stability. Year-on-year growth in the HICP excluding energy, food, alcohol and tobacco has been declining since last April, and is expected to reach a low of just over 1% at the beginning of next year. The average annual growth in this core inflation indicator is forecast at around 1.6% for 2009, and 1.1% for next year. In line with the recovery of the domestic economy and demand, growth in the aforementioned index is expected to rise again slightly in 2011 to a level around 2%. The other core inflation indicators are expected to move in line with the main core inflation indicator throughout the projection horizon.

Alongside domestic factors, trends in the international environment are also expected to be a factor in this year's fall in inflation, the movement of commodity prices in particular. After falling in the second half of last year, oil prices are expected to remain between USD 50 and USD 60 per barrel, as a result of the significant decline in global economic activity compared with the previous several years. The assumed oil price for this year is almost 50% down on last year's average. Inflation will be on average 1 percentage point lower this year on account of the base effect alone, and year-on-year inflation is actually projected to be negative in the middle of the year. In addition to oil prices, growth in other commodity prices is also expected to slow sharply, with an average fall of 25% assumed for this year. Growth in consumer prices in the euro area and the US is also expected to be significantly lower than in previous years, as is growth in prices of manufactured goods in Germany.

Growth in individual price indices has been revised downwards in line with the headline inflation index. The revision to this year's forecasts is primarily the result of certain risks being realised, in particular those concerning energy prices, and the lower projections of growth in aggregate demand and labour costs. The forecast for this year's average annual growth in energy prices has been revised downwards by 11.4 percentage points to -8.2%, after which the rate is expected to rise to 6.3% in 2010 and 4.7% in 2011. The significant decline in growth in these prices this year is primarily the result of a base effect, as the projected current growth in energy prices is significantly lower than that of last year (see Box 6.1). March's rise of 10% in electricity prices has already been taken into consideration in this calculation. The forecasts for growth in prices of non-energy and non-food industrial goods and for services prices have also been revised downwards. Growth in the former is forecast at 0.5% this year, -0.1% in 2010, and 0.9% in 2011. Growth in services prices is expected to range between 2% and 3% over the projection horizon in line with the slowdown in domestic demand. Alongside the lower growth in aggregate demand, the main factor in the revisions to growth in services prices is that the growth forecast for labour costs is lower than in previous projections. Growth in food prices has also been revised significantly downwards: the rate is expected to decline to 2.2% this year and 1.4% next year, before rising again to 2.6% in 2011.

The low growth in energy prices on global markets will allow the government to raise certain excise duties and administered prices this year. This will give the government additional budget funds without problematic inflationary pressures. In contrast to previous years, the government is expected to be less restrictive in its pricing policy for administered prices and excise duties. The need to secure additional funding for government measures to mitigate the economic crisis means that the government is expected to significantly raise excise duties on alcohol and tobacco this year, while growth in administered prices is expected to be faster than in

Table 6.2: Assumed direct effects on inflation of government measures in 2009

Measure	expected change	expected effect on HICP (percentage points)
– Changes in prices of selected textbooks	average price increase of 2.6%	0.007
– Changes in prices of railway tickets	average price increase of 3.5%	0.007
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000
– Changes in network charge and supplements to network charge for electricity transmission	increase in final electricity price by 1.4%	0.032
– Change in excise duties on alcoholic beverages	average increase in prices of alcoholic beverages of 9%	0.160
– Change in excise duties on tobacco	average increase in prices of tobacco products of 9%	0.300
Total effect on inflation		**0.506**

Source: Plan for managing regulated prices in 2008 and 2009 previous years. This government action is expected to be facilitated primarily by exceptionally low growth in energy prices this year, which will primarily be the result of base effects. The government has already raised railway ticket prices and electricity network charges. According to the plan for managing regulated prices for 2008 and 2009, the direct effects of changes in administered prices on inflation are expected to be higher this year than last year. The impact on inflation this year is expected to be around 0.5 percentage points, of which 0.2 percentage points have already been realised in the early part of the year. In addition, the government has raised excise duties on energy products and alcohol this year, the impact on inflation of which is expected to amount to 0.16 percentage points. Excise duties on tobacco are also expected to be raised on 1 May, with an estimated impact on inflation of 0.3 percentage points. Growth in other administered prices has been assumed to be in line with the movement of non-administered prices, as envisaged in the plan for managing regulated prices for 2008 and 2009.

The uncertainties regarding future macroeconomic developments remain unusually high. The financial turmoil has deepened since the release of last October's Price Stability Report, and has transformed into a global economic crisis, while the uncertainties regarding the normalisation of conditions on the financial markets and the eventual dimensions of the crisis remain extremely high. The economic growth forecasts for Slovenia's most important trading partners have been revised downwards several times since October. There has also been a significant deterioration in the latest projections for trading partners from central, eastern and south-eastern Europe, which is a reflection of the spread of the economic crisis to emerging countries. Slovenia's high dependence on exports means that uncertainties regarding the economic conditions in trading partners are reflected in full in uncertainties regarding the economic outlook for Slovenia. Given the exceptional circumstances, on this occasion only an evaluation of the effects of the credit crunch on economic activity (Box 5.1) has been presented, based on the use of econometric models.

The main risks in the projections relate to economic growth in the coming years, and remain focused on the downside, while the risks regarding inflation projections are balanced. The deterioration in the conditions on global financial markets and the slowdown in economic activity in the international environment have materialised the main risk to economic growth, and thus inflation, identified in October's Price Stability Report. Nevertheless the possibility of a more severe, longer-lasting slowdown in economic growth in the international environment and an even greater impact from the financial turmoil remains the main downside risk, particularly regarding medium-term macroeconomic projections.

The key to the economic growth projections for Slovenia is the timing of the recovery in the global economy. The baseline scenario assumes that foreign demand will decline in 2009, but will then gradually begin to strengthen, normalising only in 2011. However there is the risk that the turnaround in the global economic cycle will arrive later, as a result of which economic growth in Slovenia would be lower than forecast, particularly in 2010 and 2011. Here it is important how effective the numerous measures recently adopted by central banks and governments around the world in response to the financial turmoil and economic crisis prove to be. The effectiveness of the measures, which mostly act with a lag, is particularly hard to assess in this exceptional situation. It is also possible that the measures already taken will prove to be more effective in stimulating the economy than currently estimated. An additional risk to global economic recovery is presented by pressures from individual lobbies to protect domestic industries.

Limitations in bank refinancing and a reduction in banks' leverage, although the latter could also reflect an equilibrium process, could hinder the functioning of the financial markets, thereby increasing the risks of a potential credit squeeze. The tighter financing conditions and lower demand are already being reflected in a slowdown in bank lending activity in Slovenia, while to a certain extent limitations on the actual supply of loans are also being seen. Obstacles to the renewal of bank funding from the rest of the world and a reduction of leverage, i.e. debt repayment, which without an appropriate injection of capital could cause a contraction in banks' balance sheets, could accelerate the credit squeeze, which would curb spending and investment. Because in the current circumstances a decline in lending activity can be either the result of tighter lending conditions imposed by banks for reason of risk re-evaluation or lower demand, or the result of an actual credit squeeze, it is crucial to analyse the data for lending activity in detail.

The largest uncertainty among the domestic demand factors relates to investment, which has been the main engine of economic growth in Slovenia over the last three years. After increasing for several years, investment fell sharply in the second half of 2008, an indication of the end of the investment cycle, and its revival

Box 6.2: Comparison of 2009 and 2010 forecasts with those of other institutions

Forecasts for Slovenia are compiled by domestic and international institutions. It is useful to compare forecasts because they highlight differences in reasoning future economic trends, despite the forecasts not being directly comparable as they cover different periods and therefore do not take into account the same information. Furthermore, the forecasts are based on different assumptions with regard to both exogenous variables in the international environment and economic policy actions.

In the current climate of extremely high uncertainty, forecasts are particularly dependent on their timing, which has a major impact on the assumptions used. The forecasts for economic activity for 2009 have been revised significantly downwards from the previous forecasting round by all the institutions that have made forecasts this year. All the institutions that produced their projections after the release of the economic growth figures for the final quarter of 2008 are forecasting negative economic growth during 2009. Most notable is the forecast by the IMAD, which is forecasting economic growth in Slovenia of -4% in 2009. The IMF mission forecast a decline in economic activity in Slovenia of at least 1% in 2009.[1] All the institutions are forecasting a gradual recovery in economic activity in 2010, albeit with growth remaining significantly below the long-term average.

The majority of the institutions are forecasting a narrowing of the current account deficit this year, and a renewed widening of the deficit in 2010. However, the prevailing opinion is that the current account deficit in 2010 will be smaller in relative terms than that of 2008.

Similarly, on this occasion all the institutions cut their inflation forecasts for 2009, while they all judge that in 2010 there will be a gradual rise in inflation compared with this year, but the rate will nevertheless remain relatively low.

[1] http://www.imf.org/external/np/ms/2009/031109.htm.

Table: Comparison of forecasts for Slovenia, and change from previous forecast

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2009		2010		2009		2010		2009		2010	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Mar 09 / Oct 08	**-2.0**	-5.5	**1.9**	-2.2	**0.4**	-3.1	**1.8**	-1.7	**-3.2**	3.0	**-4.4**	1.8
EIPF	Mar 09 / Sep 08	**-0.9**	-5.3	**1.8**	…	**-0.1**	-4.7	**4.2**	…	**-0.5**	4.1	**-5.1**	…
IMAD	Mar 09 / Dec 08	**-4.0**	-5.1	**1.0**	-2.1	**0.4**	-0.7	**1.6**	-1.4	**-2.2**	2.0	**-3.5**	0.6
Consensus Forecasts	Mar 09 / Sep 08	**-0.5**	-5.2	**1.3**	…	**2.1**	-4.0	**2.7**	…	**-4.7**	0.5	**-4.3**	…
European Commission	Jan 09 / Oct 08	**0.6**	-2.3	**2.3**	-1.5	**0.9**	-2.8	**2.8**	-0.3	**-5.8**	-0.5	**-6.0**	0.0

Δ: difference between current and previous projections
Sources: Bank of Slovenia, EIPF, IMAD, Consensus Economic Forecasts, European Commission; Bank of Slovenia calculations

will depend to a great extent on, in addition to foreign demand, the competitive position of domestic companies, i.e. how competitive Slovenia will emerge from the crisis. As a member of the monetary union, Slovenia can solely influence competitiveness via domestic adjustment mechanisms, in contrast to countries outside the monetary union, which can exploit exchange rate flexibility to improve competitiveness. Competitiveness will thus depend on the functioning of the labour and product markets , and on the introduction of structural reforms to improve the functioning of the markets. The subsequent pace of investment will also depend on the availability of credit, as investment is primarily financed by external resources, and on developments on the real estate market, where demand vanished at the end of 2008. Investment related to government projects will depend on a wide-ranging package of measure, particularly savings in other areas of government expenditure, and on the exploitation of EU funds. With this in mind the government has created a special working group to improve coordination between the ministries, and to ensure greater disbursement of money from EU funds. The disbursement of EU funds also depends on the government's ability to cofinance the approved projects, which is very difficult in the current economic climate.

There also remains great uncertainty regarding the projections of private consumption, which could additionally deteriorate as a result of wealth effects related to the falling value of financial assets and real estate. The movement in the value of household assets, real estate and securities prices in particular, is currently extremely uncertain. Also uncertain is the impact of a decline in assets on household consumption, as assets have risen sharply in recent years, while private consumption was also exceptionally high, particularly in 2007. To a certain extent government measures will also have a counter-cyclical effect on private consumption, primarily indirectly by mitigating the adverse conditions on the labour market.

There remains the risk that the expected cyclical rise in unemployment related to the crisis in demand will cause a rise in structural unemployment. This would entail the high unemployment rate persisting for a longer period, which would have adverse consequences on domestic consumption and on budget trends, and later could give rise to bottlenecks in certain segments of the labour market and wage pressures as the economy recovers. Government measures, in particular the partial subsidisation of working hours, are forcing companies to preserve jobs, with the aim of maintaining the human capital in the workforce, but it is difficult to evaluate the extent to which this will be successful. However, a high proportion of temporary employees and non-residents, particularly in sectors that are heavily cyclical, helps to bring greater flexibility to the labour market, which means that it is easier for companies to lay off during adverse economic circumstances. As a result these factors will have a significant impact on corporate costs in the medium term, which will be the key to successful and competitive corporate performance.

The uncertainties surrounding the inflation projections are primarily related to the pattern of economic recovery and the developments in wages and commodity prices. Should the depth and length of the economic downturn be longer than assumed in the baseline scenario, this could entail lower inflation over the projection horizon, as wage and price pressures depend on the level of spare capacity in the economy. Inflation is also strongly dependent on the commodity prices, which have fluctuated a great deal, recently in particular, and thus have a key impact on inflation projections, both directly and via base effects. This entails additional uncertainty regarding the inflation projections, while the risk is that commodity prices rise again, particularly in the event of an increase in global economic activity. There is currently no risk of deflation in Slovenia, although year-on-year inflation is expected to temporarily fall below zero as a result of the aforementioned base effects.

The significant deterioration in macroeconomic conditions means that it is difficult to assess the infla-

tionary effects of wage increases in 2008, when wage growth responded to inflation shocks. According to the projections, companies will partly compensate for wage rises during times of slow productivity growth by cutting their profit margins, which will be reflected in relatively low core inflation. In addition, wage growth is expected to be lower than that implied by the wage agreements reached in 2008, as there should be a downward adjustment as a result of the adverse economic climate. However, such adjustments, particularly if they entail postponed adjustments as in the case of public sector wages, increase the uncertainties regarding the future wage developments. By contrast, in the current economic situation the rigidity in labour costs dynamics can slow down the deceleration in core inflation, step up the rise in unemployment, and worsen the cost competitiveness of the economy in the medium term.

Other risks to inflation come from the developments in electricity prices and other energy prices, such as natural gas. For both products, the providers state that price rises are unavoidable. Despite the rise in network charges of 10% already made this year, distributors have proposed additional price rises to the government, which it has yet to accept. Given the unfavourable economic situation and the downward pressures on commodity prices, the projections this time do not incorporate an assumption of an additional rise in electricity and other energy prices.

Not least, there are evolving uncertainties related to the maintenance of fiscal balances, as the deterioration in economic trends and the stimulus-oriented fiscal policy mean that there is a possibility that the Stability and Growth Pact will be violated. The projected deterioration in macroeconomic conditions will result in lower general government revenues via lower employment, wages and consumption, which entails a deterioration in the general government position as a result of the operation of automatic stabilisers. The general government position will also be less favourable because of the discretionary measures adopted or envisaged, which are primarily aimed at mitigating the consequences of the financial turmoil and the economic crisis. The general government deficit in 2009 is thus expected to be larger than the Maastricht criterion, while the credible consolidation of public finances at the earliest opportunity will be vital to establishing sustainable economic growth. Any deviation from the fiscal balance would be a particularly large problem in Slovenia because of its adverse demographics, which in the future will dictate rising expenditure on pensions and health.