BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

PRICE STABILITY REPORT

APRIL 2010

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Published by:

BANK OF SLOVENIA
Slovenska 35
1505 Ljubljana
Tel: 01 47 19 000
Fax: 01 25 15 516

This publication is based on figures and information available on 4 March 2010, except where stated otherwise.

This publication is also available in Slovene.

ISSN 1855-1424

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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
BG	Bulgaria
BoS	Bank of Slovenia
CEE	central and eastern Europe
CPI	consumer price index
CZ	Czech Republic
DARS	Motorway Company in the Republic of Slovenia
DAX	German stock market index
EA	euro area
ECB	European Central Bank
EE	Estonia
EIPF	Faculty of Law Institute of Economics
EMU	Economic and Monetary Union
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	euro interbank offered rate
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve
GDP	gross domestic product
HICP	harmonised index of consumer prices
HU	Hungary
ILO	International Labour Organisation
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
LIBOR	interbank interest rate
LT	Lithuania
LV	Latvia
MFIs	monetary financial institutions
NFCs	non-financial corporations
OECD	Organisation for Economic Cooperation and Development
p.p.	percentage points
PL	Poland
PPI	industrial producer prices
Q	quarter
RO	Romania
RS	Republic of Slovenia
SMEs	small and medium enterprises
SORS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar
WEO	World Economic Outlook

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Introduction

Slovenia's economy, like almost all others, was caught up by the effects of the global financial and economic crisis. Indeed, the contraction in economic activity was greater than elsewhere. According to the latest SORS figures, economic activity declined by almost a tenth from its high in the first half of 2008 to the low in early 2009, and by 7.8% in 2009 alone. The decline seems to have ended. Economic activity has increased by just over 1% since the second quarter of 2009, although even this small growth has been volatile. Activity has continued to decline in the construction sector. Global trade declined in 2009, and Slovenia's exports were down 15%. The largest decline in domestic demand was recorded by investment, at 30%. Private consumption also declined, but government spending increased. The large decline in domestic demand meant that imports declined more than exports, net trade thus making the decline in GDP smaller than it would otherwise have been. As a result of the larger decline in imports than exports, and an improvement in the terms of trade and a decline in the deficit in income in the current account, the current account was almost in balance. Employment tracked the decline in economic activity with a small delay, falling by around 4% in year-on-year terms in recent months.

The larger decline in economic activity compared with the euro area average was the result of domestic developments before the crisis, which increased the vulnerability of the economy. Before the outbreak of the crisis, the booming domestic climate was encouraged by demand based on heavy borrowing. The economy overheated, which led to a rise in inflation and various asset prices. The rapid growth in investment, particularly in construction such as roads, was also the result of favourable financing in the euro area. The banks were also competing among themselves, expanding lending to maintain or increase their market shares. The prevailing expectation was that economic growth would remain high in the long term. Creditworthiness was overestimated by both the corporates taking on debt, and by the banks providing the loans.

After the outbreak of the crisis prices of financial and non-financial assets began falling rapidly. This very quickly led to a decline in economic activity in the construction sector, and at producers of capital goods. Given the uncertainty enveloping the business world, and the high indebtedness at many corporates, the banks were no longer prepared to expand loan activity. Corporates began to reduce their debts, or were forced to do so. There was a similar situation at the banks, as a result of which certain corporates found themselves in financial difficulties, which brought an additional decline in economic activity.

The main factors in inflation in 2009 were the deterioration in the macroeconomic environment, and the large fluctuations in energy prices. Headline inflation as measured by the harmonised index of consumer prices fell from an average of 5.5% in 2008 to an average of just 0.9% in 2009. Core inflation indicators also fell sharply compared with the high levels of 2008. Year-on-year growth in certain core inflation indicators actually became negative in the first months of 2010. This was a reflection of the large decline in demand and economic activity, and the trend of decline in year-on-year growth in nominal labour costs. Because of the base effects, the high growth in the middle of 2008 and the rapid fall in energy prices towards the end of the year were major factors in the fluctuation in inflation in 2009. In the middle of 2009 there was a brief period of negative year-on

-year growth in prices, as in the euro area. Inflation rose towards the end of the year as a result of the reversed base effects.

Economic activity began increasing again in the majority of other countries in the second half of 2009. International institutions are forecasting a gradual increase in import demand in Slovenia's trading partners in the period to 2012. However, this growth will be smaller than the long-term average before the crisis. Growth in economic activity is expected to vary considerably this year between individual countries and regions. Asian countries will record the highest growth. Given that a large portion of the increased economic activity in many countries is the result of government measures to stimulate consumption that will gradually be withdrawn, economic growth will remain small in the period ahead. An expansive fiscal policy has led to an increase in the general government deficit, and thus in government debt. Some countries are already having difficulty in financing their budget deficits or in refinancing their debts. Unemployment has increased sharply in almost all countries. Unemployment stands at around 10% in the euro area and the US. In the majority of developed countries there are pressures to reduce labour costs and inflation. The gradual global economic recovery and the high economic growth in certain Asian countries is causing rises in commodity prices. These are however expected to slow.

The basic economic projections for Slovenia for the period to 2012 indicate a gradual and moderate recovery. However, there will be no major changes in domestic demand or employment. GDP growth is forecast at 1.3% for this year, later approaching 3%. Economic growth is dependent on growth in Slovenia's most important trading partners, primarily euro area countries. However, there will be a turnaround in economic growth as GDP growth rates will be smaller than they were before the crisis. As a result of excess production capacity and the standstill in construction, growth in investment could stand at merely around 3%, despite the relatively high economic growth in the final two quarters of 2009. Private consumption is not expected to increase for another year. In the context of lower government spending, and the need to return public finances to within normal boundaries, low domestic demand means that export growth will outpace import growth, and net trade will contribute towards economic growth. Despite a deterioration in the terms of trade as a result of the anticipated growth in commodity prices, the current account deficit in 2010 will be small. Employment will continue to decline by slightly less. The employment could decline by a further 2% due to carry-over effects. A more sustained rise in employment can be expected in 2011. Unemployment according to ILO methodology could reach 8%.

The uncertainty surrounding economic growth remains large, and the same applies to the risks resulting from domestic factors. There is no sign yet of a reversal in the construction sector. Companies are failing to pay one another, but housing prices remain high despite low sales. Unsold housing is causing a further contraction in construction activity. Workers are losing jobs, and construction companies and companies in related sectors are failing. Banks are reducing their indebtedness and are being more prudent in lending, and the economic recovery is therefore likely to be slower. Unemployment could remain relatively high if labour costs or unit labour costs in general do not correspond to productivity. The economic recovery could also be faster and more intense if uncertainty were to diminish. The economic situation in euro area countries and in the countries of south-eastern Europe is contributing much to this uncertainty.

Inflation will rise over the period to 2012, but will not exceed 2% annually. The gradual recovery of domestic demand and the spare capacity in the economy will prevent higher inflation. Another factor will be low growth in labour costs, which are expected to increase by less than 3% each year in the period to 2012. The movement in oil prices and energy prices will make the same contribution to inflation in 2010 that it did in 2008, but their contribution is later expected to diminish. Inflation could be higher than currently projected as a result of oil prices, and, as far as domestic factors are concerned, a potential rise in administered prices and indirect taxation.

As far as economic policy is concerned, paramount importance lies with the exit strategy, i.e. the consolidation of public finances and structural reforms. According to this strategy, the general government deficit is to be cut to below 3% of GDP by 2013. The government measures are aimed primarily at reducing public expenditure and making efficiency savings in the public sector. The withdrawal of fiscal stimulus and a decline in government spending will lead to a short-term reduction in eco-

nomic growth, which is also envisaged by the baseline projection. However, any deviations from the plan could endanger Slovenia's long-term developmental possibilities. Government borrowing would become more expensive, and/or access to loans would be made more difficult, as the country's credit rating for example would be downgraded. In addition, its lack of credibility and/or its unpredictability could lead to expectations that the public finances could no longer remain such as they are. Higher taxes, should they occur, would cause a decline in investment and in consumption in general. For this reason it is vital to strictly uphold the planned timetable for cutting the budget deficit.

In the longer term structural reforms are of course vital. In the reform of the labour market, the right combination should be found between job and income security for workers and flexibility for companies in hiring and firing to adapt more easily to the changing situation on the market. Pension and health reform should increase the efficiency of this part of the public sector, and ensure the long-term sustainability of the financing of health and pensions. Encouraging market competition and innovation expands business opportunities, thereby accelerating economic development.

The Stability and Growth Pact represents a key support to ECB monetary policy. It is impossible to reach and maintain macroeconomic equilibrium and price stability in the medium term without the support of national fiscal policy. Long-term wage policy is also important, and must maintain the cost competitiveness of the economy. A small open economy, as Slovenia, will always be subject to shocks arising outside its borders. A timely and appropriate response by national economic policy is vital.

The current economic crisis is giving rise to overall structural changes. The view of many risks to which financial institutions in particular are exposed is changing. Opinions of this of course vary greatly, even among the largest economies. Within the EU, there is new deliberation of its future actions. However, new arrangements and new rules of economic behaviour will be slow to arise. The same is likely to apply to the emergence from the economic crisis.

								Projections					
								2010		2011		2012	
	2003	2004	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
Activity, employment and wages	*real growth, %*												
GDP	2.8	4.3	4.5	5.8	6.8	3.5	-7.8	1.3	-0.3	1.8	0.1	2.9	…
Employment	-0.4	0.3	-0.1	1.5	2.9	2.9	-2.2	-2.3	0.3	-0.1	0.3	0.3	…
Compensation per employee	8.4	7.9	6.0	5.4	6.6	7.2	2.6	1.7	0.7	2.7	-0.9	3.4	…
Productivity	3.2	4.0	4.5	4.3	3.7	0.7	-5.7	3.7	-0.6	1.9	-0.2	2.6	…
ULC (nominal)	5.0	3.8	1.5	1.0	2.8	6.5	8.9	-1.9	1.3	0.8	-0.7	0.8	…
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. change in inventories	4.2	3.6	3.2	4.9	6.8	4.3	-6.6	0.5	-1.4	1.1	-0.6	2.7	…
Net exports	-2.1	-0.9	2.2	0.1	-2.0	-0.1	2.2	1.4	2.2	0.6	0.7	0.2	…
Inventories	0.6	1.4	-0.8	0.8	1.9	-0.7	-3.5	-0.7	-1.2	0.2	0.1	0.0	…
Domestic demand	*real growth, %*												
Domestic demand	4.9	4.9	2.4	5.7	8.7	3.5	-9.9	-0.2	-2.6	1.3	-0.5	2.7	…
Private consumption	3.3	2.8	2.8	2.9	6.7	2.1	-1.4	-0.4	0.0	0.7	-1.5	1.9	…
Government spending	2.2	3.4	3.4	4.0	0.7	6.2	3.1	0.5	-0.4	0.0	-0.6	0.3	…
Gross fixed capital formation	8.1	5.6	3.7	9.9	11.7	7.7	-21.6	2.6	-5.8	2.9	1.1	6.4	…
Balance of payments	*real growth, %, unless stated*												
Exports of merchandise and services	3.1	12.4	10.6	12.5	13.7	2.9	-15.6	5.1	3.1	6.0	2.0	6.7	…
Imports of merchandise and services	6.7	13.3	6.6	12.2	16.3	2.9	-17.9	3.0	-0.3	5.3	1.2	6.5	…
Current account: EUR billion	-0.2	-0.7	-0.5	-0.8	-1.6	-2.3	-0.3	-0.2	1.0	-0.5	0.9	-0.9	…
as % GDP	-0.8	-2.7	-1.7	-2.5	-4.8	-6.2	-1.0	-0.5	2.7	-1.4	2.5	-2.3	…
Terms of trade*	0.8	-1.0	-2.0	-0.5	0.6	-1.9	4.3	-2.6	-0.7	-1.0	-0.6	-0.8	…
Prices	*average annual growth, %*												
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	5.5	0.9	1.6	0.1	1.4	-0.3	2.0	…
HICP excluding energy	6.0	3.2	1.2	1.7	3.8	4.9	1.7	0.2	-0.9	1.2	-0.5	1.8	…
HICP energy	3.4	7.0	11.9	8.5	3.4	9.4	-4.5	10.8	7.2	3.0	2.0	2.5	…
International environment	*average annual growth, %, unless stated*							Assumptions					
Foreign demand**	5.7	7.5	4.3	8.6	7.4	2.5	-12.9	3.1	3.2	5.1	1.5	5.1	…
Oil (USD per barrel)	29	38	54	65	73	98	62	75	-4	80	-2	82	…
Non-oil commodities	11.0	22.5	11.6	29.0	17.1	9.7	-15.9	20.0	3.7	7.0	11.8	7.0	…
EMU inflation	2.1	2.1	2.2	2.2	2.1	3.3	0.3	1.2	0.0	1.5	-0.5	1.9	…
PPI Germany	1.8	1.6	4.4	5.4	1.3	5.4	-4.0	0.2	-0.7	1.8	-0.6	2.0	…

* Based on national accounts deflators
** Volume of imports from basket of foreign partners
Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: SORS, Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook

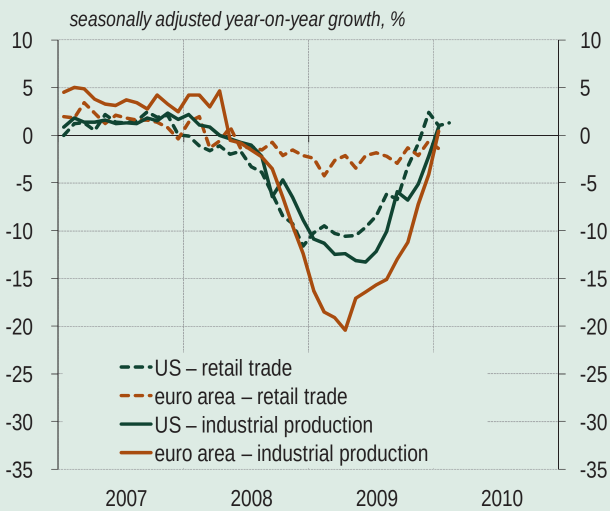
1 The International Environment

Global economic activity began to gradually rise again in the second half of 2009. This was helped by an expansive monetary and fiscal policy, measures to stimulate the money markets and financial markets, and tax stimulus measures. The recovery has been moderate, and varies from country to country. Import demand from China is playing a vital role. As a result of the sharp rise in unemployment and public debt, and the problems in the financial sector in many countries, the effects of the crisis will be long-lasting. Oil prices and other commodity prices rose gradually during the year, but did not reach their pre-crisis heights.

Economic developments

The global economic recession reached its maximum in the first half of 2009. Increasing economic activity meant that the situation began to improve in the second half of the year, although a rise in employment is not yet present. According to the IMF, the global economy contracted by 0.8% last year, while global trade contracted by 12.3%. Even in the previous year global economic growth stood at 3.0%, while global trade expanded by 2.8%. A quarter on quarter rise in GDP meant that the recession technically ended in the US and the EU in the third quarter of last year. Imports began increasing at the same time, slightly faster in the US than in Europe. In both economies the quarterly increase in imports in the third quarter was larger than in the final quarter, an indication of the slowdown in growth in import demand towards the end of the year. Renewal of inventories also contributed to the current growth in activity. Even before this, indicators of economic sentiment and consumer confidence had already pointed to an improvement in the situation. A decisive role in the emergence from recession is attributed to the expansive monetary and fiscal policy. Employment in the US fell by 3.8%, but in the euro area the fall was smaller at 1.8%, partly because of temporary measures to protect jobs. The smaller fall in employment in the euro area could also entail a more rigid adjustment of the labour market to the market situation, which is also being reflected in higher growth in gross wages per unit of output, which stood at 5.8% in the euro area last year, but 0.4% in the US.

Figure 1.1: Trade and industrial production



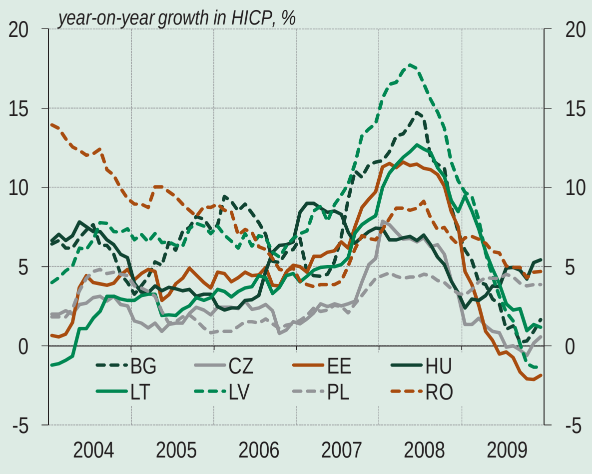
Sources: Eurostat, FED St Louis database

Box 1.1: The impact of the global financial and economic crisis on the countries of central and eastern Europe

The countries of central and eastern Europe (CEE) were hit later than other countries by the global financial and economic crisis, but more deeply. There are significant variations between the individual countries and groups of countries. High growth in the majority of the countries proved unsustainable in the long term. It caused overheating of the economy, and in addition was based on the financing of domestic demand by loans from the rest of the world. The larger this was, the larger was the decline in activity for most. The crisis brought a reduction in the current account deficit, a fall in inflation and a deterioration in public finances.

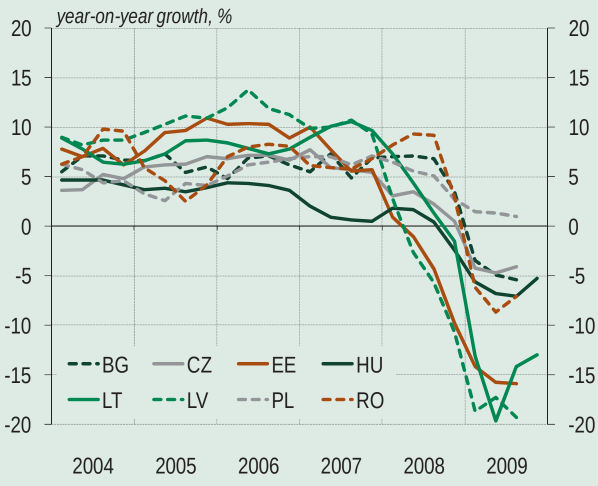
The exceptionally high economic growth typical in the years before the crisis in the majority of the CEE countries turned into a recession at the outbreak of the crisis almost everywhere. The Baltic states were notable for their high economic activity, in particular Latvia, whose GDP growth of 10.0% between 2004 and 2007 made it the fastest-growing economy in the EU. GDP growth averaged 6.5% in Bulgaria and Romania, and 5.5% to 6.0% in the Czech Republic and Poland. It was domestic consumption that contributed most to growth in the majority of the countries. Net exports made a negative contribution to economic growth in almost all of them. Of the

Figure 1: Inflation



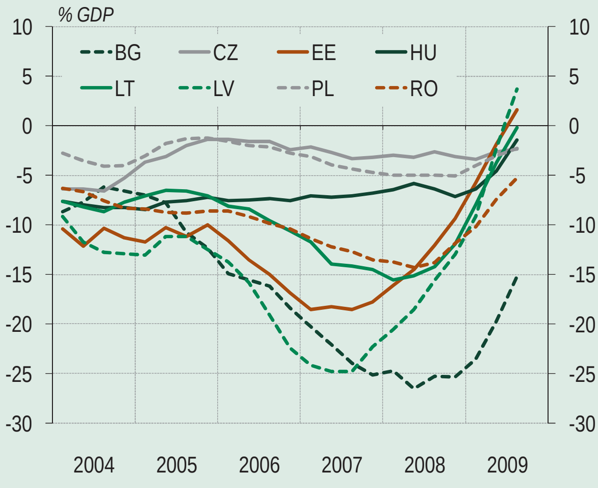
Source: Eurostat.

Figure 2: GDP



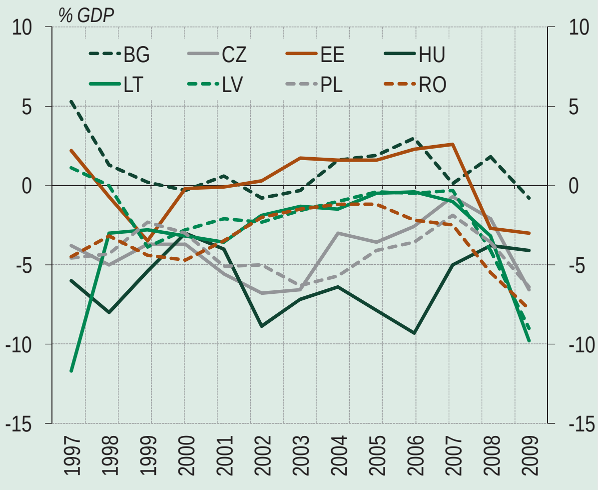
Source: Eurostat

Figure 3: Current account



Source: Eurostat

Figure 4: General government balance



Source: European Commission, November 2009 selected countries, the lowest growth before the crisis was recorded by Hungary, where GDP growth averaged 3.5%. Its low growth was primarily the result of an unstable domestic macroeconomic environment, in particular problems with public finances. It was only in the final quarter of 2008[1] that the financial and economic crisis was strongly reflected in the majority of the CEE countries, when GDP recorded an average current fall of 2.0%, and fully 3.6% in the Baltic states. The decline in economic activity continued in the first quarter of 2009 in the majority of the CEE countries, typically followed by a gradual recovery in the second half of the year. The largest contributions to the fall in GDP came from the decline in investment and the fall in household consumption, while net trade made a positive contribution to GDP growth as a result of imports recording a larger decline than exports. Poland was the only CEE country where GDP rose in 2009, primarily as a result of the contribution made by household consumption, the relatively small fall in employment, high wage growth and increased index-linking of pensions. At the same time the zloty also fell sharply towards the end of 2008, which contributed towards a smaller fall in exports and had an adverse impact on imports.

The decline in economic activity and domestic demand in the CEE countries brought a large fall in inflation in 2009. The high inflation in these countries in 2007 and 2008 was the result of high growth in commodity prices on global markets and the overheating of the economy. In 2009 inflation averaged 2.6% in the CEE countries, down 4.3 percentage points on the average of the preceding two years. Base effects in commodity prices and the sharp decline in economic activity were factors in the lower price growth in 2009. The fall in inflation in the countries with a flexible exchange rate (Hungary, Poland and Romania), where the domestic currencies fell towards the end of 2008 or in early 2009, averaged 1.6 percentage points, significantly less than the average of 7.5 percentage points in the other countries. The current account deficits in the CEE countries narrowed in 2009. Estonia and Latvia recorded very large deficits in 2007 and 2008, of an average of 20.0% of GDP, but the figures fell sharply in 2009, and they actually moved into surplus by the third quarter. In all the other countries the deficits in 2009 almost halved from their average of the preceding two years. The narrowing of the deficits was the result of imports falling by more than exports, and favourable developments in the terms of trade. Imports fell primarily as a result of lower demand in the economy and a decline in investment, while exports fell as a result of lower foreign demand.

Active measures, the automatic fiscal policy stabilisers and the fall in fiscal revenues as a result of the decline in economic activity and income had a profound impact on public finances. The general government deficit rose sharply in all the CEE countries in 2009, to an average of 6.0% of GDP. The largest increases in the deficit were recorded by Latvia (4.9 GDP percentage points), Lithuania (6.6 GDP percentage points) and the Czech Republic (4.5 GDP percentage points), while the smallest increases were recorded by Estonia and Hungary (0.3 GDP percentage points each). The majority of general government revenues fell as a result of the decline in economic activity, most notably in Lithuania and Latvia (by around 15% to 20%). General government expenditure contrastingly rose, in particular expenditure on social security, most notably in Poland (by almost 7%).

[1] In the euro area GDP recorded a current decline of 0.3% in the second quarter of 2008, and the largest decline of 2.5% was recorded in the first quarter of 2009. Similarly in Japan GDP declined by 0.6% in the second quarter of 2009, while the largest decline of 3.2% followed in the first quarter of 2009. In the US GDP declined by 0.7% in the third quarter of 2008, and the largest decline of 3.2% was recorded in the first quarter of 2009.

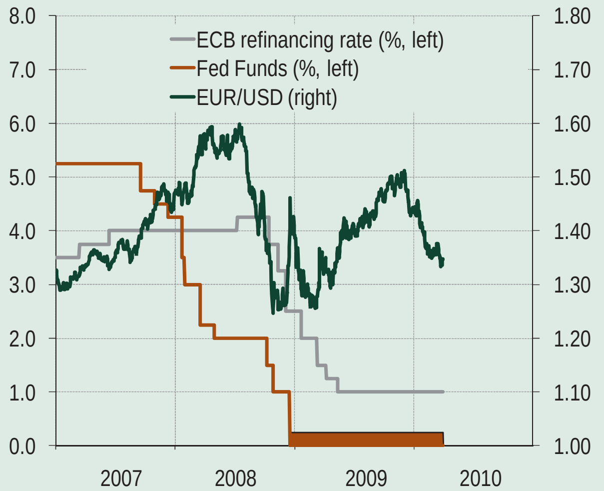
All of Slovenia's most important trading partners underwent a decline in economic activity and import demand last year. Of the nine most important trading partners, which together account for 90% of Slovenia's exports, GDP fell by 5.0% last year in Germany according to initial estimates, by 4.8% in Italy, by 5.7% in Croatia, and by 7.9% in Russia, the largest figure. The decline in economic activity was also reflected in a decline in import demand, of 12.9% according to the latest estimates. This decline is exceptional compared with the long-term average growth in import demand from these countries of between 5% and 6% annually. It declined in all nine countries, but the largest contributions to the decline in foreign demand came from the lower demand from Italy and Croatia, and also slightly less markedly from Germany.

Financial markets and commodity prices

The major central banks cut their interest rates to almost zero. In addition, they used unusual instruments to stabilise the money markets and the financial markets. The ECB's key interest rate has stood at 1% since last May. In the US, the Federal Reserve has maintained its interest rate in the interval between zero and 0.25% since December 2008. The key interest rate at the Japanese central bank has been 0.1% since December 2008, while the Bank of England has maintained its key interest rate at 0.5% since March 2009. In addition, the world's major central banks have made use of non-standard monetary policy measures.[1] Given the easing of the situation in the money markets and financial markets, certain central banks, including the ECB, have already begun to withdraw the non-standard monetary policy measures. In some economies, such as Australia, the central bank has even raised the key interest rate. Similarly, in China monetary policy is already becoming restrictive. Economic growth is expected to be sufficiently fast and stable.

After falling in late 2008, the euro primarily rose against the US dollar last year. Towards the end of the year the euro fell again, partly as a result of Greece's problems in consolidating its public finances. The euro primarily rose against the US dollar in 2009 other than in the first two months of the year, but its average value for the year was nevertheless down on the previous year. The euro lost 5.3% against the US dollar in 2009, and was worth USD 1.39. The gradual fall in the US dollar in the majority of last year was the result of confidence returning to the financial markets, which reduced the appetite for investment in US dollar instruments. The euro fell against the US dollar during the first two months of this year, primarily as a result of Greece's uncertain fiscal position, and signs of the US economy recovering more quickly than the euro area.

Figure 1.2: Euro / US dollar exchange rate and central bank interest rates



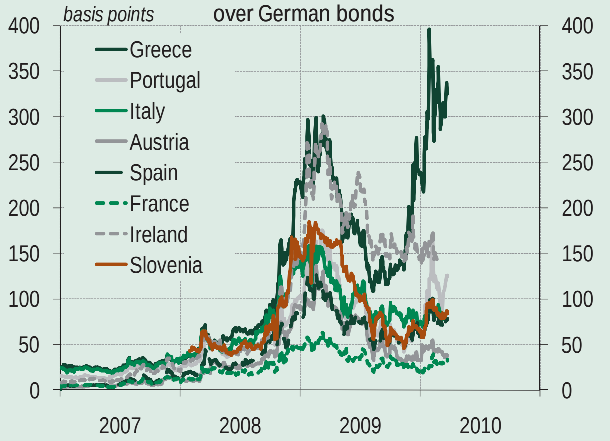
Sources: ECB, Federal Reserve

Stock market indices rose gradually last year as a result of diminishing uncertainty and an improvement in liquidity on the financial markets, and rising confidence in the economic recovery. After falling sharply in 2008, stock market indices gradually rose last year but did not regain the levels reached before the outbreak of the financial and economic crisis. The Dow Jones fell by around 31% and the DAX by 37% in 2008, while in 2009 the Dow Jones rose by 24% and the DAX by 29%. The rises in stock market indices mostly began in the second quarter of 2009, when global economic sentiment indicators began to improve and certain major central banks made their final cuts in their key interest rates. Stock market indices slid again in the early part of this year, partly as a result of the increasing uncertainty on the financial markets triggered by the deterioration in the fiscal position in certain European countries.

Uncertainty diminished on the financial markets in the majority of 2009, but in early 2010 fiscal problems in certain countries again led to a rise in the yields demanded on their bonds. In the heat of the financial and economic crisis, premiums on government bonds over the comparable German bonds rose sharply in the period to the end of 2008. As confidence gradually returned to the financial markets, the premiums mainly fell again in 2009. The premiums leapt again at the end of

[1] See Price Stability Report, September 2009, Box 2.2, p 24.

Figure 1.3: Premiums of 10-year government bonds over German bonds



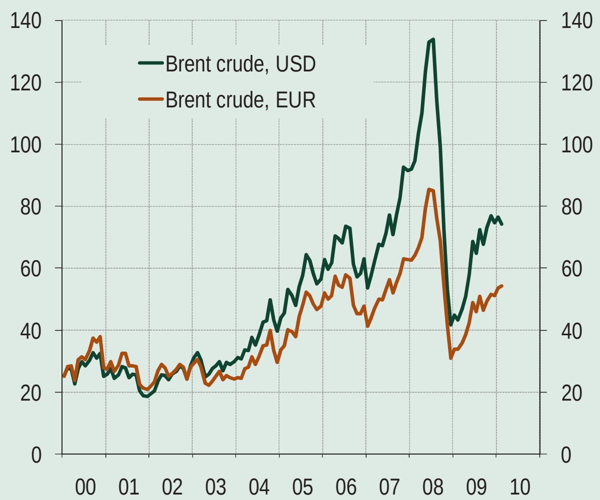
Source: Bloomberg, Bank of Slovenia calculations
*Note: Premium is calculated as spread between yield on 10-year government bonds and yield on reference (German) bonds on daily basis, reflecting risks ascribed to the country by the markets. * New SLOREP 01/20 bond included in figures for Slovenia from 18 January 2010*

last November, when Greece was downgraded because of its uncertain fiscal position. The deterioration in the fiscal situation in the early part of this year is also causing high premiums in the yields on government bonds in certain euro area countries in addition to Greece, most notably Ireland and Portugal.

The example of Greece shows the need to maintain the macroeconomic equilibria. This means taking responsibility for eliminating any imbalances that arise. In Greece the rise in the general government deficit to over 12% in 2009 was caused by the postponement of structural reforms, including pension reform, a deterioration in competitiveness, a decline in general government revenues as a result of inefficient tax collection and excessive increases in government expenditure. As late as 2007 the deficit was just 3.7%. This rise provoked a strong reaction from the financial markets, which assessed the deficit as unsustainable. The Greek government was forced to draw up a comprehensive plan for consolidating public finances, under which the deficit is to be cut to below 3% by 2012. According to the Greek finance ministry, the majority of the proposed measures have already been enacted. The relatively rapid response by the Greek authorities has already been reflected in a decline in the premiums on Greek government bonds. There has also been increased support from EU institutions, which showed themselves ready to help Greece overcome its problems in refinancing debt. This demonstrated the need for the EU to establish mechanisms to facilitate institutionally regulated assistance in similar cases.

Economic results and expectations are causing significant fluctuations in oil prices and other commodity prices, which rose gradually last year but remained below previous levels. A barrel of Brent crude averaged USD 62 in 2009, compared with USD 98 in 2008. Despite sustained growth, oil prices did not reach their high levels from the previous year, which meant that year-on-year growth in oil prices was negative until October. The rise in oil prices last year was the result of the gradual recovery of the global economy. Prices of other primary commodities and food also rose gradually last year, primarily as a result of increased demand from large Asian economies and low interest rates during the year. Average commodity prices excluding oil were down 16%. During the economic crisis, as expected, prices of industrial commodities fell more than food prices, but their growth was also faster during the improvement in the economic situation.

Figure 1.4: Oil prices



Sources: Bloomberg, ECB, Bank of Slovenia calculations

Inflation and price factors

Price developments in the euro area and the US last year were profoundly affected by the decline in economic activity and the lower level of commodity prices. Inflation in the euro area last year amounted to 0.3%, the lowest since the creation of the euro, while in the US prices actually fell by 0.3%. The low or negative inflation in the first ten months of 2009 was caused by the high basis of energy prices from 2008. Low domestic demand meant that core inflation[2] also fell in 2009, to stand at 1.3% in the euro area and 1.7% in the US, compared with 2.4% and 2.3% respectively a year earlier. The movement in producer prices was the result of lower commodity prices and the decline in activity in industry. Producer prices fell by 4.0% last year in Germany, and by 5.1% in the euro area overall.

[2] In the euro area the calculation of core inflation includes all prices other than energy and unprocessed food, while in the US it includes all prices other than energy and food.

2 Economic Trends and the Labour Market

Economic activity declined sharply in late 2008 and early 2009, by around 10% overall, before beginning to gradually increase again. The largest factor in the decline was a decline in investment, including a decline in inventories, but household consumption also declined. The recovery was primarily the result of a positive contribution by net trade, as exports grew faster than imports. The decline in foreign demand hit manufacturing the hardest. Excessive growth in previous years meant that value-added in the construction sector also fell sharply. On the labour market, the fall in employment is easing, but the change remains negative. The number of unemployed rose by a third, the surveyed unemployment rate reaching 6.4% in the final quarter of 2009. The number of new job openings has also been increasing in recent months. Growth in unit labour costs is gradually declining as a result of the economic recovery, the adjustment of employment to the lower economic activity and a significant decline in wage growth.

According to initial SORS estimates, Slovenia's GDP fell by 7.8% in 2009, one of the largest falls in the euro area, and the largest fall since independence. GDP was down almost 9% in year-on-year terms in the first half of the year, but by just over 7% in the second half of the year. The significant decline in economic activity was the result of the simultaneous impact of the economic crisis in the rest of the world and a significant decline in domestic demand in Slovenia. The fall in GDP over the entire year was double that in the euro area overall.

After recording positive growth in the second quarter, economic activity continued to grow thereafter. The main factors in the rise of 0.6% in GDP in the third quarter were higher final domestic consumption and increased foreign demand as a result of temporary anti-crisis measures in certain trading partners. By the final quarter of last year some of these measures were ending, e.g. the car scrappage scheme in Germany. At the same time uncertainty surrounding the strength of the global recovery rose, and quarterly GDP growth in Slovenia slowed to 0.1%. Overall economic growth in the euro area in the final quarter was the same.

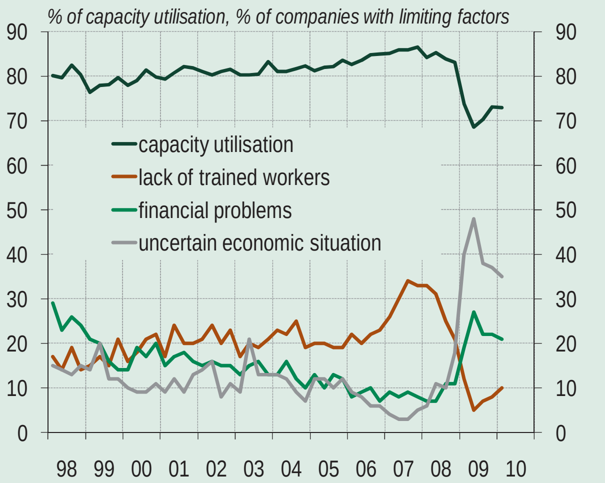
Aggregate demand

Domestic demand declined by 9.9% last year, although the contribution of net trade was positive. The largest factor in the domestic demand decline was gross investment, while household consumption fell only moderately. Government spending also fell in the final quarter, having recorded relatively high growth in the early part of the year. The large decline in domestic demand was partly mitigated in the second half of the year by strong foreign demand. High economic growth in fast-emerging Asian economies through their demand had an

Figure 2.1: Domestic demand and GDP

Sources: SORS; Bank of Slovenia calculations

Figure 2.2: Trends in manufacturing: utilisation of capacity and limiting factors



Source: SORS

indirect impact on performance of Slovenian exports, so that exports fell by less than imports as a result, and net trade thus contributed 2.2 percentage points towards year-on-year GDP growth.

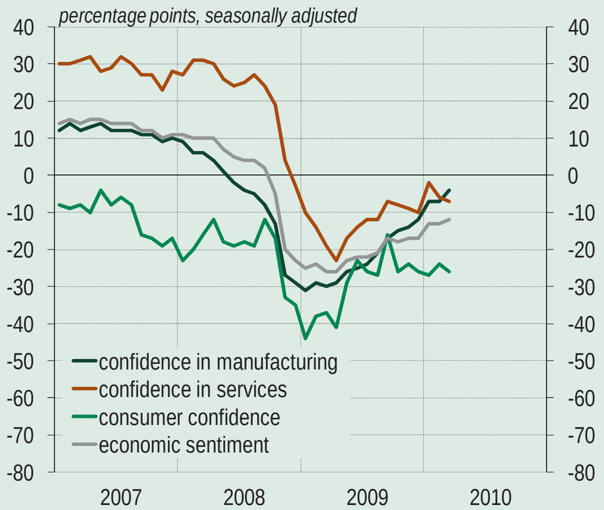
After increasing strongly in recent years, gross investment fell sharply in 2009. Changes in inventories were also a major factor in the fall. Gross fixed capital formation fell by just over 20% last year, although the fall slowed slightly in the second half of the year. Gross investment increased by 0.7% in the final quarter, with investment in machinery and equipment recording significant growth. This was in line with the gradual recovery of activity in industry towards the end of the year, where nevertheless the utilisation of production capacity remains well below its long-term average. Investment in transport equipment was down over 30% in year-on-year terms in the final quarter, but was stabilising in quarterly terms. The contribution of changes in inventories to GDP was negative and amounted to 3.5 percentage points. This was probably the result of the simultaneous rapid decline in foreign and domestic demand, and the adverse financing conditions. In this situation, corporates first reduced inventories in the context of the large fall in imports, but the continuing contraction in inventories in industry reveals persistent uncertainty surrounding growth

Table 2.1: GDP and components of demand

	GDP 2009				Private consumption 2009				Government spending 2009				Gross fixed capital formation 2009				Exports 2009				Imports 2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	quarter-on-quarter change, %, seasonally adjusted and adjusted for number of working days																							
EA*	-2.5	-0.1	0.4	0.1	-0.5	0.1	-0.2	0.0	0.6	0.6	0.8	-0.1	-5.4	-1.7	-0.9	-0.8	-8.3	-1.1	2.9	1.7	-7.6	-2.9	2.8	0.9
EU**	-2.5	-0.2	0.3	0.1	-0.8	-0.2	-0.2	0.0	0.2	0.6	0.7	0.1	-5.5	-2.5	-0.7	-1.3	-8.0	-1.4	2.5	1.9	-7.9	-2.9	2.8	1.4
US	-1.6	-0.2	0.6	1.4	0.2	-0.2	0.7	0.4	-0.3	1.0	0.4	0.1	-9.9	-1.7	0.1	0.7	-8.5	-1.0	4.2	5.2	-10.7	-3.9	4.9	3.6
Japan	-3.2	1.3	0.0	1.1	-1.3	1.1	0.6	0.7	0.8	0.3	0.1	0.8	-6.2	-2.9	-3.1	-0.2	-23.8	9.2	8.4	5.0	-17.6	-3.9	5.4	1.3
Slovenia	-6.8	0.3	0.6	0.1	-1.2	-1.0	0.7	-0.2	0.0	0.4	0.7	-2.4	-19.6	-0.8	1.4	1.7	-11.8	0.7	2.9	2.9	-10.9	-1.9	1.5	0.6

** euro area (16 countries), ** European Union (27 countries)*
Sources: Eurostat, SORS

Figure 2.3: Confidence indicators



Source: SORS

in orders in early 2010.

Gross investment in buildings and structures fell by a fifth. Last year's significant fall of around 18% in investment in housing construction represented the first major fall in residential construction since 2004. The fall of 20% in non-residential construction was primarily the result of the completion of investment in motorway infrastructure in 2008. The fall was slightly smaller in the second half of the year, but the decline in the number of building permits issued for new buildings suggests that activity in the construction sector will continue to decline. The number of building permits issued for new buildings last year was down just over 14%, the number of building permits issued for new residential properties falling by just over 29%.

Household consumption fell by 1.4% last year and by 0.2% in the final quarter. The main factors in the fall were low wage growth, the rise in unemployment, and more prudent consumer behaviour. The fall in employment and lower wage growth brought a decline in real disposable household income. Total wages rose by just under 1% last year. Transfers to the unemployed, pensions and the number of claimants all rose. Other factors in last year's fall in household consumption alongside the deterioration in the labour market were worse lending conditions and negative wealth effects. These derived primarily from previous fluctuation in securities prices. Household expectations also deteriorated last year, particularly with regard to employment, the timing of major purchases and the outlook for future economic developments.

Final government spending rose by 3.1% last year. Final government spending in the first half of 2009 was up just under 5% in year-on-year terms. Growth in government spending slowed in the second half of the year, and in the final quarter government spending was down 1.4% in year-on-year terms. The latter was primarily a reflection of cuts in expenditure on goods and services. Employment in the general government sector rose by 1.4% last year. Of this, employment in the public administration sector rose by 1%, less than in the previous year. The number of employees in the education sector and the health and social work sector rose by 2.4%.

Exports of merchandise and services fell sharply last year as a result of the decline in foreign demand, but the sharp decline in domestic demand meant that imports of merchandise and services fell even more rapidly. Exports were down by just over 15% last year, although they increased in the second half of the year as a result of anti-crisis measures in certain major trading partners, particularly in the car industry. The decline in domestic demand brought a fall in imports of merchandise and services, which were down just under 18% last year. A fall in re-exports also contributed to the fall in merchandise imports. Growth in exports was significantly outpacing growth in imports at the end of 2009.

Supply side

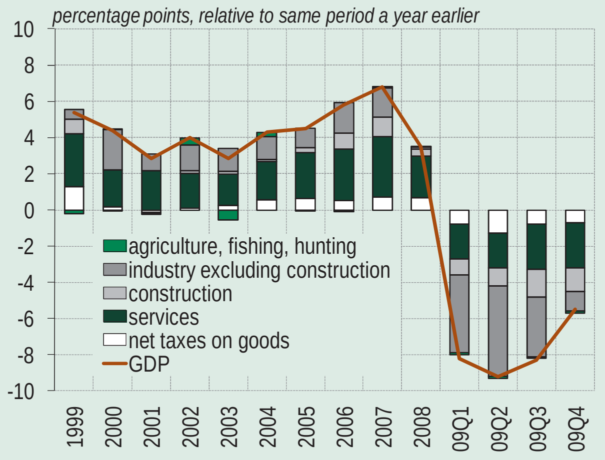
Following the large decline in demand the output gap turned negative, while growth in potential output also declined. This is indicated by the majority of indicators, including those showing utilisation of production capacity. Although in the current circumstances estimates of potential output are extremely uncertain, there has probably been a reversal in the trend. After a long period of unusually high growth, in certain sectors there have probably been sustained changes in the breakdown of value-added, which will have an impact on future economic growth.

Last year value-added declined most in the manufacturing sector, by 16.5%. The negative year-on-year growth slowed significantly in the second half of the year, the decline in value-added slowing to 4.3% by the final quarter. In current terms value-added in manufacturing rose by 4% in the third quarter, and by 1.9% in the final quarter in line with the movement in industrial production in the euro area. The largest decline over the entire year was recorded by the production of capital goods, at 19%, which is a reflection of the low utilisation of production capacity in Slovenia and in the rest of the world.

Value-added in construction declined by just under 16% last year, the first fall since 2001. While the decline in the real value of construction work performed in the EU as a whole stabilised at the end of last year, the decline continued in Slovenia. The real value of construction work performed declined by just under a quarter last year, one of the largest falls in the EU. Total activity in the construction sector thus approached its level of 2006. Towards the end of the year the housing construction decline in year-on-year terms reached 40% in the final quarter. The decline in the real value of construction work in housing was partly the result of a significant fall in sales on the real estate market, and partly the result of a decline related to a deterioration in liquidity at domestic construction companies.

Value-added also declined significantly in the majority of service sectors in the private sector. There were very few signs of recovery even at the end of last year. The contraction in activity in the service sector is an indication of the gradual spread of the crisis from the export-oriented sectors of the economy to services. Last year value-added in the sector of trade and repair of motor vehicles declined by just under 13%. There were also sharp declines in the sectors of hotels and restaurants, transport, storage and communication, and real estate, renting and business activities, where the decline increased further at the end of the year. Among the service sectors, value-added increased last year in the sectors of financial intermediation (by 5.3%), public administration and education (by just over 3%), and health (by just under 2%). The rise in value-added in the financial intermediation sector was primarily the result of high growth in

Figure 2.4: Value added contributions to GDP growth by individual sectors



Sources: SORS, Bank of Slovenia calculations

Figure 2.5: Industrial production*

Sources: Eurostat, Bank of Slovenia calculations

Box 2.1: Cost adjustment of euro area economies to the decline in activity in 2009[1]

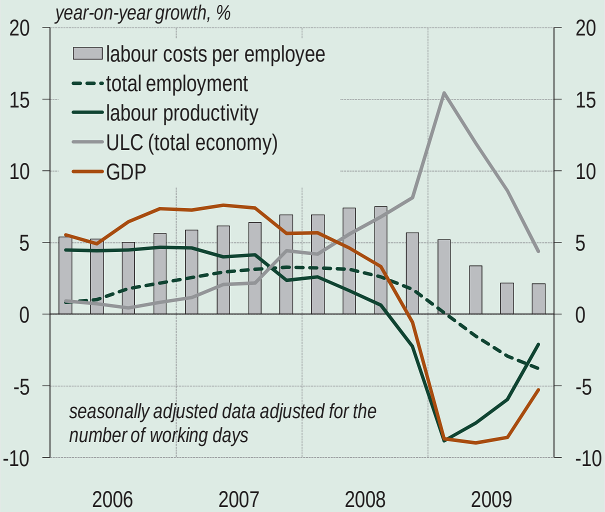
With certain exceptions, the fall in employment in euro area economies was lower than the fall in GDP. The slower fall in employment caused a sharp decline in productivity and an increase in unit labour costs, particularly in the first quarter of 2009. Growth in the latter stalled during the remainder of the year as a result of the continuing gradual decline in employment, the decline in growth in labour costs and the gradual recovery of economic activity in the majority of member states.

The subsidisation of reduced working hours in the majority of euro area countries was a factor in the relatively small increase in unemployment. At the euro area level the harmonised unemployment rate rose by just under 2 percentage points in 2009 to 9.4%. The smallest rise in unemployment was recorded by Germany, where the rate rose by just 0.2 percentage points to 7.5%. The rise in unemployment in Slovenia was one of the smallest in the euro area relative to the decline in activity (a rise of 1.6 percentage points to 6.0%). In Spain and Ireland the fall in employment was larger than the decline in economic activity. Growth in labour costs declined sharply in both countries, but unemployment nevertheless rose significantly. Unemployment rose by 6.7 percentage points to 18.1% in Spain, and by 5.8 percentage points to 11.8% in Ireland.

Given the rigidity in labour costs in the majority of cases, the maintenance of a relatively high employment was reflected in a sharp deterioration in the cost competitiveness of the economies. This was particularly the case in Slovenia, where activity and employment declined significantly more than in the euro area overall, but the adjustment of the labour market was nevertheless relatively small with regard to the fall in GDP. The smaller adjustment is primarily related to the slower response in sectors predominantly dependent on domestic consumption, while the response in manufacturing was one of the strongest in the euro area. In the context of a fall of 8.1% in GDP, total employment in Slovenia fell by 2.0%, while employment in the euro area fell by 1.8% during a 4.1% fall in GDP. In Slovenia the adjustment in employment was weak in the construction sector and overall in trade and repair, hotels and restaurants, transportation and communication, despite the above-average decline in value-added in each of these two categories. Spain and Ireland recorded a notable response in these categories, most evidently in construction. In Spain value-added in construction declined by 6.3%, while employment fell by just under a quarter. In Ireland the decline in value-added and fall in employment in the construction sector exceeded 30%.

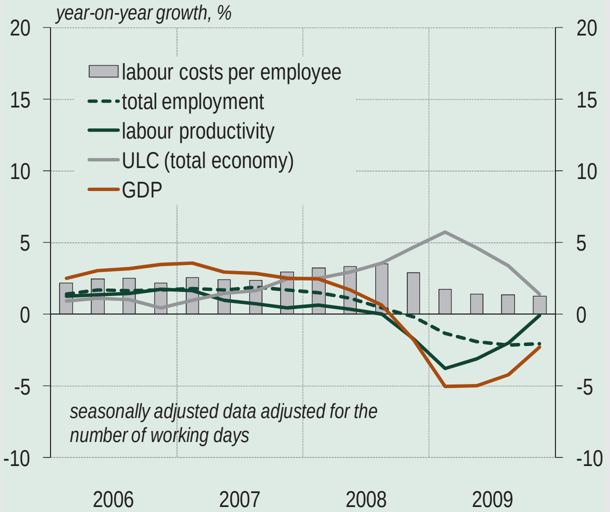
Slovenia, Finland and Ireland, the euro area countries recording the largest falls in GDP in 2009, all have an above-average proportion of GDP accounted for by industry, a small domestic market and a highly export-oriented economy. The decline in sectoral activity was nevertheless not entirely equal

Figure 1: Cost adjustment of the economy (Slovenia)



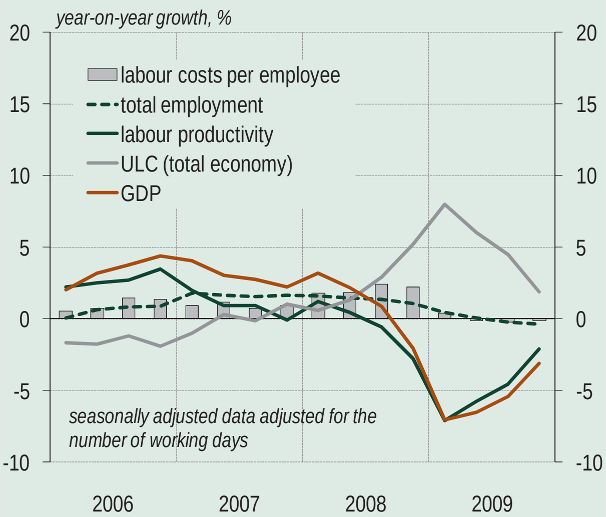
Sources: Eurostat, Bank of Slovenia calculations

Figure 2: Cost adjustment of the economy (euro area)



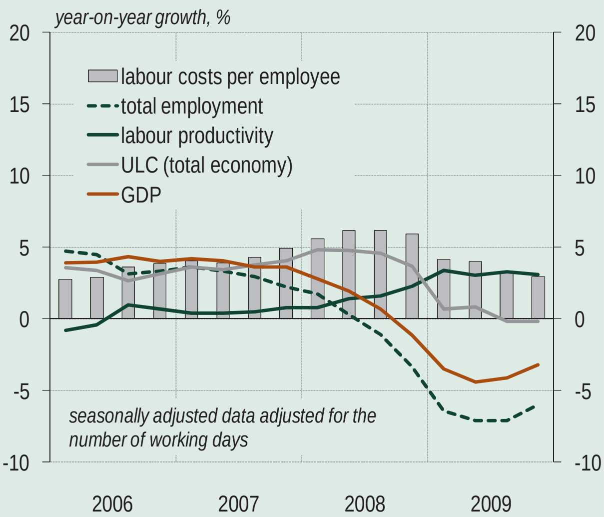
Sources: Eurostat, Bank of Slovenia calculations

Figure 3: Cost adjustment of the economy (Germany)



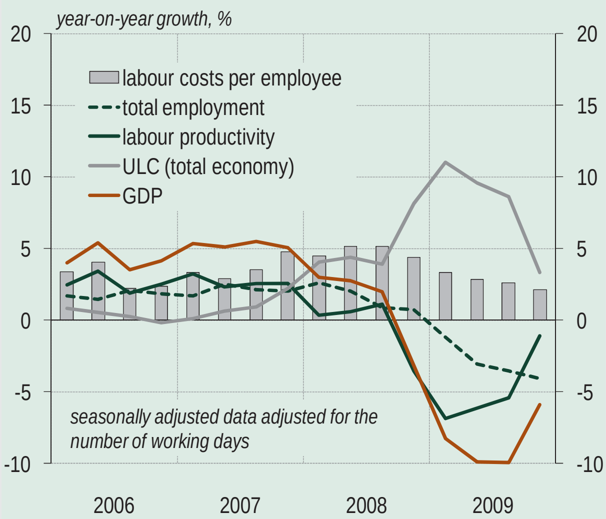
Sources: Eurostat, Bank of Slovenia calculations

Figure 4: Cost adjustment of the economy (Spain)



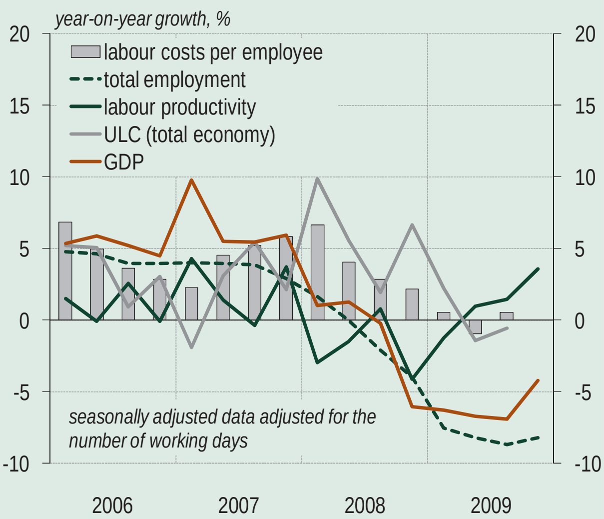
Sources: Eurostat, Bank of Slovenia calculations

Figure 5: Cost adjustment of the economy (Finland)



Sources: Eurostat, Bank of Slovenia calculations

Figure 6: Cost adjustment of the economy (Ireland)



Sources: Eurostat, Bank of Slovenia calculations

in each country. The decline in industrial production in Finland was even larger than in Slovenia, while Ireland recorded the smallest decline in the euro area. A common feature was the crisis in construction, with a sharp decline in value-added in the sector. This was even larger in Ireland than in Slovenia and Finland. Correspondingly, the overall decline in value-added in financial intermediation, real estate activities and business activities in Ireland was the largest of all the euro area countries. The decline in value-added in the overall category of trade and repair, hotels and restaurants, transportation and communication was significantly above-average in all three economies.

The adjustment of the labour market in euro area countries primarily entailed job losses, particularly in construction and industry, while labour costs remained relatively rigid. Labour costs per employee slowed in Slovenia primarily as a result of their slowdown in industry. The decline in growth in labour costs was comparable to that in the euro area in other parts of the private sector as well. The most notable decline in costs was recorded by industry in Germany, where the fall in the number of jobs was relatively small, but was partly compensated for by a significant decline in labour costs per employee. The labour market reacted in the opposite way in Spain, where growth in labour costs in industry remained high, but the fall in employment was one of the highest in the euro area.

Growth in labour costs per employee in the category of other services,[2] with its prevailing proportion of public services, did not cease significantly in 2009, despite the public finance problems in the euro area. In Greece, which last year had the largest general government deficit in the euro area, growth in labour costs in this category exceeded 7% for the third consecutive year. Slovenia is also among the countries with the highest growth in labour costs in this category, the introduction of a new wage system in the public sector having led to high wage growth. Growth in labour costs in this category in the euro area overall was also higher than in the total economy, an indication of the need for the public sector to make cost adjustments to the harsh macroeconomic situation in the majority of euro area countries.

[1] Eurostat figures adjusted for the season and the number of working days are used.

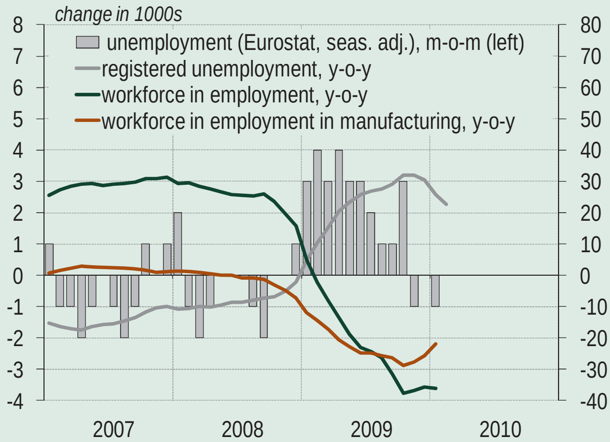
[2] Other service sectors comprise public administration, defence, compulsory social security, education, health and social work, other community, personal and social service activities, and activities of households

earnings from activities on securities markets, while the rise in value-added in public services was primarily the result of last year's growth in wages and employment in these sectors.

Labour market

As economic activity gradually recovers, the workforce in employment in the private sector is continuing to decline, albeit at a slower pace. Year-on-year growth in the workforce in employment in the private sector stood at more than 2% in the final quarter of 2008, but had reached -5.4% by the final quarter of 2009. The current decline was sharp in the first three quarters of 2009 at more than 1% in each quarter, but slowed in the final quarter.

Figure 2.6: Workforce in employment and unemployment

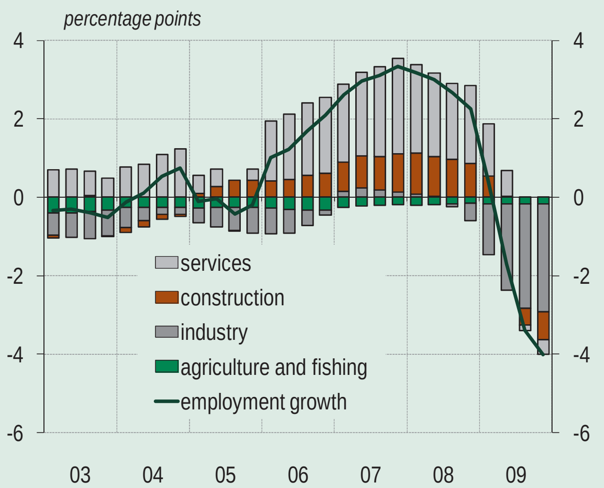


Workforce in employment includes employees and self-employed.
Sources: SORS, Employee Service of Slovenia, Eurostat, Bank of Slovenia calculations

Having hit manufacturing by the end of 2008, the fall in employment had spread to the majority of the rest of the private sector by the end of 2009. The largest reversal in employment trends was witnessed in the construction sector, where year-on-year growth was still positive in the second quarter of last year, but had reached -7.5% by the end of the year. Although the year-on-year fall in employment in manufacturing was even more pronounced in the final quarter of 2009 at 11.9%, the current rate of contraction slowed significantly in the final quarter. Among the other major sectors of the private sector, the fall in employment at the end of the year was particularly large in transportation and storage.

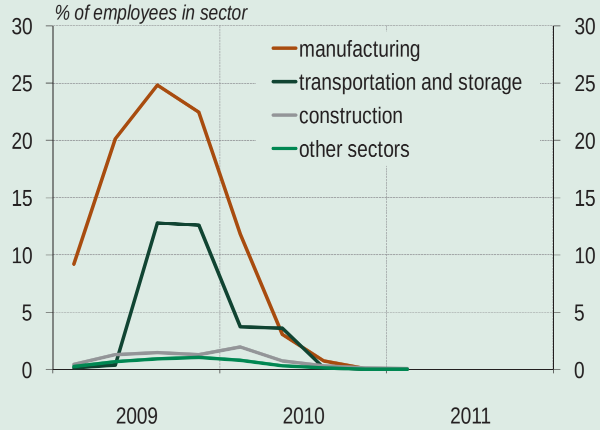
A clearer picture of demand for labour is given by the movement in the number of actual hours worked in the private sector. This indicator better reflects the short-term trend in demand for labour, as employers are more flexible in changing the number of hours worked (by ordering overtime or reducing working hours) than in hiring or firing workers. This indicator does not take account of the effect of the government measure to subsidise temporary lay-offs. The largest year-on-year decline in the number of hours worked in 2009 was recorded in the second quarter, when it stood at 7.7%, compared with 5.5% in the third quarter.

Figure 2.7: Sector contributions to employment growth



Sources: SORS (national accounts); Bank of Slovenia calculations

Figure 2.8: Proportion of employees included in measures to subsidise full-time employment or temporary lay-offs*



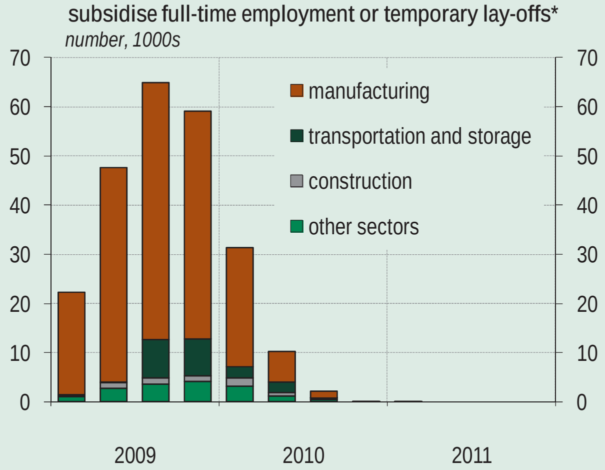
* According to figures for contracts concluded by the beginning of March 2010.
Sources: Employment Service of Slovenia, AJPES; Bank of Slovenia calculations

The largest year-on-year decline in the number of hours worked was recorded by manufacturing in the second quarter of 2009, when it stood at 17.0%, with the figure then easing. In addition to manufacturing, there were year-on-year declines in the third quarter in construction, in transportation and storage, and in other business activities. In other sectors of the private sector year-on-year growth in this indicator is already positive. Construction stands out as the only sector where there was a year-on-year decline in the number of hours worked in the third quarter, of 5%.

Growth in employment in the public sector mitigated the fall in employment in the total economy, which stood at 4.0% in year-on-year terms at the end of 2009. Year-on-year growth in employment in the public sector fluctuated around 2% in 2009. Year-on-year growth in employment was positive in all sectors of the public sector, but was highest in education.

The government attempted to mitigate the fall in employment primarily by partially subsidising full-time working hours and by subsidising temporary lay-offs. These two measures are estimated to have helped save around 20,000 jobs.[3] On the basis of the measure to

Figure 2.9: Number of employees included in measures to subsidise full-time employment or temporary lay-offs*



* According to figures for contracts concluded by the beginning of March 2010.
Sources: Employment Service of Slovenia, AJPES; Bank of Slovenia calculations

partly subsidise full-time employment, which entered into force in February 2009, employers were given the opportunity to reduce the working week by a maximum of 8 hours, and to claim a subsidy in the amount of EUR 120 per employee per month. In the period between the introduction of the measure and the beginning of March 2010, there were around 66,000 employees included in the measure, which is estimated to have helped save around 8,000 jobs. The vast majority of those included in the

[3] The estimate of the number of jobs saved is calculated on the basis of data for contracts concluded with the Employment Service in early March 2010. It is assumed that even if the government had not adopted the measures, total wage costs would have remained at the same level, but that this would have been achieved by laying workers off. There are also assumed to be no severance costs, which means that the number of jobs saved is overstated.

measure, around 85%, were employed in manufacturing, while trade accounted for 2.8% of the total, construction for 1.9%, and transportation for 1.6%. The other major government measure, the subsidisation of wage compensation for temporarily laid-off employees, has been in force since last June, and represents a more radical intervention in the labour market. Under this measure workers have their wages reduced to 85% of the base wage. Of this, workers who temporarily cannot be provided with work receive just over 40% from the employer, and just under 60% from the government. By the beginning of March 18,500 people had been included in this measure, which is estimated to have helped save 12,000 jobs. As in the first measure, the majority (around 70%) were employed in manufacturing, while transportation accounted for a significant 18% of the total. This measure was used in the construction sector to a greater extent than the measure to partially subsidise full-time employment, construction accounting for around 6% of the employees included in the measure.

The slowdown in the negative dynamic on the labour market is also gradually being reflected in the number of notified vacancies and new hires. The number of vacancies is continuing to decline, but the year-on-year decline had slowed significantly by the end of 2009. As was the case before the economic crisis, vacancies for fixed-term employment are prevalent, accounting for around 78% of all vacancies, up 5 percentage points in 2009. It can be concluded that during times of relatively high uncertainty companies will remain cautious in hiring in the near future, and will be even more inclined towards flexible forms of employment. The number of new hires is moving similarly to the number of vacancies, having improved in recent months after falling sharply until the middle of 2009. Having declined sharply in the final quarter of 2008, the proportion of unfilled job vacancies as measured by the ratio of the number of new hires to the number of newly notified vacancies began to rise towards the end of 2009.

The rise in the number of registered unemployed is gradually slowing, primarily as a result of an increase in job creation. Although there were 99,784 people registered as unemployed in February, up around a third on a year earlier, year-on-year growth has been slowing since October 2009, when it stood at 51.1%. In addition to a base effect, there has also been a slowdown because of current movements in the number of people entering and leaving unemployment. Inflows into unemployment have recently declined slightly, while outflows from unemployment have been rising to an even greater extent, primarily into entering employment. Outflows from registered unemployment in each month since the second half of 2009 have exceeded the five-year average, while the monthly inflows into unemployment have gradually been falling towards the five-year average. In line with the sharp decline in economic activity, the proportion of inflows into unemployment for reason of bankruptcies has risen sharply since the beginning of 2009, while expiration of fixed-term employment contracts has remained the most important reason for unemployment.[4] The registered unemployment rate has continued to rise, and reached 10.6% in January 2010. It was up 3.3 percentage points in year-on-year terms, although the current rate of growth is slowing. The surveyed unemployment

Figure 2.10: Job vacancies and new hires

Sources: Employment Service of Slovenia, Bank of Slovenia calculations

[4] The proportion of inflows into unemployment due to bankruptcies in 2009 was almost double that of the previous year at 27.6%, while the proportion of inflows into unemployment due to fixed-term contract expiration remained unchanged at close to 40%.

Box 2.2: Effects of a rise in the minimum wage

In February 2010 the National Assembly adopted a new Minimum Wage Act and an Act Amending the Personal Income Tax Act, thereby raising the minimum net wage from EUR 459 to EUR 562. According to the analysis of the Institute for Economic Research, the new minimum wage thus just covers the minimum cost of living.

The new level was obtained by setting the legal minimum gross wage for full-time employment at EUR 734.15, while raising the additional personal income tax allowance for the lowest-paid. Under the Minimum Wage Act, this will be adjusted once a year by at least the value of the consumer price index. Given the special circumstances during the economic recession, companies whose survival might be endangered or which might have to lay off a large number of workers because of the rise in the minimum wage are allowed to make a gradual transition. In this, they are obliged to consult the trade union or workers' representatives and reach a written agreement.. During the transitional period, the gross wage should not be lower than EUR 654.7 by the end of 2010. After 1 January 2011 the gross wage should not be lower than EUR 685.3 plus an adjustment for the consumer prices index in 2010. The transitional period should not extend beyond the end of 2011.

According to a rough estimate, the rise in the minimum wage will raise wage costs by around 0.9%. On the basis of SORS data on the breakdown of the workforce by gross wages in September 2008, around 108,000 employees are estimated to have a gross wage of less than EUR 734.2. Based on this, the rise in the minimum wage will cause a rise in total wages by EUR 110 million at the annual level. Taking employer contributions on gross wages into account, the rise in gross wage cost will amount to EUR 128 million. This result is based on an assumption that only employees below the threshold of EUR 734.2 will see a rise in gross wages, and that there will be no upward pressure on wages within other wage brackets. It is also assumed that there will be no additional lay-offs due to the rise in the minimum wage.

The rise in gross wages and the rise in additional personal allowances will also bring changes to the public financial flows. The change in personal income tax legislation relating to additional allowances is expected to reduce annual public revenues by around EUR 58 million. However, the rise in gross wages will also result in the rise of EUR 42 million in the social contributions paid by employers and employees. Transfers to households from the state budget tied to the minimum wage[1] will also rise, by around EUR 23 million at the annual level according to Government estimates. The overall net effect on public sector revenues and expenditure will amount to a net outflow of EUR 39 million at the annual level.[2]

The rise in labour costs will not be evenly distributed, as the proportion of low-paid employees is very high in certain labour-intensive sectors. The largest rises in gross wage costs among manufacturing activities will be in the manufacture of clothing (almost 10%), and the manufacture of textiles, the manufacture of leather, the wood industry and the manufacture of furniture (between 2% and 3%). Gross wage costs will also rise by similar amount in the construction sector and the hotels and restaurants sector. The rise in wage costs will also be reflected in a decline in corporate earnings, particularly in labour-intensive sectors. Therefore, at a time when a large portion of the private sector is facing losses, a rise in the minimum wage could prove to be too much of a cost pressure to bear by some companies.

The estimates above take into account the direct effects on costs, but there are likely to be additional effects on the movements in wages, consumption, prices, output and employment. According to the IMAD, the rise in labour costs due to the rise in the minimum wage will cause 5,000 job losses in the short term, and 20,000 job losses in the long term.[3] On the other hand, a simulation using a Bank of Slovenia macroeconomic model shows that a rise of 0.9% in the average wage results in a fall in employment of around 1,500 in the short term, and around 3,000 in the medium term. The small size of the effect compared with the IMAD estimates is partly related to the positive effect of the rise in wages on consumption, and thus on economic activity. Higher wages also gradually pass through into inflation, which itself will rise by around 0.7 percentage points in the medium term. The rise in prices will to a great extent neutralise the real cost to companies, but also the real effect of the increased purchasing power of

[1] Such as unemployment benefits, scholarships, certain family benefits.
[2] It should be noted that the calculations take no account of the impact on the wages, personal income tax and social contributions of the self-employed paying to themselves a wage below the new minimum wage.
[3] IMAD, Slovenian Economic Mirror, January 2010.

wages. However it is important to note that in the crisis and in the context of fierce competition companies have limited scope for passing costs through to prices. If the rise in the minimum wage turns to have a lasting effect on the real costs, or if it is followed by additional upward wage adjustments, the competitiveness of the domestic economy will be severely hurt. The overall effect of falling employment could thus be significantly greater.

rate and the harmonised unemployment rate were up slightly less in this period, by 2.1 and 2.6 percentage points, to 6.4% and 6.8% respectively.

In addition to a fall in employment, the economy is responding to the decline in economic activity via other methods to reduce total labour costs. Year-on-year growth in labour costs per employee stood at 5.7% in the final quarter of 2008, but had fallen to 3.0% by the final quarter of 2009 as the financial turmoil spread into the real sector. The decline in year-on-year growth in gross wages was particularly sharp in the first half of the year, as a result of a decline in wage growth in the private sector, particularly in manufacturing and in financial and insurance activities. The abolition of the payroll tax additionally reduced growth in labour costs last year by approximately 1 percentage point.

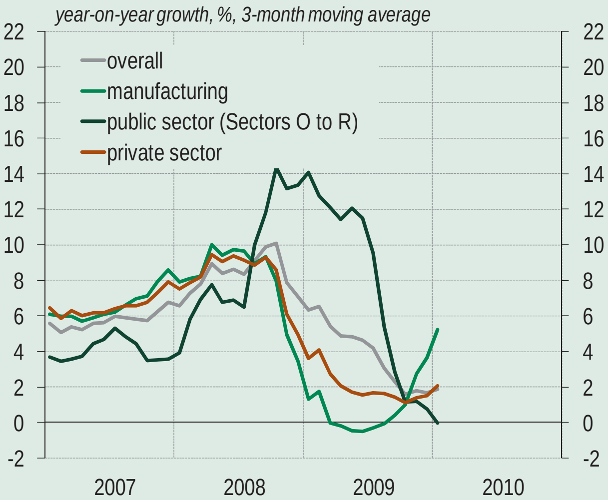
Since declining sharply in the first quarter of last year, labour productivity has been gradually rising, as employment has continued to fall despite the stabilisation of economic activity. Labour productivity

Table 2.2: Labour cost indicators

	2005	2006	2007	2008	2009	Q408	Q109	Q209	Q309	Q409
	nominal year-on-year growth, %									
Gross wage	3.6	4.8	5.9	8.3	3.5	7.1	5.4	4.6	2.3	1.7
Gross wage in private sector	3.7	5.5	6.8	7.9	1.8	4.9	2.7	1.6	1.4	1.5
Gross wage in public sector	3.1	3.4	4.0	9.8	6.6	13.4	12.1	11.5	2.9	0.8
Gross wage in manufacturing	5.8	5.6	6.9	7.6	0.9	3.4	0.0	-0.5	0.4	3.7
Labour costs per hour worked[1]	5.1	4.5	4.5	9.1	3.7	9.8	7.3	7.9	2.5	-2.5
Labour costs per hour worked in manufacturing[1]	8.0	3.6	5.1	10.5	5.7	10.8	8.3	10.4	5.5	-1.0
Gross wage per unit output	-1.0	0.5	2.2	7.6	9.8	10.4	15.3	13.2	7.7	3.3
Gross wage per trend-unit output[3]	1.4	2.6	3.6	6.1	1.3	4.8	3.2	2.4	0.0	-0.6
Gross wage in manufacturing per unit output	-0.5	-3.1	0.1	6.9	9.5	11.8	18.8	17.3	6.9	-4.4
Gross wage in manufacturing per trend-unit output[2]	0.9	0.7	2.0	2.8	-4.0	-1.5	-4.9	-5.4	-4.5	-1.2
Unit labour costs[2]	0.9	1.0	2.6	6.3	9.3	9.0	15.2	11.4	7.5	3.7
Trend-unit labour costs[2,3]	3.4	3.0	4.1	4.7	0.8	3.5	3.0	0.7	-0.2	-0.2
Labour costs per employee[2]	5.6	5.3	6.4	7.0	3.0	5.7	5.3	3.0	2.0	2.0
Output per employee	4.7	4.2	3.7	0.7	-5.8	-3.0	-8.6	-7.6	-5.0	-1.6
Output per employee (manufacturing)	6.4	9.0	6.8	0.6	-7.8	-7.5	-15.8	-15.2	-6.0	8.5
HICP	2.5	2.5	3.8	5.5	0.9	3.1	1.7	0.6	-0.2	1.4
GDP deflator	1.6	2.1	4.2	3.8	1.9	3.5	3.9	2.5	0.7	0.8

[1] Labour costs according to SORS calculations
[2] Labour costs calculated on the basis of employee compensation (national accounts)
[3] Output per employee, average over last 10 years: 2.3%
Output per employee in manufacturing, average over last 10 years: 4.9%
Unit of output is the ratio of real GDP to employment according to the national accounts, or in the manufacturing sector the ratio of value-added in manufacturing to employment in manufacturing according to the national accounts
Sources: SORS, Bank of Slovenia calculations

Figure 2.11: Nominal gross wages



Sources: SORS, Bank of Slovenia calculations

Figure 2.12: Productivity, unit labour costs and employee compensation (total economy)

Sources: Eurostat, Bank of Slovenia calculations

reached its low in the first quarter of 2009, when output per employee was down 8.6% in year-on-year terms. Since then the current rate of growth in economic activity has been positive, while employment has continued to fall. Labour productivity has thus been gradually improving, but by the final quarter of 2009 had still not reached its pre-crisis level. The decline in productivity was particularly pronounced in manufacturing, where the decline in activity in late 2008 and early 2009 was sharpest. After a sharp fall in employment, and the stabilisation of economic activity, year-on-year growth in productivity in manufacturing turned positive again at the end of 2009.

Growth in unit labour costs reached a very high level in early 2009, since which it has been gradually declining. The rapid decline in economic activity saw growth in unit labour costs reach 15.2% in the first quarter of 2009, up 6.2 percentage points on the final quarter of 2008. Since then it has been declining evenly, reaching 3.7% in the final quarter of 2009. The movement in growth in gross wages per unit of output has been very similar: in the final quarter of 2009 it was down 7.1 percentage points in year-on-year terms for the total economy, and down 16.2 percentage points in the manufacturing sector. Given the high proportion of workers included in government measures to subsidise jobs, the movement of labour costs per hour worked should also be noted. According to this indicator, growth in labour costs had begun to decline even in the final quarter of 2008, and was negative in the final quarter of 2009.

Indicators adjusted for cyclical trends reveal a certain adjustment to the worsened situation, which is vital in terms of maintaining the cost competitiveness of the Slovenian economy. In the second half of 2008 growth in unit labour costs began to outpace the GDP deflator, the largest gap of 11.3 percentage points being recorded in the first quarter of 2009. The gap had narrowed to 2.9 percentage points by the final quarter. Unit labour costs adjusted for cyclical productivity fluctuations show the inflationary pressure of labour costs if economic growth were close to the long-term average. This indicator had begun to improve by the final quarter of 2008, and turned negative last year as a result of the sharp decline in growth in labour costs in the second half of the year, reaching -0.2% in the final quarter. As a result of the significant decline in growth in gross wages, the indicator of trend-unit gross wages has continued to decline, its year-on-year fall reaching 0.6% in the final quarter of 2009. Growth in this indicator has continued to decline in manufacturing.

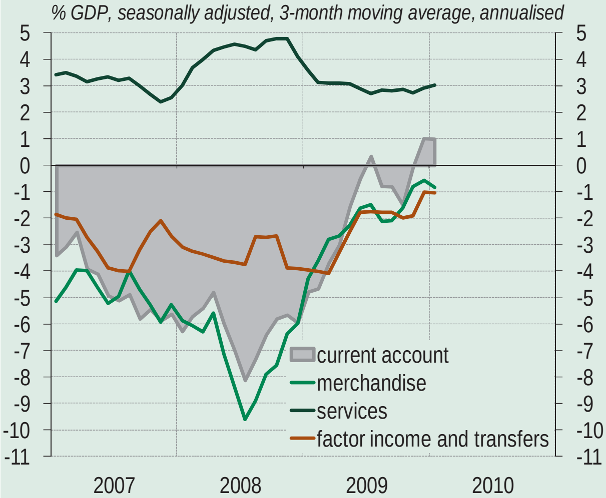
3 Foreign Trade and Competitiveness

The current account deficit declined from 6.2% of GDP in 2008 to 1.0% of GDP in 2009. The impact of the decline in domestic demand on imports was greater than the impact of the decline in foreign demand on exports. Together with the improvement in the terms of trade, this reduced the current account deficit in 2009 to a fifth of that recorded in the previous year. The decline in foreign demand also acted indirectly to reduce imports. Despite the surplus of trade in services declining by a third, lower interest rates and thus a decline in net outflows of factor income together with higher inflows of official transfers in the final months of last year were also factors in the decline in the current account deficit. The competitiveness indicators mostly deteriorated in 2009, both those expressed as price aggregates, and those tied to labour costs.

Foreign trade

The current account deficit, which had been widening since 2003, narrowed significantly in 2009 and averaged virtually zero over the year. The current account deficit widened by approximately 1.5 GDP percentage points each year between 2006 and 2008. The current account deficit stood at EUR 2,287 million or 6.2% of GDP in 2008, the largest figure since Slovenia became independent. As a result of the financial and economic crisis, alongside foreign demand domestic consumption contracted sharply in 2009, and with it import demand. Imports of merchandise and services fell faster than exports. The deficit in merchandise trade in 2009 was down to one fifth of that in 2008. With the surplus of trade in services and net outflows of factor income declining by a third, as well as net outflows of current transfers declining by a half, the current account deficit narrowed to EUR 340 million or 1.0% of GDP.

Figure 3.1: Components of the current account

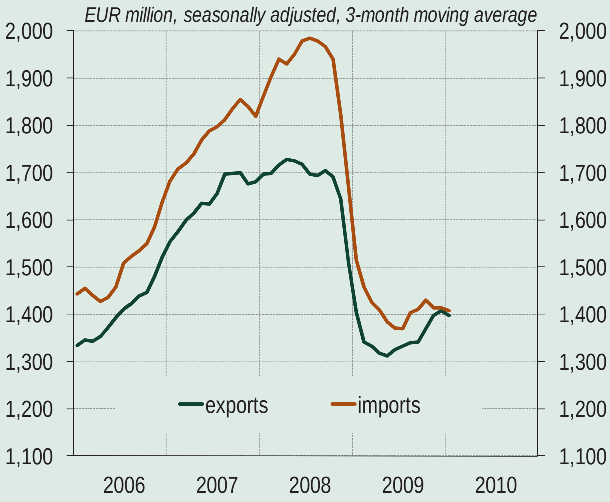


Source: Bank of Slovenia

The largest factors in the decline in the current account deficit were merchandise imports and exports. According to balance of payments figures, Slovenia's trade deficit[5] stood at EUR 621 million or 1.8% of GDP in

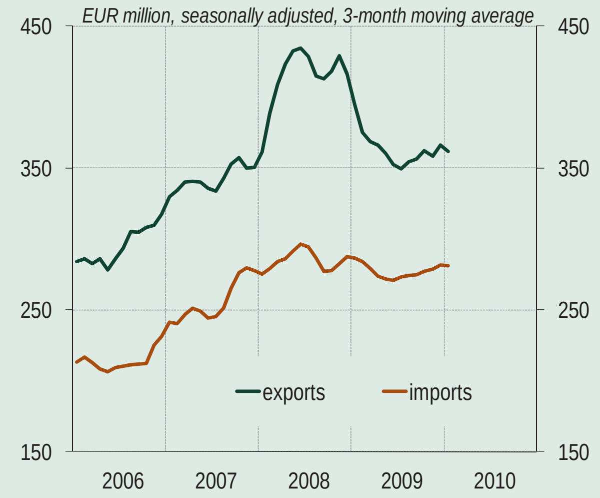
[5] According to SORS figures (cif for imports, fob for exports), and excluding any adjustments in coverage in the balance of payments methodology for disclosing merchandise trade, the merchandise trade deficit declined from EUR 3,238 million to EUR 1,013 million in 2009 (explanation given in the Methodological Notes appendix to the Bank of Slovenia's monthly bulletin).

Figure 3.2: Merchandise exports and imports



Source: Bank of Slovenia

Figure 3.3: Imports and exports of services



Source: Bank of Slovenia

2009. This was down 5.3 GDP percentage points on 2008, and was the lowest figure since Slovenia joined the EU in 2004. Merchandise trade was declining sharply in year-on-year terms in both value and volume terms as early as the final quarter of 2008, as a result of the financial and economic crisis. The decline in merchandise trade continued in 2009. The low point on the export side was reached in April, when merchandise exports were down 30.0% in year-on-year terms, while on the import side it was reached in May, when imports were down 33.5% in year-on-year terms.

The strong global fiscal stimulus for demand, supported by measures by the world's major central banks to support the liquidity of their banking systems, helped to raise Slovenia's exports from the second quarter on. The aforementioned measures, particularly in Germany and France, and the indirect effects of larger import demand from Asian countries, China and India in particular, also encouraged exports by Slovenian companies. The trend of decline in merchandise trade gradually slowed, and its current rate of growth has turned positive since the middle of the second quarter of 2009. The current rate of growth in merchandise exports outpaced the current rate of growth in merchandise imports in the second half of the year, other than in December. The result of these movements was a sharp decline in the merchandise trade deficit. Merchandise imports amounted to EUR 16.8 billion in 2009, down 25.9% on 2008, while merchandise exports were down 19.2% at EUR 16.2 billion. As the gap between the rates of decline in merchandise imports and exports widened, the coverage of imports by exports rose by 8.0 percentage points in year-on-year terms to 96.3%.

More favourable terms of trade also contributed to the decline in current account deficit by 2.5 percentage points of GDP. The faster fall in import prices began in the first quarter of last year, peaking in the third quarter, when import prices were down 10.2% in year-on-year terms, compared with the fall of 5.6% in exports prices. Import prices fell by 8.9% in 2009, while export prices fell by 4.6%. The major factors in the fall in import prices, in which intermediate goods are prevalent, were falls in euro prices of oil, industrial commodities and food on global markets. The beneficial effect of a fall in import prices was partly offset by the euro's fall against the US dollar. The terms of merchandise trade improved by 4.7% compared with 2008, which exceeded the total deterioration in the terms of trade between 2005 and 2008. The improvement in the terms of trade contributed approximately EUR 860 million or 2.5% of GDP to the decline in the current account deficit.

The smallest contraction among all the categories of intended use of products was recorded by exports of consumer goods, while the largest contraction was recorded by exports of intermediate goods. Exports of consumer goods were down 9.7% in year-on-year terms, the largest contraction of 15.9% being recorded in the first quarter. As a result of faster current growth from the second quarter, the year-on-year contraction fell to 10.0% in the third quarter, while the final quarter actually saw year-on-year growth of around 2%. Because investment activity also declined sharply in the rest of the world, the year-on-year contraction of exports of capital goods was twice as large as that of consumer goods at 20.5%. The largest impact of the crisis was the decline in foreign demand for intermediate goods. Exports of intermediate goods contracted by 24.5% in 2009, the year-on-year contraction peaking at 30.7% in the second quarter.

Development on the import side was similar, as the contraction in imports of consumer goods over the year amounted to 15.0%, while the contraction in imports of capital goods was more than a third. In addition to the volume factors seen in lower domestic and foreign demand, lower prices were also a factor in the contraction of 28.6% in imports of intermediate goods in value terms. Import prices of energy and primary commodities fell sharply, particularly in the first half of last year. The largest impact of the crisis was on imports of capital goods, which were down 34.0% over the year, the contraction peaking at 40.8% in the second quarter. Im-

Tabela 3.1: Components of the current account

	2003	2004	2005	2006	2007	2008	2009
				EUR million			
Current account balance	-196	-720	-498	-771	-1646	-2287	-340
1. Merchandise	-543	-1009	-1026	-1151	-1666	-2650	-621
2. Services	540	688	920	993	1047	1609	1022
2.1. Transport	260	324	398	456	525	591	415
2.2. Tourism	522	608	743	783	834	1037	764
- of which, exports	1186	1312	1451	1555	1665	1932	1800
2.3. Other	-243	-245	-221	-247	-312	-19	-156
3. Factor income	-219	-322	-295	-440	-789	-1039	-651
3.1. Labour income	135	138	128	107	50	-4	83
3.2. Capital income	-353	-460	-424	-547	-839	-1035	-734
4. Current transfers	26	-76	-97	-173	-239	-206	-90
				as % GDP			
Current account balance	-0.8	-2.7	-1.7	-2.5	-4.8	-6.2	-1.0
1. Merchandise	-2.2	-3.7	-3.6	-3.7	-4.8	-7.1	-1.8
2. Services	2.2	2.5	3.2	3.2	3.0	4.3	2.9
2.1. Transport	1.0	1.2	1.4	1.5	1.5	1.6	1.2
2.2. Tourism	2.1	2.2	2.6	2.5	2.4	2.8	2.2
- of which, exports	4.7	4.8	5.0	5.0	4.8	5.2	5.2
2.3. Other	-1.0	-0.9	-0.8	-0.8	-0.9	-0.1	-0.4
3. Factor income	-0.9	-1.2	-1.0	-1.4	-2.3	-2.8	-1.9
3.1. Labour income	0.5	0.5	0.4	0.3	0.1	0.0	0.2
3.2. Capital income	-1.4	-1.7	-1.5	-1.8	-2.4	-2.8	-2.1
4. Current transfers	0.1	-0.3	-0.3	-0.6	-0.7	-0.6	-0.3

Source: SORS, Bank of Slovenia.

ports of capital goods in the final quarter were up in quarterly terms, reducing the year-on-year contraction to 29.1%.

According to SORS figures, merchandise trade with EU Member States rose faster than with non-EU countries in the second half of 2009. This was primarily the result of measures to revive economic activity. The effect of government subsidies for the car industry was most evident in exports to France, which rose by 5.3%, and exports to Germany, where the annual contraction of 15.5% was significantly smaller than the contraction in total exports. As a result of these movements, merchandise exports to EU Member States in 2009 were down 18.0% in year-on-year terms, while merchandise exports to non-EU countries were down 21.0%. The regional differences in merchandise imports widened in the final months of 2009, but over the year they did not differ significantly from those on the export side. Imports from EU Member States were down 25.3% in year-on-year terms, while imports from non-EU countries were down 28.3%. In merchandise trade with the former Yugoslav republics, imports also fell faster than exports. Merchandise imports were down 27.6% in year-on-year terms, while exports were down 23.6%. Exports to Croatia and Serbia also recorded above-average contractions of 26.7% and 24.8% respectively. On the import side, the largest contractions were in imports from Montenegro (55.9%) and Macedonia (45.7%). Merchandise trade with Russia also contracted more sharply in year-on-year terms than trade with non-EU countries overall (by 41.5% on the import side, and 35.0% on the export side). The merchandise trade deficit with EU Member States almost halved, to EUR 2,199 million, while the trade surplus with non-EU countries increased from EUR 1,029 million in 2008 to EUR 1,186 million, despite the decline in merchandise trade.

Exports of services fell much faster than imports, though the contraction in trade in services was much smaller than that in merchandise trade. The surplus of trade in services declined by EUR 587 million to EUR 1,022 million. Imports of services amounted to EUR 3.3 billion in 2009, down 3.9% in year-on-year terms, while exports were down 14.3% at EUR 4.3 billion. The majority of the various categories of service recorded a contraction in both imports and exports. The sole exception on the export side was financial services, where revenues were up 26.3%. Despite the economic crisis, there were sharp year-on-year increases in imports of tourism services (15.9%), financial, computer and information services and intellectual property services (more than 20%).

The deterioration in transport and tourism services accounted for over four-fifths of the year-on-year decline in the surplus of trade in services. The decline in the surplus in tourism services accounted for EUR 274 million of the decline in the overall surplus of trade in services, tourism revenues having declined by 6.8% while tourism expenditure rose by 15.9%. The decline in exports of tourism services was primarily the result of a decline of 6% in the number of arrivals and the number of overnight stays by foreign visitors. Among the major countries of origin of foreign visitors to Slovenia, there was a decline of more than 20% in the number of arrivals from the UK, and a decline of around 10% in the number of arrivals from Germany and France. With the number of arrivals from Austria stagnating, the number of arrivals from Italy was up 5% and the number of overnight stays by visitors from Italy was up 4%. The movement in transport services closely tracked merchandise trade, last year's contraction exceeding 20% on both the import and export sides. The result was a sharp decline in the surplus of trade in transport services, by EUR 176 million to EUR 415 million.

The deficit in net factor income declined by EUR 388 million in 2009 to EUR 651 million. The largest contribution to the improvement in the position came from the decline in net interest expenses. The decline in the deficit in factor income contributed more than 1 GDP percentage point to the decline in the current account deficit. The deficit in capital income declined by

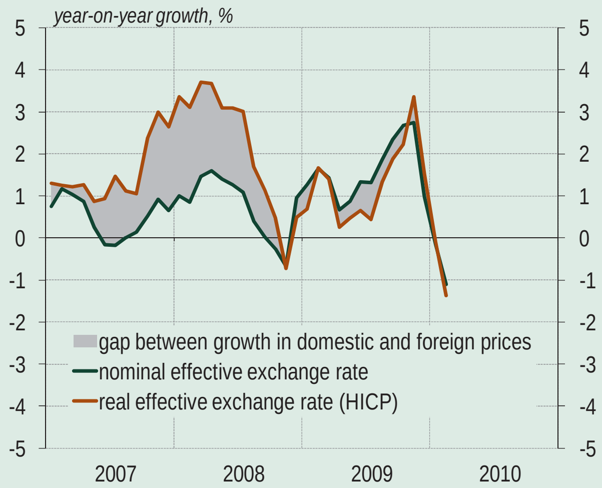
EUR 300 million to EUR 735 million. Capital income expenditure was down more than a quarter, while receipts were down a fifth. Gross external claims and liabilities remained relatively high in 2009, despite the decline in economic activity. The net debt repayments by banks were compensated for by net government borrowing. Under these conditions, the net external debt remained relatively stable at around EUR 10 billion. Low interest rates meant that the largest decline among all capital income items was recorded by net interest payments to the rest of the world, from EUR 793 million in 2008 to EUR 307 million in 2009. Surplus from investments in securities declined by EUR 178 million to EUR 73 million. Labour income expenditure halved in 2009, primarily as a result of the crisis in construction and manufacturing and the resulting fall in the number of foreign workers. There was a surplus of EUR 84 million in labour income, compared with a deficit of EUR 4 million in the previous year.

Last year's decline in the deficit in current transfers from EUR 206 million to EUR 90 million also contributed towards to the decline in the current account deficit. With the deficit in private transfers unchanged at EUR 12 million, the deficit in official transfers declined from EUR 111 million in 2008 to EUR 78 million. Official transfers into Slovenia totalled EUR 514 million last year. Just under half of this figure, in the amount of EUR 232 million, was realised in the final two months of last year, primarily from the increased use of available EU funding. The realisation of the forecast flows with the EU budget stood at 73.1% on the receipt side (compared with 46.4% in 2008), and 97.2% on the expenditure side. The overall position was a net inflow (in current and capital transfers) in the amount of EUR 156 million.

Competitiveness

The value of the nominal effective exchange rate of the domestic currency increased by 1.6% in 2009. The year-on-year increase peaked in November, the exchange rate subsequently began to fall as a result of the deterioration in the fiscal situation in certain euro area countries. By last December the euro had recorded the largest rises relative to last January against the US dollar (10.6%) and the Japanese yen (9.6%). The euro rose slightly against the Swiss franc, by 0.7%, and fell by 2.2% against the pound sterling. The euro's gradual rise against the US dollar for the majority of last year was the result of confidence returning to the financial markets and uncertainty surrounding the recovery in the US, which reduced investment in US dollar securities, government bonds in particular. The euro continued to fall in both current and year-on-year terms during the first two months of this year, primarily as a result of a deterioration in the fiscal situation in certain European countries, and entails an improvement in the euro area's competitiveness.

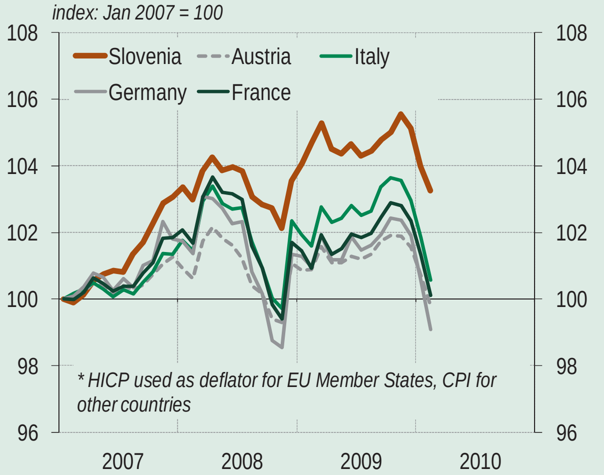
Figure 3.4: Harmonised competitiveness indicators in Slovenia (compared with 41 countries and the rest of the euro area)



Source: ECB

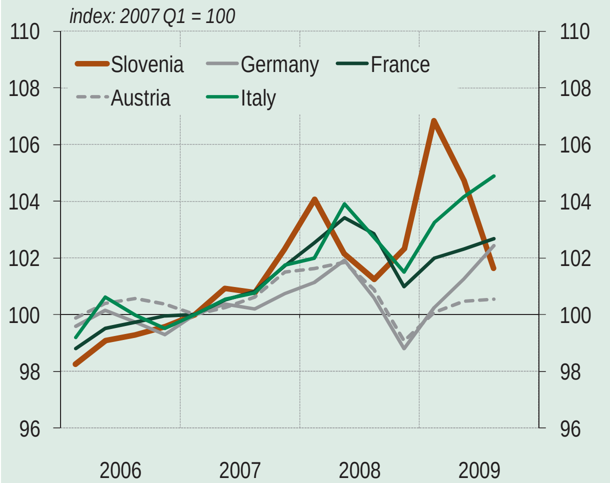
Price competitiveness deteriorated in 2009, partly as a result of movements in relative prices, but to a greater extent as a result of the rise in the euros' nominal effective value. The price competitiveness indicator as measured by consumer prices (the HICP) recorded its largest increase last year in the final quarter. The real effective exchange rate on average appreciated by 1.3% in 2009, primarily as a result of the appreciation in the nominal effective exchange rate, domestic prices

Figure 3.5: Harmonised competitiveness indicator based on consumer price indices *
(compared with 41 countries and the rest of the euro area)



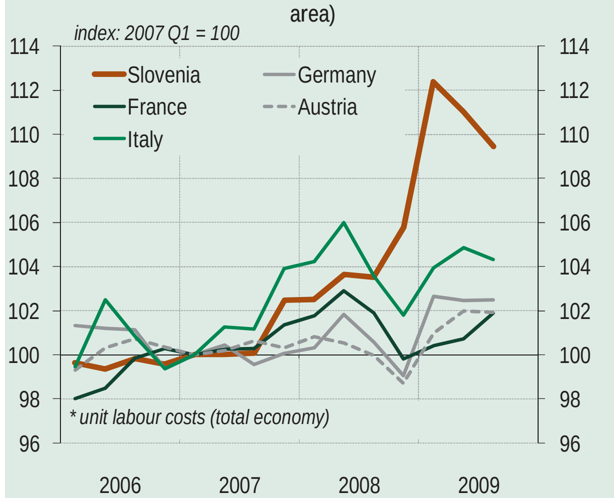
Sources: ECB, Bank of Slovenia calculations

Figure 3.6: Harmonised competitiveness indicator based on GDP deflator (compared with 21 countries and the rest of the euro area)



Sources: ECB, Bank of Slovenia calculations

Figure 3.7: Harmonised competitiveness indicator based on ULC indices* (compared with 21 countries and the rest of the euro area)



Sources: ECB, Bank of Slovenia calculations

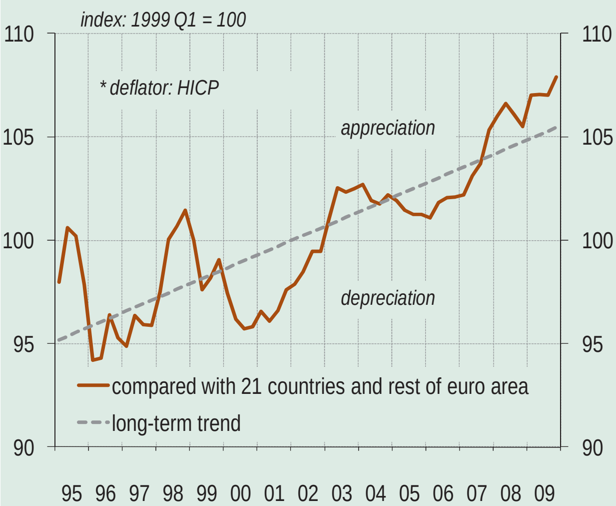
having grown slower than the basket of foreign prices. The harmonised competitiveness indicator as measured by the GDP deflator,[6] which reflects the movement of the general level of prices in the economy, recorded its largest increase last year in the first quarter, at 2.7%. Current declines meant that the year-on-year increase had declined to 0.4% by the third quarter, primarily as a result of the movement in the GDP deflator, which was up 3.9% in year-on-year terms in the first quarter, its year-on-year increase declining to 0.7% by the third quarter of last year.

The harmonised cost competitiveness indicator as measured by unit labour costs in the total economy reveals a sharper decline in competitiveness. The year-on-year increase amounted to a high 9.6% in the first quarter of 2009, before declining to 5.7% by the third quarter. The deterioration in cost competitiveness was primarily the result of wage adjustments in the public sector in summer 2008, and a sharper decline in productivity in manufacturing in early 2009. The year-on-year increase gradually declined in the second and third quarters as a result of the high basis from 2008 and the current improvement in productivity. These two factors are also expected to have caused a decline in the year-on-year increase in the final quarter of last year.

Slovenia is lagging behind relative to its trading partners in terms of price and cost competitiveness. The average year-on-year increase in the competitiveness indicator as measured by consumer prices in the most important euro area trading partners was 0.9 percentage points less than that in Slovenia. The competitiveness

[6] The European Commission also publishes price and cost competitiveness indicators (http://ec.europa.eu/economy_finance/db_indicators/db_indicators8642_en.htm). These differ from those of the ECB because of methodological differences resulting from the countries covered, the different sources for the deflators and the data conversion methods.

Figure 3.8: Harmonised competitiveness indicator*



Sources: ECB, Bank of Slovenia calculations

indicator as measured by the GDP deflator recorded an overall increase of 1.9% in the first three quarters of last year, but declined by 0.1% on average in the most important trading partners. The average year-on-year increase in the cost competitiveness indicator as measured by unit labour costs in the total economy over the first three quarters of last year in Slovenia was 7.1 percentage points larger than the average in the countries under comparison. The high year-on-year increase in this indicator in Slovenia, particularly in the first quarter of 2009, was the result of a larger decline in productivity in manufacturing relative to the countries under comparison. Another factor in the deterioration was the wage adjustment in the public sector. This competitiveness indicator declined over the remainder of the year as a result of an improvement in productivity in the majority of the countries under comparison, but the decline of the indicator in Slovenia was greater as a result of the abatement of the high base effect.

The movement of price competitiveness indicators can also reflect the effects of long-term real convergence, which are neutral as far as competitiveness is concerned. Taking the long-term trend of increase in the real effective exchange rate since 1995 into account, these effects have been moderate in Slovenia, as indicated by the gradient of the trend of appreciation in Figure 3.8. However, the movement since the middle of 2007 has shown a sustained deviation from the long-term trend. Should these deviations not be reflecting a potential reversal in the trend of a balanced real increase, the movements would indicate a deterioration in the price competitiveness of the economy since 2007.

4 Financing[7]

The private sector savings-investment gap moved from a large deficit to a surplus practically equal to the deficit recorded by the public sector, primarily as a result of the sharp decline in investment. Financing from the rest of the world is almost in balance. The decline in the borrowings of credit institutions prompted by the situation on the international financial markets was compensated for by bond issues by credit institutions and the government. Credit institutions replaced the shortfall of foreign bank funding by borrowing at the Eurosystem and by raising deposits. Government deposits were the main factor in this. The competition to attract deposits and banks' greater prudence in lending to relatively highly indebted non-financial corporations raised the cost of financial resources for the private sector, particularly for short-term loans. In the context of the reduced demand for loans resulting from the decline in economic activity, the situation on the supply side was reflected in a stagnation in corporate loans. At the end of the year there was slight increase in loans to households, the year-on-year rate reaching around 7.5%, primarily as a result of an increase in housing loans. The guarantee scheme for loans also helped in the replacement of short-term loans to non-financial corporations with longer-term loans, thereby mitigating a decline in corporate lending.

Domestic saving and foreign resources

As a result of the impact of the crisis on investment, the private sector's financial surplus increased sharply in 2009, while the public sector's deficit increased. The result of these movements was a small deficit in the current account. The increase in the private sector's net saving in 2009 was primarily the result of the large decline in gross investment. The sharp increase in the private sector's net saving has been more than compensated for by government borrowing since the middle of 2008. The public sector deficit rose to 5.5% of GDP in 2009. Net saving by the total economy declined to 1.0% of GDP in 2009, which entails a significant decline in the financing of domestic spending by borrowing in the rest of the world.

At the forefront of last year's decline in liabilities to the rest of the world was the decline of almost EUR 3 billion in the borrowings of domestic credit institutions, of which over EUR 2 billion was recorded in the first half of the year alone. Last year's decline in the borrowings of credit institutions was the result of the situation on interbank markets and the increased difficulty of refinancing in the rest of the world. Domestic credit institutions primarily replaced the longer-term funding

[7] Unless stated otherwise, figures from the Bank of Slovenia's monthly bulletin are used in this section.

Figure 4.1: Savings-investment gap

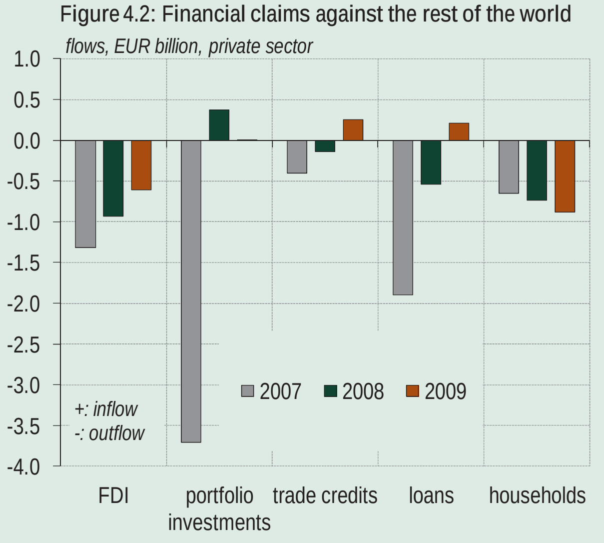
Sources: SORS, Bank of Slovenia

** The net savings of the public sector are defined as the consolidated public sector position using the ESA 95 methodology. Net borrowing from the rest of the world is defined as the negative of the current account position. The net savings of the private sector are defined as the difference between the current account position and the net savings of the public sector.*

from the rest of the world by raising government deposits and by seeking long-term funding on the capital markets supported by the government guarantee scheme. Credit institutions primarily covered their short-term liquidity needs by raising liquidity at the ECB. As a result of the uncertainty on the financial markets and the changes in the funding structure at domestic credit institutions, deposits by non-residents also declined at domestic credit institutions. They were down more than EUR 200 million on 2008. Growth in deposits by non-residents increased again in the final quarter of 2009, primarily as a result of domestic credit institutions offering higher deposit rates than those elsewhere in the euro area. All of this brought major changes to the structure of funding on the banking system's balance sheet. The proportion accounted for by foreign banks declined from 32.9% in December 2008 to 25% in December 2009. The availability of funding in the second half of 2009 was increased slightly by an inflow of portfolio investments, while inward FDI and trade credits from the rest of the world dried up entirely. The sectoral financial adjustments triggered by poor access to funding resulted in a decline in export trade credits granted, a small increase in household holdings of currency and deposits in the rest of the world and a standstill in outward FDI.

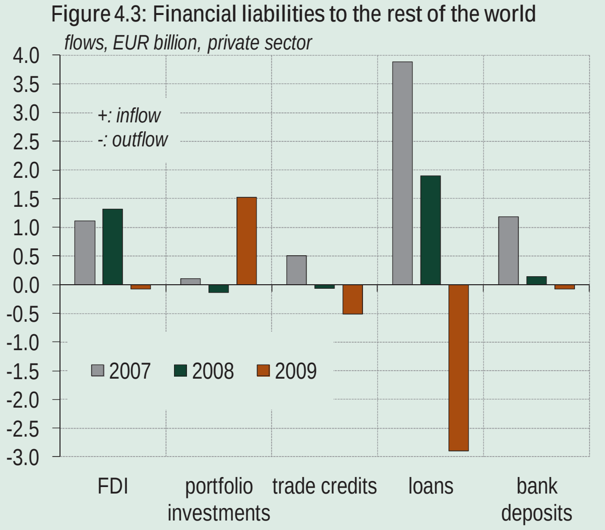
Non-financial corporations (NFCs) saw their surplus of financial liabilities over financial claims increase from EUR 40.9 billion in the final quarter of 2008 to EUR 42.1 billion in the third quarter of 2009.[8] NFCs'

Figure 4.2: Financial claims against the rest of the world



Source: Bank of Slovenia

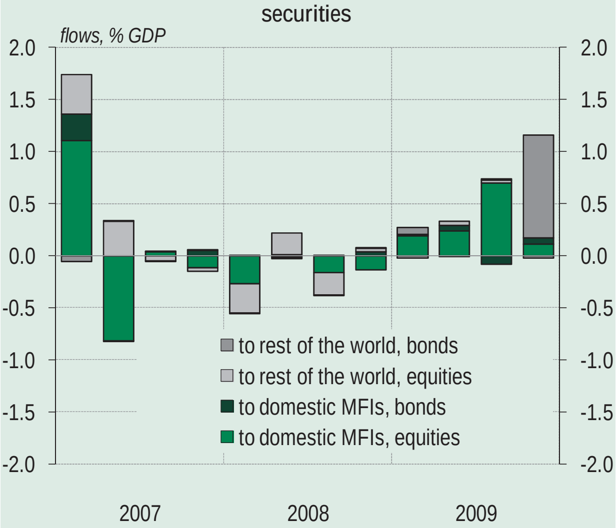
Figure 4.3: Financial liabilities to the rest of the world



Source: Bank of Slovenia

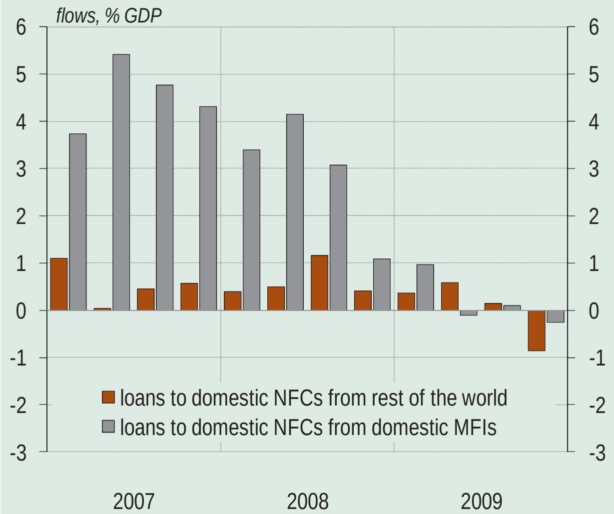
[8] The figures used are from the Bank of Slovenia's financial accounts.

Figure 4.4: Non-financial corporations' liabilities based on securities



Sources: Bank of Slovenia, SORS

Figure 4.5: Loans to domestic non-financial corporations



Sources: Bank of Slovenia, SORS

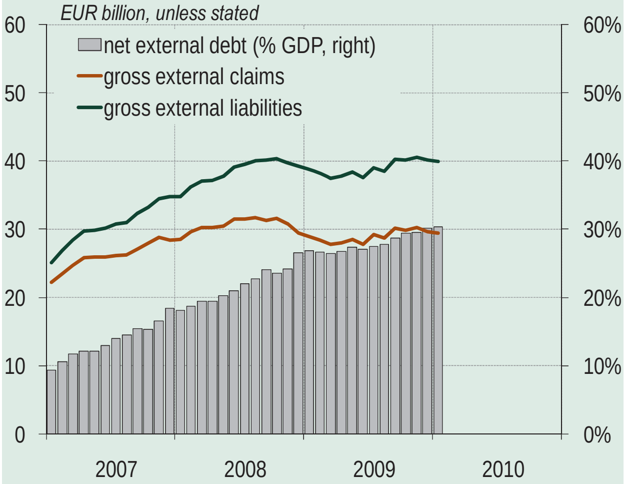
net liabilities to other domestic monetary financial institutions[9] from loans increased by almost EUR 290 million over the same period, while net borrowing by NFCs in the rest of the world increased by almost EUR 270 million. Long-term financing from the rest of the world was positive and stable until the middle of 2009, an indication that despite the crisis corporates with good credit ratings were able to obtain or at least refinance their long-term resources from the rest of the world. However, in the final quarter of last year the flow became negative. This was slightly compensated for by the issue of bonds by two domestic corporates on the capital market, thereby replacing their long-term financing. The inflows of short-term loans to NFCs from the rest of the world were positive in 2007 and 2008, but because of the decline in output in 2009 the domestic corporates made a reduction of almost EUR 90 million in their short-term borrowing. The contraction in imports meant that corporates reduced their short-term liabilities from trade credits by more than EUR 500 million in the last year alone, while short-term trade credit claims declined by approximately EUR 250 million, primarily as a result of the contraction in exports. Financing via long-term trade credits was insignificant in 2009.

Households' net financial claims increased by around EUR 2 billion between the final quarter of 2008 and the third quarter of 2009. Net claims against other domestic monetary financial institutions increased by around EUR 400 million in the first half of 2009, primarily as a result of higher deposit rates, but had declined to just EUR 30 million by the third quarter. Claims against the rest of the world increased by EUR 755 million during the first three quarters of 2009, as a result of an increase in households' holdings of currency and deposits in the rest of the world.

The private sector's liabilities against the rest of the world declined by EUR 1.6 billion in 2009, primarily as a result of the decline in the borrowings of domestic credit institutions, while the private sector's claims against the rest of the world increased by EUR 1.8 billion. The largest increase on the claim side was recorded by claims from currency and deposits. Investments in securities declined by EUR 0.2 billion in 2009, although sustained growth in stock market indices and the easing of the situation on foreign financial markets meant that investments in foreign securities increased by almost EUR 0.9 billion in the second half of 2009 alone. Outward FDI increased in the first half of the year in particular, and exceeded EUR 0.6 billion in 2009. Non-

[9] Includes banks, savings banks and money-market funds.

Figure 4.6: External debt



Source: Bank of Slovenia

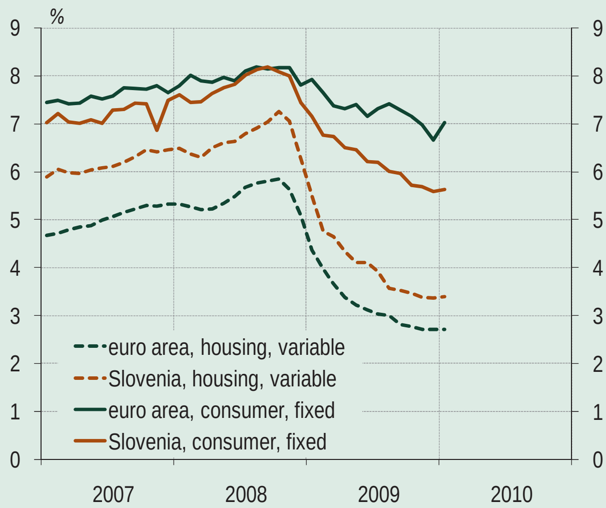
residents' portfolio investments were the most important factor in the increase in the private sector's liabilities to the rest of the world. The prevailing proportion consisted of investments in new bond issues by domestic banks in the amount of EUR 2 billion.

Gross external claims and the gross external debt were mostly unchanged last year at around EUR 30 billion and EUR 40 billion respectively. However, on the liability side there was a significant change in the sectoral and maturity breakdown of debt during this period. The decline in credit institutions' borrowings in the rest of the world was compensated for by government borrowing. The average maturity of the debt increased at the same time. The financial inflow into the general government sector was primarily the result of new issues of government bonds in the amount of EUR 4 billion. There was no significant change in the net external debt in 2009, which remained at around EUR 10 billion, but the sectoral breakdown did change. The private sector's net borrowing was replaced by the government.

Financing costs

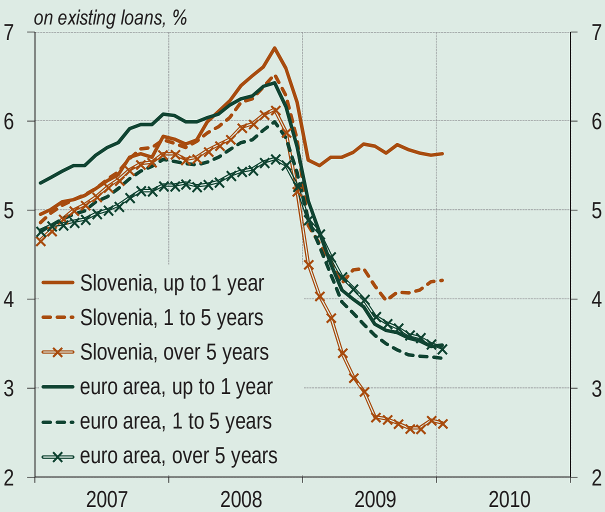
The fall in ECB interest rates was followed by domestic credit institutions to a significantly lesser degree than elsewhere in the euro area, resulting in the creation of a significant spread between domestic and foreign interest rates. This occurred primarily as a result of the simultaneous action of three factors. The first was corporate reliance on bank financing, and the relatively high corporate indebtedness, which in certain circumstances actually increases their debt costs. Second, credit institutions had access to (cheap) funding in the rest of the world in the years before the crisis. At the outbreak of the crisis longer-term funding became relatively more expensive and less accessible (syndicated loans

Figure 4.7: Interest rates on loans to households (new business)



Sources: ECB, Bank of Slovenia

Figure 4.8: Interest rates for non-financial corporations, by maturity



Sources: ECB, Bank of Slovenia

and deposits). A portion of these higher costs were then passed through to their clients, which made loans more expensive. Third, credit institutions pass increased impairment and provisioning costs through to higher lending rates, which prevents interest rates falling as they do in the euro area.[10]

The fall in the ECB's interest rates primarily led to a decline in interest rates on loans to NFCs of longer maturities, while the spread between domestic and foreign interest rates on shorter maturities widened significantly during the crisis. On longer maturities the credit risk is increasing, for which reason credit institutions are requiring greater collateral for these loans. The price of these loans can also be lower for this reason. A large portion of interest rates on loans for long-term investments, over 80%, are tied to the EURIBOR: the decline in the EURIBOR therefore resulted in a sharp decline in interest rates on these loans from 7.21% at the end of 2008 to 3.65% in early 2010. On loans with maturities of between 1 and 5 years, which in principle are intended for the longer-term financing of working capital, the interest rate of domestic credit institutions is above the euro area average, although the spread is much smaller than on short-term loans. One factor in this was the government guarantee scheme, via which a portion of the credit risk was transferred from corporates to the government. The cost of short-term loans did not decline despite the improvement in the liquidity situation on the financial markets in Slovenia. This occurred primarily because the interest rates on short-term loans are mostly fixed. Credit institutions are therefore able to pass the higher funding costs through to clients much more easily than on long-term loans, where the majority of loans carry a variable interest rate.

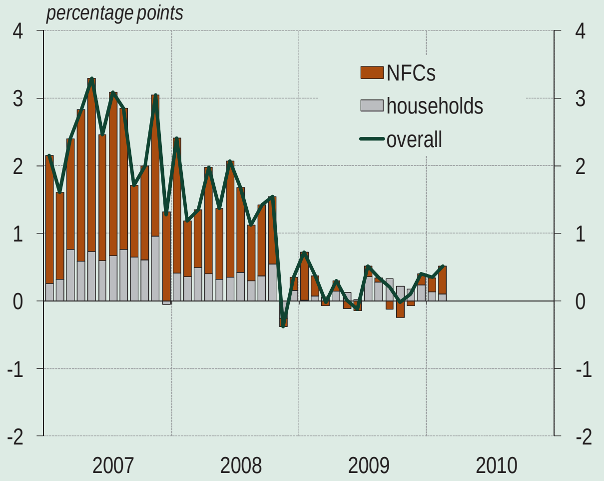
Interest rates[11] on household loans fell sharply last year on consumer loans and housing loans. While interest rates on consumer loans over the last five years were lower than the euro area average, interest rates on housing loans were an average of 1 percentage point higher than the euro area average. During 2009 interest rates on housing loans fell more than in the euro area, the gap narrowing to just 0.64 percentage points by December 2009. The average interest rate on housing loans stood at 3.35% in Slovenia and at 2.71% in the euro area overall. Given that interest rates on housing loans are predominantly (over 80% of the total) variable and are tied to a reference interest rate (the EURIBOR or the Swiss franc LIBOR), the fall in the reference interest rates brought a sharp decline in the cost of financing such loans. The fall in interest rates on consumer loans was not as pronounced as for housing loans, given the larger proportion of consumer loans with a fixed interest rate.

Lending activity[12]

The decline in domestic demand and economic activity and the harsher financing conditions caused growth in loans to other non-monetary sectors to stall.[13] However, there was no decline in the stock of lending. Year-on-year growth in loans to non-banking sectors has been declining since the beginning of 2008, reaching 3% at the beginning of this year, while the current rate of growth in loans to other non-monetary sectors has fluctuated between zero and 2% since the final quarter of 2008. Both supply-side and demand-side factors have contributed to the decline in lending growth. The decline in domestic demand and output as a result of the impact of the global economic crisis sharply reduced the demand for loans. An additional factor was the high indebtedness of other non-monetary sectors, which rose sharply in the pre-crisis credit cycle. This has dictated greater prudence on the part of corporates in raising loans and on the part of credit institutions in approving loans, which is being reflected in tighter terms of lending

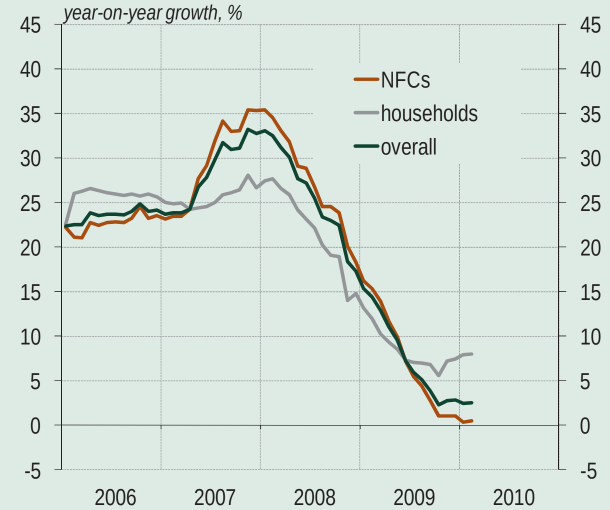
[10] For detailed analysis, see Stability of the Slovenian Banking System, Bank of Slovenia, December 2009.
[11] Interest rates on newly approved loans. A fixed interest rate applies to consumer loans, and a variable interest rate to housing loans.
[12] The figures used are from the Bank of Slovenia's monthly bulletin.
[13] Other domestic non-monetary sectors comprise non-financial corporations, households, non-profit institutions serving households, and non-monetary financial institutions.

Figure 4.9: Contributions of components to current growth in loans



Source: Bank of Slovenia

Figure 4.10: Loans to households and non-financial corporations



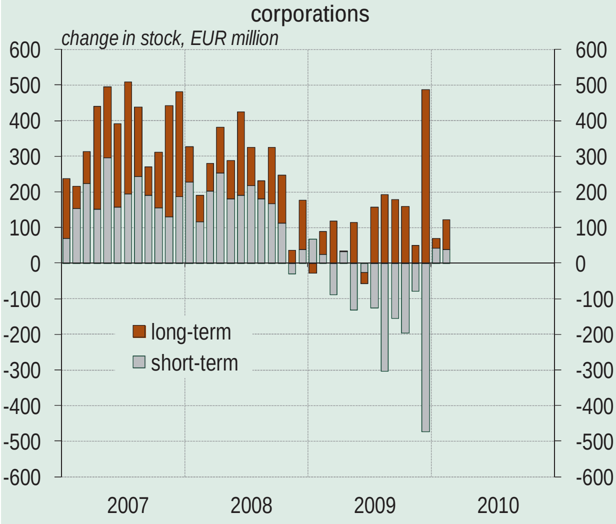
Source: Bank of Slovenia

and higher financing costs at credit institutions compared with the euro area overall.

Year-on-year growth in loans to non-financial corporations stood at less than 1% in the final quarter of 2009, while the proportion of long-term loans is increasing. Favourable financing conditions for short maturities in the pre-crisis period meant that often corporates raised short-term loans to finance longer-term activities, renewing them at maturity by raising new short-term loans. After the outbreak of the crisis, the banks primarily approved short-term loans for corporates, but not in a sufficient extent to yield positive year-on-year growth, which was partly the result of the diminishing need to finance working capital because of low output. The net stock of such loans therefore declined, thereby increasing the proportion of the total stock of loans accounted for by long-term loans. The stock of long-term financing at domestic credit institutions increased in the final quarter of last year. Alongside low reference interest rates and an increase in investment, another factor in this increase in longer-term loans was the guarantee scheme introduced by the government in mid-June 2009 to encourage the long-term financing of SMEs.

Growth in loans to households also declined sharply, but nevertheless remained positive throughout the crisis. Year-on-year growth stood at around 7.5% at the beginning of 2010, primarily as a result of an increase in housing loans. Between 2005 and 2007, when lending activity was extremely high, growth in loans to households stood at around 25%. The rise in unemployment and the sustained decline in real disposable income compared with the trend of growth before the crisis were reflected in a decline in household demand for all types of lending. Given the smaller fall in household consumption relative to the fall in investment, growth in loans to households outpaced growth in loans to NFCs

Figure 4.11: Maturity breakdown of loans to non-financial corporations



Source: Bank of Slovenia

throughout the crisis period.

The largest decline in growth among loans to households was recorded by housing loans, whose rate more than halved between 2007 and 2009, but nevertheless remains strongly above the euro area average. At the beginning of 2007 growth in housing loans exceeded 40%, before declining to just 13.4% by October 2009. Growth in housing loans strengthened again in the final two months of 2009, as a result of higher volume on the real estate market and more favourable financing conditions, and reached 16.5% this January. Growth in consumer loans also declined in 2009, as a result of the fall in household consumption. Growth in consumer loans was actually negative in the third quarter of 2009 (at -0.3%), but strengthened to turn positive again in the final quarter. Growth in consumer loans stood at 13% in 2008, just 1.2% in 2009, and 1.1% in January of this year.

Measures to encourage lending to the private sector

The government adopted measures to encourage lending activity via the take-up of an additional proportion of the risks in bank lending to non-banking sectors. Among the most important were the Republic of Slovenia Guarantee Scheme Act and the Republic of Slovenia Guarantee Scheme for Natural Persons Act. In addition, Slovenia also issued guarantees to banks for the issue of bonds in the rest of the world, with the aim of securing long-term funding for banks.

Under the guarantee scheme, the government can offer banks guarantees for lending to undertakings and cooperatives in the total amount of EUR 1.2 billion. Auctions are held on behalf of the government by SID banka (formerly the Slovene Export Corporation). EUR 310 million of guarantees were offered at the first three auctions held in June and July. The quotas were EUR 60 million at the first auction (the government taking up a maximum of 40% of the risk), EUR 150 million at the second auction (a maximum of 35% of the risk), and EUR 100 million at the third auction (a maximum of 33% of the risk). Banks that were allocated a guarantee quota must conclude loan agreements with clients rated A, B or C, the total value of the guaranteed portion of the loans being covered by the allocated guarantee quota. The principal of the loans can amount to between EUR 100,000 and EUR 70 million, while the maturity may be from 1 to 10 years. Four more auctions had been held by the end of last year, and three more were held in the first two months of 2010. The guarantees assumed by the government by the beginning of this March amounted to EUR 622 million, while the total lending potential from the two guarantees was slightly less than EUR 2.0 billion. By the middle of March a total of EUR 603 million of lending had been approved for non-banking sectors on the basis of the guarantee scheme, which entails utilisation of half of the available volume of the scheme, and 33.7% exploitation of the lending potential created on the basis of the scheme.

In addition to the guarantee scheme for undertakings and cooperatives, in July 2009 the National Assembly also adopted the Republic of Slovenia Guarantee Scheme for Natural Persons Act, which will be in force until the end of 2010. Under this law the government has earmarked EUR 350 million for guarantees for banks in the event of non-payment of liabilities by certain population groups. Guarantees in the amount of EUR 300 million have been earmarked for temporary employees and young families from the National Housing Saving Scheme Act, the government taking up risk relating to 50% of the loan value. The maturity of the loans is limited to 25 years, while the principal may range from EUR 5,000 to EUR 100,000. The remaining EUR 50 million has been earmarked for guarantees for consumer loans to people losing their jobs after 1 October. Here the government is taking up 100% of the risk. The maximum principal of the loans is EUR 10,000, with a maturity of up to 10 years. Banks that offer to approve lending with the lowest overall effective interest rate will have priority in the allocation of guarantee quotas. The government can allow borrowers to defer loan repayment until they are again able to make repayments.

On behalf of the government, between September 2009 and January 2010 SID banka issued four invitations to banks to attend an auction for the guarantee scheme for household lending. At the first of the two auctions held last September, a quota of EUR 50 million was offered with a 50% guarantee, and a maximum bid rate of 8.00%, while at the second a quota of EUR 10 million was offered with a 100% guarantee and a maximum bid rate of 9.00%. The maximum bid rate was lower in the following two auctions held this January. In the third a quota of EUR 50 million was offered with a 50% guarantee, the maximum bid rate declining by 1 percentage point to 7.00%, while at the fourth a quota of EUR 20 million was offered with a 100% guarantee, the maximum bid rate declining by 4 percentage points to 5.00%. The quota allocated to banks at the first two auctions in September 2009 reached EUR 38.4 million, the approved lending totalling EUR 14.7 million and the value of government guarantees issued totalling EUR 8.2 million. The quota allocated to banks at the final two auctions in January 2010 declined to EUR 33.9 million, and the approved lending in the amount of EUR 4.5 million was just a third of that in the September auctions, the value of government guarantees issued totalling EUR 2.4 million.

5 Public Finance Developments

The general government deficit reached 5.5% of GDP in 2009, according to SORS estimates. The rise of almost 4 percentage points of GDP in the general government deficit from the previous year was the result of a decline in revenues as a result of the fall in GDP, the operation of fiscal stabilisers and the introduction of economic stimulus measures by the government. The Stability Programme and the exit strategy for emerging from the deteriorated public finance situation envisage measures focused on the expenditure side. A cut in the deficit to 1.6% of GDP by 2013 is projected. The general government debt stood at 35.9% of GDP at the end of 2009, while according to Stability Programme projections borrowing to finance the deficit is expected to increase debt until 2012, when it is forecast to exceed 42% of GDP.

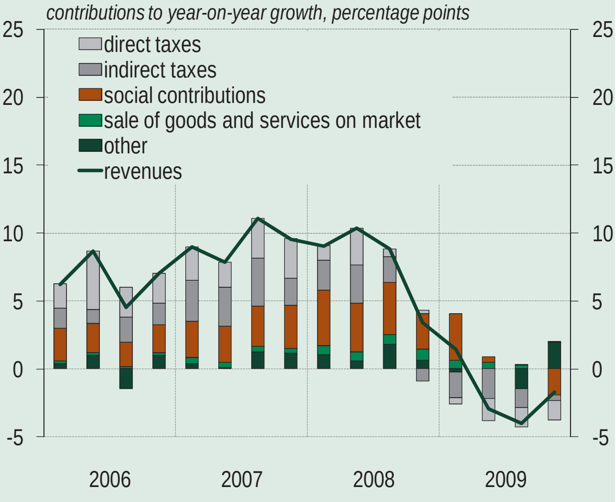
The crisis had a major impact on the fiscal results in 2009, and was reflected in a rise in the general government deficit to above the Maastricht criterion for public finance stability. Slovenia has thus been in an excessive deficit procedure since 2 December 2009, like the vast majority of EU Member States. For almost a year and a half, fiscal policy has been acting in an extremely bad macroeconomic environment, which has been reflected in a decline in economic activity. The general government deficit rose to 5.5% of GDP in 2009. The general government debt also rose, to 35.9% of GDP. An excessive deficit procedure was consequently initiated against Slovenia, as is currently the case for 20 EU Member States. According to European Commission estimates, the general government deficit of EU Member States reached 6.9% of GDP last year, having stood at 2.3% of GDP in 2008, while the general government debt rose from 61.5% of GDP in 2008 to 73.0% of GDP last

Table 5.1: General government deficit and debt in Slovenia, 2007–2013: realisation, projections from the Stability Programme, and European Commission forecasts (as % GDP)

	SORS			Stability Programme					European Commission		
	2007	2008	2009	2009	2010	2011	2012	2013	2009	2010	2011
Revenues	42.4	42.6	44.4	42.4	43.2	42.9	42.7	42.5	43.2	43.2	42.9
Expenditure	42.4	44.3	49.9	48.1	48.9	47.1	45.9	44.2	49.5	50.2	49.9
Net lending (+) / borrowing (-)	0.0	-1.7	-5.5	-5.7	-5.7	-4.2	-3.1	-1.6	-6.3	-7.0	-6.9
Structural balance	…	…	…	-4.8	-4.2	-2.8	-2.1	-1	-4.7	-5.4	-5.6
Debt	23.3	22.6	35.9	34.4	39.6	42.0	42.7	42.1	35.1	42.8	48.2

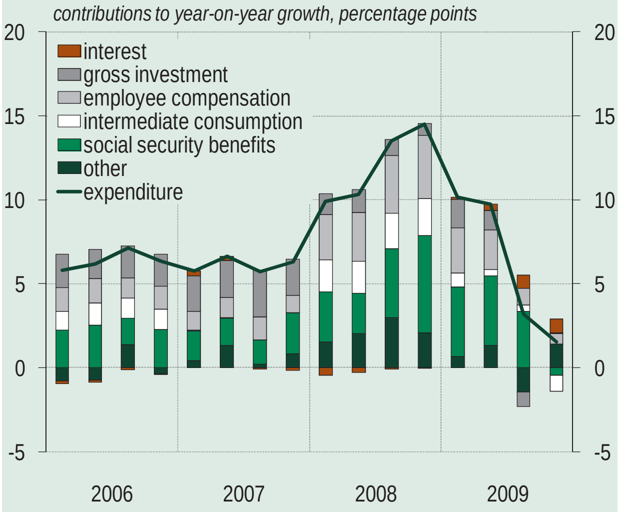
Sources: SORS, Ministry of Finance, European Commission (November 2009). The European Commission forecasts do not take account of the measures envisaged in the Stability Programme

Figure 5.1: General government revenues



Sources: SORS, Bank of Slovenia calculations

Figure 5.2: General government expenditure



Sources: SORS, Bank of Slovenia calculations

year. According to the same estimates, the general government deficit of euro area countries reached 6.4% of GDP, while the general government debt rose to 78.2% of GDP.

The increase of almost 4 percentage points of GDP in the general government deficit was primarily the result of the decline in economic activity. This brought a significant decline in general government revenues, while certain expenditures increased. Growth in general government revenues had begun to decline sharply, in line with the economic situation, by the final quarter of 2008, and revenues continued to decline in 2009. As is evident from Figure 5.1, the financial and economic crisis affected all categories of revenue. The decline in indirect taxes is prominent, while the most notable of the direct taxes is revenues from corporate taxation. Despite their decline, general government revenues actually rose as a proportion of GDP last year as a result of the sharp fall in GDP. General government expenditure was later in beginning to adjust to the change in circumstances, and did so to a lesser extent. As a result expenditure as a proportion of GDP increased sharply last year. The largest increase was in expenditure on the unemployed, but growth in other social transfers also remained high last year. Compensation of employees, which accounts for a quarter of all general government expenditure, also increased as a result of the introduction of the new wage system. Increased government borrowing also brought growth in interest payments.

Anti-crisis measures also contributed to the rise in the deficit in 2009. The key measures included the subsidisation of jobs to maintain employment, and cuts in certain taxes. In the update to the Stability Programme the Ministry of Finance estimates that anti-crisis measures raised the general government deficit by the equivalent of 0.7% of GDP. Around EUR 50 million was spent on discretionary measures on the labour market last year, less than originally planned. The majority of the money was spent on the measure to partially subsidise full-time work. Employers had until 31 March 2010 to claim subsidisation under the two measures, which will expire this year and in March 2011. Other discretionary measures in the area of taxation, namely the abolition of payroll tax, a cut in the corporate income tax rate and an increase in investment relief, also acted to reduce revenues in 2009. The loss of revenues was partly offset by a rise in excise duties on petrol, tobacco and alcohol.

The deficit is primarily being generated by central government, although local government is also generating a large deficit. According to SORS estimates,

Box 5.1: Movements in the general government debt, and its sensitivity to interest rates

According to the Stability and Growth Pact, the general government debt may not exceed 60% of GDP, or should approach this value if higher. Slovenia's general government debt had ranged between 20% and 30% of GDP over the long term, but since the outbreak of the financial and economic crisis it has risen significantly, reaching 34.4% by the end of the year according to the estimates in the Stability Programme. The general government debt is forecast to rise to 48.2% of GDP by 2011 according to European Commission projections from October 2009, or to 42.0% of GDP according to the projections from this January's Stability Programme, as a result of measures to cut the deficit. Despite the projected rise, Slovenia's general government debt will remain among the lowest in the EU. However, the rise in the debt will need to be controlled, not merely because of the costs of servicing the debt, which encompass interest payments, but also because of the anticipated effect of an aging population on the need for additional public expenditure. A possible measure to reduce debt after 2012 cited in the government's exit strategy is the sale of state-owned capital holdings, which would reduce the debt by 2 percentage points of GDP.

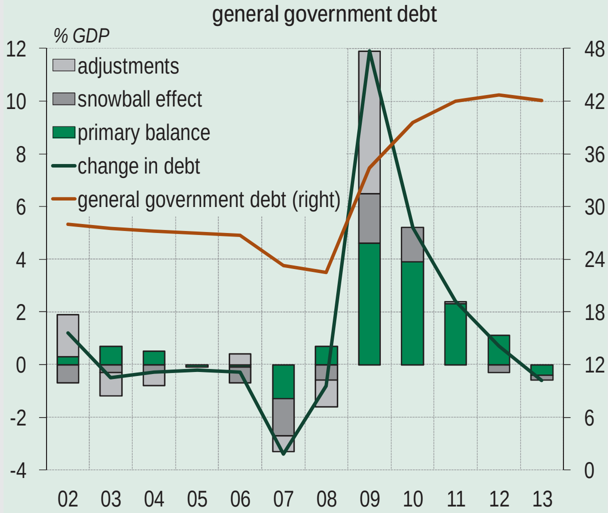
Three factors (illustrated in the figure) have a general impact on the movement of the general government debt expressed as a proportion of GDP:

- the primary balance, i.e. the general government position excluding interest,

- the so-called snowball effect, which is a reflection of the gap between the implicit interest rate (the ratio of interest payments to the stock of general government debt), and growth in nominal GDP,

- adjustment factors, e.g. value changes in the debt (exchange rate differences), government capital investments, privatisation inflows and the difference between the cash and accrual accounting principles of calculating debt as result of the differences in calculation under ESA 95 methodology and national methodology.

Figure: Contributions of components to change in general government debt



Sources: European Commission, Slovenian government, Bank of Slovenia calculations

As is evident from the figure, the general government debt gradually declined from 2003, particularly in 2007, when economic growth was relatively high and the government recorded a primary surplus. The government also used the proceeds from selling the capital holding in NLB d.d. to re-

Table: Impact on interest payments of rise of 1 percentage point in interest rates

Year	Maturing principal of state budget debt	General government deficit* (Stability Programme)	Borrowing requirement	Annual increase in interest payment (1% of borrowing requirement)	Cumulative increase in interest payment	Cumulative increase in interest payment
	(1)	(2)	(3) = (1) + (2)	(4)	(5)	(6)
			EUR million			*as % GDP*
2010	1,730	2,073	3,803	38	38	0.10
2011	986	1,636	2,622	26	64	0.17
2012	1,174	1,315	2,488	25	89	0.22
2013	141	771	912	9	98	0.23

*Note: * From 2011 on, includes new interest payment from previous year, i.e. the amount in column (5) in the previous year*
Sources: Ministry of Finance (maturing principal), government (deficit projections), Bank of Slovenia calculations

duce the debt. According to the projections from the government's January Stability Programme, the debt has been rising since 2009. The main factor in the rise in the debt this year and in the next two years will be financing the primary deficit. The snowball effect is more pronounced last year and this year as a result of negative and then weak economic growth. The adjustments were more prominent in 2009 as a result of the rise in government borrowing under the amended Public Finance Act, which in addition to borrowing to finance the implementation of the state budget in the current year allows additional borrowing up to the amount of the government debt principal repayments falling due in the next two budget years. Here the government put money into the banking system, thereby easing the position of banks in refinancing their liabilities. In subsequent years no such adjustments are projected.

The proportion of the debt with a variable interest rate is small, and the need for borrowing was relatively small in the past. The increased need for borrowing for reason of the maturity of the principal of the general government debt and the general government deficit could alter this situation. In the event of a change in interest rates, the interest burden could increase, irrespective of the relatively high proportion of debt with a fixed interest rate. A rise of 1 percentage point in interest rates in a given year would affect 1) the portion of the debt falling due for payment in that year that needs to be refinanced, and 2) the portion of debt arising in that year as a result of financing the deficit. The limited availability of data means that only the maturing of the state budget debt is taken into account in the calculations. The central government debt, which consists predominantly of the state budget debt, accounted for approximately 97% of the total general government debt according to ESA 95 methodology. The impact of a rise of 1 percentage point in interest rates on interest payments in the 2010 to 2013 period is illustrated in the table.

It is evident from the table that a rise of 1 percentage point in interest rates in 2010 would entail an increase of around EUR 38 million (0.1% of estimated GDP) in interest payments compared with their level had interest rates remained unchanged. The amount of principal falling due for payment in the next years is lower. The planned general government deficit is also declining, but the accumulation of interest payments on the debt from previous years means that interest payments are nevertheless rising. Given the necessary borrowing, a rise in interest rates of 1 percentage point would entail a rise of around EUR 64 million in interest payments in 2011 (EUR 38 million from borrowing in 2010, and EUR 26 million from borrowing in 2011), a rise of around EUR 89 million in 2012, and a rise of EUR 98 million in 2013. The aforementioned calculations represent an upper limit on the impact of higher interest rates on the deficit, as they have been made under the assumption that the entire amount of borrowing at the higher interest rate would be made at the beginning of the year. The calculations in the Stability Programme are similar. In addition to the impact of a change in interest rates on the debt, the impact of changes in exchange rates on the general government debt is also usually calculated, but in Slovenia this is extremely small, as only around 0.2% of the general government debt is in foreign currency.

Sources:
- European Commission: General Government Data, Autumn 2009 (http://ec.europa.eu/economy_finance/publications/publication16110_en.pdf)
- Ministry of Finance: Stability Programme, 2009 update, January 2010 (http://www.mf.gov.si/slov/mediji/2010/Program_stabilnosti_2009.pdf)
- Government of the Republic of Slovenia: Exit Strategy 2010-2013, February 2010 (http://www.vlada.si/fileadmin/dokumenti/si/sklepi/seje_vlade/67_seja/strategija.pdf)

the central government deficit reached 4.6% of GDP in 2009. The local government deficit was again relatively high, at an estimated 0.5% of GDP. The social security funds recorded a deficit of 0.4% of GDP. In line with the described movements, government indebtedness is increasing fastest in the central government sector, but indebtedness is also increasing at the local level.

The general government deficit is to a great extent structural in nature, which means that the anticipated economic recovery will not suffice to establish the balance in public finances. The available estimates indicate that the structural deficit amounted to just under 5% of GDP in 2009. Re-establishing the balance in public finances will therefore require measures of a structural nature or discretionary cuts in expenditure and/or rises in the tax burden. Estimating the structural position under the current circumstances is less reliable, and is subject to frequent revision, as it relies on uncertain estimates of potential output.

The general government debt rose to EUR 12.5 billion or 35.9% of GDP in 2009, but remains among the lowest in the euro area despite the large rise. The general government debt rose by more than 13 percentage points of GDP in 2009. In addition to the financing of the general government deficit, the rise in the debt was also a result of a snowball effect (see Box 5.1) and adjustment factors. The debt remains significantly lower than the debt in the majority of euro area countries. According to European Commission estimates, euro area debt in 2009 was up around 9 percentage points of GDP on the previous year at 78.2% of GDP, only Luxembourg and Slovakia recording lower debt figures than Slovenia.

Government borrowing in 2009 and in early 2010 was primarily undertaken by issuing long-term bonds. Three Slovenian government bonds were issued in 2009, with a total nominal value of EUR 4 billion. By the middle of this March, Slovenia had increased its borrowings via two further government bond issues with a nominal value of EUR 2.5 billion. In addition to financing the deficit, the proceeds from the bond issues will also be used to repay debt. A total of EUR 1.7 billion of government debt falls due for payment this year, the majority before the end of March. The individual bond issues in 2009 and 2010 had nominal values of either EUR 1 billion or EUR 1.5 billion, and maturities of between 3 and 15 years.

Around EUR 2.2 billion of government guarantees were exploited last year as part of the package of measures aimed at stimulating the functioning of the financial markets and lending. The guarantees related to three stimulus measures. (1) The government has issued guarantees to banks for bond issues in the amount of around EUR 3.5 billion to date, of which EUR 2 billion has been exploited.[14] (2) As part of the guarantee scheme for corporate lending, the government has issued guarantees to banks for loans made to corporates, in a proportion determined at auction. By the middle of March the government had allocated approximately 52% of the available quota of EUR 1.2 billion in ten auctions, the banks having utilised approximately a third of the quota. The value of the approved loans reached just over EUR 600 million, the government taking up an average of approximately 35% of the risk relating to the loans. (3) EUR 350 million is available in the guarantee scheme for household lending, but exploitation has been small to date.

The stock of government guarantees issued rose sharply in 2009, to stand at more than 20% of GDP at the end of the year. Any call of the guarantees would therefore entail an increase in the general government debt. The stock of government guarantees issued stood at EUR 7.1 billion at the end of 2009, compared with EUR 4.7 billion at the end of 2008. The guarantees from previous periods primarily concerned the construc-

Table 5.2: Basic information about government bonds issued in 2009 and 2010

Date of issue	Maturity, years	Nominal value, EUR million	Coupon rate, %
5.2.2009	3	1,000	4.25
2.4.2009	5	1,500	4.375
9.9.2009	15	1,500	4.625
26.1.2010	10	1,500	4.125
17.3.2010	5	1,000	2.75

Source: Ministry of Finance.

[14] NLB issued a government-guaranteed bond with a nominal value of EUR 1.5 billion (out of the available EUR 2.5 billion) last July, and in September Abanka issued bonds with a nominal value of EUR 0.5 billion (out of an approved EUR 0.75 billion). Government guarantees for the issue of long-term bonds abroad were also obtained by Factor banka and Deželna banka Slovenije, each in the amount of EUR 100 million.

Box 5.2: Exit strategy

At the outbreak of the financial and economic crisis in the middle of 2008, many countries, Slovenia among them, introduced a variety of anti-crisis measures as part of a European economic programme. These fiscal measures were temporary in nature, mostly with a timetable of application until the end of 2010. After a fiscal expansion, consolidation of the public finances becomes vital. In addition, when economic growth recovers too much state involvement could hinder the functioning of the market economy. At the beginning of February the government therefore drew up an exit strategy, to define the gradual withdrawal of the short-term anti-crisis measures and to introduce longer-term structural measures, economic policy measures and institutional adjustment measures aimed at encouraging sustainable long-term economic growth. The measures of the exit strategy are also in line with the Stability Programme, which was submitted to the European Commission for review at the end of January. The Stability Programme envisages a reduction in the general government deficit below the threshold of 3% of GDP by 2013, as set by the European Council guidelines within the framework of the Stability and Growth Pact. Like the majority of EU Member States, Slovenia is undergoing an excessive deficit procedure.

The exit strategy primarily bases the projected consolidation of public finances on reductions in government expenditure. Given the envisaged introduction of the so-called fiscal rule,[1] the exit strategy also pursues the Stability Programme's targets for the size of the general government deficit and debt. The fiscal rule planned by the exit strategy ties nominal growth in government expenditure to growth in potential GDP. The exit strategy forecasts that average growth in potential GDP over the next four years will stand at 3.9%, while growth in government expenditure as allowed in the fiscal rule will average 2.2%. Expenditure growing more slowly than potential GDP is at the forefront of the planned consolidation of public finances.

The exit strategy measures primarily relate to the following:

a) Withdrawal of the fiscal stimulus measures by 2010, and the gradual abandonment of aid to financial institutions.

b) Fiscal consolidation within the framework of which savings on the expenditure side are required in the amount of EUR 1.2 billion by 2013. This would meet the target of reducing the

Table: Government priority programmes and their financing until 2013

	Expenditure in 2008 (realisation)	Expenditure in 2009 (realisation)	Expenditure in 2010 (plan)	Expenditure in 2011 (plan)	Expenditure in 2012 (plan)	Expenditure in 2013 (plan)
Priority 1: Entrepreneurship and know-how for development						
as % GDP	2.2	2.8	3.2	3.0	3.2	3.2
as % of budgetary expenditure	9.1	9.8	9.9	9.9	11.2	11.9
as % of expenditure from EU funding	1.2	2.3	3.8	3.5	2.7	3.1
Priority 2: Flexicurity and social cohesion						
as % GDP	6.3	7.6	8.6	7.9	7.8	7.8
as % of budgetary expenditure	26.2	28.5	26.9	26.2	28.1	30.0
as % of expenditure from EU funding	0.0	0.4	0.8	0.7	0.5	0.4
Priority 3: Transport and energy infrastructure						
as % GDP	1.7	1.7	2.4	2.1	2.1	2.1
as % of budgetary expenditure	7.0	6.0	7.2	6.7	7.4	7.9
as % of expenditure from EU funding	0.5	1.0	2.6	2.2	3.2	2.9
Total						
as % GDP	10.2	12.1	14.2	13.1	13.1	13.1
as % of budgetary expenditure	42.4	44.3	44.0	42.8	46.7	49.8
as % of expenditure from EU funding	1.7	3.7	7.2	6.4	6.4	6.4

Source: Exit Strategy 2010 to 2013, pp 13–14 state budget deficit to 1.3% of GDP by 2013. Major savings are envisaged primarily in the area of cuts in labour costs in the public sector. These savings are forecast to amount to around EUR 1 billion by the end of 2012, and have already been taken into account in the budgets for 2010 and 2011. The main measures envisaged are (1) a cut of 1% each year in the number of civil servants (around 1,600 employees each year), (2) organisational change in the functioning of the public sector, (3) saving measures already adopted regarding civil servants' wages, which apply until November 2011 under the so-called intervention act, and (4) additional wage-related measures. Savings are also being planned by means of the optimisation of government spending, particularly in relation to the costs of goods and services, and in the area of social transfers.

c) Setting of priorities within government spending. These should allow the longer-term developmental objectives of sustained economic growth to be met. The priorities and earmarked funds are illustrated in the table-

It is envisaged that the available spending entitlements from previously adopted budgets be redirected to the priorities in the table, which primarily encompass:

- Priority 1: promoting enterprise and competitiveness, e.g. new investment, business clusters, business support environments, science, the information society and e-government.
- Priority 2: measures to increase labour market flexibility and to increase the participation of less-employable groups in the labour market, and measures in the area of social security and healthcare.
- Priority 3: measures in the areas of transport infrastructure, such as the rehabilitation of Slovenian Railways, and energy, such as energy efficiency for buildings.

There are three major reforms envisaged as part of the (longer-term) structural measures, which are aimed at achieving long-term sustainability in public finances while maintaining social security. These include reform of the pension system, reform of the health system, also related to the introduction of a system for long-term care, and reform of the labour market. The institutional changes envisage a host of innovations to increase the efficiency of the public administration, and to improve environmental efficiency in transport and energy infrastructure.

[1] Only government expenditure over which the government can exert an influence is taken into account in the fiscal rule. That is the portion of expenditure that is not tied to funding from the European budget, or to specifically earmarked funding from the revenue side of the state budget.

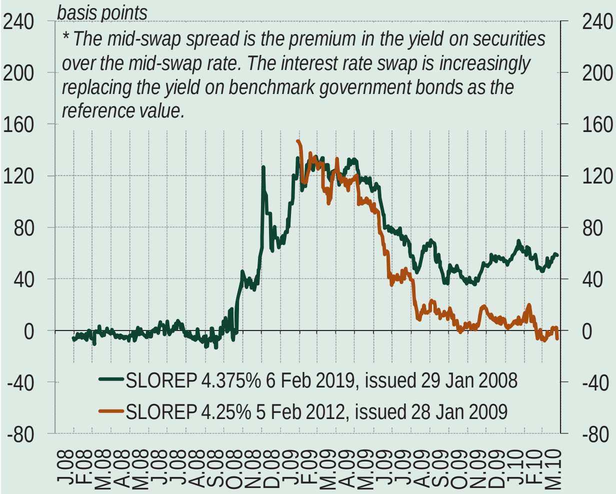
Sources:
- Government of the Republic of Slovenia: Exit Strategy 2010-2013, February 2010
- Summary of ministry measures to overcome the crisis and revive the economy (department-by-department review)
- Descriptions of departmental measures

tion of transport infrastructure, and related to DARS. The increase in government guarantees in 2009 is primarily a reflection of government guarantees aimed at limiting the impact of the financial turmoil. Any call of the guarantees would entail a higher general government deficit, and additional upward pressure on the debt.

The Council of the EU set Slovenia a deadline of 2013 for eliminating its excessive deficit. The updated Stability Programme therefore envisages the maintenance of this year's general government deficit at last year's level, and a gradual reduction in the next years, whereby the deficit should reach 1.6% of GDP by 2013. The structural deficit between 2010 and 2013 is forecast to shrink by an average of 1 percentage point of GDP each year, more than the 0.75 percentage points of GDP recommended by the Council of the EU. The available projections of economic developments in the coming years suggest that growth in revenues can be expected to remain low, particularly given government policy, which is not planning any significant changes in the tax burden. The size of the planned reduction in the budget deficit is therefore relatively high, particularly given the rise in interest payments caused by the rising debt.

Credible consolidation will be the key to maintaining Slovenia's favourable position on the sovereign debt markets. Retaining confidence will depend on the successful and timely implementation of the exit strategy. This confidence is being reinforced by Slovenia's credit rating remaining unchanged. Similarly to the majority of other euro area countries, the premiums of Slovenian government bonds over the benchmark declined in the middle of last year and this year, having risen sharply in late 2008 and early 2009. By reducing the premiums demanded on recently issued Slovenian government bonds, the markets have also demonstrated their confidence in the fiscal consolidation as announced.

Figure 5.3: Mid-swap spread: Slovenian government bonds yield premium over mid-swap rate*



Source: Bloomberg

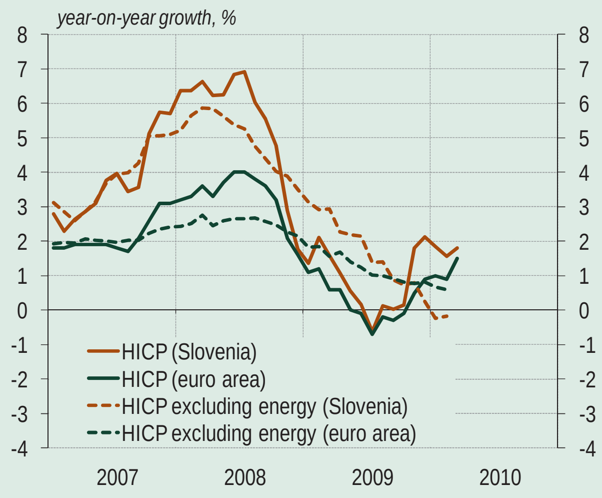
6 Price Developments

The main features of inflation in 2009 were the large fall in core inflation, and the significant fluctuation in the contribution made by energy prices. Growth in the harmonised index of consumer prices stood at 0.9% in 2009, down 4.6 percentage points on 2008. The exceptional decline in aggregate demand and the trend of declining growth in labour costs helped to reduce core inflation indicators from their high levels of 2008. By the end of 2009, they were below the averages in the euro area. The most notable external factors were the base effects of the significant fluctuation of oil prices in 2008, which caused a temporary year-on-year fall in prices in the summer, as in the euro area overall.

Macroeconomic factors and core inflation indicators

The trend of increasing core inflation reversed after the second quarter of 2008 from the high levels recorded before the crisis as a result of the deterioration in the domestic macroeconomic environment. In early 2010 certain core inflation indicators were even showing a year-on-year fall in prices. Core inflation as measured by the HICP excluding energy and unprocessed food stood at 2.6% in the first half of the year, and at 1.2% in the second half of the year, and had fallen to zero by February 2010. The fall in this measurement of core inflation was slowed by growth in prices of processed food caused by rises in excise duties on alcohol and tobacco. The narrowest core inflation indicator, namely the HICP excluding energy, food, alcohol and tobacco, was negative in early 2010, as was the widest core inflation indicator, the HICP excluding energy. Since the first half of 2008, the narrowest core inflation indicator has fallen by a total of more than 4 percentage points, and the widest even by close to 6 percentage points.

Figure 6.1: Inflation

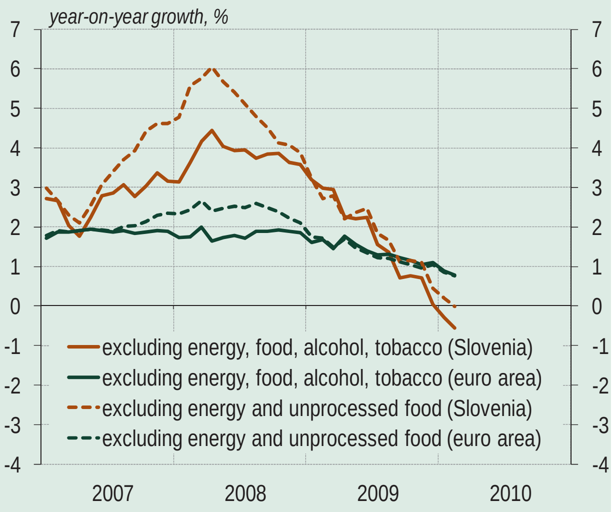


Sources: Eurostat, SORS, Bank of Slovenia calculations

After a period when all the core inflation indicators were above those of the euro area, they have all been lower since the second half of 2009, although core inflation has also fallen in the euro area overall. This is in line with the more pronounced inflation cycle in Slovenia, and the more pronounced reversal in the cycle and sharper recession. All the indicators were more than

2 percentage points higher than those of the euro area overall in 2008, and more than 0.4 percentage points higher in 2009. In February 2010 growth in the HICP excluding energy and unprocessed food was 0.8 percentage points lower than the corresponding figure for the euro area overall, the narrowest indicator was 1.4 percentage points lower and the widest indicator was 0.8 percentage points lower.

Figure 6.2: Core inflation



Sources: Eurostat, Bank of Slovenia calculations

The rapid fall in core inflation was the result of the large decline in aggregate demand and of the trend of declining growth in labour costs. Lower household consumption, particularly in the second half of 2009, has restricted providers of goods and services in raising prices. The decline in aggregate demand gave rise to a negative output gap, excess production capacity and downward pressure on prices. After the first half of last year, when growth in unit labour costs was temporarily extremely high because of the fall in GDP and productivity and the high wage growth in the public sector, unit labour costs began to rapidly adjust downwards. Quarterly labour costs dynamics had already begun to decline at the end of 2008. Growth in labour costs in the private sector as measured by growth in the average gross wage has fallen below 2.0% by the end of 2009, having exceeded 7.0% in the 2007 to 2008 period.

The increase in the nominal effective exchange rate and real effective exchange rate, and the medium-term trends on the money markets are acting to curb

Table 6.1: Breakdown of the HICP and price indicators

	weight	average annual growth, %					year-on-year growth in quarter, %				
	2009	2005	2006	2007	2008	2009	08Q4	09Q1	09Q2	09Q3	09Q4
HICP	*100.0%*	2.5	2.5	3.8	5.5	0.9	3.1	1.7	0.6	-0.2	1.4
Breakdown of HICP:											
Energy	*11.6%*	11.9	8.5	3.4	9.4	-4.5	-1.2	-6.6	-9.1	-8.1	7.0
Food	*22.1%*	0.2	2.7	7.1	8.1	1.8	4.1	3.0	2.2	1.3	0.9
processed	*15.0%*	0.6	2.5	6.3	9.9	2.7	5.5	2.4	2.8	3.0	2.7
unprocessed	*7.1%*	-0.8	3.1	8.7	4.6	0.0	1.5	4.2	0.9	-2.2	-2.9
Other goods	*31.2%*	-0.3	-0.9	0.3	2.2	0.0	2.5	1.9	0.8	-0.8	-1.6
Services	*35.1%*	3.3	3.5	4.9	5.3	3.2	4.7	4.1	3.5	3.0	2.4
Core inflation indicators											
HICP excluding energy	*88.4%*	1.2	1.7	3.8	4.9	1.7	3.8	3.0	2.2	1.2	0.6
HICP excluding energy and unprocessed food	*81.3%*	1.3	1.5	3.4	5.0	1.9	4.0	2.9	2.3	1.5	0.9
HICP excluding energy, food, alcohol and tobacco	*66.3%*	1.5	1.3	2.7	3.8	1.7	3.7	3.0	2.2	1.2	0.5
Other price indicators:											
Industrial producer prices on domestic market		2.8	2.4	5.5	5.6	-0.4	4.2	1.5	-0.4	-1.5	-1.1
GDP deflator		1.6	2.1	4.2	3.8	1.9	3.5	3.9	2.5	0.7	0.8
Import prices[1]		5.0	3.3	1.8	3.6	-7.1	2.2	-4.3	-7.7	-8.0	-8.3

Note: [1] National accounts figures.
Sources: SORS, Eurostat, Bank of Slovenia calculations

price growth. The euro's rise of 8.3% last year reduced the pass-through of growth in US dollar prices of oil and other primary commodities into corporate costs in the euro area. The recent rise in the domestic currency has also brought an additional downward adjustment in inflation. The adverse economic situation and the financing conditions led to exceptionally low growth in corporate and household lending, which remains a limiting factor in the medium-term dynamic in core inflation.

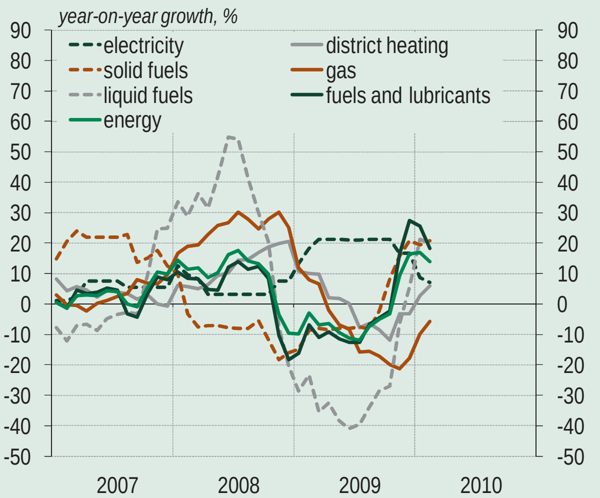
Microeconomic factors and the structure of inflation

Energy prices fell by 4.5% last year, primarily as a result of the oil price developments on global markets. The negative contribution made to inflation was the result of prices of fuels and lubricants and prices of liquid fuels, while the contribution made by electricity prices was positive. The latter rose as a result of a government measure to raise the price of the network charge and the introduction of two new charges related to electricity at the beginning of 2009. Higher growth in electricity prices and a rise in excise duties on motor fuels were the two main factors in Slovenia recording a smaller fall in energy prices than the euro area overall, where it stood at 8.1%.

Figure 6.3: Energy prices

Sources: Eurostat, Bank of Slovenia calculations

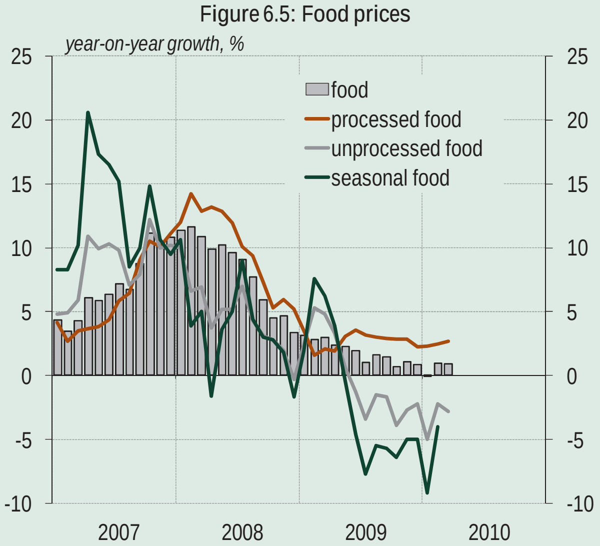
Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia

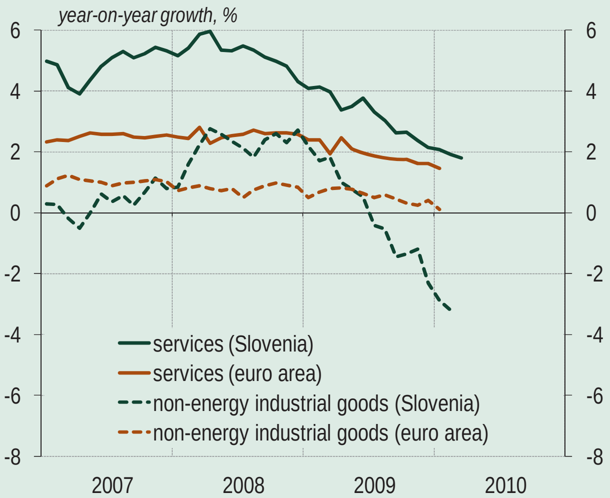
The first ten months of 2009 all recorded a year-on-year fall in energy prices alongside a monthly rise. The year-on-year growth recorded in the final two months of 2009 made a significant contribution to the rise in year-on-year inflation. The year-on-year fall in energy prices was largest in July 2009, at 11.9%, but growth had reached 16.5% by the end of the year. This was primarily the result of changes in prices of Bent crude, which averaged a year-on-year fall of 37%, but recorded year-on-year growth of around 80% in December.

Figure 6.5: Food prices



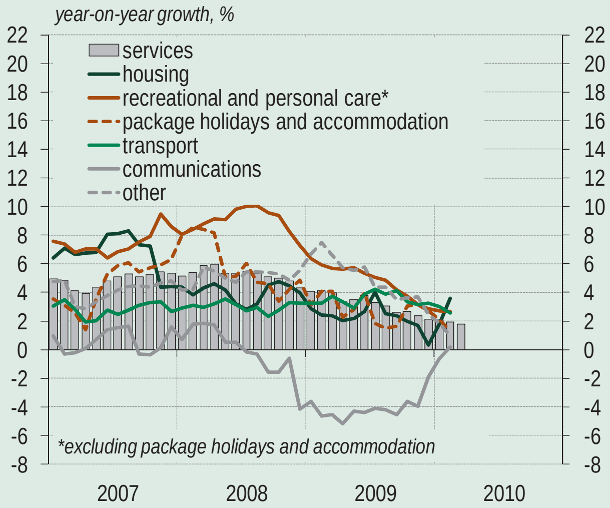
Sources: Eurostat, Bank of Slovenia calculations

Figure 6.6: Services prices and prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations

Figure 6.7: Services prices

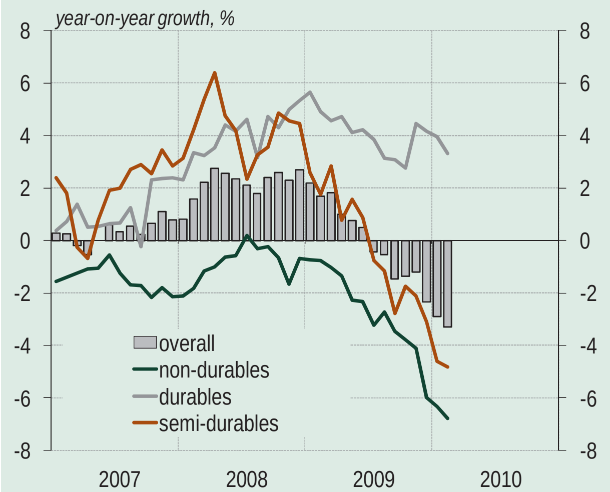


Source: Eurostat

The slowdown in growth in food prices at the end of 2008 continued last year, partly as a result of the fall in food prices and commodity prices on global markets, and partly as a result of the decline in domestic demand. Growth in food prices stood at 1.8% last year, down 6.3 percentage points on 2008, but 1.1 percentage points higher than in the euro area overall. The main factor in growth in food prices was prices of processed food, prices of unprocessed food having remained unchanged overall during 2009. Prices of unprocessed food were still rising during the first five months of 2009, but the fall that followed deepened further in early 2010. The main factor in the year-on-year dynamic in prices of unprocessed food was the base effect of high growth in 2008.[15] The rise in excise duties on alcohol and tobacco in the first half of 2009 acted to curb the decline in growth in prices of processed food, despite low domestic demand.

Growth in services prices continued to slow in 2009, the slowdown becoming prominent towards the end of 2009 and in the early part of this year, when growth in services prices fell below 2.0% for the first time since August 2005. Growth in services prices stood at 3.2% last year, down 2.1 percentage points on the previous year. The main factors in the lower growth in services prices were the sharp decline in growth in prices of hotel and restaurant services, package holidays and passenger air transport, and the fall in prices of telephone products and services. The adoption of a European Commission proposal to reduce hosting prices on mobile networks inside the EU was a factor in the fall in the latter. Prices of passenger railway transport rose on the basis of the plan for managing regulated prices. Healthcare prices also rose, but prices of hospital services were unchanged

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations

[15] Prices of food commodities on the global market fell by 13% in 2009, having risen by 35.5% in 2008.

from 2008. Within the municipal services segment, prices of refuse disposal rose in early 2010. Growth in services prices also declined last year in the euro area overall, but significantly less than in Slovenia, by 0.6 percentage points to 2.0%.

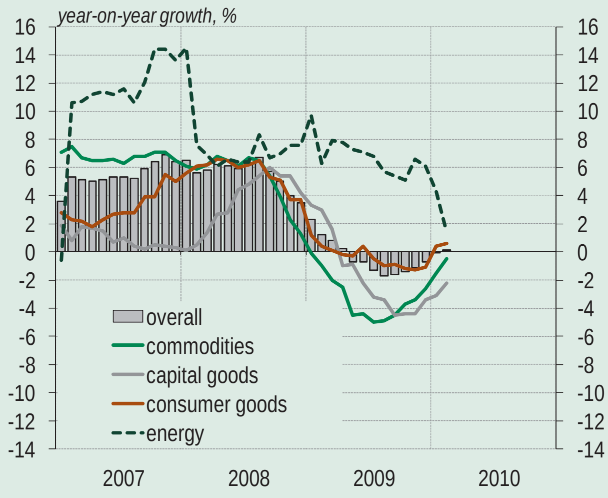
Year-on-year growth in non-energy industrial goods was still above 2% at the beginning of 2009, but had declined to around -3% by the first quarter of 2010. Prices of non-energy industrial goods were unchanged overall in Slovenia in 2009, but rose by 0.6% in the euro area overall. The largest contribution to the decline in growth in prices of non-energy industrial goods in 2009 came from prices of clothing and footwear, and car prices. The latter have been falling since the end of 2004, the fall averaging 5.7% last year. Prices of clothing fell by 1.2% last year, while prices of footwear fell by 0.2%. The fall in prices seen in the second half of 2009 continued in early 2010, when retailers made further cuts in prices of clothing and footwear in seasonal sales. Prices of water supply rose in November 2009 and February 2010 as a result of upgrades and the introduction of new services in line with the stricter supply standards and environmental standards.

According to a report from the plan for managing regulated prices issued by the government in December 2009, administered prices rose by 7.2% over the first ten months of 2009. The main contribution to the rise came from growth in retail prices of liquid fuels for transport and heating, which rose by 17.9% over this period. Prices of domestic passenger railway transport rose by 3.9%, while prices of textbooks rose by around 2.6%. Retail electricity prices for household consumers rose by 16.1%, while the RTV fee rose by 9.1% and road tolls rose by 8.7%.

Producer prices

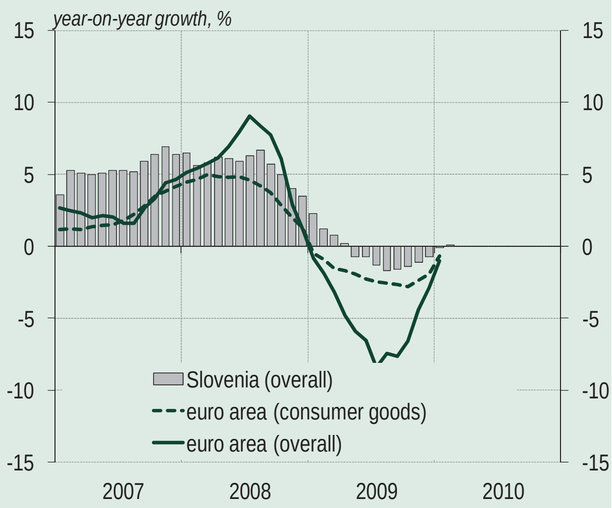
Industrial producer prices fell by 0.4% last year on the domestic market, and by 5.0% in the euro area overall. The year-on-year fall has diminished in the early part of this year, primarily as a result of rises in commodity prices and prices of consumer non-durables. The main factor in last year's fall in industrial producer prices on the domestic market was the development in commodity prices.[16] Prices of capital goods and

Figure 6.9: Breakdown of industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations

Figure 6.10: Industrial producer prices on the domestic market



Sources: Eurostat, Bank of Slovenia calculations

[16] Primary commodity prices on the global market fell by 15.8% in 2009, having risen by 13.1% in 2008.

consumer non-durables also fell. Energy prices rose by 6.8%. In the euro area energy prices fell as a result of base effects in producer prices of refined petroleum products. The year-on-year change in Slovenia became positive in February 2010, primarily as a result of higher monthly dynamics in producer prices of commodities, beverages, and pharmaceutical raw materials and preparations.

7 Projections of Economic Trends and Inflation 2010–2012[17]

After the large decline in activity in 2009, the recovery of economic growth will be very gradual. GDP growth will stand at 1.3% in 2010, but should rise to around 2.9% towards the end of the projection horizon. Given the adverse trends on the labour market and the onset of fiscal consolidation, the contribution of domestic consumption to economic growth will remain relatively small until 2012. Growth in foreign demand is expected to be stronger than forecast in the autumn. Export growth will therefore be the strongest growth factor in the next two years. Despite export growth outpacing import growth, a deterioration in the terms of trade means that the current account deficit will widen slightly after 2011, but will remain moderate. Energy prices are expected to be the main factor in this year's inflation of 1.6%, core inflation remaining very low. Inflation is forecast to be similar in 2011, and to rise to 2.0% in 2012.

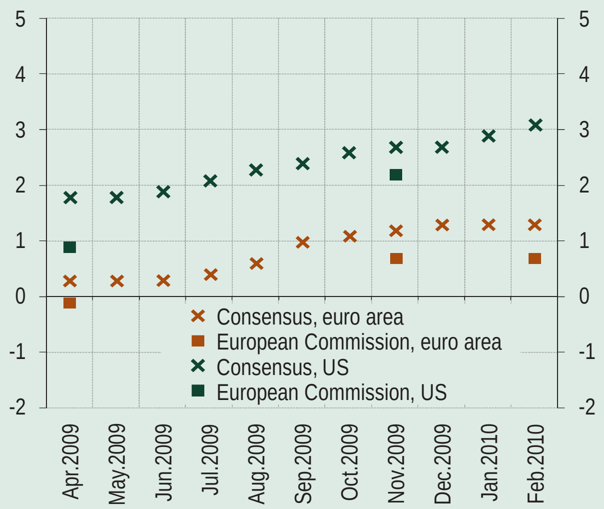
The risks in the projections are balanced in relation to both GDP growth and inflation, but are significant and manifold. The risks relating to growth primarily originate in the domestic environment. At the sectoral level, there could be a continuation of the sharp decline in construction activity. Problems could occur with bank lending activity. In the medium term, inadequate fiscal consolidation could hinder the financing of the public sector. By contrast, the high quarterly dynamics in exports and investment in particular indicate the possibility of a more rapid recovery. The risk in the inflation projection is that inflation will be higher, in connection with oil prices. A stronger impact on core inflation from macroeconomic factors could result in lower inflation.

International environment and external assumptions

The improvement in the projections of economic growth in the most important trading partners is an indication that growth in foreign demand is likely to be higher than assumed in the autumn projections. After the end of the stimulus measures and the partial restocking of inventories, demand from global growth is expected to slow slightly. The recovery of global economic activity in 2010 is expected to be rather uneven, with the major contribution from emerging Asian econo-

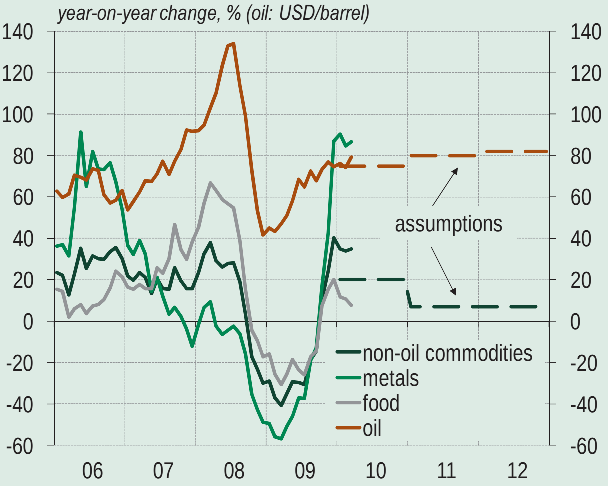
[17] The projections were made on the basis of available data and the statistical methodology applicable on 4 March 2010. The projections of macroeconomic factors presented in this Price Stability Report are based on assumptions for movements in variables from the international environment and in certain domestic factors dependent on economic policy decisions. Assumptions regarding the movement of variables from the international environment are summarised from Consensus Forecasts and Eastern Europe Consensus Forecasts (February 2010), JP Morgan (Global Data Watch, 20 February 2010), the OECD Outlook (November 2009) and IMF WEO Update (January 2010). 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 assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex in the April 2008 Price Stability Report.

Figure 7.1: Changes in economic growth forecasts for 2010



Sources: Consensus, European Commission

Figure 7.2: Primary commodity prices on global markets



Sources: The Economist, Bloomberg, Bank of Slovenia projections

mies. Despite the anticipated temporary slowdown, the assumed growth in foreign demand for this year is up 3.2 percentage points at 3.1%. The increase is based on the improvement in the economic growth forecasts for 2010 for the majority of the most important trading partners in the second half of last year. Consensus's February forecast for GDP growth in Germany in 2010 is 1.7%, up 1 percentage point on last August. The only country among the major trading partners with a downward revision in GDP growth is Croatia, whose GDP growth forecast for 2010 was down 0.2 percentage points at -0.3%. Growth in foreign demand is forecast to be slightly higher in 2011 and 2012, but still below the long-term average.

The markets expect oil prices to gradually rise, but not to reach the high levels from before the economic crisis. Growth in other commodity prices is expected to be high this year, but will slow over the next two years. In the early part of this year relatively high stocks and low demand in developed economies held the oil price below USD 75 per barrel, but in the remainder of the projection horizon it is expected to rise slightly, given the current price trends on futures markets. The assumed price rise is thus in line with the expectations of a gradual recovery of the global economy, particularly in certain fast -growing and energy-intensive Asian countries. In 2010 the low basis from the first half of 2009 is expected to

Table 7.1: Assumptions regarding factors from the international environment

						Assumptions					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
	annual growth, %, unless stated										
Foreign demand*	4.4	8.6	7.3	2.2	-12.9	3.1	3.2	5.1	1.5	5.1	...
Oil (USD/barrel)	54	65	73	98	62	75	-4	80	-2	82	...
Non-oil commodities	11.6	29.0	17.1	9.7	-15.9	20.0	3.7	7.0	11.8	7.0	...
EMU inflation	2.2	2.2	2.1	3.3	0.3	1.2	0.0	1.5	-0.5	1.9	...
PPI Germany	4.4	5.4	1.3	5.4	-4.0	0.2	-0.7	1.8	-0.6	2.0	...

** Quantitative imports from basket of foreign partners*
Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook

have an impact on growth in prices of other primary commodities, which is forecast to rise to 20%. In 2011 and 2012 growth in commodity prices is expected to slow to a level below the long-term average, which is in line with the expectations that global economic growth will not have reached its potential.

The forecasts by international institutions are predicting slightly higher inflation in the euro area and in the US in 2010, primarily as a result of commodity price developments, which will also contribute to growth in producer prices. However, there is no expectation of major changes in price pressures on inflation, given the still-low growth in demand and the extensive spare production capacity. Growth in labour costs is also expected to remain weak, as a result of the adverse situation on the labour market. Consensus's forecast for growth in labour costs in the euro area between 2010 and 2012 is 1.8%, the annual rate having averaged 2.8% over the eight years before the crisis. Consensus is forecasting average growth in labour costs of 1.9% for the US over the same period, compared with an average of 3.4% over the eight years before the crisis. Producer prices in Germany will rise again in 2010 as a result of commodity price increases, the rate approaching the long-term average in the period to 2012 as the economy recovers.

Domestic demand

Household consumption will only begin to increase moderately in the next year, in line with the low growth in disposable income and lower employment. The anticipated continuation of the higher risk of loss of employment and low growth in earnings from employment will act to curb household consumption. Total wages are expected to decline in 2010 in real terms, and consequently so is household consumption. Growth in household consumption is not expected to rise slightly until 2011, when employment is expected to rise again. Such a projection of household consumption is also in line with the relatively pessimistic consumer sentiment in early 2010. Some stimulus for household consumption over the projection horizon could be provided by the rise in the minimum wage, as it would affect people with relatively high propensity to consume. However the rise in the minimum wage could also cause a rise in unemployment among the low-paid.

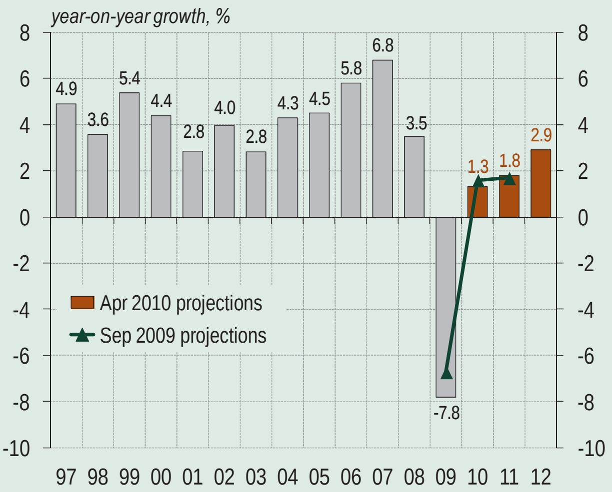
Growth in investment could be lower than 3% in the next two years, depending on the sustainability of the economic recovery and limiting factors, in particular low profits in 2009, low utilisation of production capacity and problems in the construction sector. The relatively high growth in investment at the end of 2009 is expected to have slowed temporarily in the early part of this year, partly as a result of the bad weather. The movements in different categories of investment will vary greatly, particularly in 2010. Having shown signs of rapid growth in the second half of last year, investment in machinery and equipment could record slightly slower growth this year. The slowdown in investment in machinery and equipment is in line with the low level of capacity utilisation and low profits in the past year. The renewal of inventories can gradually be expected, these having declined sharply last year, accounting for a significant portion of the decline in gross investment. Conversely, the uncertain situation on the real estate market indicates the likely continuation of the decline in housebuilding. Non-residential construction is expected to be limited by government saving measures. In line with these measures, government investment over the 2010 to 2012 period is expected to decline by slightly less than 2%. Higher growth in investment can only be expected in 2012, when GDP growth is also expected to increase.

Overall growth in government spending is expected to be lower than 1% over the next three years, in line with the requisite fiscal consolidation. The decline in government spending at the end of last year has already indicated how government spending will develop. January's update to the Stability Programme also envisages an increase in savings in the future. As far as government spending is concerned, the action will involve wage-related measures, job cuts in the government sector and savings in material costs, as stated in Box 5.2.

GDP growth and developments on the labour market

The increase in economic activity will be very gradual. The projection for GDP growth is down slightly on September 2009 at 1.3% in 2010 and 1.8% in 2011,

Figure 7.3: GDP growth projections



Sources: SORS, Bank of Slovenia forecasts

before a rise to around 3% in 2012. The main factor in the slight downward revision since September, of 0.3 percentage points for 2010, was low growth at the end of last year. Given that last year's growth has failed to be carried over to this year, the trend of increase in activity until the end of the projection horizon will be slow. In the first half of the year there is even likely to be a temporary decline in the current rate of growth, as a result of slower growth in investment and foreign demand. GDP growth in Slovenia is expected to outpace projected GDP growth in the euro area by less than 1 percentage point. The projected GDP growth over the projection horizon will not compensate for the sharp decline in activity in late 2008 and early 2009. It is even possible that the level of GDP at the end of 2012 could be lower than before the outbreak of the crisis.

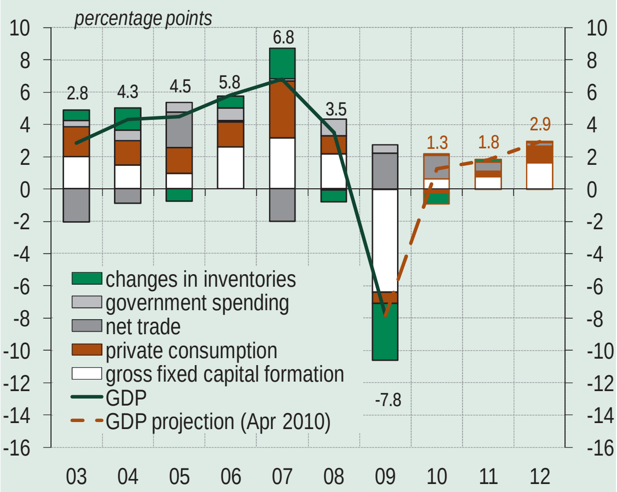
Economic growth will initially be based primarily on foreign demand, followed by a gradual increase in the contribution made by domestic consumption. Together with inventories, the projected decline in domestic demand will again make a negative contribution to GDP growth this year. The contribution will then become positive, and rising. Exports too are projected to see a temporary decline in the current high growth, then more stable

Table 7.2: Activity, employment and wages

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
	real growth, %										
GDP	4.5	5.8	6.8	3.5	-7.8	1.3	-0.3	1.8	0.1	2.9	...
Employment	-0.1	1.5	2.9	2.9	-2.2	-2.3	0.3	-0.1	0.3	0.3	...
Compensation per employee	6.0	5.4	6.6	7.2	2.6	1.7	0.7	2.7	-0.9	3.4	...
Productivity	4.5	4.3	3.7	0.7	-5.7	3.7	-0.6	1.9	-0.2	2.6	...
ULC (nominal)	1.5	1.0	2.8	6.5	8.9	-1.9	1.3	0.8	-0.7	0.8	...
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding change in inventories	3.2	4.9	6.8	4.3	-6.6	0.5	-1.4	1.1	-0.6	2.7	...
Net exports	2.2	0.1	-2.0	-0.1	2.2	1.4	2.2	0.6	0.7	0.2	...
Inventories	-0.8	0.8	1.9	-0.7	-3.5	-0.7	-1.2	0.2	0.1	0.0	...

Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: SORS, Bank of Slovenia

Figure 7.4: Contributions of spending components to GDP growth



Sources: SORS, Bank of Slovenia forecasts

growth in line with growth in foreign demand. Moderate domestic consumption means that export growth will outpace import growth. The contribution made to economic growth by net trade will therefore remain positive, but will gradually decline when growth in domestic consumption recovers.

Having fallen in 2009 in almost all sectors, value-added developments in 2010 will show great variation in different sectors. Value-added is primarily expected to increase in export-oriented manufacturing. In the short term a large improvement can also be expected in service sectors more dependent on the foreign economic developments, such as transportation. By contrast, after a sharp decline last year, activity in the construction sector could continue to decline, and value-added could fall by 5% to 10%. One factor in this is the effect of the negative current dynamic in the sector from the end of last year being carried over to 2010.

Employment will fall again in 2010, as a result of the usual lag in the adjustment to the economic activity cycle. The surveyed unemployment rate could exceed 8%, peaking in 2011. September's forecasts of a large fall in employment in manufacturing are being materialised. The further fall is expected in 2010, as a result of bankruptcies and labour cost rationalisation. The largest fall in employment is likely to be in construction, primarily through lay-offs of foreign workers. Employment is projected to fall by 2.3% in 2010, in the context of these movements and weak activity in certain service sectors, which is expected to be followed by very gradual growth in employment. The surveyed unemployment rate is expected to exceed 7.5% this year. It will peak in early 2011, and will only record a small fall in 2012.

The pace of economic recovery and the rise in the minimum wage will be major factors in the movement of wages. The government saving measures will curb wage growth in the public sector. Growth in the average wage is forecast at 1.7% in 2010, 2.7% in 2011 and 3.4% in 2012. This projection takes account of the effects of the law adopted in March that envisages a raise in the minimum wage to EUR 562 per month. This will primarily affect wage growth in the private sector, where the pro-

Table 7.3: Components of domestic demand

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
	real growth, %										
Domestic demand	2.4	5.7	8.7	3.5	-9.9	-0.2	-2.6	1.3	-0.5	2.7	...
Private consumption	2.8	2.9	6.7	2.1	-1.4	-0.4	0.0	0.7	-1.5	1.9	...
Government spending	3.4	4.0	0.7	6.2	3.1	0.5	-0.4	0.0	-0.6	0.3	...
Gross fixed capital formation	3.7	9.9	11.7	7.7	-21.6	2.6	-5.8	2.9	1.1	6.4	...

Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: SORS, Bank of Slovenia

portion of minimum-wage employees is higher. The law allows employers to gradually raise the minimum wage. Growth in average wages will also be faster because of changes in the workforce structure as it is primarily low-paid workers who are being laid off. Wages are expected to be adjusted in line with inflation and productivity growth. Wages in the private sector are forecast to rise by around 1.5% in 2010, and by more than 3% in 2012. Wages in the public sector are adjusted for inflation in line with the collective agreement. Given the economic situation, the government and the public sector unions have agreed to defer the final introduction of the new wage system, which would significantly raise wages in the public sector. The third phase has been postponed until October 2010, and the fourth to October 2011. However, in line with the Stability Programme and the government's exit strategy, in 2010 and 2011 there will be additional wage-related saving measures, and the agreed waiver of performance bonuses will be enforced. According to these assumptions, growth in the average wage in the public sector will stand at 1.9% in 2010, while afterwards it will be similar to that in the private sector.

Foreign trade

The current account deficit is expected to narrow slightly this year, and is then expected to gradually widen, primarily as a result of less favourable terms of trade. In 2012 it may exceed 2% of GDP. The higher growth in volume terms in exports of merchandise and services than in imports will make a positive contribution to the current account position. The unfavourable terms of trade will therefore account for almost all of the increase in the deficit. The terms of trade are expected to deteriorate by more than 4% overall in the period to 2012, as a result of higher commodity prices, the largest deterioration being recorded this year as a result of base effects from 2009. The deficit in factor income will increase as a result of the gradual rise in interest rates expected by the financial markets. The balance of receipts and expenditure related to the EU budget is expected to record a small net surplus, while other official transfers are expected to record a small net deficit.

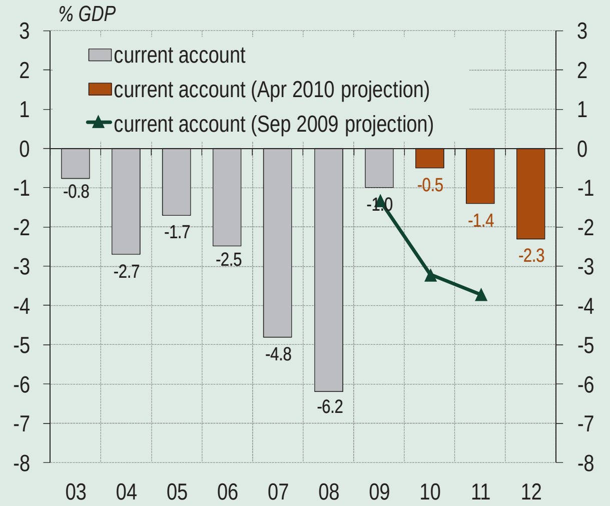
Foreign trade will gradually increase. The merchandise trade deficit is expected to double by 2012, while the surplus of trade in services is expected to increase. The merchandise trade deficit is forecast to increase from 1.8% of GDP in 2009 to around 3% in 2012. The unfavourable terms of trade will contribute the majority of the increase in the merchandise trade deficit, in the context of a positive contribution by volumes. The balance of trade in services is forecast to remain in surplus over the projection horizon, rising from 2.9% of GDP in 2009 to just under 4% of GDP in 2012. After falling in

Table 7.4: Current account

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
Exports of merchandise and services	10.6	12.5	13.7	2.9	-15.6	5.1	3.1	6.0	2.0	6.7	…
Imports of merchandise and services	6.6	12.2	16.3	2.9	-17.9	3.0	-0.3	5.3	1.2	6.5	…
Current account: EUR billion	-0.5	-0.8	-1.6	-2.3	-0.3	-0.2	1.0	-0.5	0.9	-0.9	…
as % GDP	-1.7	-2.5	-4.8	-6.2	-1.0	-0.5	2.7	-1.4	2.5	-2.3	…
Terms of trade*	-2.0	-0.5	0.6	-1.9	4.3	-2.6	-0.7	-1.0	-0.6	-0.8	…

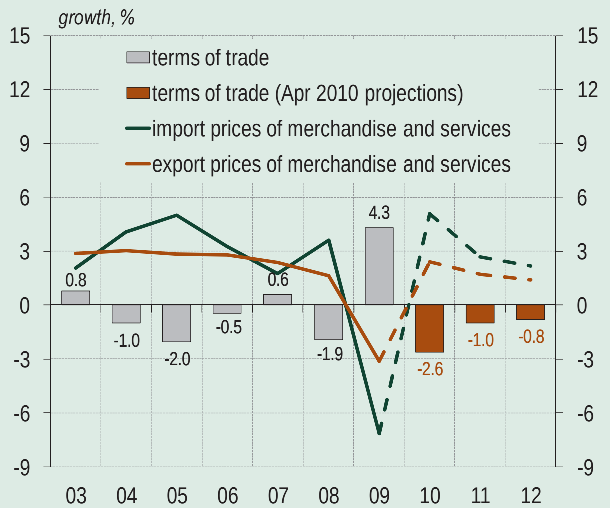
** Based on national accounts deflators*
Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: SORS, Bank of Slovenia

Figure 7.5: Current account



Sources: SORS national accounts, Bank of Slovenia calculations

Figure 7.6: Terms of trade



Sources: SORS national accounts, Bank of Slovenia calculations

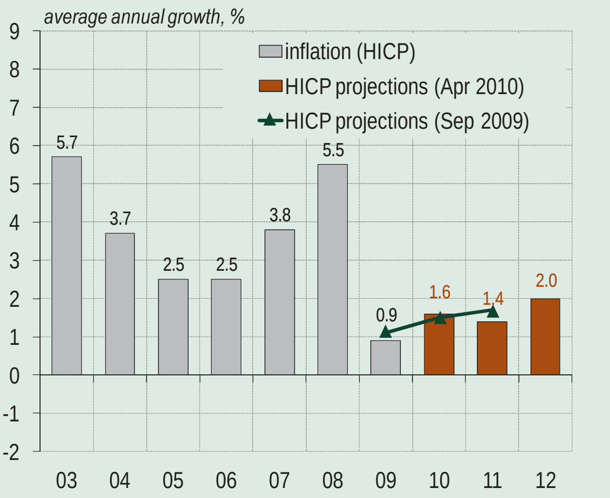
2009, trade in services is expected to grow in the next years, and is expected to again outpace growth in merchandise trade from 2011. The gradual growth in economic activity and the increase in foreign demand are expected to result in an increase in trade in services related to merchandise trade, primarily transport services as well as business and technical services. As a result of the problems in the construction sector, revenues and expenditure from investment work are expected to decline in the coming years, while the gradual recovery of activity in Slovenia's most important trading partners is expected to lead to an increase in tourism revenues.

The deficit in factor income is expected to decline in 2010 to around 1.5% of GDP, and then to double by the end of the projection horizon, primarily as a result of the increase in the deficit in capital income. Relatively low interest rates are also expected to reduce the net outflows of factor income in 2010. The main factors in the decline in the deficit in capital income in 2010 are expected to be the decline in interest payments and the decline in expenditure on dividends and distributed earnings, while reinvested earnings are expected to remain at around EUR 200 million. With the gradual re-establishment of employment growth and the simultaneous anticipated rise in interest rates, net outflows of factor income are expected to rise again in the next years. Another factor in the increase in the deficit in factor income is the decline in net income from investments invested in foreign debt securities. At the end of 2008 the stock of these investments was more than twice in excess of the stock of inward investments in domestic debt securities. This ratio had declined to 1.24 by the end of 2009, as a result of government and bank borrowing via bond issues on foreign markets. Given the continuation of government borrowing in the coming years, this ratio is expected to decline slightly further. As a result of the fall in employment of foreign workers, net inflows of labour income this year and next year are expected to stand at around 0.2% of GDP.

Inflation

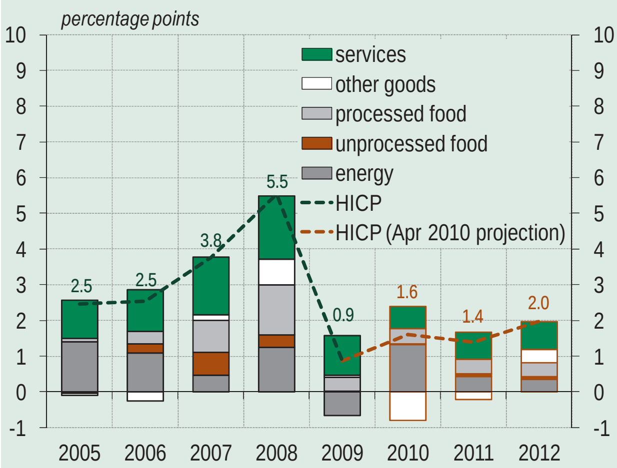
Inflation is expected to stand at 1.6% in 2010, but after a small temporary fall 2011, it is expected to rise again to around 2% until 2012. Core inflation is forecast to be exceptionally low this year. The inflation projections for 2010 are slightly higher than the September projections, primarily as a result of the effect of energy prices, but are lower for 2011 as a result of the consequent base effect. Low domestic demand and the

Figure 7.7: Inflation projections



Sources: SORS, Bank of Slovenia forecasts

Figure 7.8: Contributions of components to inflation



Note: The sums of the components may differ from the aggregate values due to rounding
Sources: SORS, Bank of Slovenia projections

situation on the labour market, which are preventing cost pressure on inflation, will be factors in the very low core inflation. Growth in the HICP excluding energy, food alcohol and tobacco is expected to be negative in the first half of the year, and is forecast at -0.4% for 2010. Core inflation measured in this way is forecast to rise to 0.8% in 2011 and 1.7% in 2012. Other indicators of core inflation are also expected to move similarly.

According to the price index breakdown, the high contribution made by energy prices will stand out in the short term, while prices of non-energy goods could fall by more than forecast in the previous projection. In line with the rise in oil prices and the assumed rise of around 3.5% in electricity prices, growth in energy prices is forecast at 10.8% this year, but is expected to decline to just over 2% in the next two years. Growth in food prices is forecast at 2.0% this year, and is expected to rise to 2.2% in 2011, remaining at that level in 2012. Growth in food prices is expected to be slightly higher

Table 7.5: Inflation

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Apr	Δ	Apr	Δ	Apr	Δ
					average annual growth, %						
Consumer prices (HICP)	2.5	2.5	3.8	5.5	0.9	1.6	0.1	1.4	-0.3	2.0	...
food	0.2	2.7	7.1	8.1	1.8	2.0	0.1	2.2	0.2	2.2	...
energy	11.9	8.5	3.4	9.4	-4.5	10.8	7.2	3.0	2.0	2.5	...
other goods	-0.3	-0.9	0.3	2.2	0.0	-2.8	-1.9	-0.9	-1.2	0.9	...
services	3.3	3.5	4.9	5.3	3.2	1.8	-0.5	2.1	-0.5	2.3	...
Core inflation indicators (HICP)											
excluding energy prices	1.2	1.7	3.8	4.9	1.7	0.2	-0.9	1.2	-0.5	1.8	...
excluding energy and unprocessed food prices	1.3	1.5	3.4	5.0	1.9	0.2	-1.2	1.1	-0.7	1.9	...
excluding energy, food, alcohol and tobacco prices	1.5	1.3	2.7	3.8	1.7	-0.4	-1.3	0.8	-0.8	1.7	...

Δ: Difference between current projections and projections in September 2009 Price Stability Report
Sources: SORS, Bank of Slovenia

relative to the previous projections, as a result of higher prices of unprocessed food. The main factor in this is the assumed growth in food prices on the global market, which is higher than in the previous projections. In line with core inflation factors, services prices are forecast to average annual growth of around 2% over the projection horizon, while prices of non-energy industrial goods are forecast to fall by around 0.9% each year.

The plan for managing administered prices for 2010 and 2011, which was adopted by the government in December 2009, reveals the small contribution made to inflation by these prices. Administered prices are expected to contribute 0.34 percentage points towards inflation this year, of which the rise in excise duties on tobacco will account for 0.25 percentage points. The contribution is expected to be slightly lower in 2011. Growth in other administered prices in both years is expected to move in line with growth in non-administered prices, as envisaged in the plan for managing regulated prices for 2010 and 2011. The weight of administered prices in the overall HICP is relatively small, at just under 6%, but the possibility of these prices having demonstration effects on the formation of non-administered prices and inflationary expectations should be taken into account.

Risks and uncertainties

In the short term, problems in the construction sector are at the forefront of the domestic economic environment, and their continuation in 2010 entails a risk to investment, GDP growth and employment. The large decline in demand for real estate has not yet been reflected in a fall in real estate prices. The reduced demand is to a great extent the result of a decline in the expected income, and thus the purchasing power, of the private sector. Excessive prices mean that potential buyers are waiting for them to fall, which is further reducing volume of transactions. However, inadequate sales are putting certain construction companies into liquidity difficulties. Increasing defaults or arrears could cause construction companies to fail, reducing employment in the sector. The simulation in Box 7.1 indicates that a continuation this year of the decline in construction activity at the same pace as in 2009 would reduce economic growth to merely around 0.5%, employment falling by an additional 15,000.

On the labour market, a sustained rise in unemployment represents an increasing risk. An economic recovery without a rise in employment would cause a significant loss to the economy's potential output. Structural unemployment could be raised by the discrep-

Table 7.6: Direct impact on inflation of government measures in 2010 and 2011

Measure	Change	Impact on HICP in 2010, percentage points	Impact on HICP in 2011, percentage points
– Changes in prices of selected textbooks	average price increase of 2.3%	-	0.009
– Changes in prices of railway tickets	average price increase of 6.0%	0.012	0.012
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000	0.000
– Change in contribution for renewable energy resources and reliable supply of domestic resources	increase in final electricity price of 3.5%	0.080	-
– Change in excise duties on tobacco	average increase in prices of tobacco products of 7%	0.250	0.250
Total impact on inflation		0.342	0.271

Source: Plan for managing regulated prices in 2010 and 2011 ancy between a workforce trained for a specific sector and the need for a change, probably at least in part, in the structure of the economy. Because the crisis has hit different sectors in divergent ways, the proportions of value-added accounted for by different sectors may be changing permanently. At the same time lay-offs could rise after the government measures to limit lay-offs in the crisis situation cease to be in effect. The key to the employment dynamic will be corporate competitiveness, particularly in relation to growth in labour costs relative to productivity growth. The crisis situation requires considerable adjustments in this area. These adjustments have to a great extent already been built into the baseline projection of economic trends. Should growth in labour costs be higher, the chances of a fall in unemployment would diminish. Here it should be noted that the baseline projection does not envisage the (immediate) rise in the minimum wage leading to a rise in the wages of other employees (Box 2.2). A sustained rise in unemployment could also further depress household consumption, and thereby the contribution made to economic growth by domestic demand. Sustained unemployment could also lead to a sharp deterioration in human capital, thereby permanently reducing the potential output of the economy.

A further decline in bank borrowings and stricter credit standards could cause additional problems in financing. Growth in loans would be reduced by the supply side. Demand for loans is dependent on the demand determined by economic activity or investment, and growth in loans can therefore be expected to remain low in the future. Given the relatively high level of household and corporate indebtedness, the reduction of borrowing in both sectors could lead to lower private sector consumption. However, loans could be further reduced because of the supply side. There, the risks are primarily related to the banking system's ability to obtain funding and to secure adequate capital for loans. The difficulties here are being caused by the decline in bank indebtedness, and stricter credit standards. In the current uncertain situation the banks are becoming more prudent, are demanding larger collateral for new loans and are stricter in evaluating the quality of clients when approving loans. Surveys show that credit standards in the euro area could tighten in the early part of this year, in contrast to the trends in the last year.[18] In this situation on the financial markets, it is SMEs in particular that could have problems with financing, as they lack the access to other financial resources. The issue of government guarantees, and future borrowing by the government, the funds then being deposited with commercial banks, could therefore be beneficial measures to improve corporate liquidity.

The insufficient or non-credible consolidation of public finances could raise the cost of government borrowing, and in the longer term could commit financial resources to the public sector that could be used by the private sector. The most likely cause of a rise in the premiums on government bonds, entailing costlier government borrowing, would be the lack of credibility in a fiscal consolidation that does not adequately reduce the general government deficit. As a result of the rise in public debt, the general government position will become increasingly sensitive to changes in financing costs (Box 5.1). At the same time Slovenia is one of 13 EU Member States with a large risk of a long-term rise in expenditure on pensions and health related to an aging population. The timely restructuring of the social security system is therefore the key to maintaining confidence in the long-term sustainability of public finances.

The renewal of inventories, a fall in uncertainty, and investment in infrastructure could all lead to faster growth, particularly via accelerated investment. Faster renewal of inventories could give impetus to economic activity even in the short term. The renewal of inventories has contributed strongly to the recovery of growth in the majority of the euro area countries. A faster improvement in confidence indicators could also have an

[18] Bank Lending Survey, January 2010.

Box 7.1: Model simulation of certain risks

Continued high growth in exports and investment: The seasonally adjusted SORS figures show high quarterly dynamics in exports and investment in the second half of 2009. Tables 1 and 2 illustrate the macroeconomic effects that would occur were the high dynamics of growth in exports and investment not to decline as sharply in 2010 as in the baseline projection, growth instead gradually reaching the rate forecast for the first quarter of 2011. Investment would also respond to higher export growth, employment would rise, and the current account deficit would narrow. Inflation would be slightly higher, by an average of around 0.2 percentage points above the baseline scenario over the projection horizon. Given the smaller proportion of GDP accounted for by investment, the impact of growth in investment on GDP growth would be smaller than the impact of growth in exports. In contrast to the simulation of higher export growth, the current account deficit would widen as a result of increased domestic demand. The model estimates show that were the growth dynamics in exports and investment to remain at the level seen in the second half of 2009, GDP growth would stand at between 2% and 3% in 2010, and more than 3% in 2011.

Continued rapid decline in construction activity: The simulation assumes that value-added in construction declines by 5% in each quarter of 2010. This entails a continuation of the negative dynamics seen in 2009, and a decline in value-added in construction of 15% to 20% in 2010, instead of the decline of just over 5% in the baseline projection. Because construction is a sector of above-average labour intensity, in the simulation employment contracts additionally in proportion to the decline in activity. GDP growth in the first year of the shock stands at just 0.5% approximately. A large portion of the decline in investment, and thus in domestic demand, would be reflected in smaller imports, and the current account deficit would therefore narrow. The fall in employment would deepen further in 2010 to 3%, employment thus falling by an extra 15,000.

Table 1: Sustained current export growth

	2010	2011	2012
deviation in growth; for current account, deviation in ratio to GDP; p.p.			
GDP	0.8	1.2	0.4
Employment	0.2	0.4	0.3
Current account	0.5	1.0	0.9

Source: Bank of Slovenia

Table 2: Sustained current investment growth

	2010	2011	2012
deviation in growth; for current account, deviation in ratio to GDP; p.p.			
GDP	0.3	0.5	0.2
Employment	0.1	0.2	0.1
Current account	-0.5	-1.0	-1.1

Source: Bank of Slovenia

Table 3: Continuation of contraction in construction

	2010	2011	2012
deviation in growth; for current account, deviation in ratio to GDP; p.p.			
GDP	-0.8	-0.1	0.1
Employment	-1.0	-0.6	0.0
Current account	1.4	0.6	0.8

Source: Bank of Slovenia

impact on household consumption, and even more on investment. The volume of investment could also be increased by additional investment in infrastructure. In the energy sector the main examples of such projects are the construction of Block 6 at Šoštanj power station (construction is projected to start in 2010, with a project value of more than EUR 1 billion), and the possible start of construction of a second block at Krško nuclear power station. Additional investment related to the overhaul of road and railway infrastructure is also possible. The considerable slack in the economy could raise the possibility of higher output. The majority of these factors would have an impact on economic growth via faster investment activity. An indication of this is given by their relatively high current rates of growth in the second half of 2009. For this reason the simulation in Box 7.1 illustrates the macroeconomic effects of a continuation of the present high current rate of growth in gross investment.

Table 7.7: Comparison of forecasts for Slovenia, and change from previous forecasts

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2010		2011		2010		2011		2010		2011	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Apr 10 / Sep 09	1.3	-0.3	1.8	0.1	1.6	0.1	1.4	-0.3	-0.5	2.7	-1.4	2.5
EIPF	Mar 10 / Sep 09	1.7	0.7	3.3	...	1.6	0.3	1.6	...	-1.6	1.1	-2.4	...
IMAD	Apr 10 / Sep 09	0.6	-0.3	2.4	-0.1	1.3	-0.2	1.6	-0.9	-1.8	-1.8	-3.0	-3.1
Consensus Forecasts	Mar 10 / Sep 09	1.0	0.4	2.4	-0.3	1.8	-0.3	2.3	0.0	-1.8	0.4	-2.3	...
European Commission	Nov 09 / Mar 09	1.3	0.6	2.0	...	1.7	-0.3	2.0	...	-0.2	4.2	-0.6	...
IMF	Oct 09 / Mar 09	0.6	-0.8	3.8	0.1	1.5	0.0	2.3	0.0	-4.7	0.3	-5.0	0.4
OECD	Nov 09 / Jun 09	2.7	2.0	3.0	...	1.1	-0.5	2.7	...	...	...	...	...

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

The likelihood of a double-dip recession in the developed economies having receded, the uncertainty surrounding foreign demand primarily relates to central and south-eastern Europe. The dynamic of export activity in Slovenia's developed trading partners is to a great extent being currently determined by import demand, in particular from emerging Asian economies. They are subject to very similar risks to the Slovenian economy, and the rise in domestic demand in these countries will be gradual, but relatively stable. Forecasts of import growth in these countries have recently been raised. The risk remains a possible decline in demand from the countries of central and south-eastern Europe. This risk could become even more pronounced should there be a lack of credible measures in the area of fiscal consolidation, as these countries are often heavily indebted. On the financial markets the premiums on bonds in some of these countries have already risen sharply. The high current growth in exports is expected to temporarily decline under the baseline scenario, in line with demand from the international environment and the temporary factors already described. The simulation in Box 7.1 illustrates the macroeconomic effects of a continuation of the current good economic momentum, or the non-realisation of a decline in export growth.

The risks relating to the inflation projections are balanced. A sharp fall is possible given the adverse macroeconomic situation, while the risk of higher price growth is primarily related to oil prices. Increasing deviations in economic growth could lead to inflation deviating from the baseline projection. However, the current core inflation rate is zero, or even negative, depending on the indicator. This could mean that adverse macroeconomic factors could be more strongly reflected in downward price adjustments. Inflationary pressures from the international environment will to a great extent be determined by the commodity price dynamics. A fall in the euro could also contribute to growth in euro prices of commodities. The medium-term risks include the possible additional effects of fiscal consolidation in the area of excise duties, other indirect taxes or administered prices. Local authorities are also facing a deficit, which could raise prices of municipal services. The cost pressures could also be increased by the recent rise in the minimum wage, particularly if demands arise for relative adjustments in the wages of other employees (Box 2.2). The chance of this occurring is less likely in the crisis situation, but it could arise as a risk when the economic situation improves.