



BANKA

SLOVENIJE

**SHORT-TERM IMPLEMENTATION
OF MEDIUM-TERM
MONETARY POLICY FRAMEWORK
OF THE BANK OF SLOVENIA**



MAY 2002

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1. INTRODUCTION

The Bank of Slovenia has a clearly defined medium-term policy orientation: to enter the EMU as soon as possible. The Governing Board of the Bank of Slovenia adopted this orientation in November 2001 and presented it to the public in the document "Monetary policy framework of the Bank of Slovenia". The endeavours of the Bank of Slovenia to achieve price stability according to the medium-term orientation will focus on reducing inflation to the level of 4% by the end of the year 2003.

Achieving a decrease in inflation to 4% in the following two years is a demanding and ambitious task, which requires the co-ordination of all key economic policies. The Bank of Slovenia is aware that its commitment to act anti-inflationary is not sufficient for an efficient reduction of inflation - it requires the consensus of all economic policies and their harmonized action.

The Bank of Slovenia evaluates the efficiency of implementation of the medium-term monetary policy framework and achievement of respective goals, by means of monetary policy indicators, divided into two pillars. On the basis of these indicators both, the need for additional measures, use of instruments and short-term monetary policy framework in general are determined. The Bank of Slovenia is aware that the relation between monetary policy and inflation is a long-term one, that the transmission mechanism is operating mainly through the quantity of money and the foreign exchange rate, and only to a minor extent through interest rates. Therefore, in the implementation of the monetary policy, the Bank of Slovenia monitors the indicators of the first and of the second pillar. The indicators of the first pillar comprise various money aggregates, their structure and some other indicators of liquidity of the banking system. The indicators of the second pillar are the exchange rate, the balance of payments, the difference between domestic and foreign interest rates, wages in the public sector and world oil prices.

The purpose of this paper is to evaluate the adequacy of the short-term monetary policy framework of the Bank of Slovenia in the light of past inflation trends and new macro-economic forecasts and in this way contribute to a greater transparency of its monetary policy. In addition to the introduction, the paper comprises three more parts.

- The first part assesses the achievement of price stability. It addresses the analysis of inflation in the past period, the trends and breakdown of inflation, pointing out major inflation determinants. It also explains the reasons and responsibilities of individual economic policies for possible deviations from the medium-term target.

- The second part presents the macroeconomic forecast of the Bank of Slovenia for the period of next two years. Given that the macroeconomic environment, both in the country and abroad, is constantly changing, the Bank of Slovenia regularly assesses the trends of and prospects for the functioning of the economy. The forecast, together with the assessment of inflation trends from the first part, is the basis for a determination of the further short-term monetary policy framework.

- Finally, the paper presents the short-term monetary policy framework. The Bank of Slovenia decides whether changes in the macro-economic environment require monetary policy implementation adjustments and whether any additional measures are needed for an achievement of the medium-term goal - inflation rate of 4% at the end of 2003.

The Bank of Slovenia intends to present such a review of inflation and short-term monetary policy framework on a six-month basis. The next report is due in autumn 2002.

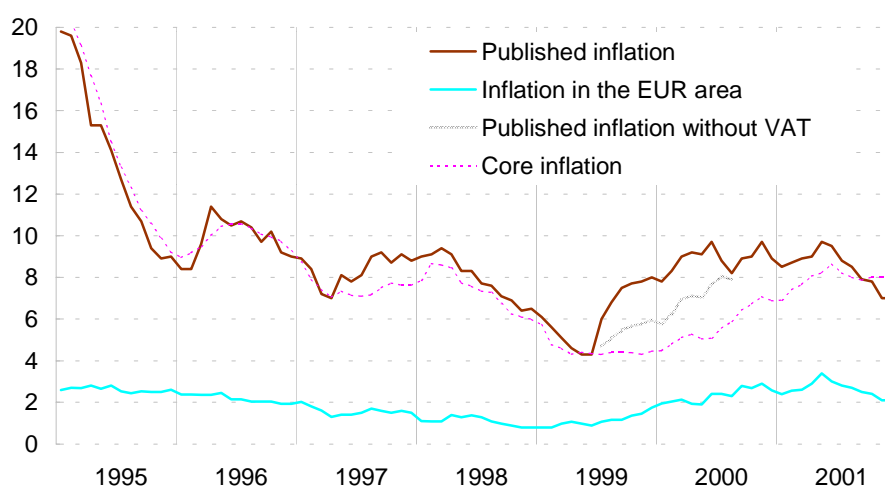
2. INFLATION TRENDS

In April 2002, the inflation - measured by consumer price index - reached 8.4% at the annual level. The cumulative price growth in the first four months reached as much as 4.6%. High price growth at the beginning of the year is mainly due to fiscal reasons, fast growth of prices of some public utility and telecommunication services, increase in prices of oil derivatives, and partially also to seasonally induced higher food prices. In this section, we shall first describe the inflation trends in the past period and analyse the reasons due to which the inflation – after the decline in 1999 – has persisted at an annual level of around 8%, and then endeavour to define the main inflation factors in this year.

2.1 Exogenous shocks 1999-2001

In July and August 1999 the introduction of VAT and excise duties brought about a unique jump of the price level by about 3%, and, not taking fuel into account, by 2.5%. Nearly at the same time the prices of oil started to climb, and increased at a quick pace mainly in the year 2000 (until the end of the third quarter, and then again in the second quarter of 2001). In 1999, the prices of oil derivatives rose by 22% and directly affected the inflation total by 1.9 percentage points, while in 2000 prices of oil derivatives recorded an increase of 31% and added 2.9 percentage points to the total annual inflation.

Graph 1: Headline and core inflation; annual growth rates in %



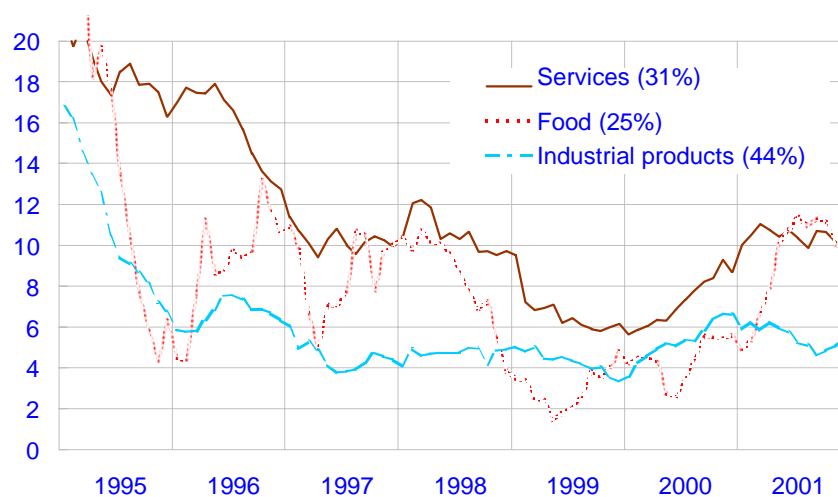
Graph 1 shows the decrease in inflation in the period before 1999, and the direct impact of both shocks – first, of fiscal reform and then of oil prices – to the headline inflation total after the year 1999. The price effects of these events, adjustment of wages and other economic policies also influenced, with a lag, the core inflation. According to an estimate, the fiscal

shock, without an unexpected additional increase in oil prices, could have been absorbed without significant consequences.¹

The core inflation was maintained below 5% right up to the end of the year 1999. In the first half of 2000 it climbed to 6%, and since mid-year of 2001 it has been maintained at the level of around 8%.

Core inflation is divided by the criterion of very different behaviour into two major price groups: into prices of the tradable and prices of the non-tradable sector. As an approximation of prices in the tradable sector the prices of industrial products (in CPI) are used, while prices in the non-tradable sector are represented by prices of services. Prices of food are held as a special group. Institutionally this market in Slovenia belongs into tradable sector. However, on account of strong informal blockades its behaviour is still quite deviant.

Graph 2: Core inflation components; annual growth rates in % (in brackets weights of individual groups in core inflation)

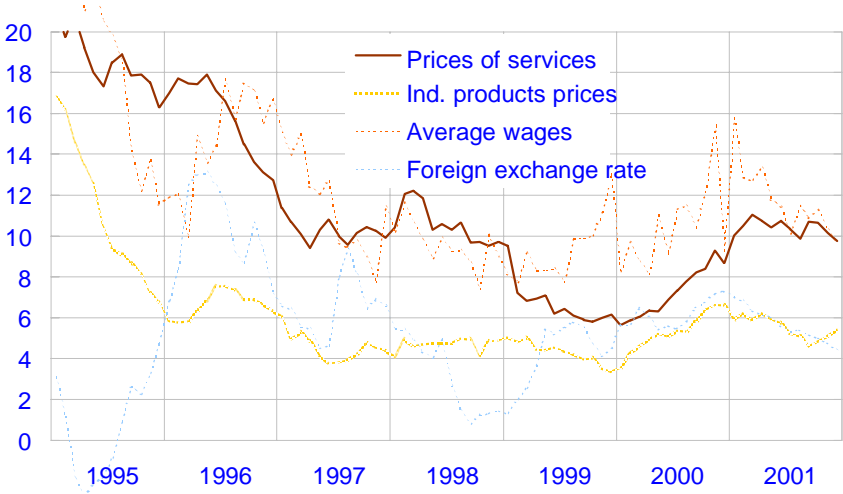


Graph 3 shows the behaviour patterns of the tradable and the non-tradable sectors. Since the introduction of foreign trade deregulation, movements of prices in the tradable sector are in full compliance with expectations. The introductory adjustment of the price level of industrial products was carried out as early as in 1994, until then they had been for a certain period increasing under current depreciation of exchange rate (with relation to foreign prices they were decreasing until the harmonisation of relative prices).

¹ Core inflation is defined as headline inflation, reduced by the following exogenous components: prices of fuels (petrol, gas, fuel oil, district heating and electricity), seasonal components of the two most volatile groups (fruit and vegetables; clothing and footwear – clearance sales) and fiscal effects in the 3rd quarter 1999 and January 2002.

Price growth in the non-tradable sector shows "domestic inflation" which is not limited by the growth of prices in the foreign environment or by foreign competition. In general, it is interlinked with growth of wages, but major groups of taxes could also be added. The group is not homogenous. It also consists of market segments, which - even in the small domestic market - have quite a competitive structure, which, since around 1995, has been characteristic of catering and bus transport. There, prices in the last two years increased considerably less than prices of motor fuels and entirely differently from energy-dependent prices of communal services, e.g. district heating. Nevertheless, economic policies have neglected the meaning of competition through the past period, so that the prevailing market structure in domestic sector is still very archaic, and will undoubtedly present (and already presents) a blockade in both, reduction of inflation and attainment of desired economic growth.²

Graph 3: Indicators of tradable and non-tradable prices; annual growth rates in %



In the period 2000-2001 exogenous shocks were transmitted into core inflation through both "channels". After the second quarter of 1999 higher depreciation, triggered by the market and resulting from increased external deficit, was observed; fast depreciation continued also in 2000, and gradually slowed down in 2001 to the level of about 4%. Graph 3 shows the effects of this turn on price growth in the tradable sector.

"Domestic inflation" – growth of non-tradable prices – has fallen to around 6% since 1999. Subsequent nominal shocks from the international environment then quickly increased this segment of inflation to about 11-12% (current) from mid-2000 until the first quarter of 2001. In

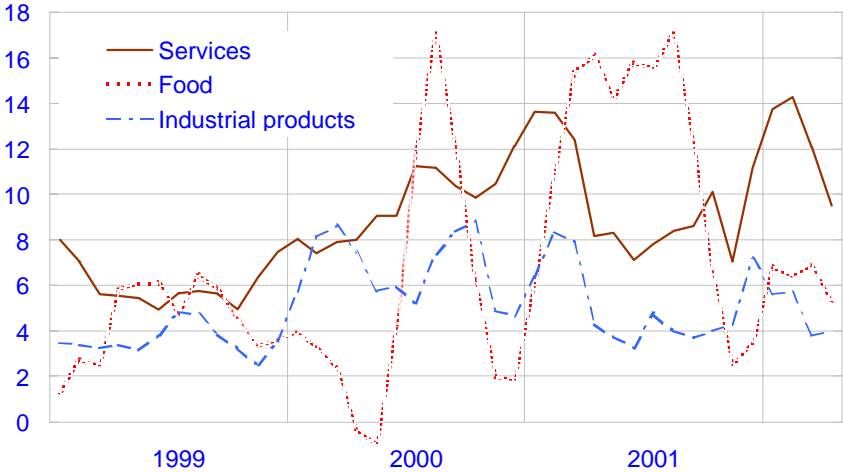
² Service prices established on competitive (domestic) markets are reflecting the demand in the short run, but already in the medium-term they are mainly anchored with labour costs. On non-competitive domestic markets price growth is being released even without an anchor, which results in initiation of wage growth irrespective of demand conditions.

the second half of 2001 the non-tradable sector price growth dropped again to 8-9% (See Graph 4).

The beginning of a reduction of core and of total inflation in the year 2001 was prevented by a wave of increases in food prices. That was closely linked with the general European stockbreeding crises and a similar jump in this part of inflation in Europe, although the reasons were to a great extent also specifically domestic. It was only in the last quarter of 2001 that the core inflation decreased back to 5%-6%. Other components of core inflation, excluding food, had been growing by 5%-6% already since April 2001.

At the very beginning of transition, following the loss of the Yugoslav market and the liberalisation of import, the greatest fall (with reference to total inflation) was observed precisely with food prices, which were earlier the most isolated from the environment. From mid - 1993 onwards they were increasing below average under the cover of "protective policy" through administered prices. On the saturated market with elastic demand any intervention through prices was an illusion; it induced a decrease in sales and in production, and such a policy was – judging from price movements – terminated somewhere in the year 1998. In 2001, new disturbances were observed: regression from the already attained effectiveness of market structure, hindering import supply of imported goods etc. The consequences will be the same, as they were in the case of an increase of "administered prices".

Graph 4: Core inflation components from 1999 to April 2002; current growth rates at an annual level in %, deseasoned



2.2 Inflation factors in 2002

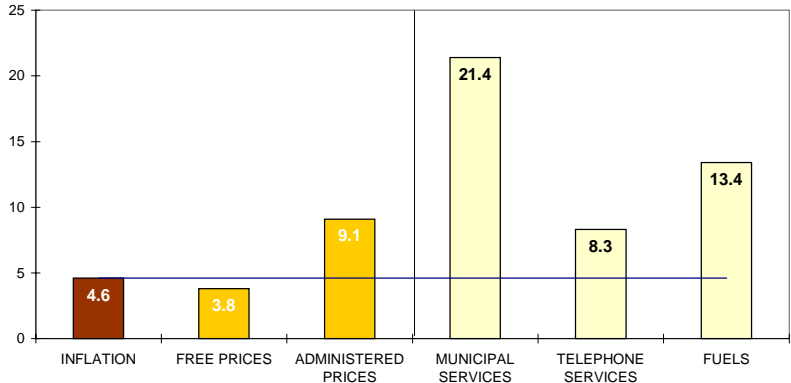
Fiscal and administrative reasons contributed substantially to higher inflation in this year. In January, value added tax and excise duties on tobacco and alcohol were increased. The general value added tax rate was increased from 19% to 20% and the reduced rate from 8%

to 8.5%. It is estimated that this sharpening of the fiscal policy added about 0.6 percentage points to inflation. Higher excise duties (on oil derivatives) according to our estimate contributed one percentage point to inflation already in the year 2001. Higher excise duties on tobacco and alcohol in January 2002 contributed further 0.3 percentage points to inflation. Although individual tax elements are otherwise of a temporary nature, temporary inflationary pressures may outgrow into inflationary pressures of a more sustainable nature, if higher taxes are systemically conditioned and if budgetary needs induce collecting of additional general government resources with inflationary consequences.

The policy of administered prices was an important factor of higher inflation in this year, while at the same time high variability of administered prices was also continued. After the period of a slowdown of administered prices in the last quarter of 2001, mainly due to lower world prices of oil derivatives, the growth of administered prices in this year again accelerated and in the first four months amounted to 9.1%. Administered prices with an annual growth of 10.7% are overtaking the growth of free prices (8.0%) and total inflation (8.4%). The high concentration of considerable rises in administered prices in first few months of 2002 activated a strong inflationary signal and warned of the fragility of the attained price stability, while at the same time creating doubts about possible achievement of the medium-term inflation target of the Bank of Slovenia.

Graph 5 presents the price growth in the first four months of the year 2002 by major groups of a basket of consumer goods, constituting CPI. Apart from free and administered prices the price growth of some of the most important groups of products and services' belonging to administered prices is presented.

Graph 5: Cumulative price growth of selected groups of consumer goods from the beginning of the year



Source: SORS, own calculations

Price pressures from abroad have, however, been slowing down for the past six months, but there remains great uncertainty regarding prices of oil derivatives. World oil prices are remaining unpredictable and highly variable and are at the moment at the high level of about \$25 per barrel. An important factor, contributing to increased uncertainty and higher inflation, is also the existing model of setting domestic prices of oil derivatives as this enables fast transfer of uncertainty from the world markets. The model as such also contributes to a more persistent inflation, since due to nominal rigidity of prices downwards, which is a general phenomenon, other prices are brought into line with prices of oil derivatives only, when the latter rise.

Exchange rate policy has significantly contributed to a slowdown in the growth of import prices and inflation in general, as the exchange rate growth is lagging behind inflation. From the beginning of 2001, the exchange rate growth has been gradually slowing down, as both current and annual growth of the exchange rate is decreasing below 4% annually. At the moment the exchange rate growth is an element of monetary policy directed towards disinflation. This is evident from the industrial producers' price growth, which has shown a decreasing trend since the beginning of the year 2001: in one year it dropped from above 10% to 5.7%.

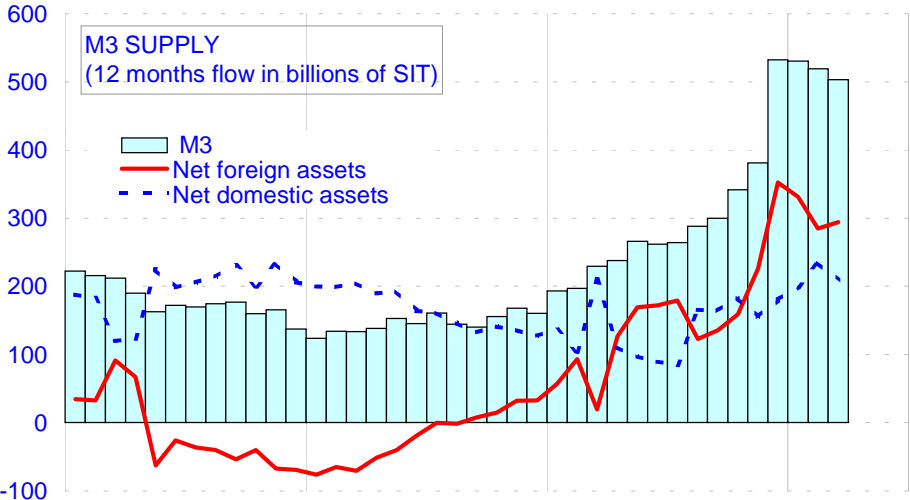
Inflation is also held back by income policy. Wage growth has been gradually slowing down since the beginning of the year 2002. Nominal wage growth, in spite of a slowdown, is remaining at a high level of around 9%. The slowdown of wage growth is owed mainly to the tradable sector, which is facing competition from abroad, as income policy in the public sector is less successful in controlling wage growth and labour costs. The continuation of uncoordinated growth of labour costs in the public sector in comparison with the private sector remains a potential threat for the development of inflationary pressures also from the aspect of demand. However, it can induce higher labour costs in the private sector in which, on account of the demonstration effect, there can be increased pressures on higher wage growth.

In this year, growth of free prices is lagging behind inflation and their volatility is considerably lower than that of administered prices. Nevertheless, the growth of free prices has slightly accelerated this year, but a part of this growth may be contributed to higher rates of the value-added tax. Considering the growth of free prices, the role of specific factors is interesting and in this manner, especially the growth of foodstuffs is surprising. Since the beginning of 2001, prices of foodstuffs have been rising above average and at the moment their growth amounts to 10.0% at an annual level. It is interesting that similar trends in price movements of food have been observed also in the EU member countries; such movements

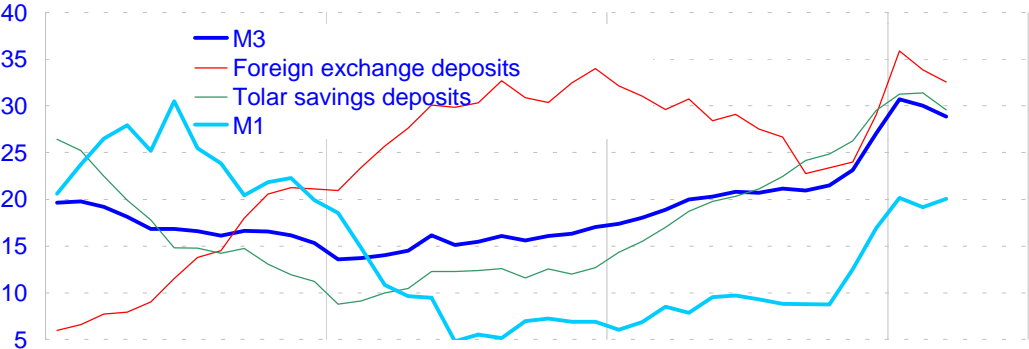
in this year are contributed to a damage done by the frost in January. On the other hand, food prices in EU candidate countries are growing at a considerably slower pace and are counted among major elements contributing to lowering inflation. It is not clear yet, whether high food prices in Slovenia are only the result of a price increase in foreign markets, which is partially of a seasonal nature, or whether it might be a matter of structural changes in the domain of setting prices from the point of amended agricultural policy. Another reason of high food prices may also be the establishing of an oligopolistic market model in the domain of setting retail food prices with a predominantly nonelastic demand for foodstuffs.

Monetary policy is not one of the factors of accelerated inflation, even though the statistics show high growth of monetary aggregates. The reason of the fast growth of monetary aggregates is twofold. The first reason is the increase of both, foreign exchange and (to a lesser extent) tolar deposits, which are the result of the inflow of foreign cash before changeover to the Euro (inflows through the household sector are estimated to about EUR 800 million or 3.5% of GDP). Before end of 2001 individuals deposited foreign cash, previously kept at home, on bank accounts – the volume of money in the economy was for that reason not increased, only its inclusion in the statistical records is now more complete. The second reason of the high growth of monetary aggregates may be found in relatively high inflows of foreign direct investments, which in the last quarter of 2001 totalled around 1% of GDP. At the beginning of 2002, high financial inflows from abroad, which were typical for the end of 2001, stopped to a certain extent. The inflow from households reversed into an outflow, while inflows deriving from sales of companies to non-residents were still relatively strong, and all together reflected in a slowdown of the growth of monetary aggregates.

Graph 6: Flows creating monetary aggregate M3

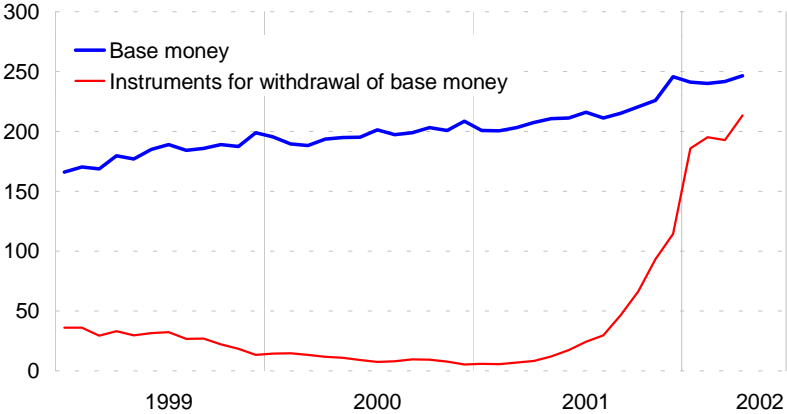


Graph 7: Growth of monetary aggregate M3 components (annually, in %)



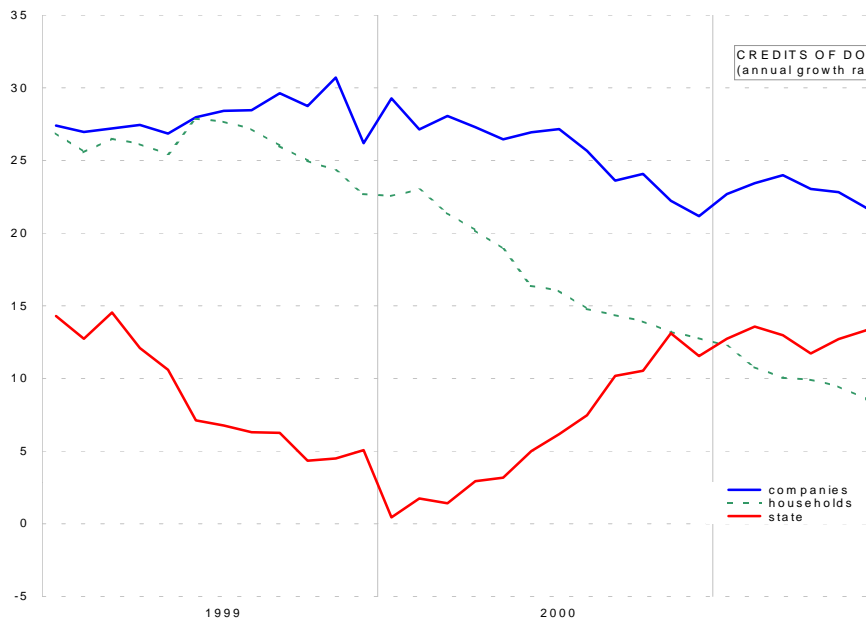
The Bank of Slovenia neutralised the impact of monetisation of high financial inflows by sterilisation and the issue of tolar bills. In the middle 2001 the stock tolar bills totalled to around SIT 30 billion, while at the end of last year they amounted to SIT 125 billion. In this way the Bank of Slovenia prevented monetisation of around SIT 100 billion, which would mean by a more than one-third higher balance of monetary aggregates. At the moment the stock of tolar bills amounts to slightly above SIT 200 billion.

Graph 8: Sterilisation efforts of monetary policy: base money and instruments for withdrawal of base money (monthly average balances; in billions of SIT)

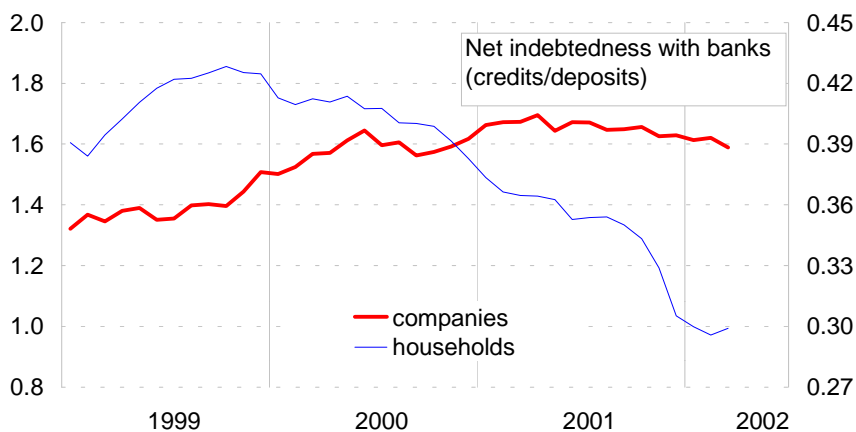


The central bank conducts an expansive monetary policy, when the volume of money allows for additional final consumption by households, and companies become less careful over cost control. An evident sign of expansive monetary policy is also a high demand for credits and their fast growth. Currently, the purchasing power of households is low as well as demand of households for credits, since the population is mainly oriented to long-term forms of saving, designated for a provision of social security at retirement and to a solution of housing problems. Corporate demand for credits is also modest.

Graph 9: Credits of domestic banks



Graph 10: Net indebtedness with banks



Although monetary policy is currently not one of the factors contributing to inflation in this year, and although the supply of money does meet the demand, the transfer of foreign cash-savings of individuals into the banking sector enables a more productive employment of savings. This is reflected in a decrease of bank deposit rates to a new equilibrium level, which is line with the increased level of savings. The important issue for monetary policy in this process is the proper identification of an equilibrium level of interest rates, especially at the time when nominal interest rates are about to be introduced.

* * *

Inflation was higher at the beginning of the year than expected and forecasted. After the period of a fast decreasing inflation at the end of 2001, which ended with an annual inflation of 7.0%, inflation accelerated again at the beginning of 2002, and reached 4.6% after only

four months. Therefore, after the acceleration of inflation in the first third of this year, it is not possible to expect that inflation will reach the desired rate of 5.8% at the end of the year. This is regardless of the fact that inflationary pressures are coming mainly from the costs-side and that the current high growth of prices is most probably temporary in nature.

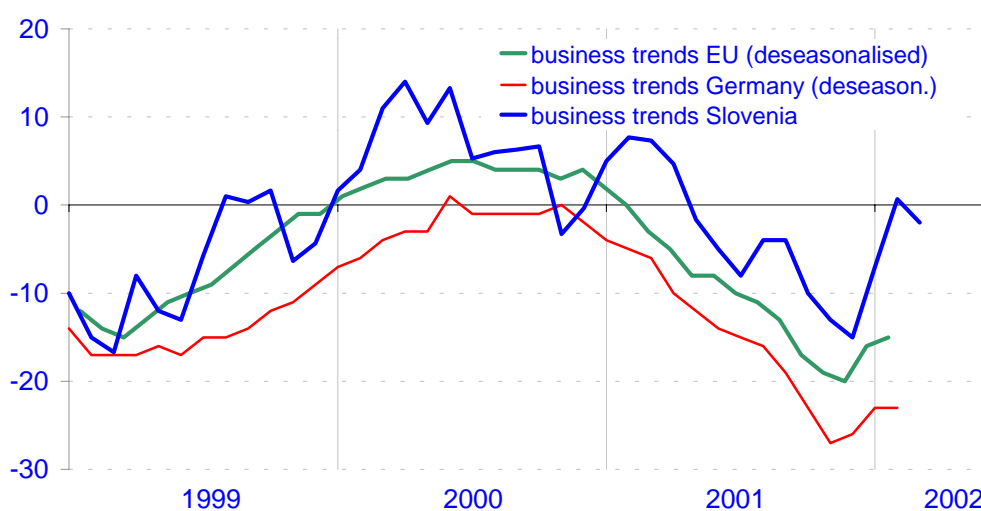
3. TWO-YEAR FORECAST OF ECONOMIC TRENDS

Projections are based on data available up to 25 March 2002

3.1. International environment

At the beginning of 2002, the conditions in the international economic environment were considerably more optimistic and less uncertain than they were in autumn last year. As it seems, the growth of the world economy reached the lowest point in the last quarter of the previous year and this year a relatively fast recovery is expected. This is also evident from various confidence indicators both abroad and in Slovenia.

Graph 11: Confidence indicators in EU and in Slovenia



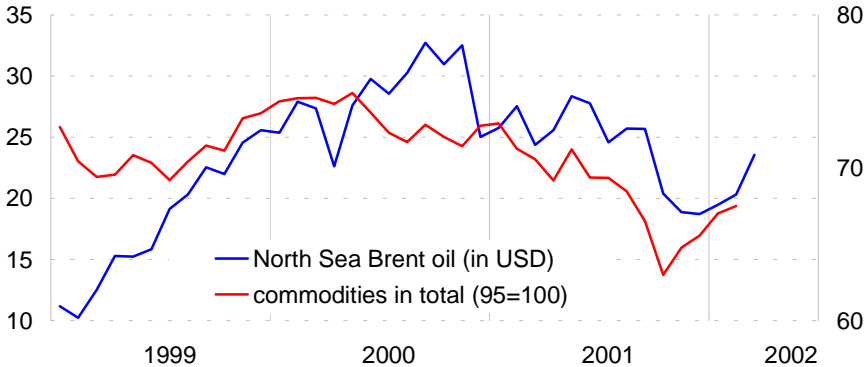
Source: SORS

More stable foreign demand is expected in the second half of the year 2002, however, economic growth in foreign countries will, on account of a relatively slow recovery in the first half of the year, be slightly lower than in the last year. According to forecasts, the recovery of economic growth will be more significant in the USA than in the European Union member countries, the major Slovenian trading partners. Among the latter the most obvious is the extremely slow strengthening of growth in Germany. After last year's very sharp increase of demand from successor countries to former Yugoslavia and from Russia, the economic growth in these countries is expected to be slower, and will thus importantly contribute to a weaker foreign demand in this year.

In 2002 oil prices are expected to stabilise at a relatively high level. On account of extremely low prices at the beginning of the year 2002, the average oil price will nevertheless be lower

than was taken into account in our assumptions in autumn 2001. We now assume that oil prices will strengthen in the first half of the year and remain on the same high level until the end of the year. This is the opposite of our assumptions from November 2001, when it was estimated that oil prices in 2002 would drop, and is consistent with a fall in oil prices at the end of 2001. The fast growth of oil prices is mainly a result of expectations of a strengthening in economic growth and demand from the USA and Asian countries, and the persistence of political tension in the Near and Middle East. The oil price should, according to expectations, remain within the OPEC target band between 22 and 28 \$/barrel. It is estimated that, with stable demand in the world economy in 2003, the oil price will amount to about 25 \$/barrel, which is 3 \$/barrel higher than assumed in November 2001.

Graph 12: Oil and commodities prices



Source: Reuters, The Economist, OPEC Bulletin; calculations ARC.

Alongside with the return of economic growth and a possible increase of inflationary pressures, mainly from higher oil prices and stronger domestic demand, a turn in foreign monetary and fiscal policy actions is expected. These tried to stimulate weak economic growth in developed economies in the last year by lowering interest rates and permitting relatively high general government deficits. Considerably more than in EMU, the interest rates were reduced in the USA, where they dropped to the lowest level in the past ten years. Given that ECB has reduced interest rates at a slower pace, the EMU member countries partly compensated the absence of a more aggressive action in monetary policy in conditions of low economic growth by a more expansive fiscal policy. This caused public deficits in some countries (i.e. Germany and Portugal) to get close the level of 3% of GDP, defined as the still permitted limit by the "Stability and Growth Pact". In the forthcoming period central banks will mainly try to prevent the inflationary effects of an overheating economy by increasing interest rates. Therefore, our forecast assumes that by the end of 2003, the interest rates will gradually return to the level from the beginning of 2001, when the period of their fast decrease began.

The forecasts on movements of exchange rates are, on the basis of expectations of a faster growth of the American economy in comparison with the recovery in EMU countries, considerably more cautious with regard to an increase of the value of Euro than in autumn 2001. Namely, only very gradual strengthening of EUR against USD is expected in 2002, limited mainly to the second half of the year. Therefore it is assumed that their average ratio in the year 2002 will remain unchanged with regard to the average of 2001, amounting to around 0.894 EUR/USD, and will thus be lower than presumed in November 2001 (0.921 EUR/USD). After recovery in the EMU member countries, and return of economic growth, the value of EUR against USD should increase to approximately 0.939 EUR/USD on average in 2003.

Inflation in EU countries began to slow down in the second half of last year, when after the postponed effects of high oil prices and high prices of other commodities, and consequences of considerable depreciation of the Euro, the highest rates of price-growth after 1993 were recorded (in May 2001 the year-to-year rate of price growth amounted to 3.5%). At the beginning of 2002, price growth was again higher mainly due to some single events (introduction of Euro, weather conditions, which had an influence on higher prices of food, increase of excise duties). Just this increase, besides the slightly higher oil prices and the presumed lower value of the EUR, contributed to the fact that this year's average inflation in the EMU countries, in spite of the expected lowering to the end of the year, will be higher than assumed in our previous forecast of November 2001. The average rate of price growth should amount to around 1.8%. In the next year, pressures will emerge on inflation due to a full utilisation of capacities and the expected higher level of commodity prices. Nevertheless, the inflation will, on average, amount to around 1.5%, and will therefore be lower than the limit of 2%, defined as a medium-term price-growth target by the ECB.

Table: Basic indicators of the international environment

<i>in %</i>	Actual			Forecast	
	1999	2000	2001	2002	2003
Foreign demand	6.9	10.6	4.3	3.2	7.2
USD/EUR	1.067	0.924	0.895	0.904	0.943
Oil USD/barrel	17.9	28.5	24.4	22.5	24.0
Commodities	-9.5	3.2	-6.5	-2.5	3.1
EU inflation	1.1	2.3	2.6	1.8	1.6
PPI Germany	-0.3	3.3	1.2	-0.2	1.0
LIBOR EUR 3m	3.0	4.4	4.1	3.1	3.8

Sources: Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook; calculations ARC

3.2. Activity, employment and wages

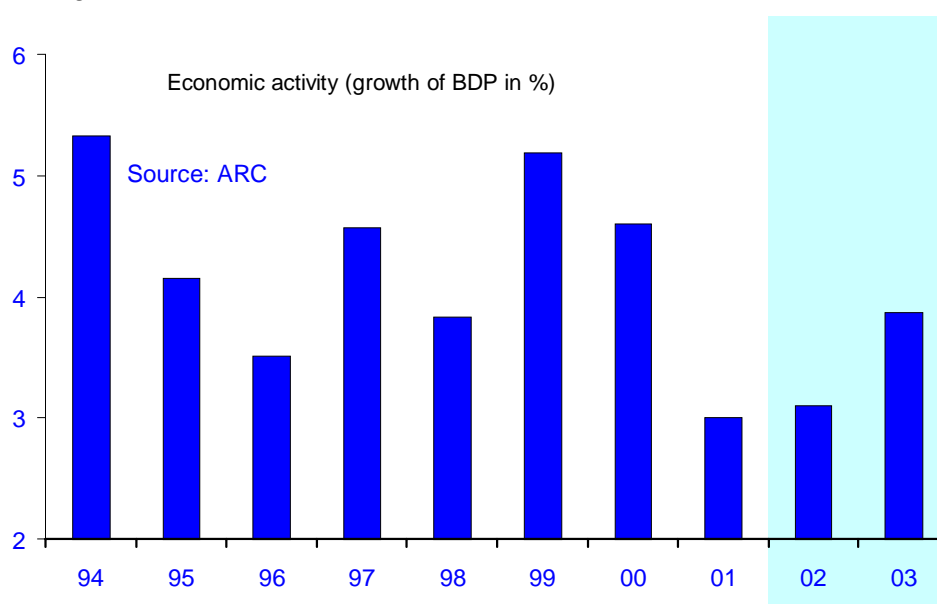
This year, the growth of domestic economic activity will be very similar to that of last year. It will be influenced by a gradual strengthening of domestic demand and the postponed negative effect of deteriorated foreign demand from the end of last year, which will partly be reflected already in the first part of this year. The growth, which will be closer to the long-term average, will probably be attained only in 2003.

In 2002 the gross domestic product will, according to our estimates, increase by approximately 3%. A slightly higher growth of about 4% is expected in 2003, when the improved conditions in the international environment and stable growth of domestic demand will also positively affect the economic activity.

	1998	1999	2000	2001	Forecast	
					2002	2003
Activity, employment, wages	real annual growth rates (in %)					
GDP	3.8	5.2	4.6	3.0	3.1	3.9
GDP per capita (USD)	9,734	9,994	9,017	9,386	9,994	11,195
Employment	0.0	1.2	1.1	0.7	0.5	0.5
Net wages	1.6	3.2	1.4	3.1	2.8	3.1
Productivity	3.8	4.0	3.5	2.0	2.7	3.4

Source: ARC

Because of the lower growth of foreign demand, the value added in manufacturing will grow slowly than in the last two years, and in spite of the increased investment activity, the value added in construction will recover only slowly and will significantly increase only after 2003. Among other activities constituting the supply side of GDP, the fastest growth of value added, according to our estimations on future economic trends, will be in catering and in the transport, storage and communication services.



Relatively slower employment-growth from the second half of 2001 will, according to our expectations, continue in the following two years because of worsened conditions in the international environment, relevant for Slovenia, and partly also because of limitations for the growth of employment in the public sector. In that period employment should grow by about 0.5% per year. This is, however, still a favourable growth-rate with regard to the fact that employment is decreasing in the EU.

In 2001 the growth of average wages total was 3.2% in real terms, which was higher than the growth of productivity which increased only by 2%. The loss of competitiveness of the Slovenian economy, measured by these indicators last year, was also due to high growth of wages in the public sector. It is estimated that a similar movement will occur also in the year 2002, while in the following years this trend, with the growth of productivity expected considerably faster, will stop. All the same the growth of wages in real terms will, due to some already agreed increases in the public sector remain at a relatively high level of around 3%.

3.3. Components of expenditure of GDP

It is estimated that this year a turn-about will occur in the contribution of individual components of aggregate demand to the growth of economy. Economic activity in this and the following year will be based mainly on the gradual strengthening of domestic demand. The contribution of international trade to economic growth will be considerably lower than in the previous two years and in 2003 will even be negative. In comparison to November 2001 forecasts our assessment remains relatively unchanged, and only the structure of domestic consumption has been slightly changed.

	1998	1999	2000	2001	Forecast	
					2002	2003
<i>Domestic demand</i>	real annual growth rates in %					
Domestic demand	6.0	9.1	1.1	0.5	3.2	4.4
Private consumption	3.3	6.0	0.8	1.7	3.3	3.7
Public consumption	5.8	4.6	3.1	3.2	2.9	3.9
Gross capital formation	12.4	18.9	0.5	-3.7	3.3	6.1

Source: ARC

In 2002, the growth of all elements of domestic demand will amount to around 3%, in which the fastest growth will be with gross capital formation and household consumption, and only government consumption will slightly lag behind.

It is expected that, after the negative growth of investment expenditure last year (-3.7%), positive growth will be regained. Taking into account the more stimulating prospects regarding international environment, investments by the private sector will gradually start to grow. They should be stimulated mainly by the planned increase of public investment expenditure (according to our estimations this represents about 15% in the total gross investments) in the field of infrastructure projects. Autonomous recovery of private sector investments is expected only in the year 2003, when public investment expenditure should become more restricted. By then foreign demand – which, after the period of transitional restructuring of production capacities, is one of the major incentives and indicators of private sector investments – should finally be strengthened. If it turns out that investments in production capacities in the area of former Yugoslavia are sustainable, both from the aspect of balance of payments and from the aspect of their security, the growth of direct investments of residents abroad might be a restrictive factor to a greater initiation of private investments at home because of the substitution effect.

According to our expectations, private consumption will – as in 2001 – be the element of domestic demand, which will contribute most to the growth of activity in 2002. The approaching release of funds from the national housing saving-scheme in 2004 might also contribute to a greater consumption of households in 2003. It is expected that individuals will increase their consumption in spite of the fact that the greatest part of the wage rise in the last few years was oriented explicitly to high-wage groups with a lower marginal propensity to consumption, and in spite of the fact that lately structural shifts can be observed in the behaviour of individuals towards long-term forms of saving. In the projections of a slower increase of consumption by individuals one of the key presumptions involves interest rate trends, which would prevent these rates from reaching the lowest point, thus possibly causing alterations to depositors' behaviour.

It is estimated that government end consumption will also be relatively modest and will grow in the following two years between 3% and 4% annually. The greatest contributing factors to this growth will be the obligation of the government to reduce general government deficit and maintain it at a sustainable level, and the somewhat worse conditions in the economy, consequentially limited general government consumption and on the other hand increased public investment expenditure.

With a relatively modest growth of investment expenditure and other components of domestic demand, and with a slightly worsened balance of goods and services, it is estimated that in the following two years the share of domestic saving in GDP will not increase further, but will stay at the level of around 26% of GDP.

3.4. External balance and conditions of financing

3.4.1. External balance

In 2001 the deficit in current transactions amounted to 0.4% of GDP and was the lowest after 1997. This was underpinned mainly by strong foreign demand in the first half of the year, partial redirection of export to the markets of former Yugoslavia and former Soviet Union countries, and a weak domestic demand.

It is to be expected that in spite of deterioration of the external balance in the following two years – which will occur mainly on account of the increased deficit in international trade of goods – this will be maintained at a sustainable level of between 1% and 2% of GDP.

	1998	1999	2000	2001	Forecast	
					2002	2003
Balance of payments	real annual growth rates (in %)					
Exports of goods and services	6.7	1.7	12.7	6.2	4.2	5.8
Imports of goods and services	10.4	8.2	6.1	2.1	4.4	6.5
Current account (mio USD)	-147	-783	-612	-67	-230	-396
in % GDP	-0.7	-3.9	-3.4	-0.4	-1.2	-1.8
Terms of trade	2.5	-0.4	-5.2	0.9	0.5	0.5

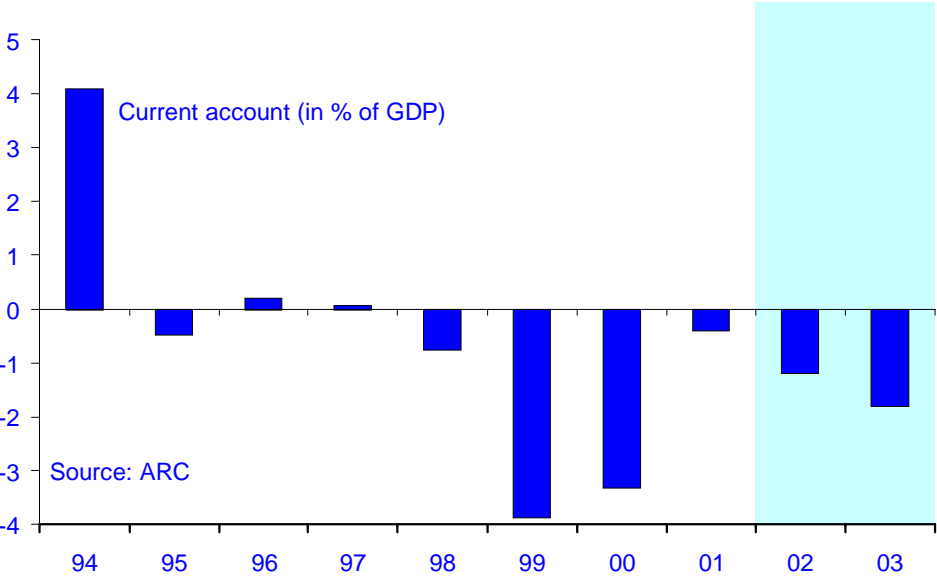
Source: ARC

In this year and in 2003 relatively favourable conditions are expected with export to the markets of former Yugoslavia and former Soviet Union countries, although slightly worse than in 2001. It is estimated that the level of export to countries of former Yugoslavia has not yet reached an adequate long-term level, and it could be jeopardised by the low payment capacity of partners from those countries. The expected – and at the beginning of the year partly realised – growth of oil prices should further enable stable financing of the Russian economy and its demand for foreign goods.

A decreased demand from the EU countries in 2002 and increased domestic demand in 2002 and 2003 will thus mostly influence the increase of deficit in current account of the balance of payments. In spite of a recovery of economic growth in the EU countries expected in the second half of this year, this will be relatively slow and will effect Slovenian exporters by a several months' lag. Import of intermediate goods will grow relatively slowly, in conformity with slower export growth. Owing to the expected increase of investment expenditure, import of investment goods will grow at a faster pace than average, which in the year 2001 even decreased in real terms. Import of consumption goods will grow faster than

last year due to the relatively fast growth of the income of individuals (net wages) in real terms, and an increased real purchasing power of these incomes abroad on account of the slightly higher appreciation of the domestic currency than forecast in November 2001.

In the following two years, the balance of trade in services will be maintained at the level of 2001. According to our expectations, the balance of tourism will improve. In the capital account no greater changes are expected in this year. In the following year the capital account should be slightly improved, due to increasing interest rates abroad and because of the relatively increased volume of foreign exchange reserves with regard to external debt balance, due to predominantly non-debt creating nature of financial inflows.



It is estimated that the contribution of terms of trade to the current account will be slightly positive, which will, in spite of a current upward turn, be added to by oil prices and strengthening of Euro against USD.

3.4.2. Conditions of financing

Expectations regarding developments in the real sector and in the balance of payments will affect the ways and conditions of financing sectors of the economy.

In 2002 and 2003 high financial inflows are expected mainly due to privatisation of state assets and foreign direct investments into the private sector, which will exceed USD 1 billion in both years. Net financial inflows will reach the level of 5.6% of GDP in 2002 and 4.7% of GDP in 2003. This is slightly less than in 2001 when net financial inflows reached 8.8% of GDP (of which cash by households approximately 3.5% of GDP). A slightly higher deficit in the current account of the balance of payments will nevertheless be totally covered by financial inflows in the following two years.

	1998	1999	2000	2001	Forecast	
					2002	2003
Financial account						
Net financial inflows (% GDP)	1.8	3.2	5.8	8.8	5.6	4.7
of which: Foreign direct investments	1.3	0.7	0.7	3.0	4.4	3.2
			<i>stock year-end</i>			
Foreign exchange reserves (mio USD)	4,781	4,115	4,376	5,738	6,813	7,635
-as % of GDP	24.8	20.6	24.3	30.6	34.1	34.1
External debt (mio USD)	4,915	5,400	6,217	6,717	7,596	8,533
- as % of GDP	25.5	27.0	34.5	35.9	37.9	38.0

Source: ARC

The highest share will be represented by foreign direct investments in Slovenia, which will amount to 4.4% of GDP in 2002 and 3.2% of GDP in 2003. According to our estimations, inflows from privatisation of state assets will prevail. These should to a great extent supplement financing of the state abroad. Assumptions, that in the following two years the state will not be financed by new or additional issues of existing euro-bonds but that all the required additional sources, including foreign exchange, will be sought from domestic banks, were taken from government forecasts. In spite of the great volume of expected inflows from privatisation in the following two years neither great pressures on the formation of monetary aggregates nor increasing interest rates are expected on account of new borrowings by the state.

Our November 2001 forecast of inflows of foreign cash through the sector of households was highly exceeded at the end of 2001. In the period before the changeover to Euro in EMU member countries, most of foreign cash ended up in banks. At the same time it turned out that the foreign cash kept "under the mattress" was primarily kept for minor transactions and, because of experience made at the time of hyperinflation, mainly as long-term savings. It is now equally uncertain to forecast the flows in the opposite direction, i.e. resumed accumulation of "stocks" of foreign exchange outside the banking sector.

It is expected that investments of Slovenian companies abroad, especially in areas of former Yugoslavia, will increase. Investments will be carried out both as direct investments and through substantial trade credits.

Borrowing by companies from domestic and foreign banks will increase in total. The portion of foreign financing of companies should gradually decrease. According to the relatively low volume of loans taken abroad in the recent past, and mainly due to opening-up of the Slovenian financial system, its increased competitiveness, and gradual dropping of domestic

interest rates, domestic loans should partly replace foreign loans. The expected increase of economic and especially investment activity since the end of 2002 will contribute greatly to maintaining quite a high growth of domestic credits to companies (year-to-year above 20%). Extension of maturity of deposits with banks, the expected increase of investment expenditure and the assessment that companies will gradually replace borrowings abroad – which are usually of a more long-term nature – by loans from domestic banks, all speak in favour of the statement that long-term crediting with domestic banks will increase at a faster pace.

The dynamics of loans to households on account of relatively weak consumption was decreasing also in 2001, while the growth rate of credits at the beginning of 2002 was even negative in real terms. Due to the anticipated increase in consumption by households in the following years, gradual suspension of redemption of debts of individuals is also expected. However, in the current time horizon of projections we still do not expect a complete upward turn in consumption and thereby not a full upswing in loans to households.

	1998	1999	2000	2001	Forecast	
					2002	2003
Banking system	<i>annual growth rates in % (last quarter)</i>					
M1	21.6	21.3	7.0	12.8	15.4	15.9
M3	21.0	16.0	16.5	23.9	19.8	14.6
M3/GDP (in %)	19.8	20.0	21.3	23.3	25.2	26.6
Domestic loans	22.8	20.7	17.8	19.1	18.5	16.9

Source: ARC

The major factor, which had an influence on the change of monetary aggregates' growth at the end of last year and at the beginning of 2002, is the single impact of the changeover of currencies of the EMU member countries to the EUR. The changeover had an influence on the growth of all components of the monetary aggregate M3 (due to their predominantly saving nature they still do not increase inflationary pressures), but most on the foreign exchange deposits of individuals. Since it is presumed that this should be a permanent change, our projections of the levels of monetary aggregates were corrected for the corresponding differences between the estimated value of developments of these aggregates and their realisation in the first quarter of this year. The effect of such a change will be mainly reflected in annual growth rates in 2002 and only to a minor extent in growth rates in 2003. It is expected that the growth of foreign exchange deposits compared to the growth of tolar deposits will slow down. Therefore, it is estimated that alongside with the increase of average maturity of tolar deposits their contribution to the growth of M3 will rise as well.

3.5. Inflation

Because of considerable deviations in growth of administered prices at the beginning of this year, two additional scenarios were prepared in this section beside the basic scenario. The first scenario indicates possible price trends until the end of the year under the condition that administered prices, after the already realised increases in the first three months of this year, remain unchanged until the end of the year. The second scenario assumes that administered prices, after the realised growth in the first quarter of 2002, will be rising with the same dynamics as in previous years.

3.5.1. The basic scenario

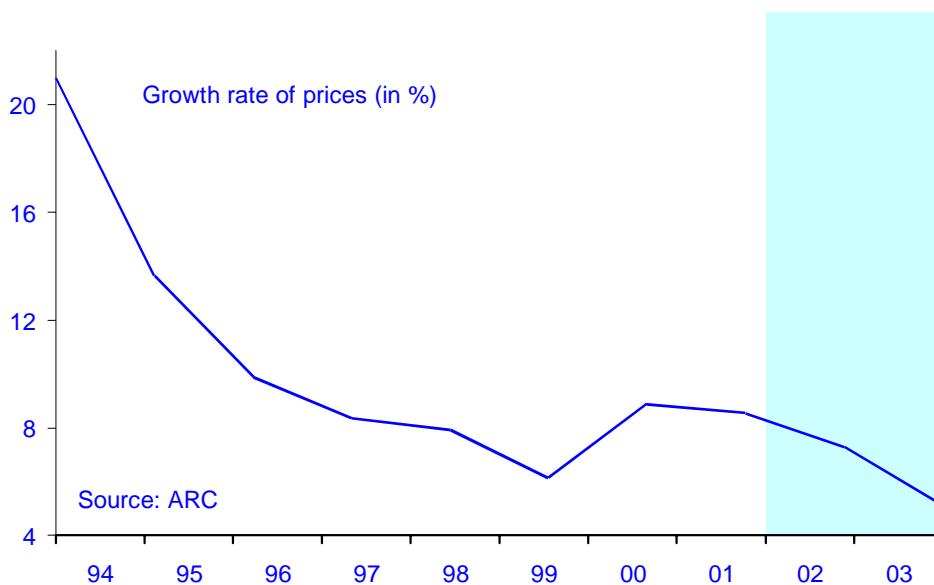
The price increase at the end of 2002 will exceed our expectations from November 2001, which is a result of an increase of seasonal foodstuff prices higher than expected and administered prices in the public sector in the first three months. The forecast presumes that growth of wages in real terms will be higher than forecast in November 2001, which may present additional inflationary pressures.

	1998	1999	2000	2001	Forecast	
					2002	2003
Prices	<i>annual growth rates in % (last quarter)</i>					
CPI	6.5	8.0	9.2	7.3	7.0	4.1
Free prices	6.0	7.1	6.8	7.9	6.9	3.7
Administered prices	9.2	12.0	21.7	5.0	7.6	5.7

Source: ARC

First of all, the positive effect of reduction of price pressures from abroad was delayed quite unexpectedly. The government policy, as regards reduction of prices, was rather tolerant in the area of administered prices and its closely related financing of the budget through excise duties. The exchange rate policy with a moderate decrease of the nominal value of the tolar has a favourable influence on the decrease of dynamics of consumer price growth and inflation expectations mainly through import prices.

Under the basic scenario, inflation will amount to about 7.0% at the end of 2002 if the policy of administered prices is set on the basis of the government Programme of administered prices. This Programme envisages the total increase of administered prices in 2002 by 7.6% by the end of the year.



The forecast of inflation until the end of 2002 and for 2003 is also based on the assumption that there will be no inflationary pressures from the international environment. The oil price should, according to expectations, remain in the range of around 25 USD per barrel. Euro is expected to stop losing value against US Dollar, and in the future, a slight appreciation of Euro is expected. Mainly the development of these two variables can substantially contribute to a slow-down of external pressures on domestic prices.

Forecasts of inflation until the end of 2003 are slightly more optimistic, as they project further relatively fast gradual decrease of price growth to approximately 4.1% on the year-to-year basis by the end of 2003. Consequently, it is assumed that in 2003, the administered prices will grow in excess of the average price index, but by not more than one and a half percentage points per year.

3.5.2. Scenario of frozen administered prices

It is our purpose to show the impact of frozen administered prices on inflation in the year 2002. To “freeze prices” in this context means that from the second quarter of 2002 inclusive, all prices, which are administered the Government of the Republic of Slovenia, would not change (as a consequence, already announced price increases of electricity, postal and railway services are not carried out). This also includes the prices of oil derivatives, which are regulated by a special price-model. At the same time this assumption means that these prices do not change, even for tax reasons, such as an increase in excise duties. At the end of 2002, the administered prices would in this way reflect 2.7% growth (Q4/Q4), which is a result of an increase of administered prices from the beginning of this year. All other assumptions are identical to those used in the basic scenario.

	Forecast	Scenario of frozen administered prices	Influence of freezing administered prices (in p.p.)
Consumer prices	7.0%	5.8%	-1.2
Free prices	6.9%	6.7%	-0.2
Administered prices	7.6%	2.7%	

Note: Price growth rates at the end of 2002 (Q4/Q4).

In this case the inflation would be lower by 1.2 percentage points and would amount to 5.8% at the end of 2002. Due to transmission of the influence of administered prices on free prices, the growth of the latter would also be lower, namely by 0.2 percentage points, and the growth of free prices would amount to 6.7% at the year-end.

3.5.3. Scenario of further rapid growth of administered prices

It is our purpose to show the influence of further rapid growth of administered prices on inflation. This scenario assumes that administered prices grow faster than envisaged in the basic scenario, and with similar dynamics as in previous years. The growth of administered prices at the end of 2002 would amount to 10.8% which corresponds to high, but still not completely unrealistic, growth of administered prices. As in the scenario of frozen administered prices, these also include prices of oil derivatives, otherwise regulated by a special price-model, and consequences of changes in administered prices for tax reasons, such as an increase in excise duties. All other assumptions are identical to those used in the basic scenario.

	Forecast	Scenario of rapid growth of administered prices	Influence of rapid growth of administered prices (in p.p.)
Consumer prices	7.0%	8.0%	+1.0
Free prices	6.9%	7.3%	+0.4
Administered prices	7.6%	10.8%	

Note: Price growth rates at the end of 2002 (Q4/Q4).

With this scenario – which, according to the past dynamics of growth of administered prices, is highly possible – the inflation is higher by one percentage point and is stabilised at 8.0% at the end of the year 2002 (Q4/Q4). The growth of free prices is also higher, by 0.4 percentage points.

SELECTION OF MAIN INDICATORS AND COMPARISON OF FORECAST RESULTS

	1999	2000	2001	2002			2003	
				Mar 01	Nov 01	Apr 02	Nov 01	Apr 02
Activity, employment, wages								
	<i>real annual growth rates in %</i>							
GDP	5.2	4.6	3.0	3.3	2.9	3.1	3.9	3.9
GDP per capita (in USD)	9,994	9,017	9,366	11,034	10,225	9,994	10,899	11,195
Employment	1.2	1.1	1.0	0.5	0.5	0.5	0.5	0.5
Net wages	3.2	1.4	3.1	1.9	1.7	2.8	2.1	3.1
Productivity	4.0	3.5	2.0	2.7	2.3	2.7	3.4	3.4
Domestic demand								
	<i>real annual growth rates in %</i>							
Domestic demand	9.1	1.1	0.5	3.8	2.8	3.2	4.7	4.4
Private consumption	6.0	0.8	1.7	4.2	2.5	3.3	4.3	3.7
Public consumption	4.6	3.1	3.2	3.0	2.9	2.9	3.9	3.9
Gross capital formation	18.9	0.5	-3.7	3.4	3.5	3.3	6.2	6.1
Balance of payments								
	<i>real annual growth rates in %</i>							
Exports of goods and services	1.7	12.7	6.2	4.5	3.8	4.2	5.0	5.8
Imports of goods and services	8.2	6.1	2.1	5.2	3.5	4.4	6.2	6.5
Current account (mio USD)	-783	-612	-67	-675	-161	-230	-250	-396
in % BDP	-3.9	-3.4	-0.4	-3.1	-0.8	-1.2	-1.1	-1.8
Terms of trade	-0.4	-5.2	0.9	0.7	0.8	0.5	0.8	0.5
Net financial inflows	3.2	5.8	8.7	5.6	6.5	5.6	4.3	4.7
of which: foreign direct investment	0.7	0.7	3.0	1.6	4.0	4.4	2.5	3.2
Foreign exchange reserves (mio USD)	4,115	4,376	5,738	5,492	6,423	6,813	7,056	7,635
- as % of GDP	20.6	24.3	30.6	24.9	31.4	34.1	32.4	34.1
External debt (mio USD)	5,400	6,217	6,717	8,912	8,077	7,596	8,908	8,533
- as % of GDP	27.0	34.5	35.9	40.4	39.5	37.9	40.9	38.0
Banking system								
	<i>annual growth rates in % (last quarter)</i>							
M1	21.3	7.0	12.8	14.0	12.5	15.4	13.5	15.9
M3	16.0	16.5	23.9	12.0	15.3	19.8	12.3	14.6
Domestic loans	20.7	17.8	19.1	14.7	16.4	18.5	15.0	16.9
Prices								
	<i>annual growth rates in % (last quarter)</i>							
CPI	8.0	9.2	7.3	4.5	5.8	7.0	4.1	4.1
Free prices	7.1	6.8	7.9	4.9	5.3	6.9	3.9	3.7
Administered prices	12.0	21.7	5.0	4.2	8.0	7.6	5.2	5.7

Source: ARC

4. SHORT-TERM MONETARY POLICY FRAMEWORK

Current inflationary trends differ from those projected in the November 2001 "Medium term monetary policy framework of the Bank of Slovenia". There, the Bank of Slovenia projected reduction of inflation to the level of 4% by the end of 2003 as its main task and envisaged the reduction of price growth to 5.8% at the end of 2002. Taking new assumptions on developments of inflationary trends abroad and taking into account the domestic price developments in the first four months of the year, the inflation is expected to exceed the target at the end of 2002, and will reach around 7%. In spite of this deviation, the forecast shows that attainment of the target price-growth at the end of 2003, provided there are no new shocks from the supply side and from abroad, is still feasible.

It is crucial for the Bank of Slovenia to find out whether the inflation acceleration from the beginning of the year is of a permanent or temporary nature, before any monetary policy measures are taken. If the present high inflation is only of a temporary nature, action by the central bank is not required. If this is not the case and high inflation is of a permanent nature, the Bank of Slovenia should take action and conduct a tighter monetary policy. The second important question for the Bank of Slovenia is whether higher inflation is the consequence of inflationary pressures from the cost-side or from demand-side. Inflation is tougher and more difficult to control when it is the consequence of inflationary pressures from the demand-side – in the latter case, the monetary policy has to take measures.

We believe that acceleration of inflation this year is mainly the result of cost factors. Weak domestic consumption, low purchasing power of households and modest demand for credits from the private sector all show that inflation pressures do not originate from the demand side. We expect that domestic demand in the time horizon of two years will not increase to such an extent as to bring about inflationary pressures.

The present inflationary pressures are most probably of a temporary nature. Forecasts of future trends do not show substantial inflationary pressures from abroad, although there is a risk that pressures would increase in case of a repeated increase of oil prices. The increase of tax rates and taxes is as a rule also a single event of a temporary nature. Likewise, it is most unlikely that the Government of RS will allow for as fast growth of administered prices as experienced at the beginning of this year to continue.

* * *

Although price stability is the basic task of the Bank of Slovenia, the Bank is limited in achievement and maintenance of such stability. The Bank of Slovenia can influence inflation by way of the exchange rate management and by way of regulation of the amount of money in circulation. Due to the liberalised capital restrictions and international mobility of capital, the Bank of Slovenia can not simultaneously regulate both instruments independently. If the Bank of Slovenia is to maintain control over the amount of money in circulation, the Bank must also adjust the depreciation rate of the domestic currency and the level of interest rates.

Simplified scheme of monetary and exchange rate policy-mix of the Bank of Slovenia in a given situation

		Monetary policy	
		Lower interest rate	Higher interest rate
Exchange rate policy	Slower depreciation of the tolar	<p>Restrictive monetary policy affecting inflation mainly through influence on import prices with restricting the growth of exchange rate. Domestic interest rates are adjusted to the level equalising the price of domestic and foreign sources of financing. Such an exchange rate policy can be conducted only in the situation where domestic consumption is modest, purchasing power weak, and until low costs of financing do not trigger demand for credits and increased consumption by individuals.</p>	<p>In the absence of international capital mobility this would be the most restrictive form of monetary policy. However, it is not possible to conduct such a policy, since more expensive sources of domestic financing are replaced by cheaper sources of financing abroad, and since the slower growth of exchange rate contributes to a fall in prices of foreign sources of financing. By broadening of the interest rate differential, the efficiency of monetary policy decreases and the central bank loses its control over the volume of money in circulation. This kind of rapid decrease of inflation is not sustainable in the long-term, as such a policy promotes domestic import oriented consumption and ends with a deficit in the current account, capital outflows and a decrease in foreign exchange reserves.</p>
	Faster depreciation of tolar	<p>Expansive monetary policy. Both import prices (higher exchange rate growth) and cheaper sources of domestic financing exert pressure on inflation.</p>	<p>Restrictive monetary policy affecting inflation mainly through higher costs of financing. The central bank is oriented mainly to limiting sources of financing. By higher costs of financing the central bank is restricting the emergence of excessive consumption and demand for credits. By higher domestic interest rates the central bank is restricting the price of domestic sources of financing, and by faster exchange rate growth the price of foreign sources of financing is adjusted to the domestic price. The influence of exchange rate on import prices induces a short-term negative impact on inflation. This kind of conducting restrictive monetary policy is important in case of more permanent pressures on inflation by consumption.</p>

The Bank of Slovenia has two options for conducting a restrictive monetary policy (see the Scheme), i.e. either by influencing import prices, or mainly through conditions of financing. The effectiveness of the chosen option depends mostly on the current state of the economy, and on the support of other economic policies. Regarding restrictiveness, the two options of action for the Bank of Slovenia are different:

- With regard to the pace of attaining price stability. The time interval, in which the monetary policy has an influence on inflation, differs depending on the applied instrumental variables, as the foreign exchange rate influences the inflation faster than the amount of money in circulation does.
- With regard to the ability of maintaining the attained price stability. In the case of an imbalanced reduction of inflation, the burden of its decrease is only born by certain sectors, which induces unnecessary costs of disinflation and also increases macro-economic imbalances, necessitating subsequent corrections, which can have strong inflationary consequences. Maintenance of price stability attained by imbalanced reduction of inflation is hard to achieve, because economic entities act accordingly to maintain existing relative prices.

The current medium-term monetary policy is based on a further gradual decrease of exchange rate depreciation and on the corresponding adjustment of interest rates. The planned growth of the foreign exchange rate may be considered as restrictive, and therefore acceleration of growth would mean higher inflation at the end of this year and additional deviation of inflation from the level projected. On the other hand, however, the additional, more ambitious decrease of the exchange rate depreciation, can result in increased domestic consumption, since lower rate of the exchange rate depreciation must be accompanied by a reduction in interest rates.

Before the Bank of Slovenia chooses appropriate measures in terms of restrictive monetary policy, it is of key importance for the Bank to determine the nature of inflationary pressures, and so is co-ordination of its action with other economic policies.

Restrictive monetary policy, based on a slow-down of a rate of exchange rate depreciation, enables faster attainment of lower inflation, since exchange rate influences inflation faster than the amount of money in circulation does. On the other hand, the risks in such case are greater, as the burden of disinflation lies mainly on the tradable sector, where the growth of prices is already limited. The risk derives from the likelihood that monetary policy is not supported by an adequate policy of administered prices, by collecting tax revenues without inflationary effects, and by a policy of moderate wage growth in the public sector. More

aggressive reduction of a rate of depreciation of exchange rate with unchanged inflation (for the above mentioned reasons) can induce unnecessary additional costs of disinflation, in form of a lag of economic growth behind the potential – and slower real convergence.

In the case of conducting a restrictive monetary policy, based on higher costs of financing, the implementation of the medium-term objective of reduction of inflation slightly lags behind, because of the longer time intervals necessary for the effects of money in circulation on inflation to be felt. This framework is necessary, if other economic policies are not ready to take part in terms of restricting the purchasing power of households, limiting final consumption, and in eliminating present short-term inflationary pressures. In this case attainment of price stability is more time-consuming, but the monetary policy is more robust and less exposed to the negative impacts of macro-economic imbalances.