BANKA SLOVENIJE

EVROSISTEM

REVIEW OF MACROECONOMIC DEVELOPMENTS

MARCH 2022

REVIEW OF MACROECONOMIC DEVELOPMENTS – MARCH 2022

Economic growth and inflation in Slovenia are higher than in the euro area; the war in Ukraine will result in mounting price pressures, and weaker economic growth

- **Quarterly GDP growth in the euro area slowed to 0.3% in the final quarter of last year under the influence of containment measures, which curtailed private consumption.** Amid disruption to supply chains, there was again a slight decline in industrial production, while the decline in construction activity slowed. GDP growth in the euro area amounted to 5.2% last year, based on the quarterly figures. The business conditions in services are improving as the pandemic wanes, but March is expected to bring a deterioration in the economic sentiment because of the geopolitical situation.

- **There remain considerable issues on the supply side of the economy, which are additionally driving inflation.** The rate in the euro area reached 5.8% in February, a new record, with an increasing share of items in the basket of consumer goods facing rising prices. Core inflation has now passed 2.0% in the majority of euro area countries. Domestic inflation is also rising, reaching 7.0% in February, with strong domestic price factors bringing notably high core inflation of 4.7%. The war in Ukraine is currently driving up energy prices, commodity prices and food prices, which is further increasing inflationary pressures in the international environment.

- **Following the outbreak of the war in Ukraine, the financial markets have not ruled out greater flexibility in the withdrawal of non-standard monetary policy measures and the rise in leading central banks' key interest rates.** The outbreak of the war has also brought increased volatility on the financial markets, a retreat to safe haven investments and already strong growth in energy products' prices.

- **With the pandemic's impact on the Slovenian economy waning, last year GDP growth surpassed 8.0% for the first time.** Domestic demand was the main driver, with net trade making a negative contribution, despite high growth in exports. Nominal merchandise imports in December were up more than 43% in year-on-year terms, and last year's annual decline in the current account surplus was the largest to date.

- **The median nowcast, at the cut-off date March 2nd, points to a 0.8% quarterly GDP growth in the first quarter of this year, albeit not accounting for risks associated with the current geopolitical situation.** The economic sentiment improved further in February, and the high-frequency activity indicators show continuing robust growth in domestic consumption and international trade. The strength of the economic growth over the remainder of the year will importantly depend on the severity of consequences of the war in Ukraine and sanctions imposed on the Russian economy. The direct exposure of Slovenian economy to Russia and Ukraine is relatively small, but a more impactful effect could nevertheless result from a combination of shocks, including higher energy prices and commodity prices, a substantial decline in foreign demand, financial stress, and a general loss in confidence. Theses adverse effects could be further amplified from disruptions to supply chains, which would add to existing limitations to production and output growth.

- **In line with the strong upturn in economic activity, the number of persons in employment has hit new highs, while real growth in the wage bill remains high.** Demand for labour remains strong, which, in addition to registered unemployment, which is now lower than in 2008 according to seasonally adjusted figures, exacerbates the structural labour market imbalances. In the wake of the high employment growth, real year-on-year growth in the total wage bill remained high in December, 3.7%, providing a solid basis for further robust growth in private consumption.

- **The general government deficit is gradually narrowing due to high economic growth, and anti-crisis expenditure is also down in year-on-year terms as the pandemic wanes.** The improvement in the fiscal position will be slowed by newly adopted or planned measures, some of which are to alleviate the energy crisis, while the wage negotiations in the public sector could also have a pronounced impact.

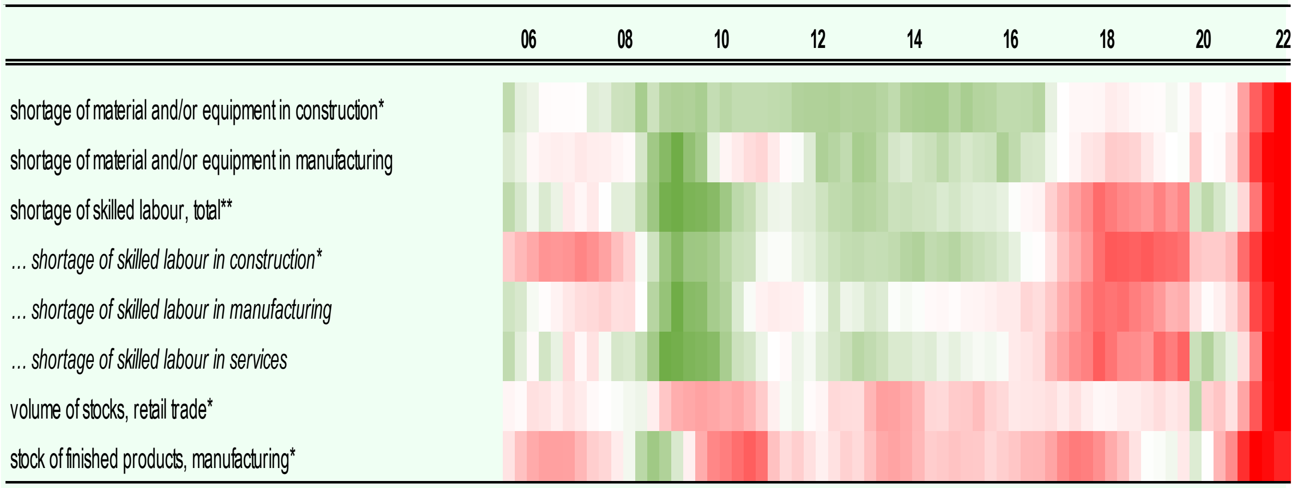
Quarterly GDP growth in the euro area slowed at the end of last year, primarily as a result of the reduced opportunities for spending by households, while the situation with supply chains remains difficult

Euro area GDP reached its pre-pandemic level in the final quarter of last year. It was up 0.3% on the third quarter, significantly less than the growth of more than 2% seen in the two previous quarters. Judging by the monthly indicator of retail turnover, the slowdown was driven by lower growth in private consumption. At the same time the quarterly decline in industrial production was comparable to that seen in the third quarter, while the decline in the amount of construction put in place slowed. Year-on-year GDP growth strengthened to 4.6%, thanks largely to the low base effect caused by the stringent containment measures in late 2020. GDP growth in the euro area amounted to 5.2% last year, based on the quarterly figures. Economic growth also remained weak in January, as the bad epidemiological situation continued to curtail activity in services in particular.

Certain high-frequency indicators rose significantly in February as the pandemic waned and the containment measures were lifted. The composite PMI jumped 3.2 points, the largest rise in the last nine months, reaching its highest level since September of last year. There was a notably strong improvement in the situation in the service sector, while manufacturing firms reported further rises in order books, but also issues with shortages of raw materials and labour, which are showing no signs of abating, at least on the basis of the European Commission's survey figures (see Figure 1). The economic sentiment in the euro area improved in February for the first time since last October, but is expected to deteriorate in March, given the geopolitical situation.

According to the European Commission's winter forecasts released on 10 February, economic growth should pick up in the second quarter, and is expected to stand at 4.0% in 2022. It is also forecast to remain robust over the medium term, despite the withdrawal of support measures. The main drivers are expected to be the buoyant labour market, the high level of household savings, the continuation of favourable financing conditions, and funding from the recovery and resilience facility. The war in Ukraine calls these forecasts into question.

Figure 1: Situation in supply chains: euro area



*Note: The data has been standardised for the entire period. The colour scale denotes the direction and size of the deviation in an individual time series from its long-term average (measured in standard deviations), where red signifies a positive deviation and green a negative, while the size is signified by the shade (a darker shade means a larger deviation). The colour scale is reversed for the inventories indicator. * Average over January and February. ** Banka Slovenije estimate based on share of value-added.*
Sources: Eurostat, Banka Slovenije calculations.

Inflation in the euro area reached 5.8% in February, where the main driver remains high growth in energy prices, but rising prices are spreading across the consumer basket

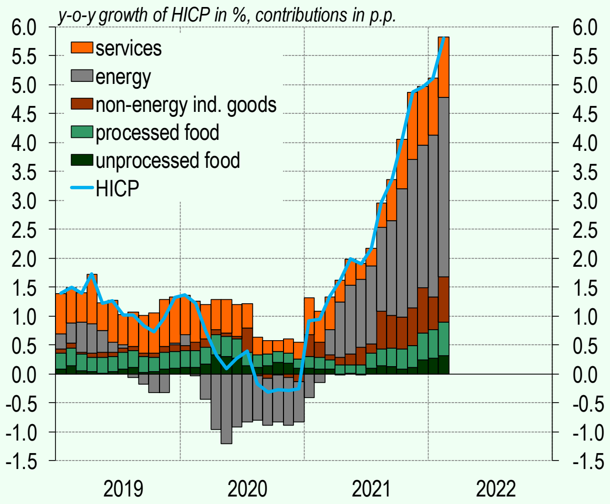
Year-on-year inflation in the euro area as measured by the HICP was not yet as high, but has been rising since July of last year, when it passed the 2% inflation target for the first time since the outbreak of the pandemic (see Figure 2). The high inflation is largely attributable to the rise in energy prices that occurred during the rapid economic recovery following the relaxation of the most stringent containment measures. Moreover, the ongoing supply chain disruptions and geopolitical tensions contribute to the prices reaching record highs. Energy prices account for more than half of headline inflation in almost all euro area countries, the contribution averaging 3.1 percentage points in February. Given agricultural producers' rising import costs in connection with rises in prices of fertiliser and transport, food prices are also undergoing a sustained rise: they were up 4.1% in year-on-year terms in February. The current developments on the energy, commodities and food markets indicate additional inflationary pressures in the international environment, under the impact of the war in Ukraine.

Despite the discontinuation of the low base effect related to the cut in VAT in Germany between July and December 2020, core inflation remains high this year. Other than a small decline in January, the narrowest indicator, which excludes energy, food, alcohol and tobacco from the headline index, has been rising for seven consecutive months, and reached 2.7% in February. Alongside the high demand and disruptions on the supply side, the high energy prices are increasingly driving growth in other price categories: services prices were up 2.5% in year-on-year terms, while prices of non-energy industrial goods were up 3.0%.

In parallel with the overall growth in prices in the euro area, the gaps between individual countries are also widening. February's lowest inflation of 4.1% was recorded by France, while Lithuania recorded the highest rate of 13.9%. Fifteen countries saw inflation of more than 5.0%, and Slovenia's rate of 7.0% ranked it ninth in the euro area (see Figure 2).

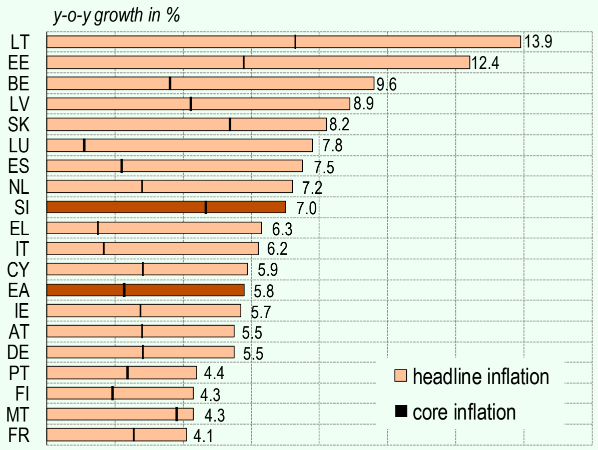
Figure 2: Inflation in the euro area

Contribution to headline HICP inflation – euro area



Source: ECB, Banka Slovenije calculations.

Headline and core inflation among the euro area members



Note: Core inflation figures for LT, EE, LV, LU, ES, IE, AT, DE in PT refer to January as the February data has not yet been released. Remaining data refer to the flash estimate from March 2, 2022. Final February data will be available on March 17, 2022.
Source: Eurostat.

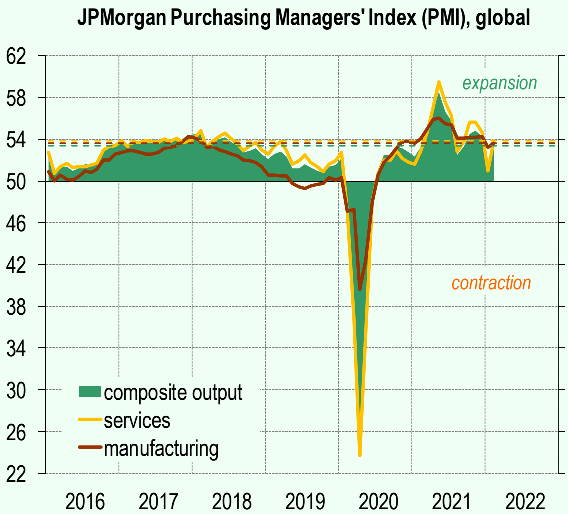
Global economic growth strengthened as the health situation eased, but the risks to economic forecasts have risen amid geopolitical tensions

After a poor January, the global economic situation improved as expected in February. This improvement was reflected in the JPMorgan PMI, which was up 2.3 points on the previous month, the largest monthly rise in more than a year and a half, to reach 53.4 points (see Figure 3). The business conditions in services have normalised, as the waning of the pandemic allowed governments to lift containment measures, but the ongoing disruptions to supply are continuing to curtail growth in global manufacturing output. The uncertainty in connection with the rise in geopolitical tensions has increased in recent weeks, which could have an adverse impact on future growth.

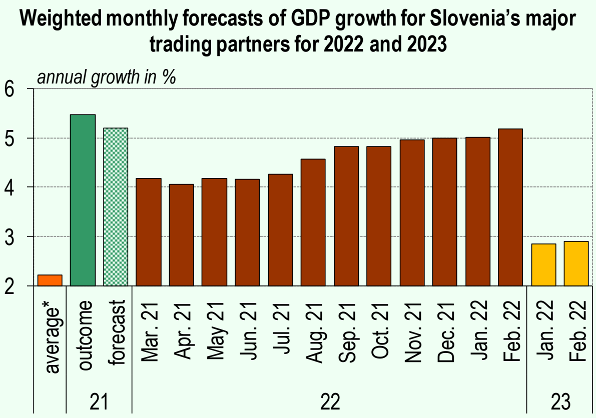
Despite a downward revision, the economic forecasts for 2022 by the World Bank and the IMF released in January were still pointing to high economic growth. The World Bank cut its forecast for global GDP growth by 0.2 percentage points to 4.1%, while the IMF cut its forecast by 0.5 percentage points to 4.4%. The IMF is forecasting even lower growth of 3.8% in 2023, which is nevertheless still above the long-term average. The reasons for the slowdown are the withdrawal of the measures to alleviate the impact of the pandemic, the persistent disruptions to supply chains, and resurgences of the pandemic. Economic growth will be lower this year than last year in all major countries other than Japan and India. The largest slowdowns will be seen in China, where growth is forecast at 4.8%, one of the lowest rates of the last 30 years, and in Brazil (where it is forecast at 0.3%). The risks to these forecasts have increased in recent days as a result of the outbreak of the war in Ukraine.

According to the forecasts released in January and February, the medium-term outlook for the Slovenian export sector remains encouraging. The latest weighted forecasts for Slovenia's trading partners suggest economic growth of more than 5.0% this year. Economic growth is forecast to slow in 2023, but to remain above its long-term average (see Figure 3). In all likelihood this outlook too has become less favourable in recent days.

Figure 3: Global economic situation and weighted forecasts for Slovenia's trading partners



Note: Dashed line represents the value of the last observation.
Source: IHS Markit.



Note: All Slovenian trade partners are included: countries with at least 1% of total Slovenian exports of goods and services in the last twelve months (January 2021–December 2021; 21 trading partners with a total share of 85.8%) and all the other countries as a difference of up to 100%. The growth forecasts for 2022 and 2023 are weighted with the share of each country in the total exports of Slovenia, for other countries the global growth forecast is used. For 2021 the weighted outcome and the December weighted forecast are shown.
**Weighted average of GDP growth, since records began.*
Source: SORS, Consensus, IMF, Banke Slovenije calculations.

Until the outbreak of the war in Ukraine, the unexpectedly high inflation and rising inflation risks were sharply increasing market expectations of the faster withdrawal of non-standard monetary policy measures and a rise in leading central banks' key interest rates

Central banks confirmed the planned discontinuation of asset purchases (the ECB discontinuation of the PEPP), and signalled (faster) rises in key interest rates. The Bank of England raised its key interest rate in February for the second time in a row, and announced the beginning of the reduction of its balance sheet. The Fed will also begin reducing its balance sheet, but not before it raises the key interest rate.

Market participants are expecting the first rise in key interest rates in the US and the euro area significantly sooner than in the past: interest rate futures suggest that the US is expecting its first rise in March of this year, which is likely to be followed by four further rises by the end of 2022, while in the euro area the first rise of 10 basis points in the deposit facility rate is priced in for June, and it is expected to reach 0.0% by early 2023 (see Figure 4).

The impact of the war in Ukraine is already reflected in the strengthening of inflationary pressures and increases the likelihood of slightly lower economic growth

According to market participants, the pace of the withdrawal of non-standard measures and the rise in key interest rates will depend on the depth and length of the impact of the geopolitical tensions on inflation and economic growth. Market participants are not expecting the withdrawal of non-standard monetary policy measures to be halted, but rather greater flexibility, for example in the size and speed of rises in key interest rates, the discontinuation of asset purchases, the approach to the reinvestment of maturing securities or the reduction of central bank balance sheets.

The sharp rise in geopolitical tensions is additionally increasing volatility on the financial markets

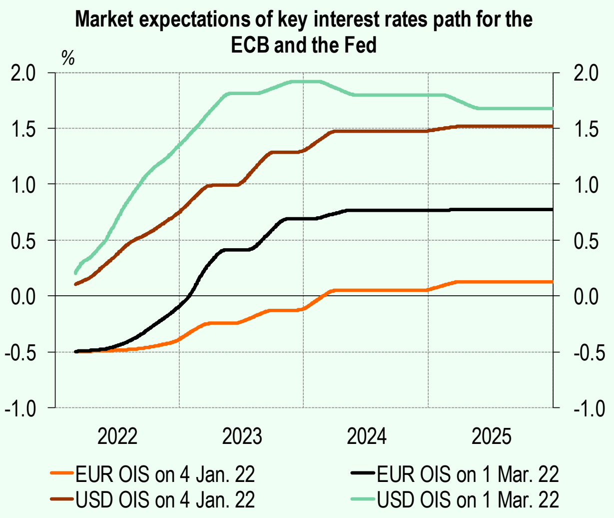
Government borrowing costs have risen since the end of December 2021, but the rise in the spreads of euro area government bonds over the German benchmark remained moderate. Private-sector borrowing costs also rose (see Figure 4), but market participants still see them as adequately supportive and favourable.

Conversely, the majority of share indices have fallen since the beginning of 2022, given the expectation of the withdrawal of accommodativeness by central banks. The fall strengthened after the outbreak of the war in Ukraine. Given the low real interest rates, the outlook for corporate performance nevertheless remains relatively favourable, judging by the solid earnings per share expected by market participants, which is increasing the resilience of the share markets to the gradual normalisation of monetary policy.

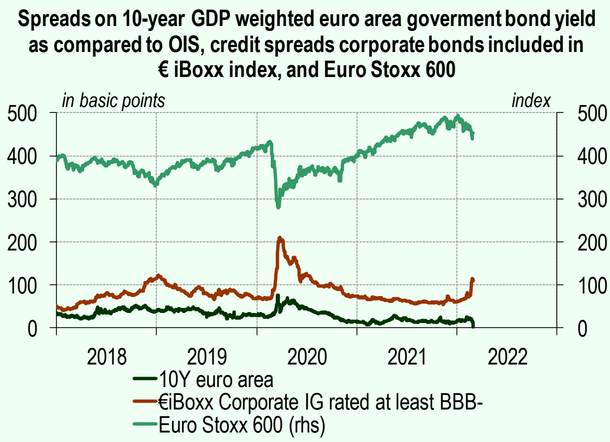
The increased demand for safe haven assets saw the price of gold hit a one-year high in early March 2022. Prices of so-called safe haven currencies, such as the US dollar, the Chinese yuan and the Swiss franc, also rose against the euro and the currencies of numerous European countries.

Among energy products, there were notable rises in prices of natural gas and Brent crude: the latter passed USD 120 per barrel in early March 2022, the highest since 2013. Alongside the sharp rise in geopolitical tensions, the rise in Brent crude prices was also driven by demand outstripping supply, OPEC's decision to not increase pumping in the future, and low inventories. Judging by futures prices, energy products' prices will remain high over the following months, while market participants are not ruling out fiscal measures to protect the economy from energy shocks.

Figure 4: Expectations and spreads on the financial markets



Note: The graph starts with March 2022. Key interest rates rises are priced in 1m overnight swap (OIS) forwards.
Source: Bloomberg, Banka Slovenije calculations.



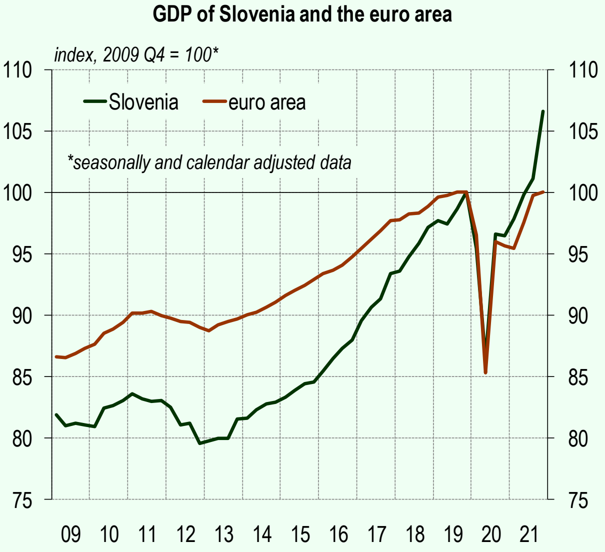
Note: GDP weighted 10-year euro area yield includes all euro area countries except the smallest ones: CY, EE, LT, LU, LV and MT. Spreads are calculated as the difference between this yield and risk-free interest rate, i.e. overnight index swap (OIS). iBoxx index includes financial and non-financial sector issuers. A proxy of credit spreads is asset swap spreads, which is calculated as the difference between yield to maturity and risk-free interest rate comparable maturity, i.e. interst rate swap (IRS).
Source: Bloomberg, Refinitiv, Banka Slovenije calculations.

Economic growth in Slovenia exceeded 8.0% last year for the first time, driven above all by private consumption, while investment also increased sharply

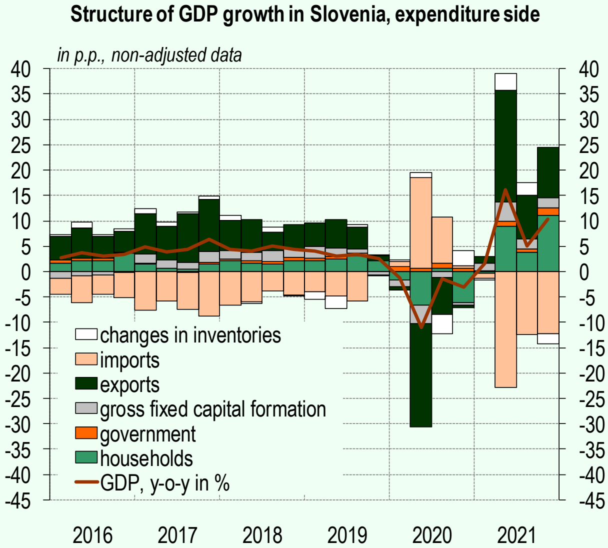
The pandemic's impact on the domestic economy is diminishing. The initial SORS figures for GDP growth in the final quarter of last year indicate a sharp rise, well above expectations. Despite the autumn deterioration in the health situation and the introduction of more-stringent containment measures, quarterly GDP growth reached fully 5.4%, 5.1 percentage points higher than the euro area average, while Germany, Slovenia's main trading partner, actually recorded a decline in GDP. Slovenia's GDP is now fully 6.6% higher than in the final quarter of 2019 (see Figure 5). Annual GDP growth reached 8.1% in 2021, based on the quarterly figures.

Despite the disruptions to supply chains and the rising geopolitical tensions, growth in exports rose strongly at the end of the year. Alongside robust household consumption, domestic activity continued to be driven by heavy investment, including in machinery and equipment. Because last year's growth in domestic demand, and with it growth in imports, was significantly stronger than growth in exports, net trade made a negative contribution to GDP growth (see Figure 5).

Figure 5: Strength and structure of economic growth in Slovenia



Source: SORS, Eurostat.



Source: SORS.

The majority of sectors again saw growth in value-added in the final quarter of last year. Because the disruptions to supply chains only had a genuinely serious impact in a small number of manufacturing activities, and demand continued to increase, quarterly growth in value-added in industry remained positive in the amount of 1.0%. Activity also strengthened in various private-sector services, with the exception of accommodation and food service activities and certain other recreational services. Quarterly growth in value-added was particularly high in financial and insurance activities, where it exceeded 43%. One exception was construction, where growth in value-added was weak last year, despite extremely strong demand, which might indicate problems with a shortage of capacity.

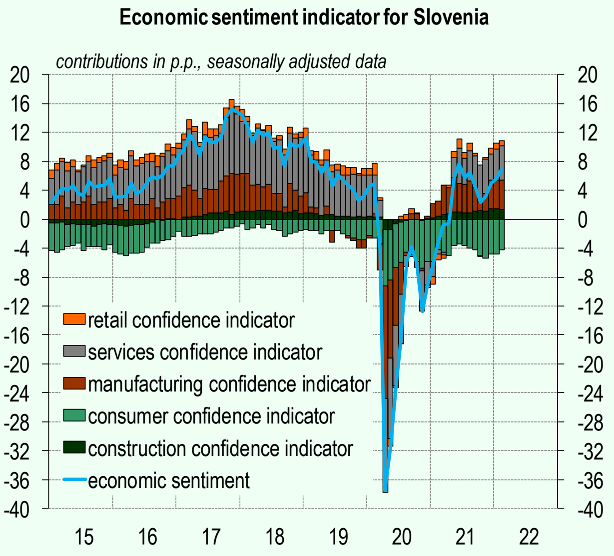
The economic sentiment in Slovenia improved again in February, but the survey was conducted before the outbreak of the war in Ukraine; alternative high-frequency activity indicators remained at favourable levels, despite the geopolitical tensions

The mood in the economy improved for the fourth consecutive month (see Figure 6). The drivers on this occasion were the rises in confidence in private-sector services other than retail and in consumer confidence, which was expected, given the lifting of containment measures. The mood among firms in other sectors remained elevated, despite the rise in input costs and shortages of raw materials and semi-finished goods.

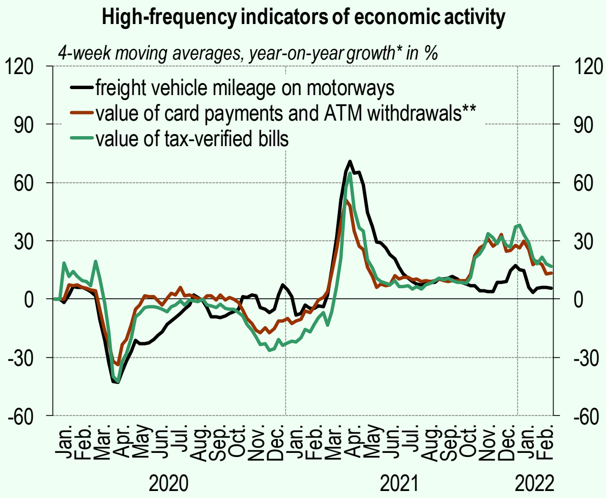
Alternative high-frequency indicators suggested continued growth in domestic demand and international trade in January and February. Card payments, cash withdrawals at ATMs, and invoices registered with tax authorities, which remained well above their pre-crisis levels, are an indication of the persistent strength of domestic consumption. Alongside the robust foreign demand, this was also reflected in freight vehicles' mileage on Slovenian motorways, which in the early part of the year remained at significantly higher levels than before the crisis. Year-on-year growth in the aforementioned indicators also remained high (see Figure 6).

With the lifting of the majority of containment measures on 21 February, business conditions also normalised in contact-intensive services, and March could therefore be expected to bring an uptick in growth in this segment of the economy. This is also supported

Figure 6: Economic sentiment and high-frequency activity indicators



Source: SORS, Banka Slovenije calculations.



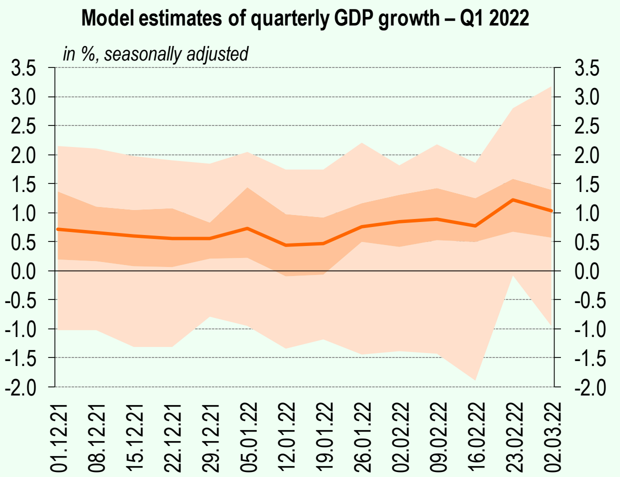
Note: *Approximation for year-on-year comparison is 52 weeks interval. **The source is Bankart, which covers more than 80% of all card payments and more than 93% of all ATM withdrawals in Slovenia.
Source: FURS, DARS, Bankart.

by firms' favourable demand expectations in February, the large build-up of household savings and record employment. Conversely, economic growth could in particular be slowed by the sharp rise in geopolitical tensions.

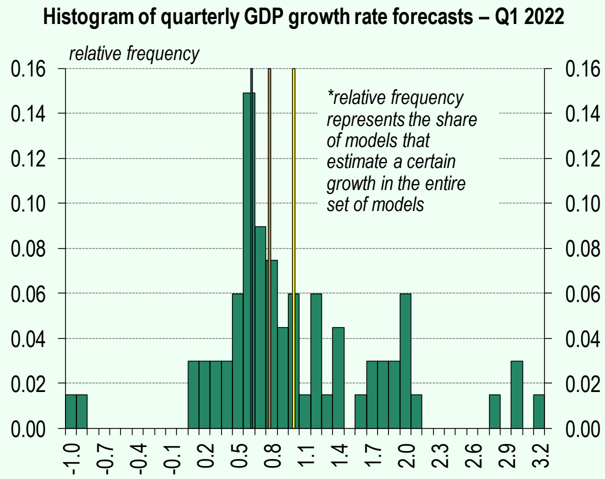
The median nowcast points to a 0.8% GDP growth in the first quarter of this year, albeit not taking into account the impact of recent developments in the international environment

The median forecast of the quarterly GDP growth for the first quarter of this year stood at 0.8% at the cut-off date of March 2nd (see Figure 7). The nowcast is entirely model-based, making use of available economic activity data for January and February (including the newly released national accounts), and does not incorporate any expert assessment of current macroeconomic developments. The set of 67 forecasting models consists of various dynamic factor models, principal component models, (U)MIDAS, (B)VAR, ARDL

Figure 7: Technical nowcast for GDP growth in the first quarter of this year



Note: The graph shows model estimates of quarterly GDP growth. The darker interval represents values between the 25th and 75th percentiles of all estimates. Average model estimate of quarterly GDP growth rate is represented by the line. Date of estimate: 2. 3. 2022.
Source: Banka Slovenije calculations.



Note: Distribution of model estimates of quarterly GDP growth in Q1 2022. The vertical brown line shows the median, yellow the average, and blue the mode of all estimates. Date of estimate: 2. 3. 2022.
Source: Banka Slovenije calculations.

and bridge models. The changes in GDP growth forecasts over the reference quarter are largely related to releases of the high-frequency data that is included in the model infrastructure, while fluctuations are to a lesser extent also caused by re-estimation of the model parameters.

The histogram of the distribution of current forecasts points to upside risks to the median prediction (see Figure 7). This largely reflects positive dynamics in high-frequency confidence indicators, particularly related to private-sector services other than retail and household consumption. Given the changing circumstances in the international environment, the final nowcast for the first quarter of the year will importantly rely on the releases of the March data.

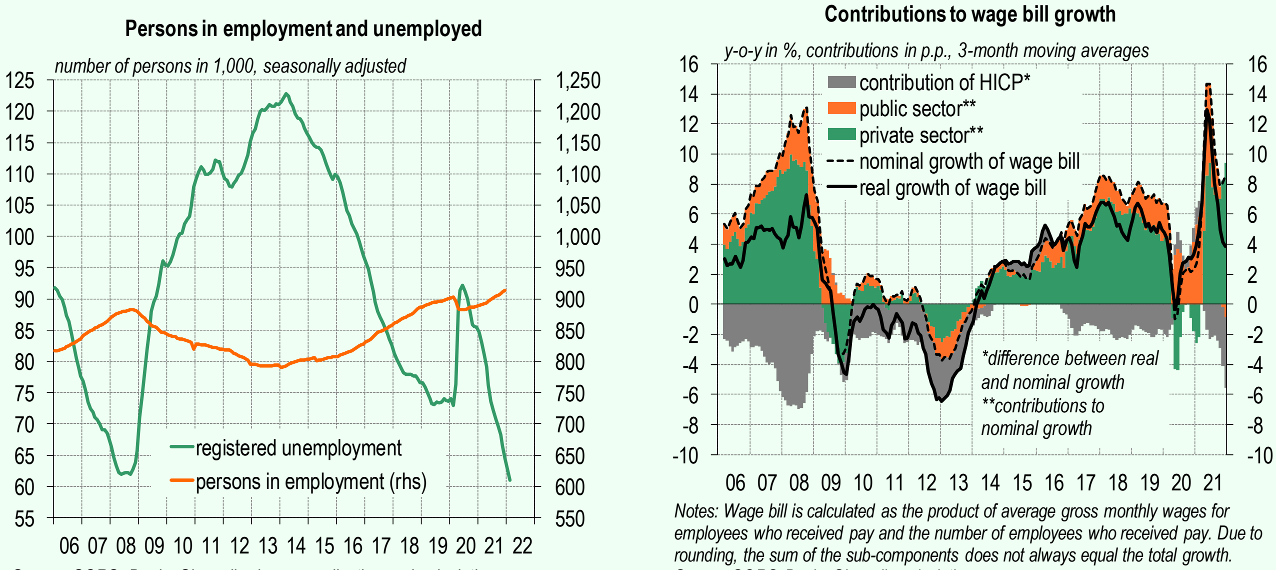
Based on the nowcast for the current quarter, and the carry-over effect of the growth realised in the final quarter of 2021, we expect the GDP growth in 2022 to exceed Banka Slovenije's baseline projection published in December of last year. Additional factor contributing to the upward revision in this year's growth projection is related to the recent measures put in place by the government, which had not been envisaged in December's projection. In this respect, the revisions could imply economic growth over 5% in this year, consistent with the alternative scenario in the December's projections, which envisaged a milder impact of the containment measures. Nevertheless, suggested projection updates remain highly uncertain at this juncture, given the war in Ukraine and the resulting sanctions imposed on the Russian economy.

Amid strong demand for labour, the number of persons in employment hit a new high in December, but structural imbalances are increasing, and real growth in the wage bill is high

The number of persons in employment excluding self-employed farmers was 0.6% higher last year on its pre-crisis level from 2019. The year-on-year rate of growth strengthened further in December, and at 3.0% was at its highest level since May 2019. It remained broadly based across sectors, where accommodation and food service activities stood out for its rate of 13.0%. This was partly attributable to a low base, as the fall in employment in this sector has been most pronounced during the stringent containment measures in place in late 2020 and early 2021. According to the figures on posted vacancies from the SORS and the Employment Service, demand for labour is continuing to increase, while the survey indicators of employment expectations also remained at high levels in February.

The supply of available labour on the domestic labour market continues to be tight (see Figure 8). Registered unemployment stood at 64,783 in February, down 26.4% on a year earlier. The seasonally adjusted figure was 1.4% below its previous low of September 2008. Employers are therefore continuing to intensively hire foreign workers, the number of which in December was up 12.7% in

Figure 8: Labour market



Source: SORS, Banka Slovenije deseasonalisation and calculations.

Notes: Wage bill is calculated as the product of average gross monthly wages for employees who received pay and the number of employees who received pay. Due to rounding, the sum of the sub-components does not always equal the total growth.
Source: SORS, Banka Slovenije calculations.

year-on-year terms. The hiring of foreign workers is most intensive in manufacturing and construction. This helps firms to mitigate the structural imbalances on the labour market, which are most evident in the high employment expectations, the record employment, and the number of vacancies and occupied jobs.

In the wake of the high growth in employment, real year-on-year growth in the total wage bill was high in December at 3.7% (see Figure 8), which provides a basis for further robust growth in private consumption. December's nominal year-on-year growth in the average gross wage of 2.1% was the lowest figure of last year, while surging inflation meant that the average gross wage was down 2.9% in real terms. Alongside high inflation, another major factor in the decline was the normalisation of wages in the public sector following June's withdrawal of the majority of the wage bonuses in connection with the pandemic. Real growth in the average gross wage in the private sector stood at 1.8% in December.

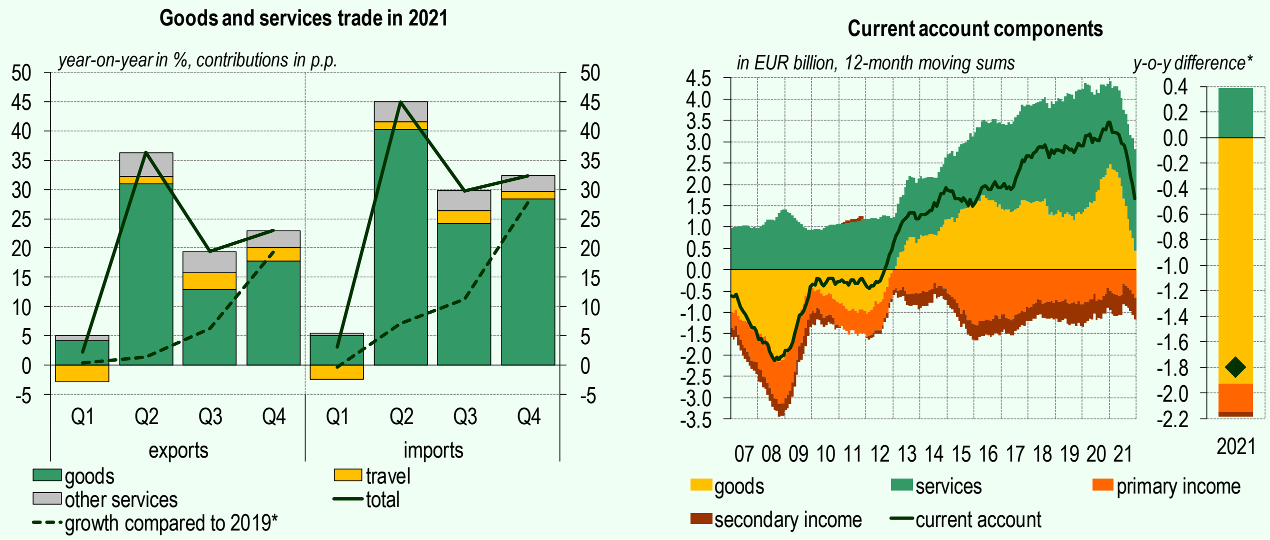
The current account surplus narrowed by more than a half last year amid sharp rises in import prices and strong domestic demand, as year-on-year growth in imports reached more than 43% in December

With prices of industrial goods continually rising, merchandise trade further increased in late 2021, and was just over a quarter up on its level from the quarter before the outbreak of the pandemic. A surge in exports from the car industry raised year-on-year growth in nominal merchandise exports to around 30.0% in December according to balance of payments figures, where the recovery in sales to Germany was the largest national factor. With imported goods rising in price by a quarter, growth in merchandise imports increased sharply, hitting 43.4% in December, largely as a result of a rise in imports of intermediate goods.

According to SORS survey figures, the situation for merchandise exporters was good in early part of this year: the short-term assessments of export expectations were significantly higher than those from 2019, despite fluctuations in recent months. We should reiterate that these assessments were published before the additional rise in geopolitical tensions between Russia and the West in late February.

Services trade increased again at the end of last year, and was up on its pre-crisis level by around a tenth, largely as a result of increased trade in transport services in parallel with the strong growth in merchandise trade, and rising trade in miscellaneous business services. The situation in trade in travel services remained bad, given the difficulties with the epidemiological situation, and the consequent restrictions on international tourism. Exports of travel services last year were still down approximately a half, or almost EUR 1.4 billion, on their 12-month pre-pandemic peak.

Figure 9: Current account



*Note: *Export (import) growth of goods and services in 2021 compared to 2019.*
Source: Banka Slovenije.

*Note: *Change in EUR million in 2021 compared to the previous year.*
Source: Banka Slovenije.

The current account surplus narrowed by a record EUR 1.8 billion last year to EUR 1.7 billion (see Figure 9), as a result of strong domestic demand and a pronounced deterioration in the terms of trade. The main driver was the decline of almost EUR 2.0 billion in the merchandise trade surplus, which fell to its level of early 2013, when the reversal in the current account position began. The deficit in income also deepened, primarily as a result of a one-off high payment of dividends to foreign owners of direct investments, while the 12-month services trade surplus gradually strengthened, but remained down approximately EUR 0.6 billion on its pre-crisis peak from February 2020. According to initial estimates, last year's deterioration in the terms of trade accounted for almost half of the decline in the trade position, and 40% of the decline in the current account surplus.

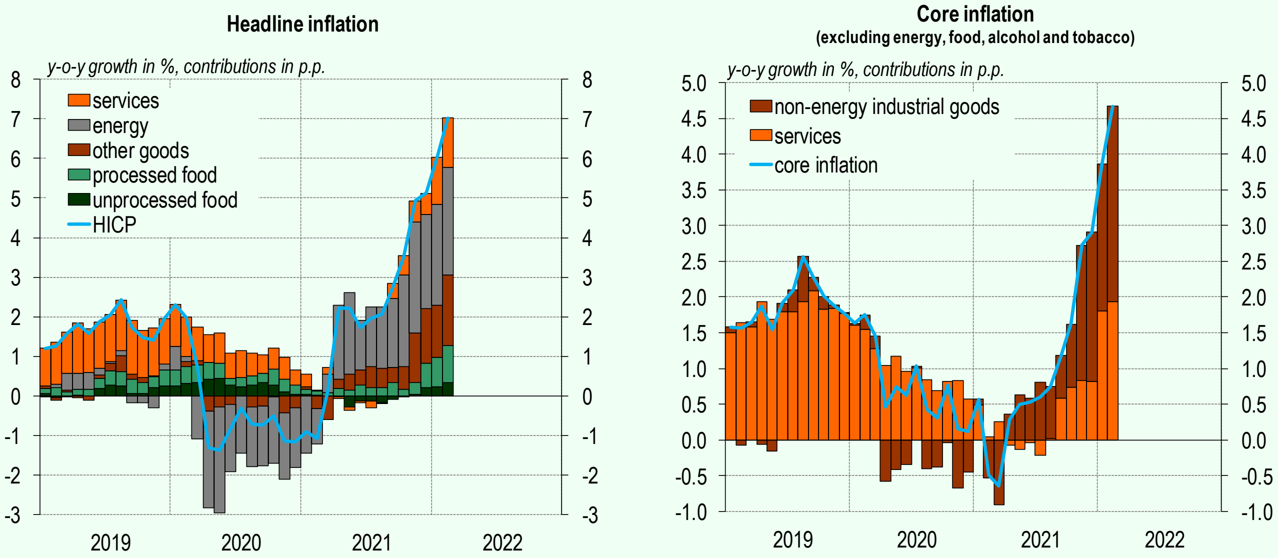
Domestic inflation is still rising, as high energy prices increasingly pass through into rises of prices of food, other goods and services, therefore the risks of a longer period of inflation are strengthening

Amid rising domestic and foreign inflationary pressures, the basket of consumer prices was up fully 7.0% in year-on-year terms in February (see Figure 10), what is more than figures before the global economic and financial crisis of autumn 2008 when the economy was overheating. Rises in energy prices and other commodity prices are increasingly passing through into the production costs of non-energy industrial goods and food production costs: the contributions to headline inflation made by these categories has more than tripled since last October and November. Another driver of inflation is this year's growth in services prices, which is becoming increasingly broad-based.

Energy inflation was again high in February as prices were up 22.9% in year-on-year terms. In addition to a rise in network charges this January, this year's increased growth in energy prices was also driven by rises in supplier prices of natural gas and electricity, with more price rises announced for the coming months. A temporary cut in excise duties on electricity, natural gas and heating oil could not hold down year-on-year price rises, while the impact of government measures to alleviate rising energy prices on the wholesale markets might be more evident in the spring, when the temporary waiver of the contribution for CHP and renewables and the freeze on network charges are expected to be taken into account in the calculation of price growth.[1]

In contrast to the euro area figures, domestic core inflation has risen sharply this year, reaching 4.7% in February (see Figure 10). Growth in prices of non-energy industrial goods has been strengthening since the end of last year, and this year has been accompanied by service price inflation. Given the increasing pass-through of higher input costs into final prices of products and services, our

Figure 10: Domestic price developments



Source: ECB, Eurostat, Banka Slovenije calculations.

Source: ECB, Eurostat, Banka Slovenije calculations.

[1] A cut in excise duties was put in place for the period of 1 February to 30 April 2022. The contributions aim to support combined heat and power (CHP) and the use of renewables.

expectation is that core inflation will remain elevated over the remainder of the year, while the outbreak of the war in Ukraine and the huge uncertainty surrounding developments in energy prices, gas in particular, could further increase the spillover effect. Further indication of high core inflation in the future comes from the expected rise in consumption after the easing of containment measures, and the situation on the labour market, where unemployment is at one of its lowest ever rates and employment is at a record high.

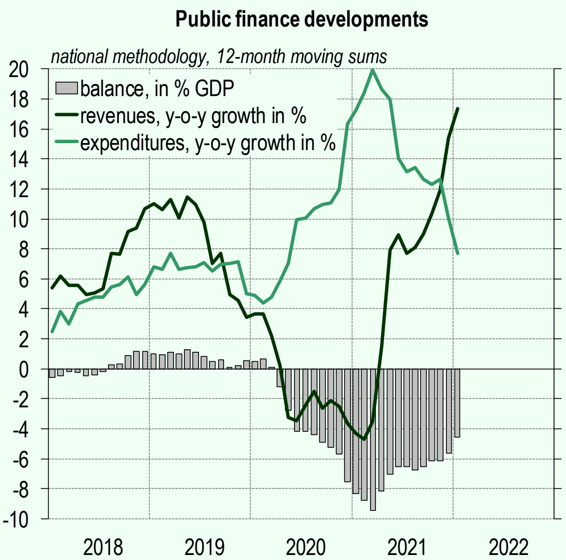
Other risks of further rises in inflation are posed by the sharp rise in geopolitical tensions, which are being reflected in higher growth in prices of energy, commodities and food. Another growing factor in a long period of elevated inflation could also be costs related to the green transition, which is strongly increasing demand for metals that are vital to green electricity generation, but whose stocks are of limited quantity and geographical distribution. Furthermore, supply is still being hindered by disruptions to supply chains, while demand will depend in part on the degree to which savings built up during the pandemic are released, the potential negative impact on household purchasing power from higher inflation, and the outcome of wage negotiations in the public sector.

The general government position improved again in January, but newly adopted and planned measures will slow its further improvement

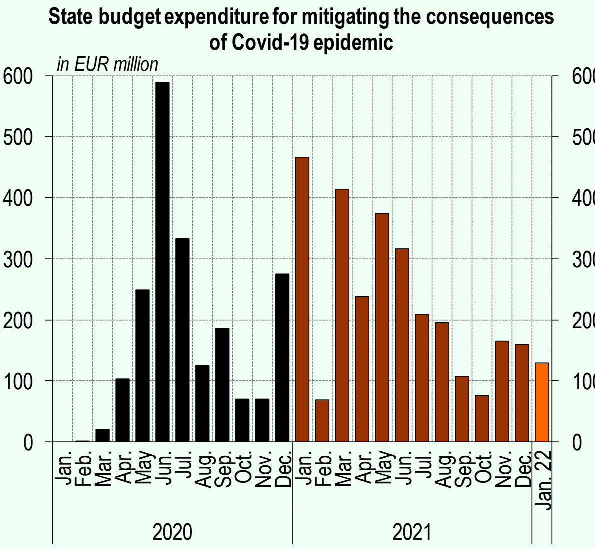
The general government deficit amounted to EUR 2.9 billion or 5.6% of GDP last year, EUR 0.6 billion less than in the previous year. The improvement in the position came despite the increase in expenditure to mitigate the impact of the pandemic, which according to state budget figures amounted to EUR 2.8 billion last year, compared with EUR 2.0 billion in the previous year. Expenditure of this type in the second half of the year was half that in the first half of the year, and was down significantly in year-on-year terms in January this year (see Figure 11). Alongside the strong economy, which has been reflected in high growth in revenues, this was the key factor in the further improvement in the general government position. All tax revenues increased in January, most notably VAT, while inflows from the EU budget also increased as funding was received from the recovery and resilience plan.

This year the government has adopted several measures with temporary or permanent effects on the public finances, and their implementation is slowing the reduction of the general government deficit. The temporary measures include measures in response to high energy prices, which encompass support payments for households, assistance for businesses and agriculture, and cuts in excise duties on electricity and energy products. They are costed at around EUR 230 million in total. An unscheduled pension increase was also made, which is raising expenditure by EUR 145 million at the annual level, while the changes to sickness benefits that took effect on 1 March will entail an additional annual burden on the Health Insurance Institute of between EUR 80 million and EUR 94 million according to its own estimates. The National Assembly has also passed the Digital Inclusion Promotion Act, the bill for which planned funding of EUR 31.5 million this year, while negotiations are also underway on wage rises in the public sector.

Figure 11: Slovenia's general government position



Source: Ministry of Finance, Banka Slovenije calculations.



Note: Includes also the budgetary reserves.
Source: Ministry of finance, Banka Slovenije calculations.

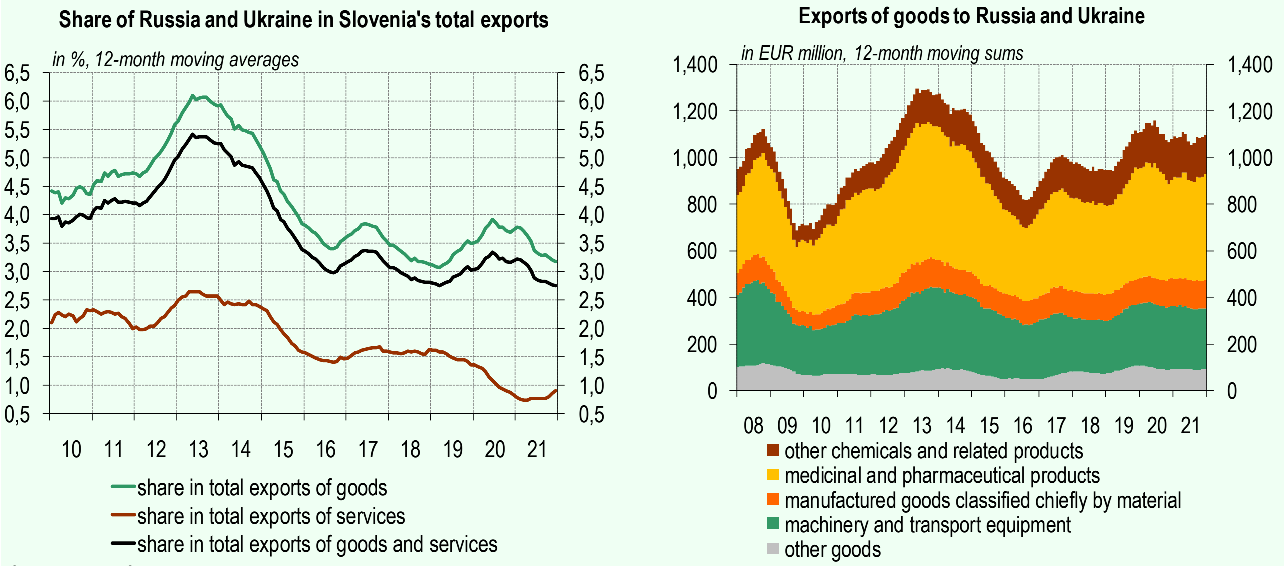
IN FOCUS

The direct impact of the war in Ukraine on Slovenia's merchandise exports is relatively small, with only the pharmaceutical industry affected significantly

Slovenia runs a merchandise trade surplus with both Russia and Ukraine. The surplus with Russia has stood at around EUR 520 million over the last two years, while the surplus with Ukraine amounted to around EUR 180 million. Each accounts for the majority of Slovenia's current account surplus with both countries. The fluctuation in the merchandise trade surplus with Russia is largely attributable to value fluctuations in imports of mineral fuels and lubricants, while the changes in the merchandise trade surplus with Ukraine are primarily driven by exports of medical and pharmaceutical products, and also by exports of electrical machinery and appliances.

The direct impact of the Ukrainian crisis on Slovenia's exports is relatively small. Exports of goods and services to the two countries accounted for just 2.7% of Slovenia's total exports in 2021, down approximately a half on its peak in May 2013, when it exceeded 5.4% (see Figure 12). The adverse impact is likely to be more significant on the domestic pharmaceutical industry, whose exports to the two countries amounted to approximately EUR 450 million last year (almost 13.0% of its total exports excluding Switzerland), of which Russia accounted for EUR 340 million, still just two-thirds of the exports in 2013 (see Figure 12). In addition to medical and pharmaceutical products, which account for approximately half of Slovenia's total exports to the two countries, the other main merchandise exports include electrical machinery and appliances and industrial machinery and equipment for general use, although their share of Slovenia's total exports of these products does not exceed 5.0%. Total exports of goods and services to Russia and Ukraine accounted for just 0.1 percentage points of last year's nominal growth in exports of 18.9%, while their contribution to the annual growth in imports of 26.3% was similar.

Figure 12: Importance of Russia and Ukraine to Slovenia's exports



Source: Banka Slovenije.

Source: SORS, Banka Slovenije calculations.

In terms of imports and exports based on the concept of value-added, Slovenia's exposure to Russia is increasing, but remains small

The assessment of the potential indirect impact of the war in Ukraine on Slovenia's merchandise exports took account of the latest data from the OECD (TiVA) for 2018, which does not include figures for Ukraine, for which reason the analysis solely covers Slovenia and Russia. Russia accounted for 3.0% of Slovenia's total exports in 2018, although after taking account of indirect flows of merchandise via other countries ("net" exports in Table 1), Slovenia's exposure would increase by 0.3 percentage points to 3.3%. Russia meanwhile accounted for 2.3% of Slovenia's total imports, although after taking account of indirect flows of merchandise via other countries ("net" imports in Table 1), Slovenia's exposure would increase by 0.8 percentage points to 3.1%. Foreign value-added in Slovenia's exports amounted to just over a third in 2018, while Russia's corresponding share of value-added was just 1.7%. Russia's share of value-added in Slovenia's total imports was 3.7%.

Table 1: Russia's share of Slovenia's imports and exports

in %, 2018	gross exports	gross imports	"net" exports	"net" imports
Slovenia	3,0	2,3	3,3	3,1

Note: The "net" imports and exports also take account of indirect flows of merchandise via other countries.
Sources: OECD (TiVA), Banka Slovenije calculations

The Slovenian economy holds more financial assets than liabilities vis-à-vis Russia and Ukraine, whereby the net position is low and stable, as is the share of direct investment between the countries

Slovenia's international investment position against Russia and Ukraine is that of a net creditor, and has not changed significantly over the last three years. According to the latest figures from the end of the third quarter of last year, it held net financial assets of around EUR 480 million against Russia, and significantly less against Ukraine at around EUR 150 million. The total amount is also relatively small, given that Slovenia's total net financial liabilities to the rest of the world amount to EUR 4.7 billion. Slovenia holds more assets than liabilities vis-à-vis the two economies with regard to the main categories of financial instruments. In both cases there is a notable positive net position in direct investment and non-financial corporations' trade credits, while there are also net holdings of securities against Russia (see Figure 13).

Figure 13: Net financial position and FDI position with Russia and Ukraine

Note: For 2021 data for the end of the third quarter.
Source: Banka Slovenije.

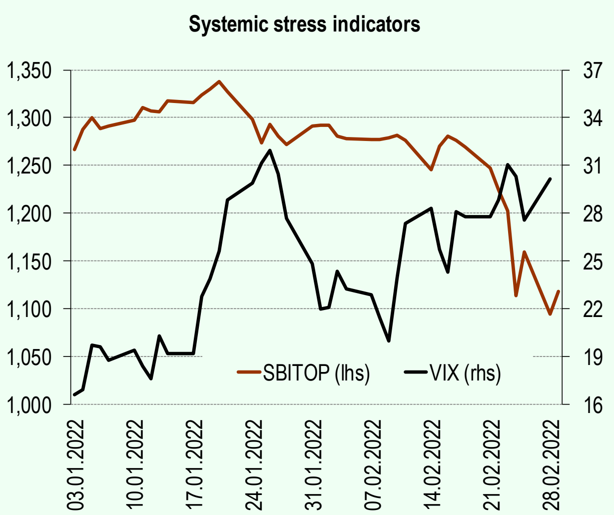
Note: The stock of direct investment can be positive or negative. A negative balance may mean that the net debt to the owner is greater than the owner's investment in equity. However, the value of equity itself may be negative (for investments that are valued at book value because they are not listed on the stock exchange).
Source: Banka Slovenije.

Russia and Ukraine accounted for less than 7.0% of Slovenia's stock of outward FDI in 2020, while they accounted for just 0.8% of total inward FDI in Slovenia (see Figure 13). Slovenia's holding of FDI in Russia amounted to around EUR 430 million, down 6.0% on the previous year. Its holding of FDI in Ukraine also declined slightly over the same period, and was significantly lower at just around EUR 40 million. The FDI holdings of Russia and Ukraine in Slovenia amounted to approximately EUR 130 million at the end of 2020, nearly all of which was under Russian ownership, both countries having recorded a slight increase relative to the previous year. In terms of the ultimate investing country, the FDI holdings of Russia and Ukraine in Slovenia were higher in terms of value and in terms of the share of total FDI in 2020: the figures for Russia were EUR 390 million and 2.4%, while the figures for Ukraine were EUR 130 million and 0.8%, which is still relatively small.

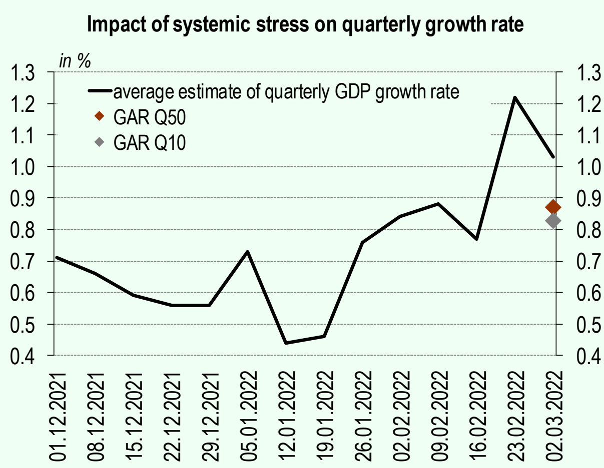
The worsening geopolitical crisis has over the last week been strongly reflected in indicators of systemic financial stress, which have empirically provided an early signal of turning points in economic activity

Figure 14 illustrates the risk to the baseline short-term forecast for quarterly GDP growth in the first quarter of this year on the basis of changes in financial indicators and the indicator of systemic financial stress recorded between 18 and 25 February. Based on this weekly rise in systemic stress, the estimated risk to the current baseline forecast ranges between -0.15 to -0.25 percentage points. The materialization of the assessed risk to quarterly economic growth remains dependent on further escalation of the crisis.

Figure 14: Systemic stress indicators and potential impact on quarterly economic growth



Note: VIX measures market expectation of near term volatility conveyed by stock index option prices.
Source: LJSE, FRED.



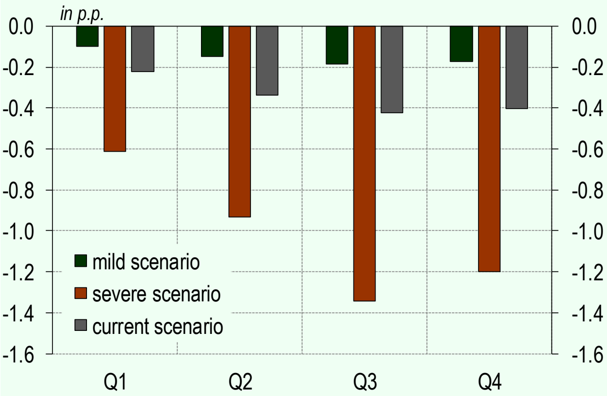
Note: The figure shows the estimated potential impact on quarterly growth rate based on estimates of the 50th and 10th quantile of the GDP growth distribution and the composite indicator of systemic stress (CISS).
Date of estimate: 2. 3. 2022.
Source: Banka Slovenije estimates.

Apart from the consequences for the short-term growth, the main medium-term impact on the macroeconomic environment can be expected to come from a fall in foreign demand and sustained rises in prices of energy and other commodities

Figure 15 illustrates the macroeconomic impact of a simultaneous decline of foreign demand and rise in energy prices under various scenarios. The current scenario is based on data derived from futures contracts for energy categories, which relative to the reference date of 14th of February (before the Russian invasion) on 28th of February predicted an average additional 7% rise in oil prices this year, a rise of 20% in electricity prices and a 25% rise of natural gas prices. In addition, the current scenario also assumes a 1% decline in foreign demand on account of the assumed 30% decline in Russia's total merchandise trade. The mild scenario envisages a sustained 0.5% fall in foreign demand, a rise of 5% in oil prices, and a rise of 10% in other energy prices. The severe scenario assumes a 50% rise in all energy prices and a 3% fall in foreign demand, proportionate with the total export exposure to Russia. Under the current scenario, the projected impact on this year's annual GDP growth could reach -0.45 percentage points, while the impact on annual inflation could amount to 0.65 percentage points. Under the severe scenario, the impact on annual GDP growth could exceed -1 percentage point, while the additional rise in annual inflation could amount to 2 percentage points. At this point, it should be reiterated that the scenarios reflect preliminary estimates on the basis of partial analysis, and do not take account of effects relating to the general loss of confidence, disruptions to supply chains, increased financial stress, and more pronounced second-round effects.

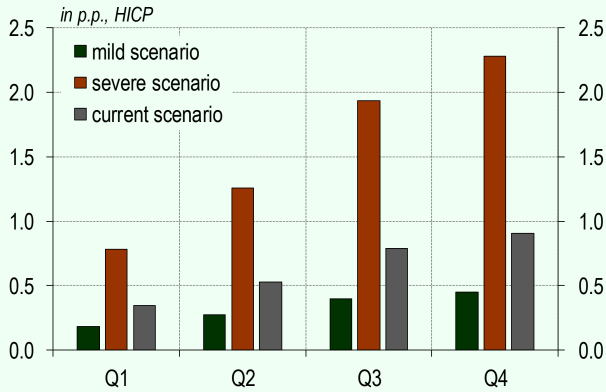
Figure 15: Impact of fall in foreign demand on GDP, and impact on inflation from pass-through of higher commodity prices

The effect of declining foreign demand on year-on-year GDP growth



Note: The effects on GDP and inflation are technical estimates based on model elasticities derived from the Bank of Slovenia's forecast model. The current scenario refers to the observed changes in the data on energy futures prices compared to the cut-off date of 15 February 2022 and the preliminary estimate of the decline of foreign demand.
Source: Banka Slovenije estimates.

The effect of higher commodity prices on year-on-year price growth



Note: The effects on GDP and inflation are technical estimates based on model elasticities derived from the Bank of Slovenia's forecast model. The current scenario refers to the observed changes in the data on energy futures prices compared to the cut-off date of 15 February 2022 and the preliminary estimate of the decline of foreign demand.
Source: Banka Slovenije estimates.

Table 2: Selection of macroeconomic indicators on a monthly basis, Slovenia

	2020	2021	12 m. 'till Dec.21	3 m. 'till Dec.20	3 m. 'till Dec.21	2021 Oct.	2021 Nov.	2021 Dec.	2022 Jan.	2022 Feb.
Economic Activity										
					balance of answers in percentage points					
Sentiment indicator	-11.8	2.5	2.5	-9.3	3.5	2.3	3.1	5.0	5.6	6.8
- confidence indicator in manufacturing	-8.6	8.3	8.3	0.7	6.3	3.0	6.0	10.0	10.0	10.0
					year-on-year growth rates in %					
Industry: - total	-6.4	10.2	10.2	-1.0	8.2	4.2	9.1	11.8	...	...
- manufacturing	-6.2	11.7	11.7	-1.1	8.7	4.7	9.9	12.0	...	...
Construction: - total	-0.7	-5.8	-5.8	6.1	-10.9	-10.6	-14.2	-6.4	...	...
- buildings	-7.8	-23.6	-23.6	1.7	-32.7	-33.0	-33.5	-31.3	...	...
Trade and service activities - total	-9.6	12.2	12.2	-9.8	18.5	15.8	20.3	19.3	...	...
Wholesale and retail trade and repair of motor vehicles and motorcycles	-14.5	8.3	8.3	-18.3	11.3	-3.9	19.1	23.1	...	...
Retail trade, except of motor vehicles and motorcycles	-5.9	16.3	16.3	-10.0	30.8	22.9	35.6	34.4	...	...
Other private sector services	-11.5	12.3	12.3	-10.8	18.2	18.5	19.4	16.8	...	...
Labour market					*year-on-year growth rates in %*					
Average gross wage	6.0	6.0	6.0	6.8	2.8	3.6	2.8	2.1	...	...
- private sector	4.5	5.9	5.9	3.9	7.0	5.7	7.2	7.8	...	...
- public sector	7.9	6.4	6.4	11.5	-3.5	0.5	-4.1	-6.3	...	...
Real net wage[1]	7.1	3.0	3.0	8.0	-1.9	-0.4	-2.1	-3.3	...	...
Registered unemployment rate (in %)	8.7	7.6	7.6	8.7	6.7	6.8	6.7	6.7	...	...
Registered unemployed persons	14.6	-12.6	-12.6	15.9	-22.4	-20.3	-22.3	-24.4	-25.9	-26.4
Persons in employment	-0.6	1.3	1.3	-1.2	2.6	2.4	2.7	2.9	...	...
- private sector	-0.9	1.3	1.3	-1.9	3.2	2.9	3.2	3.5	...	...
- public sector	0.1	1.1	1.1	0.5	1.2	1.2	1.3	1.1	...	...
Price Developments					*year-on-year growth rates in %*					
HICP	-0.3	2.0	2.0	-0.9	4.5	3.5	4.9	5.1	6.0	7.0
- services	1.8	0.6	0.6	1.3	1.5	1.4	1.6	1.6	3.5	3.7
- industrial goods excluding energy	-0.5	1.3	1.3	-0.9	3.3	1.7	3.9	4.4	4.3	5.8
- food	2.8	0.7	0.7	2.1	1.8	0.5	1.4	3.6	4.1	5.5
- energy	-10.8	11.3	11.3	-12.7	22.2	20.7	25.1	20.8	21.9	22.9
Core inflation indicator[2]	0.8	0.9	0.9	0.3	2.4	1.6	2.7	2.9	3.9	...
Balance of Payments - Current Account					*in % GDP*					
Current account balance	7.4	3.2	3.2	7.8	0.7	3.2	2.4	-3.7	...	...
1. Goods	5.0	0.8	0.8	4.3	-1.6	0.1	0.0	-5.1	...	...
2. Services	4.3	4.6	4.6	4.3	4.9	5.3	5.0	4.3	...	...
3. Primary income	-0.9	-1.3	-1.3	0.1	-1.6	-1.3	-1.4	-2.2	...	...
4. Secondary income	-1.0	-1.0	-1.0	-0.8	-0.9	-0.9	-1.2	-0.6	...	...
					nominal year-on-year growth rates in %					
Export of goods and services	-10.1	18.9	18.9	-2.9	22.8	16.9	24.3	27.8	...	...
Import of goods and services	-11.7	26.3	26.3	-3.4	32.3	28.9	29.5	38.7	...	...

Public Finances	2020	2021	12 m. 'till Jan.22		2021 Jan.-Jan.		2022 Jan.-Jan.	
Consolidated general government (GG) balance[3]	*EUR milions*		*% GDP*	*y-o-y, %*	*EUR mio*	*y-o-y, %*	*EUR mio*	*y-o-y, %*
Revenue	18,529	21,382	42.1	17.4	17,041	-5.1	20,258	18.9
Tax revenue	16,460	18,784	36.9	16.3	15,012	-6.0	17,704	17.9
From EU budget	730	951	2.1	43.8	730	-0.6	1,048	43.6
Other	1,338	1,647	3.1	16.2	1,300	3.5	1,506	15.9
Expenditure	22,071	24,297	46.8	7.7	20,917	18.7	22,412	7.1
Current expenditure	9,128	10,390	20.2	14.1	8,492	10.4	9,684	14.0
- wages and other personnel expenditure	4,965	5,758	11.0	12.2	4,678	12.2	5,249	12.2
- purchases of goods, services	3,021	3,341	6.5	13.1	2,776	7.5	3,135	12.9
- interest	778	732	1.3	-5.6	686	-3.0	643	-6.3
Current transfers	10,868	11,321	21.6	-0.9	1,157	48.0	973	-15.9
- transfers to individuals and households	8,251	9,168	17.4	4.3	973	56.0	773	-20.6
Capital expenditure, transfers	1,549	1,957	3.8	28.2	52	-19.4	64	23.4
GG surplus/deficit	-3,542	-2,915	-4.6		-393		128	

Note: Economic activity data are working day adjusted (with exception of sentiment and confidence indicators data, which are seasonally adjusted). Other data in the table are original. Monthly activity indicators for industry, construction and services are shown in real terms.
[1] HICP deflator. [2] Inflation excluding energy, food, alcohol, tobacco. [3] Consolidated central government budget, local government budgets and social security funds (pension and disability insurance fund and health insurance fund) in cash accounting principle.
Source: SORS, Banka Slovenije, Ministry of finance, Banka Slovenije calculations.

Title: Review of macroeconomic developments
No.: March 2022

Published by: BANKA SLOVENIJE
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 Analysis is based on data available up to 3 March 2022. The report was discussed at the Banka Slovenije Governing Council meeting on 4 March 2022.

This publication is also available in Slovene.