Autumn Forecast of Economic Trends (2006)

The autumn forecast of economic trends is based on the IMAD's model and expert estimates built on the following source data: (i) the first statistical data on economic growth for the first two quarters of 2006, the first annual estimate for 2005 and revised data for 2002-2004; the official figures from the quarterly and annual national accounts were still not harmonised and therefore the expected effect of this harmonisation is taken into account in the forecast; (ii) data on economic growth in the international environment for the first half of 2006 and the announced or released autumn revisions to forecasts made by international institutions; (iii) consultations with other institutions that make forecasts for Slovenia, and results of the econometric models used in forecasting[1]; and (iv) detailed data on the structure of consumer price trends for this year and revised expectations regarding oil price trends.

The autumn forecasts of economic trends are based on the implemented or approved measures of economic policy and budget realisation for 2006. The forecasts of the government's current and investment consumption in 2007 and 2008 are based on the starting positions for proposed changes to the national budget for 2007 and the proposed budget for 2008. In addition to the already enforced phasing out of the payroll tax, whose expected positive effects on employment and economic growth have already been included in the spring forecast this year, the 2006 autumn forecast also takes account of the projected effects of the draft amended laws on personal and corporate income tax that were approved by the government in September 2006. As expected, the amended Personal Income Tax Act will have a more significant impact on economic growth and will result in slightly higher growth of private consumption in 2007.

The analytical background of the forecasts will be explained in more detail in the Autumn Report 2006.

1. ASSUMPTIONS ABOUT THE INTERNATIONAL ECONOMIC ENVIRONMENT

In the first half of 2006, economic growth in the euro area exceeded the spring expectations so upward revisions have been made to the 2006 forecasts. The revised forecasts still project that economic growth will slow down next year while a slight rebound is expected in 2008. Economic growth in the euro area has been gaining momentum since the second half of 2005. In the first six months this year it even reached the highest rate on record in six years (3% in Q1 and 2.1% in Q2, year on year, seasonally and working days unadjusted data). The acceleration of economic growth was mainly underpinned by the stronger growth of domestic demand: a boom in private consumption was followed by increased investment in Q2. With the expected continued robust growth of domestic demand, the economies in the euro area are expected to remain vibrant until the end of 2006. GDP growth in the euro area is forecast to total 2.5% this year, one percentage point more than in 2005. Forecasts of GDP growth have been revised upwards for all of Slovenia's main

[1] In the final phase of its preparation, the IMAD's autumn forecasts of economic trends were presented to other forecasting institutions (ARC – Analysis and Research Centre of the BS, SKEP – Department of Economic Analysis and Economic Policy of the Chamber of Commerce and Industry, EIPF – Economic Institute of the Faculty of Law, IER – Institute for Economic Research). The forecasts also take into account the results obtained using the model of leading indicators and the IER's economic model constructed to evaluate the effects of economic reforms (September 2006).

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trading partners, including Italy, where economic growth stagnated in 2005 (see Table 1). Next year we expect a slowdown of economic growth in the euro area due to the combined effect of the further appreciation of the euro against the dollar and the expected slowdown of economic growth in the United States, which will dampen the growth of European exports. Looking at internal factors, the more restrictive monetary policy of the European Central Bank and the raising of VAT in Germany will cause the growth of domestic demand to be weaker again at the beginning of 2007 and, consequently, the GDP growth rate will decelerate next year, especially in Germany. In 2008, economic growth is set to rebound slightly, which will also result in slightly higher growth in the euro area than in 2007.

Forecasts of world economic growth in 2006 and 2007 have also seen upward revisions compared to spring. The IMF's autumn forecasts project 5.1% real global GDP growth for this year and 4.9% growth for 2007. The IMF's forecasts of world trade growth are also higher (8.9% and 7.6%, respectively). Forecasts of economic trends in the USA, Japan and China therefore remain favourable for this year whereas next year a slowdown is expected in the USA (as a result of high interest rates and effects of the falling prices in the real estate market on domestic consumption) and in Japan, while China's economy is set to continue growing at a robust pace. Risks that could result in a substantial slowdown of global GDP growth, especially in 2007, include high oil prices that would increase cost pressures on prices and force banks to resort to even more restrictive monetary policies. Another factor that would have an adverse effect on the world economy is the possible stronger slowdown of GDP growth in the USA relative to the currently prevailing forecasts.

Table 1: **IMAD's assumptions regarding economic growth in Slovenia's main trading partners, 2006-2008**

		2006		2007		2008	
	2005	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)
Euro area	1.4	2.0	2.5	1.8	1.8	1.9	1.9
Germany	0.9	1.6	2.2	1.0	1.1	1.5	1.5
Italy	0.0	1.3	1.7	1.3	1.2	1.5	1.5
Austria	2.0	2.2	2.5	2.0	2.3	2.2	2.3
France	1.2	1.9	2.3	2.0	1.9	2.1	1.9
UK	1.9	2.2	2.7	2.4	2.4	2.3	2.5
Czech Republic	6.0	4.5	6.0	4.2	5.0	4.3	4.8
Hungary	4.1	4.2	4.0	4.0	2.3	4.0	2.8
Poland	3.2	4.0	5.0	4.2	4.5	4.5	4.7
Croatia	4.3	3.7	4.2	3.8	4.0	3.8	4.0
Bosnia & Herzegovina	5.7	6.0	5.7	6.0	6.0	5.4	6.0
Serbia	6.3	4.0	4.0	4.0	4.0	4.0	4.0
Macedonia	4.0	4.0	3.5	4.0	4.0	4.5	4.0
USA	3.2	3.2	3.2	3.0	2.7	3.1	3.1
Russia	6.4	6.0	6.2	6.0	5.9	5.0	5.5

Sources of data: Eurostat; Consensus Forecasts, May 2006, July 2006, August, September 2006; WIIW Research Report, July 2006; Eastern Europe Consensus, May 2006, July 2006; European Commission, DG Ecfin – Interim Forecast, September 2006; European Commission, DG Ecfin – Economic Forecasts, Spring 2006, WIFO – Monatsberichte, May 2006; IMF World Economic Outlook, September 2006; OECD Interim Assessment, September 2006; own estimate.

The economies of Slovenia's main trading partners among the new EU member states – the Czech Republic, Poland and Hungary – have continued to grow strongly this year. Except for Hungary, forecasts for the whole 2006-2008 period have been revised upwards although they still project a progressive slowdown for the next two years. In addition to the continued vigorous growth of exports, the growth of domestic demand has been accelerating this year. The Czech economy enjoyed the strongest economic growth in the first half of the year (6.7%, year on year), followed by Poland (5.1% year on year). Forecasts for 2006-2008 for both countries have accordingly been revised upwards (see Table 1). The forecast for Hungary has been scaled down for the entire period, particularly for 2007 and 2008, when the effects of the stabilisation programme it adopted in June this year to reduce the high general government deficit are expected to set in.

Forecasts of GDP growth for 2006 in the group of countries of former Yugoslavia have seen some revisions. Croatia's economic growth is estimated to be higher than projected in spring, the forecasts for Macedonia and Bosnia & Herzegovina have been revised downwards, while the outlook for Serbia remains unchanged. Forecasts for 2007 remain unchanged in all countries except Croatia, where GDP growth will be higher than projected in spring. In 2008 we assume the same growth rates as in 2007. The Croatian economy recorded the highest growth in two and a half years in Q1 (6.0%) but is projected to slow down until the end of the year and come in at a similar annual level (4.2%) as in 2005. It will also remain close to that level in 2007-2008 (4.0%). Economic growth in BiH will total around 5.7% this year according to the latest forecasts, slightly less than projected in spring mainly due to the current developments in industrial production and distributive trades. Growth of the Bosnian economy should be stable at 6% over the next two years. The economic growth forecasts for Macedonia have seen a downward revision (to 3.5%) largely owing to the weak growth of industrial production which makes the prospect of lower economic growth this year than expected in spring highly probable. In the next two years, the economy should continue to grow at a 4% rate. The forecast for Serbia for this year and the next two years remains unchanged relative to the spring forecast (4.0%), projecting a softening of GDP growth over 2005, primarily as a result of lower private and investment consumption.

The increase in oil prices seen in Q2 and Q3 this year had an upward effect on the autumn assumption regarding the average oil price in 2006, despite the significant drop in September. Given the latest estimates of the oil supply to demand ratio, assumptions for the next two years are also higher than in spring. During preparation of the spring forecast the price of Brent crude was expected to rise to USD 64/barrel over the year and remain at this level until the end of 2006 and to then gradually fall to an average of USD 61.5/barrel in 2007. However, oil prices have risen much more rapidly than expected this year (to USD 69.8/barrel in Q2 and even more in July and August – to USD 74.0/barrel), which resulted in upward revisions of the IMAD's autumn assumptions regarding the expected average price of Brent crude in 2006 to USD 69/barrel. In September, when the IMAD's autumn forecast was being made, oil prices moderated to an average level of USD 65/barrel thanks to favourable conditions (absence of any major hurricanes in oil pumping areas, mitigation of several geopolitical tensions). Nevertheless we expect that factors fuelling oil prices on both the supply and demand sides and their strong sensitivity to one-off events will continue to exist in the future. The autumn forecast therefore assumes that in 2007 and 2008 oil prices will remain at a higher average level than this year (at USD 73/barrel).

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Table 2: **Autumn forecast assumptions regarding the price of Brent crude**

	2005	2006		2007		2008
		Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Autumn forecast (Sept. 2006)
Average price per barrel, USD	54.4	63.5	69.0	61.5	73.0	73.0

Source of data: World Bank; forecasts by IMAD.

The dollar's depreciation against the euro seen in the last six months was bigger than projected in the spring technical assumption which was based on the dynamics of the previous six months. The new rate was determined as a technical assumption for the entire forecasting period on the basis of developments in the months from April toSeptember 2006). In the first eight months of 2006, the euro generally appreciated against the dollar and achieved its highest average monthly value since April 2005 in August this year (USD 1.28 for EUR 1). The assumed euro/dollar rate is therefore slightly higher compared to the spring forecast: 1.248 dollars for 1 euro in 2006 and 1.265 for 1 euro in 2007-2008 (the spring forecast assumed a rate of 1.20 for the whole forecasting period).

2. REVISIONS OF DATA USED IN THE AUTUMN FORECAST 2006

2.1 First annual estimate of gross domestic product for 2005 and a revision for the 2002-2004 period

In September 2006 the Statistical Office of the Republic of Slovenia (SORS) released its first annual gross domestic product (GDP) estimate for 2005 and a revision of GDP for the 2002-2004 period. The biggest revisions relative to prior releases were made for 2004 and 2005. The revised estimate of GDP in 2004 in current prices totals SIT 6,272 bn, SIT 20.6 bn more than in the previous estimate, mainly due to higher gross fixed capital formation. The estimated real GDP growth for 2006 was also revised upwards (by 0.2 p.p. to 4.4%), with the biggest upward revision having been made to the real growth rate of gross fixed capital formation (from 5.9% to 7.9%). The revision of data for 2002 and 2003 brought no changes to nominal GDP or its growth rate, resulting only in some corrections to individual GDP components. According to the first annual estimate, GDP in current prices totalled SIT 6,620 bn in 2005, which is SIT 62.4 bn more than in the preliminary estimate based on quarterly national accounts. The difference was largely generated by the increase in the change in inventories and valuables. GDP growth totalled 4%, 0.1 p.p. more than estimated in the preliminary release, however several substantial revisions were made to the real growth rates of individual expenditure components of GDP and their contributions to overall GDP growth. The new estimate received positive inputs from the upward correction to private consumption growth (from 3.3% to 3.4%) and the smaller negative contribution of the change in inventories to GDP growth (-0.6 p.p. over the -1.7 p.p. estimated in the preliminary release). On the other hand, downward revisions were made to the real growth of gross fixed capital formation (from 3.7% to 1.5%) and government consumption (from 3.0% to 2.2%), and the positive contribution of external trade to economic growth was scaled down (from 2.3 p.p. to 2.0 p.p.) due to the relatively bigger increase in the real growth of imports than exports.

2.2 Revision of the balance of payments in 2002-2005

September 2006 also saw the release of revisions to Slovenia's balance of payments for 2002-2005, where the main changes were again made to data for the last two years. The goods and services trade balance for the 2002-2004 period remained unchanged after the revision, while the inclusion of the SORS' final data on the trade in goods and services in 2005 resulted in a slightly lower trade deficit and a lower surplus in trade in services. Methodological changes resulted in more substantial corrections to the incomes balance, where the deficit expanded throughout the 2002-2005 period, and to the current transfers balance of 2004 and 2005, which was positive before the revision but turned negative after it. These changes have resulted in a higher current account deficit in the entire period: EUR 720 m or 2.7% of GDP in 2004 (EUR 544 m in the preliminary release), and EUR 547 m or 2.0% of GDP in 2005 (over the previous EUR 301 m).

3. AUTUMN FORECASTS OF ECONOMIC TRENDS IN 2006-2008

3.1 Analysis of the current developments and forecasts of economic growth in 2006-2008

The Slovenian economy grew by 5% in the first six months of 2006. Quarterly GDP growth was even, totalling 5.1% in Q1 and 4.9% in Q2[2]. Exports of goods and services and gross fixed capital formation were the main drivers of economic growth in the first half of the year, rising by a real 11.6% over the same period of 2005 and 8.9% in real terms, respectively. The strong exports and investment also underpinned the acceleration of GDP growth compared to 2005, when the economy grew by 4%, since private consumption growth remained at last year's average level (3.4%) in the first half of 2006. The stronger growth of domestic consumption and exports was matched by the faster growth of goods and services imports (10.6%, year on year).

The strong real export growth of Slovenian goods and services seen in Q1 (14.9% year on year) and its slowdown in Q2 (8.6%) followed the dynamics of GDP growth in the EU[3]. A similar dynamic was observed in the growth of goods and services imports (13.5% and 8.0%). Both aggregates rose more in the first six months of the year than in 2005 on average. Given the expected slowdown in the growth of road vehicles exports that helped maintain the strong growth of merchandise exports particularly in the first half of 2005 when the trading partners' economies were growing at a subdued pace, the growth of merchandise exports in the first six months this year was largely generated by the growth of exports in other goods. The latter rose by 18.4% from January to June, year on year (in 2005 as a whole by 8.6%, nominal terms, EUR), while exports of road vehicles increased by 7.9% (35.4% in 2005). Regional data on exports show relatively level growth of merchandise exports to the EU and other countries, while within the EU exports have continued to grow more rapidly to new member states, which also achieved high GDP growth rates in the first half of 2006. The growth of road vehicles exports remains a significant driver of the strong growth of exports to the UK along with Germany, to which exports of industrial machinery and non-ferrous metals have also increased considerably this year on the back of the robust industrial and investment activity. The growth of exports to Austria and Italy in the six months to June was mainly fuelled by exports of electricity. Exports to the countries of former Yugoslavia have been rising at a slower pace than exports to the EU, mainly due to the further drops in exports to Bosnia and Herzegovina and Macedonia, while exports to Croatia, Serbia and Montenegro have continued to increase. As a result of the accelerated growth of exports and domestic consumption, imports have also increased at a faster pace this year. All end-use product groups (investment, consumer and intermediate goods) in the structure of imports recorded approximately level increases, between 15% and 17% year on year (nominal terms, EUR). Trade in services also peaked in Q1 this year and eased off in Q2. Contrary to 2005, when exports of services mostly grew at a much higher rates than their imports throughout the year, the real growth of services exports and imports was fairly level in the first half of 2006 (exports 11.3%, imports 11.1%, year on year). In exports, the fastest growth was seen in other services (particularly business and insurance services), while transport services were in the lead in imports.

The growth of domestic consumption has strengthened this year, owing primarily to the faster growth of gross fixed capital formation. Gross fixed capital formation began to increase rapidly at

[2] According to working-days adjusted data, year-on-year GDP growth was lower in Q1 (4.8%) than in Q2 (5.6%).
[3] Real GDP growth in the EU totalled 3% in Q1 and 2.2% in Q2, year on year, according to the comparable seasonally- and working-day-unadjusted data.

the end of 2005 and continued to expand in the first half of 2006 (by 9.1% in Q1 and 8.7% in Q2 year on year). This indicates that the accelerated growth in Q4 of 2005 was not triggered solely by the tax changes (reduced tax relief) that started to take effect in 2006. Investment in transport equipment enjoyed the biggest increase in the first six months this year (by 16.8% in real terms), followed by investment in other equipment and machinery (12.7%). Investment in housing construction also continued to grow strongly (13.6%). The contribution of the change in inventories to economic growth was again negative in both quarters (-0.4 p.p. and -0.5 p.p.), remaining at a level close to that of 2005 (-0.6 p.p.). Looking at other components of domestic consumption, the growth of private consumption remains stable (3.5% in Q1, 3.3% in Q2), which was expected and already indicated by the current short-term consumption indicators (the growth of turnover in retail trade and VAT charged to final consumers).

The autumn forecast of GDP growth for 2006 totals 4.7%, 0.5 of a percentage point more than projected in spring. The upward revision is based mainly on the higher expected growth of investment consumption, which will result in a higher contribution of domestic consumption to growth this year (4 p.p.) compared to the spring estimate (3.8 p.p.). The faster growth of domestic consumption as well as exports will also speed up the growth of imports, but the contribution of external trade (0.6 p.p.) will nevertheless slightly exceed the spring estimate (0.4 p.p.) thanks to the favourable export flows.

Unlike in 2005, the contribution of domestic consumption to GDP growth will largely be based on the growth of gross fixed capital formation rather than private consumption. Given the dynamics in the first half of the year, when investment in transport and other equipment and machinery recorded booming growth, and providing for the expected acceleration in investment in civil engineering in the second half of the year based on the national motorway company's data and statistics on the contracts concluded in this construction segment, the growth of gross fixed capital formation (8.6%) will significantly exceed the spring estimate (6%). Despite the slightly lower real growth of the gross wage bill than expected in spring and despite the upward revision to private consumption growth for 2005 the forecast of the real growth of private consumption remains unchanged (3.3%) based on, among other things, the growth achieved in the first half of the year (3.4%) and the dynamics of current indicators. Taking into account the revision of the estimated government consumption for 2005 and the realisation of this year's budget we also project that the annual growth of government consumption will come in approximately at the level forecast in spring (2.8%).

Foreign demand underpinned by the stronger economic growth in most of Slovenia's main trading partners will be an even more important driver of economic growth this year than estimated in spring. Assuming that the international economic environment will remain supportive, the growth of merchandise exports is expected to be somewhat higher than in Q2 in the second half of the year but nevertheless slightly lower than in the first six months on average, year on year. At the annual level, the growth of goods exports (10.6%) will exceed the spring forecast (8.5%) and end up at a similar level as last year (10.3%). In the regional structure of exports, the share of EU countries will further increase on the back of their growing economies. The overall Slovenia's export growth in 2006 will be lower than in 2005 only due to the slowdown in services exports growth (6.6%) compared to the robust growth rates achieved in the past two years, although it will remain within the range of the spring expectations.

Table 3: **Autumn forecasts of GDP growth and consumption aggregates and a comparison with the spring forecasts for 2006-2008**

Real growth rates (%)

	2005	2006		2007		2008	
		Spring forecast (March 2006)	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**
GROSS DOMESTIC PRODUCT	4.0	4.2	4.7	4.0	4.3	3.9	4.2
Exports of goods and services	10.5	8.2	9.9	7.9	8.3	8.0	8.5
Imports of goods and services	7.0	7.6	9.1	7.4	7.7	7.5	7.7
Private consumption	3.4	3.3	3.3	3.3	3.6	3.6	3.6
Government consumption	2.2	2.7	2.8	2.8	2.5	2.4	2.8
Gross fixed capital formation	1.5	6.0	8.6	5.0	5.5	4.0	4.5

Source of data: SORS; forecasts by IMAD.

Economic growth is expected to soften in 2007, however to a higher level than projected in spring (4.3% over the 4.0% forecast in spring). Stimuli from both domestic and foreign demand will be stronger than expected in spring. The anticipated economic slowdown in the international environment is expected to result in weaker growth of goods and services exports than this year, but it will nevertheless be higher (8.3%) than projected in spring thanks to the positive carry-over of this year's favourable export flows. As imports of goods and services will rise by an estimated 7.7% in real terms, the contribution of external trade will remain positive (0.5 p.p.) and at a similar level as this year. In domestic demand, which is projected to contribute 3.8 p.p. to economic growth, private consumption growth is expected to be higher (3.6%) given the projected positive effects of lower personal income tax rates on one hand and the restrictive impact of higher interest rates on the other. The reduced tax burden is anticipated to particularly benefit employees in higher income brackets who have a higher propensity for saving than others, and will therefore not turn entirely to final consumption[4]. Consequently, the average propensity to consume will decline and the growth of private consumption is therefore expected to remain below the estimated growth of disposable income in 2007 (3.8%). The forecast of investment consumption, which has been revised slightly upwards over spring (5.5%) projects continued steady growth of housing investment and motorway construction. The growth of investment in machinery and equipment will ease off relative to 2006 as result of the slightly less dynamic economy as well as the abolition of the general investment tax relief pursuant to the proposed amendments to the Corporate Income Tax. The government consumption growth forecast for 2007 is based on the starting positions for proposed amendments to the national budget for 2007 and projects a slowdown from 2.8% growth in 2006 to 2.5%.

Real GDP growth in 2008 (4.2%) is projected to remain at a similar level as in 2007 (4.3%). Against the background of the anticipated rebound in the international environment, the real growth of goods and services exports will come in at 8.5%. Compared with 2007, the growth of gross fixed capital formation will decelerate further as the vigorous housing construction seen in the preceding years is expected to ease off due to the enforcement of a higher VAT rate on new housing. On the other hand, stimuli for investment growth should come from the continued growth of civil

[4] The estimate takes into account the results of the Institute for Economic Research's model designed to estimate the effects of tax legislation on the growth of macroeconomic aggregates (September 2006).

engineering construction (based on plans of the national motorway construction company), higher funds from the EU and a further easing of the corporate tax burden through phasing out payroll tax and reducing corporate income tax. The growth of private consumption should again achieve 3.6% in 2008 on the back of the positive employment prospects on one hand and purchases of durables and semi-durables that will follow increased housing purchases in the preceding period on the other. Household consumption is again expected to grow at a slower pace than disposable income (3.7%) in 2008 since the repayment of loans taken out in previous years (mainly housing loans, where instalments are relatively high) will somewhat reduce household budgets. Given these anticipated trends in exports and domestic consumption, the imports of goods and services are projected to grow by a real 7.7% in 2008.

3.2 Balance of payments forecast for 2006-2008

The current account deficit will narrow progressively in 2006-2008 but will remain higher than projected in spring. In addition to the new forecasts of the real export-import flows and terms of trade, the higher projected deficit also reflects the methodological changes that were introduced with the revisions made to the balance of payments for 2002-2005 (see Chapter 2) and will also impinge upon the future balance of payments flows. Based on the current data on the balance of trade in goods and services, which recorded a higher surplus in the seven months to July than in the same period of 2005, and the flows projected for the rest of the year, the forecast of the trade deficit at the annual level has been revised downwards over spring. The higher projected current account deficit for 2006 compared to the spring forecast will therefore be attributable exclusively to the higher deficit in factor incomes and a deficit in current transfers, where a surplus was forecast in spring. The latter hinges solely on the higher deficit in non-government sectors transfers resulting from the changed methodology of recording the Pension and Disability Institute's remittances to non-residents in the balance of payments, whereas a positive net financial flow is expected in the government sector. On the other hand, factor incomes expenditure has exceeded the revenue from this source since 2002, which will also create higher current account deficits in 2007 and 2008, given the expected reinvested earnings and higher payments of interest on loans from the rest of the world. The balance of trade in goods and services will be in equilibrium in 2007 and run a surplus in 2008. In 2008, the current account deficit is projected to contract back towards 1% of GDP, partly owing to the higher projected surplus of the government sector in the current transfers balance compared to 2006-2007, based on bigger funds from the EU budget provided for by the new financial perspective for 2007-2013.

Table 4: **Autumn forecast of the current account of the balance of payments and a comparison with the spring forecast for 2006-2008**

	2005	**2006**		**2007**		**2008**	
		Spring forecast (March 2006)	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**
Current account of the BoP, EUR m	-547	-480	-693	-390	-503	-300	-410
Current account of the BoP, % of GDP	-2.0	-1.7	-2.4	-1.3	-1.6	-0.9	-1.2

Source of data: Bank of Slovenia; forecasts by IMAD.

3.3. Labour market outlook for 2006-2008

3.3.1. Employment and unemployment

Based on the projected economic trends, employment growth will remain at around 0.9% in the period from 2006 to 2008. Thanks to the positive developments in the labour market in the first half of 2006 supported by a vibrant economy, the forecasts of employment growth for this year, as well as for the next two years, are slightly higher than in spring (Table 5). According to the national accounts statistics, employment was 0.9% higher in the first half of the year than in the same period of 2005 and rose the most in construction (6.5%), real estate, renting and business services (4.7%) and in other community, social and personal services (3.6%). In addition to the anticipated stronger economic growth, the forecast of employment growth for 2006-2008 also reflects the expected effect of phasing out the payroll tax[5] and the effects of changes to legislation regulating the obligations of unemployment benefit and social assistance claimants aimed at stimulating their activity, already taken into account in the spring forecast. Lower personal income tax rates will provide a further incentive for activity. At the same time, faster GDP growth than projected in spring will also increase the demand for labour.

The current flows suggest that the registered unemployment rate will decrease at a slightly faster pace in 2006-2008 than projected in spring, while ILO unemployment will remain below the spring forecast. Considering the first half of the year, when the registered unemployment rate totalled 9.9%, its forecast rate remains unchanged for 2006 (9.8%) while it is slightly lower for 2007 (9.5%) and 2008 (9.1%). In the first six months of the year a substantial number of people were taken off the unemployment registers for reasons other than finding work[6] (47.5% more than in the first half of 2005) and the outflow of the unemployed to employment increased as well, however there was also a bigger inflow of first-time job-seekers and people who lost work. The number of registered unemployed, which in May hit its record low since October 1991, continued to fall further to total 84,675 people in June. These flows are expected to continue on a roughly equal scale, resulting in a slightly lower registered unemployment levels and rates in the next two years than projected in spring. The ILO unemployment rate has similarly been revised downwards as both formal and informal employment continued to grow[7], and the ILO activity and employment rates consequently rose more than we projected in spring. We expect that the employment rate will remain above the spring forecasts in the next two years while ILO unemployment should be lower than projected (6.4% in all three years).

[5] In the 2006-2009 period, during which payroll tax is planned to be phased out, the private sector will save around SIT 109 bn (SIT 13 bn in 2006, SIT 20 bn in 2007, SIT 36 bn in 2008 and SIT 40 bn in 2009). We assume that companies will be able to use a part of these remaining funds to hire new labour and the other part to increase their investment levels.

[6] Voluntary sign-offs, neglecting the obligations or transition to inactivity (retirement, education etc.).

[7] Unpaid family workers, work on a contractual basis and employment in the grey economy.

Table 5: **Autumn forecasts of labour market flows and a comparison with the spring forecasts for 2006-2008**

	2005	2006		2007		2008	
		Spring forecast (March 2006)	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**	**Spring forecast (March 2006)**	**Autumn forecast (Sept. 2006)**
Employment according to national accounts (growth in %)	0.3	0.8	0.9	0.6	0.8	0.8	0.9
Registered unemployment rate (%)	10.2	9.8	9.8	9.6	9.5	9.3	9.1
Survey unemployment rate (%)	6.5	6.6	6.4	6.7	6.4	6.7	6.4
Gross wage per employee (real growth (%)	2.2	2.4	2.2	2.6	2.5	2.8	3.0

Source of data: SORS; forecasts by IMAD.

3.3.2. Wages

The social partners for the private sector have reached an agreement on the wage adjustment mechanism in 2006 and 2007. Negotiations on the public sector wage policy for 2006-2009 were completed as well. The wage policy framework applied so far was set out in the Social Agreement 2003-2005, which has expired, while the social partners are still negotiating the new Agreement. The social partners for *the private sector* defined minimum wage policy standards for 2006-2007 in the *Collective Agreement on the Wage Adjustment Mechanism, Reimbursement of Work-Related Costs and Holiday Allowances*. The agreement provides for a 2% rise in August each year plus an additional rise in August 2007 in the event that inflation exceeds 2.3% in 2006. The agreed minimum standards apply primarily to those employees who are not covered by any sectoral collective agreement. However, the social partners may negotiate higher standards and adjustment percentages in sectoral agreements than those specified in the overarching Collective Agreement. So far, this has been the case mostly in the adopted sectoral collective agreements for 2006, while new negotiations for 2007 are yet to be conducted. The inclusion of productivity growth in wage rises depends on the achieved results in a given business period. In June, the social partners for *the public sector* agreed upon a separate wage adjustment mechanism for 2006 and included it in the *Act Amending the Salary System in the Public Sector Act*. In line with this agreement, part of the adjustment percentage (2.35%) was earmarked for the general indexation of all wages (1.3%) while the remaining part (1.05%) was set aside for the elimination of wage disparities in the public sector. In *the Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in 2007-2009*, the social partners additionally negotiated the adjustment mechanism and additional funds intended to eliminate the wage disparities for the next three years. By 2009 the wage disparities in this sector should be eliminated.. According to the agreed adjustment mechanism for 2007, of the 2.1% price rise projected in spring forecasts 1.3% will be earmarked for the common wage adjustment while 0.8% will be used for the elimination of disparities. In addition, a further 14% of the estimated overall labour productivity growth will be set aside for the elimination of wage disparities. In 2008, the common adjustment will equal half of the estimated consumer price rise and the other half will be used to reduce the disparities. Additionally, 30% of the estimated overall labour productivity growth will be earmarked for the elimination of disparities. In 2009, the additional funds for the elimination of disparities are raised to 50% of the estimated overall labour productivity growth. In the event that inflation may exceed the forecasts in 2006-2009, the agreement also provides for an additional wage increase in January's gross wages by the actual difference.

The gross wage per employee is estimated to rise by a nominal 5.0% and by a real 2.2% in 2006, assuming 2.7% estimated average inflation. Labour productivity will grow by an estimated 3.8%. In *the private sector,* the accelerated growth of the gross wage seen in the first six months of the year will be followed by more moderate growth in the second half of the year, linked mainly to the expected slight softening of economic growth. In the year as a whole, the gross wage will rise by a nominal 5.8% and a real 3.0%, with labour productivity in the private sector rising by 4.6%. In *the public sector*, the gross wage per employee is expected to rise by a nominal 3.1% in 2006 on average, taking into account the 1.3% common wage adjustment, the 3% salary increase in the education sector provided for in the Annex to the Collective Agreement for Education, and routine promotions. The estimated nominal wage growth in the public sector has not been revised since spring as the adjustment was carried out as agreed, however the real wage growth will be lower (0.4%) than projected in spring due to higher inflation.

In 2007, the real growth of the gross wage per employee is projected to total 2.5% while labour productivity should rise by 3.5%. In *the private sector,* the estimated 2.8% real growth of the gross wage per employee is based on the autumn estimate of economic trends and the agreed adjustment mechanism for 2007: a 2% rise in the August wage and the adjustment for actual inflation exceeding the 2.3% forecast for 2006, which, taking into account the autumn forecast, means an additional increase of 0.7% in August. Labour productivity growth in the private sector is projected to total 4.2%. The estimated growth of the gross wage per employee *in the public sector* is based on expectations that wages will begin to be disbursed according to the new law on the salary system in the public sector in the first half of 2007. It takes into account the adjustment mechanism provided for in the Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in 2007-2009, as well as the percentage of inflation diverging from the projected 2.35% in 2006, which will be accounted for with January's wage increase of 0.69%. Based on these assumptions and taking into account routine promotions, the gross wage per employee in the public sector will rise by a real 1.8%.

In 2008, the growth of the gross wage per employee is estimated to total 3% while labour productivity will grow by 3.2%. The real gross wage per employee in *the private sector*, taking into account the economic outlook for that year, will rise by approximately 3.2%, with labour productivity going up by 4.0%. The forecast 2.2% growth of the real gross wage in *the public sector* is based on the Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in 2007-2009 and routine promotions.

3.4 Inflation forecast for the 2006-2008 period

After having fallen to the level of the Maastricht criterion in November 2005, inflation in Slovenia has been relatively stable, hovering close to the achieved level. In the first eight months this year, consumer prices rose by 2.5% while average inflation totalled 2.6% in August, 0.1 p.p. more than at the end of 2005. Average inflation, measured by the harmonised index of consumer prices, which is used as the convergence criterion, totalled 2.7% in August, 0.2 p.p. more than in December 2005 and 0.1 p.p. below the Maastricht criterion for that month (the Maastricht criterion was 0.3 p.p. higher in August 2006 than in December 2005). Slovenia thus fulfilled the Maastricht price stability criterion for the tenth month in a row, which shows that the disinflation achieved in the preceding years was sustainable. Since the beginning of 2005, the year-on-year indices of consumer prices

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have oscillated relatively more than in the previous years from month to month but the fluctuations around the average have been fairly level and the relatively bigger monthly increases or drops in the year-on-year inflation indices therefore still do not indicate a reversal of inflationary trends.

The price of oil, which the government could not control with economic policy measures, has been the main inflationary factor of inflation in Slovenia this year and has also diverged from the spring projections. In the first eight months of the year, the prices of liquid fuels for transport and heating directly contributed 1.2 p.p. (50%) to the 2.5% overall price rise. Since excise duties on liquid fuels have been set at the minimum level still permitted by EU regulations since July 2005, the government had no room for manoeuvre in the eight months to August for a counter-cyclical adjustment of excise duties on liquid fuels to smooth the price swings of petroleum products. As a result, the effect of the 17% price rise of Brent crude recorded in the first eight months of 2006 was fully reflected in the price rise in liquid fuels for transport and heating.

Food prices have also had a significant impact on this year's price dynamics. Market-determined prices rose by 1.3% in the eight months to August and contributed 1.1 p.p. to inflation. Within that, food prices showed the biggest divergence from the dynamics recorded in previous years as well as from the spring forecasts. In the eight months, food prices contributed 0.4 p.p. to inflation, compared to the negative contribution (-0.14 p.p.) recorded in the same period of 2005. In our estimate, this is in part related to the fact that the downward pressure on food prices created by Slovenia's entry to the EU (stronger competition, abolition of the remaining customs restrictions on imports from the EU, opening up the market to third-country products) is losing its impetus. This is reflected particularly in the prices of non-seasonal foods, which have this year risen at an average rate similar to that of other market-determined prices after having decreased for two years. What is more, the prices of foods which are prone to seasonal swings have also recorded atypical monthly seasonal dynamics this year.

The stable growth of prices that are not affected by external factors has again been underpinned by the co-ordinated application of macroeconomic policies by the Bank of Slovenia and the government this year. The tolar's stable exchange rate supported by a firm commitment to the restrictive administered prices adjustment plan and the wage policy set out in the social agreement provided for the stable growth of prices that do not depend on external factors in the first eight months this year. Administered prices excluding liquid fuels rose in line with the Administered Prices Adjustment Plan in the eight months to August and contributed 0.2 p.p. to inflation in this period. The government has also continued with the progressive harmonisation of excise duties on tobacco and tobacco products with the agreed rates in the EU, which has added a further 0.2 p.p. to inflation this year. The lagging of wage growth behind productivity growth prevented any potential upward pressures on prices from increased household demand or labour costs.

Average inflation will continue to hover around the achieved level of 2.7% until the end of 2006 and in 2007. The 0.6 p.p. upward revision of the average inflation forecast for 2006 is largely based on the higher rises of the prices of oil as well as food seen in the first eight months of the year relative to spring projections. In 2007 the upward effect of oil prices on inflation will also be somewhat stronger than projected in spring. However, the upward revision of the average inflation forecast for 2007 (from 2.1% to 2.7%) is mainly based on the planned increases of various excise duties, linked partly to the changes in tax legislation that should enter into force next year. The speeding up of harmonisation of excise duties on tobacco and tobacco products, which is now planned to be completed by the middle of 2007 (instead of 2008 as originally planned) will contribute a further

0.3 p.p. to inflation, and another contribution of approximately the same size will originate from the overall effect of the planned raising of excise duties on alcohol and automotive fuels and the imposition of excise duties on electricity in line with EU regulations. On the other hand, the projected increase in private consumption resulting from the reduced personal income tax rates will not create any inflationary pressures since this acceleration will be relatively small and macroeconomically sustainable. Other key economic policies that have helped bring inflation down to a level comparable to the EU average will be retained to ensure that the price rises which depend on these policies will remain at roughly this year's level in the future. In line with the adopted administered prices adjustment plan, these prices should not rise more than market-determined prices in 2007 – prices under direct government control are planned to rise by 0.4%. According to the adopted agreements on the wage policy for the public and the private sector (see Chapter 3.3.2) we also expect no significant upward pressures on prices from higher labour costs in 2007. The retention of disinflationary macroeconomic policies will also be vital for boosting the competitiveness of the economy as it will prevent price rises in Slovenia from being relatively higher than in its main trading partners, which would make Slovenia's tradable sector less competitive.

In addition to the counter-inflationary macroeconomic policies, structural reforms will play a key role in achieving price stability and improving the cost competitiveness of the Slovenian economy in the forthcoming years. In 2008, average inflation is expected to decline to a level around 2.5% (annual inflation to 2.2%). The forecast is based on the expected lower inflationary impact of external factors and a neutral contribution of fiscal policy measures to price rises[8]. In order to sustain inflation at the achieved level and prevent deterioration of Slovenia’s competitiveness as a result of a deteriorated relative price ratio in future, it is therefore vital that Slovenia carries out structural reforms, above all the liberalisation and creation of competitive conditions in sectors where prices are still state-regulated or markets still monopolised, combined with measures that will boost the flexibility of the labour market.

Table 6: **Autumn forecasts of inflation and a comparison with the spring forecasts for 2006-2008**

	2005	2006		2007		2008	
		Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)
Inflation (annual average, %)	2.5	2.1	2.7	2.1	2.7	2.1	2.5
Inflation (Dec/Dec, %)	2.3	2.0	3.0	2.1	2.7	2.2	2.2

Source of data: SORS; forecasts by IMAD.

[8] The raising of both VAT rates in 2008, which has been mentioned as a possible source to compensate for a potential tax revenue shortfall in 2008, has not been included in the baseline forecast since the final decision on this issue has yet to be made. If the VAT rates were raised from 8.5% to 9% and from 20% to 21%, the estimated effect of this raising on consumer price rises would total between 0.2 and 0.6 p.p., taking into account the different pass-through rates of the tax rise to final prices.

4. COMPARISON WITH FORECASTS MADE BY OTHER INSTITUTIONS

In the final phase of its preparation, the IMAD's autumn forecast of economic trends was presented to other forecasting institutions (ARC – Analysis and Research Centre of the BS, SKEP – Department of Economic Analysis and Economic Policy of the Chamber of Commerce and Industry, EIPF – Economic Institute of the Faculty of Law, IER – Institute for Economic Research) and compared with the results of the leading indicators model[9]. Although other institutions have not yet officially published their autumn forecasts, their expectations are generally consistent with the IMAD's projections. For example, all institutions will make upward revisions to their spring forecasts of economic growth on the basis of improved current flows in this year's exports and investment activity. The forecasters share the view that the robust economic growth in the euro area, which is the main partner in international trade, as well as in the domestic economy, was of a transitory character and does not indicate a reversal of the trends seen in the last few years. Therefore, they still expect that economic growth will decelerate towards 4% in the next two years. The forecasting institutions also estimate that the projected increase in inflation this year, which has been above the spring expectations of all institutions, is largely linked to external factors (oil price rises) and that the risk of this leading to increased inflationary pressures against swift economic growth is low. There are minor divergences in view of inflationary trends for the next few years, where some forecasters are anticipating a slightly higher inflation than the IMAD on the assumption that higher producer price rises both nationally and abroad will pass through more rapidly to consumer prices.

5. MAIN RISKS FOR THE REALISATION OF THE AUTUMN FORECAST

Risks for the realisation of the IMAD's autumn inflation forecast are similar as in spring and linked to the potential pressures on consumer price rises arising from the euro changeover at the beginning of 2007 and the liberalisation of the electricity market in 2007. However, the probability of their realisation is estimated to be low. The prospects of the euro changeover at the beginning of 2007 exerting an upward risk on inflation are low since the Act on Double Pricing in Tolars and Euros took effect in March 2006 to minimise the potential negative effects of the currency changeover on prices. Experience from countries that have already adopted the euro and which also imposed obligatory dual pricing prior to the changeover confirms the positive effects of such measures. The rise in living costs in these countries was small (around 0.2 p.p.). This risk will be additionally reduced by the unofficial price control ('pricewatch') and the existing competition in many industries. The realisation of the second risk, i.e. the potential increase in inflation due to liberalisation of the electricity market for households on 1 July 2007, is similarly not very probable. In the long run, the final opening up of this market is expected to boost competition as households will be able to choose from among several electricity providers, which will have a positive impact on the price dynamics in this sector. Even in the short run, given the relative electricity prices in Slovenia and the EU, there are no economic reasons for a rise in electricity prices once the market is liberalised. If necessary, however, the government may also resort to imposing some caps on these prices in the transition period until a more competitive market is established to prevent excessive swings in retail electricity prices after July 2007.

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[9] The model of leading indicators, designed to forecast inflation and GDP components applying the expenditure approach, was developed for the IMAD by Dr Igor Masten from the Faculty of Economics in Ljubljana (an upgrade of the model developed by Stock, J. H. & Watson, M. H. in "Diffusion indexes", NBER Working Paper No. 6702).

If the above risks were to be realised despite the low probability of that happening, we estimate that year-on-year inflation in 2007 could exceed the forecast by a maximum of 0.4 p.p. while average inflation would not be more than 0.3 p.p. higher than projected. If the currency changeover were to cause prices to rise despite the adopted measures and final liberalisation of the electricity market should result in higher prices of household electricity[10], these effects are expected to be short-lived and to contribute a maximum of 0.4 p.p. to inflation at the annual level.

As already estimated in the spring forecast, the realisation of these risks would have a minor effect on the dynamics of other macroeconomic aggregates. Inflation in 2007 that would be around half of a percentage point higher than projected in the baseline scenario would affect the dynamics of macroeconomic aggregates marginally. The potential price rise upon the euro changeover and the liberalisation of the household electricity market would primarily affect final consumers while it would have a negligible effect on the costs of businesses and industry. Higher inflation would result mainly in lower real growth of wages and private consumption, which could also slow down GDP growth by a maximum of 0.1 p.p. The effects of such a price rise on other macroeconomic aggregates, taking into account the reasons for the increase, would be negligible. Given the low response of exports to changes in the real effective exchange rate (the latter would appreciate slightly due to changes in relative prices in Slovenia and the EU), export growth would remain unchanged compared to the baseline scenario, as would the growth of gross fixed capital formation.

[10] If the household electricity price in Slovenia rose by just 8% after July 2008, it would exceed the price of more than half of the EU countries. The effect of such an increase on inflation would total around 0.2 p.p.

Table 7: **Autumn forecasts of the main macroeconomic aggregates and a comparison with the spring forecasts for 2006-2008**

real growth rates in % (unless otherwise indicated)

	2005	2006		2007		2008	
		Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)	Spring forecast (March 2006)	Autumn forecast (Sept. 2006)
GDP – real growth rates, %	**4.0**	**4.2**	**4.7**	**4.0**	**4.3**	**3.9**	**4.2**
GDP in SIT million (current prices)	**6.620.145**	**6.963.900**	**7.055.200**	**7.426.200**	**7.586.400**	**7.901.800**	**8.098.200**
GDP in EUR million (current prices, calculated at the exchange rate SIT 239.640 for EUR 1				**-**	**31.657**	**-**	**33.793**
INFLATION (Dec/Dec of the preceding year, %)	**2.3**	**2.0**	**3.0**	**2.1**	**2.7**	**2.2**	**2.2**
INFLATION (Jan-Dec/Jan-Dec annual average, %)	**2.5**	**2.1**	**2.7**	**2.1**	**2.7**	**2.1**	**2.5**
GDP deflator (%)	**1.5**	**1.9**	**1.8**	**2.6**	**3.1**	**2.4**	**2.5**
USD **EXCHANGE RATE** (BS)	**192.7**	**199.6**	**191.9**	**-**	**-**	**-**	**-**
EUR EXCHANGE RATE (BS)	**239.6**	**239.6**	**239.6**	**-**	**-**	**-**	**-**
EUR/USD exchange rate	**1.244**	**1.20**	**1.248**	**1.20**	**1.265**	**1.20**	**1.265**
EMPLOYMENT according to the SNA (% growth)	**0.3**	**0.8**	**0.9**	**0.6**	**0.8**	**0.8**	**0.9**
REGISTERED UNEMPLOYMENT RATE, %	**10.2**	**9.8**	**9.8**	**9.6**	**9.5**	**9.3**	**9.1**
ILO UNEMPLOYMENT RATE, %	**6.5**	**6.6**	**6.4**	**6.7**	**6.4**	**6.7**	**6.4**
PRODUCTIVITY (GDP per employee), % growth	**3.7**	**3.4**	**3.8**	**3.3**	**3.5**	**3.1**	**3.2**
GROSS WAGE PER EMPLOYEE	**2.2**	**2.4**	**2.2**	**2.6**	**2.5**	**2.8**	**3.0**
EXPORTS OF GOODS AND SERVICES	**10.5**	**8.2**	**9.9**	**7.9**	**8.3**	**8.0**	**8.5**
- exports of goods	**10.3**	**8.5**	**10.6**	**8.2**	**8.6**	**8.3**	**8.9**
- exports of services	**11.7**	**6.8**	**6.6**	**6.7**	**6.7**	**6.8**	**6.8**
IMPORTS OF GOODS AND SERVICES	**7.0**	**7.6**	**9.1**	**7.4**	**7.7**	**7.5**	**7.7**
- imports of goods	**6.8**	**7.6**	**9.3**	**7.4**	**7.7**	**7.5**	**7.7**
- imports of services	**8.4**	**7.0**	**8.1**	**7.1**	**7.1**	**7.5**	**7.5**
Current account **BALANCE** (EUR million)	**-547**	**-480**	**-693**	**-390**	**-503**	**-300**	**-410**
- as % of GDP	**-2.0**	**-1.7**	**-2.4**	**-1.3**	**-1.6**	**-0.9**	**-1.2**
GROSS FIXED CAPITAL FORMATION	**1.5**	**6.0**	**8.6**	**5.0**	**5.5**	**4.0**	**4.5**
- as % of GDP	**24.4**	**25.5**	**25.4**	**25.8**	**25.6**	**25.9**	**25.8**
PRIVATE CONSUMPTION	**3.4**	**3.3**	**3.3**	**3.3**	**3.6**	**3.6**	**3.6**
- as % of GDP	**54.9**	**55.0**	**54.6**	**54.3**	**54.0**	**53.9**	**53.7**
GOVERNMENT CONSUMPTION	**2.2**	**2.7**	**2.8**	**2.8**	**2.5**	**2.4**	**2.8**
- as % of GDP	**19.6**	**19.6**	**19.4**	**19.4**	**19.2**	**19.3**	**19.2**

Sources of data: SORS, BS; forecasts by IMAD.

IMAD

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