GOVERNMENT OF THE REPUBLIC OF SLOVENIA
INSTITUTE OF MACROECONOMIC ANALYSIS AND DEVELOPMENT

Revised Autumn Forecast of Economic Trends 2008–2010

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As a result of the deepening global financial crisis and its pass-through into the real sector, the situation in the international economic environment and expectations regarding future trends have deteriorated notably since the release of the IMAD Autumn Report. The most recent data on domestic activity and particularly the indicators of expected developments also point to the fact that, through lower demand and a pronounced tightening of financing conditions, the changes in the international environment have begun to spill over into Slovenia's economy. The main risks to our Autumn Forecast have thus materialised. We have, therefore, prepared a revised Autumn Forecast of Economic Trends for the period 2008–2010, based on revised assumptions of expected economic growth in our main trading partners, oil prices on the global market and the euro exchange rate, and also taking into account the most recent data on economic trends in Slovenia.

Economic growth will post a significant slowdown in 2009, and the recovery in 2010 will be slower than forecast in the autumn. The crisis is expected to have the strongest impact on economic activity in Slovenia in the last quarter of 2008 and in the first two quarters of 2009. Due to the tightening of lending conditions, in 2009 the most notable decline is expected in construction investment and investment in machinery and equipment. Given the global moderation of economic growth, export growth will also continue to slow. Private consumption growth will moderate as well, given that the expected increase of unemployment rate will dampen the impact of higher real household income following the moderation of inflation as a consequence of considerably lower prices of oil and other commodities and slowing economic activity. As a result of significantly diminished economic activity, employment is expected to decline in 2009 instead of increasing slightly as originally foreseen, and in 2010 the number of employed persons will rise at a slower pace. Inflation in 2009 will be much lower than forecast in the autumn, but in 2010 it is projected to stabilise around the long-term equilibrium level, as anticipated in the Autumn Forecast.

1. FORECAST OF ECONOMIC TRENDS

Assumptions of the Revised Autumn Forecast

Since September, when we prepared our regular Autumn Forecast of Economic Trends for the period 2008–2010, certain key risks to the forecast have materialised. Since then, the forecasts of economic conditions in the international environment have deteriorated notably due to the consequences of the financial crisis. The world economic outlook for the next two years and the conditions for financing the domestic economy have deteriorated significantly due to the deepening and spreading of the financial crisis. The assumptions on the dynamics of prices of oil and other commodities have been revised significantly, affecting favourably domestic economic trends and particularly inflation.

The forecasts for global economic growth by the main international institutions declined significantly in the last two months. In November, the International Monetary Fund revised its October world economic growth outlook downward by 0.2 p.p. to 3.7% for 2008 and by 0.8 p.p. to 2.2% for 2009. Most of our main trading partners are projected to fall into recession in 2009. Similarly, the OECD also predicted a lowering of economic growth (-0.4%) in all its Member States for 2009 and a recovery to 1.5% in 2010. Forecasts by international institutions are based on the assumption that conditions in financial markets will stabilise in mid-2009, which would contribute to a gradual revival of economic growth.[1] Uncertainty regarding future economic developments in our main trading partners remains extremely high and represents the main risk of additional deterioration of economic conditions in Slovenia.

The most recent forecasts for the euro area predict that GDP will continue to decline at least until mid-2009. Given the significant deterioration of prospects, real GDP is expected to decline in most of our main trading partners in the euro area – a considerable worsening compared with the assumptions from our Autumn Forecast, where 1% average economic growth was projected for the euro area.

[1] The IMF outlook does not yet explicitly include the impacts of measures to mitigate the consequences of the financial crisis adopted in the last two months, while in the OECD forecast these measures have already been partly taken into account.

Table 1: **Revised assumptions on economic growth in Slovenia's main trading partners in 2008–2010 and comparison with the autumn 2008 forecast**

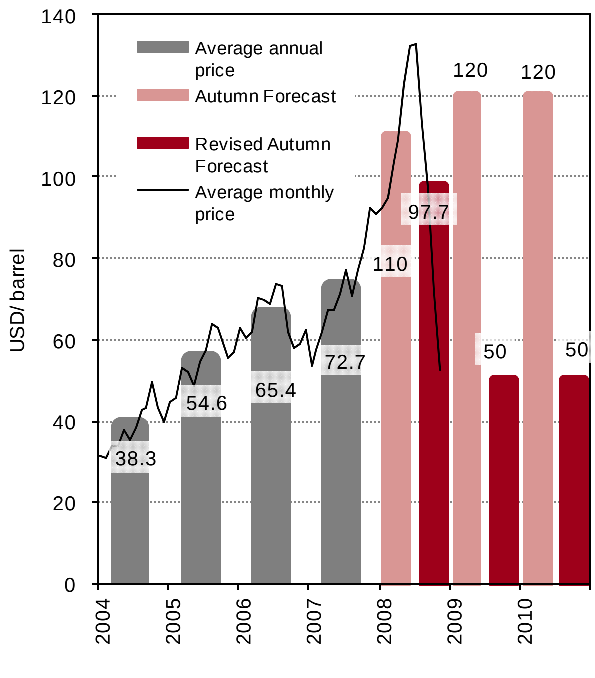
	2006	2007	2008		2009		2010	
			Autumn forecast (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)
EU	3.1	2.9	1.4	1.4	1.1	-0.2	2.0	1.1
Euro area	2.8	2.7	1.3	1.2	1.0	-0.5	1.8	0.9
Germany	3.0	2.5	1.6	1.6	0.9	-0.6	1.6	1.0
Italy	1.8	1.5	0.1	-0.1	0.5	-0.6	1.2	0.6
Austria	3.4	3.1	2.2	1.9	1.8	0.5	2.3	1.2
France	2.2	2.2	1.1	0.8	1.0	-0.5	2.0	1.0
UK	2.9	3.1	1.2	0.8	0.9	-1.3	1.8	0.8
Czech Republic	6.8	6.5	4.6	4.4	4.7	3.0	5.0	4.2
Hungary	3.9	1.3	2.4	1.2	3.2	0.3	4.3	1.5
Poland	6.2	6.5	5.5	5.4	5.0	3.5	5.0	4.0
Croatia	4.8	5.6	4.4	3.5	4.7	3.0	5.0	4.0
Bosnia and Herzegovina	6.7	6.0	5.0	5.0	5.2	4.0	6.0	4.5
Serbia	5.7	7.5	5.5	5.5	5.5	4.5	6.0	4.8
Macedonia	4.0	5.1	4.8	5.0	5.5	4.5	6.0	5.0
USA	2.8	2.0	1.6	1.4	1.4	-0.7	2.8	1.3
Russia	7.4	8.1	7.5	7.0	6.9	5.5	6.0	6.0

Source of data: Eurostat; Consensus Forecasts, August 2008, September 2008; Eastern Consensus Forecast, August 2008; European Commission, DG Ecfin – Interim Forecast, September 2008; European Commission, DG Ecfin – Economic Forecasts, Spring 2008, Economist Intelligence Unit Country Reports (for Bosnia and Herzegovina, Serbia, Macedonia), August 2008, September 2008; OECD Economic Outlook, June 2008; WIIW Current Analysis and Forecasts, July 2008; IMAD estimates.

The revised forecast is based on significantly lower assumptions regarding oil prices than the original forecast. Due to the slowdown of economic activity and deteriorated prospects, oil prices have plummeted since last September. The price of Brent crude fell below USD 50 by the beginning of December, USD 65/barrel down from the previous assumption. The assumptions on oil price dynamics in the future were revised significantly as well. In the revised forecast we have taken into account the average price of Brent crude in the amount of USD 97.7/barrel for 2008 (USD 16/barrel less than in the autumn) and, based on futures prices in the two months to the revision of the forecast, USD 50/barrel for 2009 and 2010 (USD 70/barrel less than in the autumn).

Due to the worsening of business expectations for the euro area, the USD/EUR exchange rate has also declined since the time of the preparation of the Autumn Forecast. The revised forecast for 2008–2010 is made under the technical assumption of the exchange rate of USD 1.27 for EUR 1. The new EUR/USD exchange rate, which was formulated on the basis of the average, realised between 22 October and 14 November 2008, is lower than the assumption from the Autumn Forecast by USD 0.23 for EUR 1.

Figure 1: **Prices of Brent crude – actual prices, assumptions of the Revised Autumn Forecast and comparison with the assumptions used in the Autumn Forecast**



Source of data: World Bank, assumptions for 2008–2010 by IMAD.

Economic growth

Against the background of the deepening international financial crisis, risks that economic growth will slow at a faster pace than foreseen in the Autumn Forecast have already been partly realised. In the autumn we estimated that the realisation of risks associated with stronger negative impacts of the financial crisis than expected might result in lower GDP growth in Slovenia than predicted in the central forecast. Economic trends and business expectations at the end of 2008, as well as forecasts for the international environment for 2009 and 2010 indicate that these risks are already materialising.

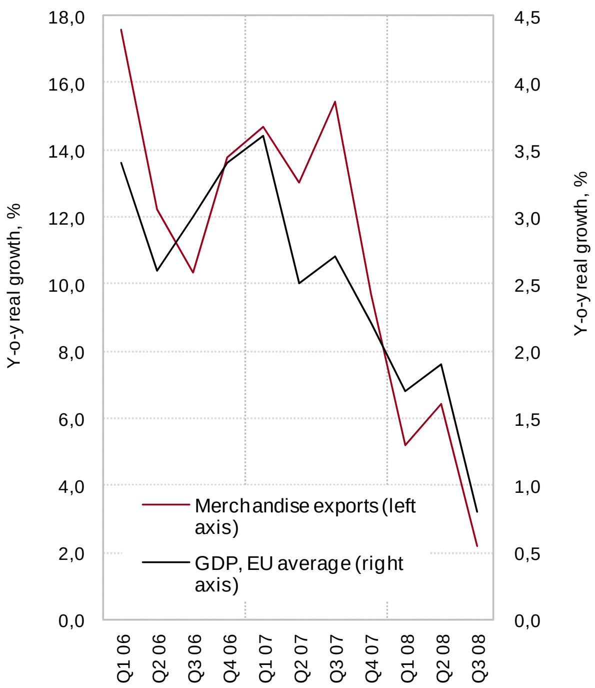
Economic growth in 2008 is forecast at 4.1%, 0.7 p.p. lower than projected in the autumn, which is essentially due to worsened conditions in the international environment. Given the deteriorated situation in the international environment, the forecast of *real export growth* for 2008 is 5.8%, 0.8 p.p. lower compared with the autumn forecast. Weaker real export growth will be a result of a greater decline in foreign demand, which mainly affected production in the car industry and, consequently, of vehicle exports in November and December. An even greater slowdown in total exports than expected in the autumn will be mitigated by growth in exports of construction and merchanting services, which given the developments in the first three quarters of the year, will be somewhat stronger than predicted in the autumn. The forecast of *real growth of gross fixed capital formation* has also been revised downward compared with the autumn forecast, to 7%, i.e. 1.8 p.p. lower than in the autumn. Investment activity already moderated significantly in Q3, in investment in buildings and construction works as well as in machinery and equipment. A further slowdown associated with the negative impacts of the financial crisis is expected in Q4. *Real growth of final consumption* will also be lower than envisaged in the autumn, due to weaker growth of private consumption, while general government consumption will be somewhat higher. Real growth of general government consumption for 2008 is forecast at 3.9%, up 0.5 p.p. from the autumn forecast, owing to lower inflation at the time of adoption of the budgets. Given the significant moderation in Q3 and the deterioration of confidence indicators, the forecast of real private consumption growth has been revised downward to 3.4%. In line with the worse outlook for investment activity and exports, *real import growth* is projected to be somewhat weaker as well (6.5%, or 0.4 p.p. lower).

Over the next two years, economic growth is expected to decline considerably, largely as a result of significantly weaker exports and investment activity against the background of unfavourable international environment. In 2009, economic growth will decelerate to 1.1% (2.0 p.p. down from the autumn forecast), the weakest growth since 1993. Economic recovery in 2010 will be slower than expected; real GDP growth at3.1% is 0.9 p.p. down from the autumn forecast.

Given the anticipated recession in Slovenia's main trading partners, the slowdown of export growth in 2009 will be much more pronounced than predicted in the autumn; the revival in 2010 will also be slower. Given that goods exported to EU countries account for over 70% of total merchandise exports, export growth is expected to slow notably in 2009 due to recession in the euro area (1.5% instead of 5.2%). Modest growth of total merchandise exports in 2009 will be largely due to the foreseen decline in growth of merchandise exports to the old EU Member States. Given that the cooling of the global economy will be more pronounced than expected in the autumn, export growth to the new EU Member States, to the countries of the former Yugoslavia and the Russian Federation will also be weaker than expected. In line with a generally worse outlook, growth of services exports is also expected to decelerate notably, particularly due to slowing exports of transport services and lower inflows from travel services. While in the autumn receipts from travel were still projected to grow, they are now forecast to be around 5% lower compared with 2008 due to a drop in visits and limited spending by foreign tourists. Consistent with slower economic recovery expected in our main trading partners, somewhat weaker export growth compared with the autumn forecast is also expected in 2010.

Given the unfavourable global economic outlook, tightened conditions in international financial markets and reduced credit availability will impede domestic investment activity. In 2009, investment will post a larger decline, but will, consequently, strengthen somewhat faster in 2010 than expected in the autumn. Coupled with limited availability of financial resources, withering global economic activity will adversely affect investment, especially in manufacturing. Investment will thus decrease by 2% in real terms in 2009 (against 1.3% growth according to the Autumn Forecast). We estimate that most enterprises, especially those that are financially weaker, will limit or postpone investment. As the situation for construction companies worsens and demand falters, the growth of residential construction, totalling 10% annually over the past four years, is expected to moderate at a faster pace, and the growth of non-residential construction will also decline. In 2010, investment growth is expected to be somewhat stronger than predicted in the autumn, largely due to a more pronounced decline of the comparative basis in 2009 than in the original forecast.

Figure 2: **Growth of Slovenia's merchandise exports and economic growth in the EU Member States**



Source of data: SORS, Eurostat.

In view of worsening economic conditions, the growth of final consumption, and especially private spending, is expected to slow somewhat more notably in 2009 than forecast in the autumn. Taking into account the valid public finance documents, the forecast of general government consumption for 2009 and 2010 remains unchanged. In line with the foreseen decline of employment, private consumption is expected to moderate further, from 3.4% in 2008 to 2.8% in 2009 (before 3.5%). A further slowdown is suggested by consumer confidence indicators, which show that consumers are increasingly tending to postpone major purchases (e.g. durable goods). In 2010, private consumption is expected to accelerate somewhat faster, to 3.8% (before 3.6%), thanks to the expected improvement of the situation in the labour market, but also as a result of the lower comparative basis in 2009.

Consistent with weaker export growth and slower domestic consumption growth, import growth will be lower than forecast in the autumn, 5% in 2009 (down 3.5 p.p.) and 5.3% in 2010 (down 1.2 p.p.). Given that withering export activity and domestic demand linked largely with declining investment will be considerably weaker relative to the autumn forecast, the slowdown of import growth (goods and services) in 2009 will be even more pronounced than foreseen. The strengthening of import growth in 2010 will also be somewhat slower than predicted in the autumn, mainly due to a slower recovery of export activity.

Table 2: **Revised autumn forecast of GDP growth and the main consumption aggregates for 2008–2010 and comparison with the autumn 2008 forecast**

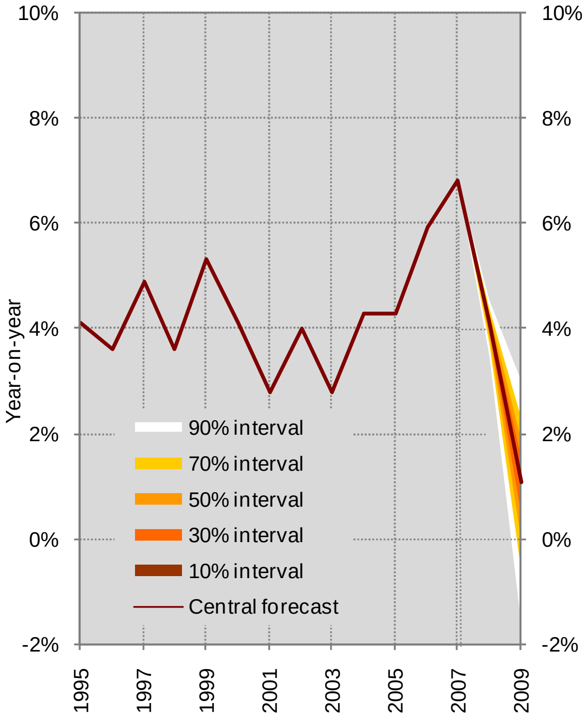
Real growth rates (in %)

	2007	2008		2009		2010	
		Autumn forecast (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)
GDP	6.8	4.8	4.1	3.1	1.1	4.0	3.1
Exports of goods and services	13.8	6.6	5.8	5.2	1.5	7.4	4.8
Imports of goods and services	15.7	6.9	6.5	4.0	0.5	6.5	5.3
Net exports, contribution to growth in p.p.	-1.3	-0.3	-0.6	0.9	0.8	0.7	-0.5
Private consumption	5.0	4.5	3.4	3.5	2.8	3.6	3.8
Government consumption	2.5	3.4	3.9	2.2	2.2	2.6	2.6
Gross fixed capital formation	11.9	8.8	7.0	1.3	-2.0	4.5	5.0
Inventories, contribution to growth in p.p.	1.8	-0.4	0.3	-0.4	-1.0	-0.2	-0.2

Source of data: SORS, forecasts by IMAD.

Risks for the realisation of the forecast for economic growth in 2009 and 2010 remain high and are distributed asymmetrically, as the probability that GDP growth will be lower by a certain percentage is higher than the probability that actual growth will exceed the central forecast by the same percentage (Figure 3). There is a considerable risk that in 2009 economic growth will be even lower than predicted in the central forecast, which is mainly due to high uncertainty regarding the dimensions and depth of the financial and economic crisis. There is also an upside risk, related to the adoption and financial scope of additional government measures to mitigate consequences of the financial crisis on the Slovenian economy. These measures, which have the scope to alleviate the projected deceleration of economic growth in the next two years, have not been taken into account in the central forecast. An estimate of the impact of positive and negative risks on economic trends in Slovenia is presented in the last two sections (see Sections 2 and 3).

Figure 3: **Central forecast of ecnomic growth and the probability of expected deviations**



Source of data: SORS, forecasts by IMAD.

Dynamics of value added by activity

Value added is predicted to rise by 4% in 2008, 0.9 p.p. less than expected in the Autumn Forecast. The forecast has been revised due to a stronger moderation of growth in the exporting sectors in the second half of the year, owing to a marked slowdown of foreign demand as a consequence of the global financial crisis. The decline of total value added growth compared with the autumn forecast will thus mainly come from weaker growth of industrial activities, and consequently, certain market services (mainly business services and transport, storage and communications). Due to notably slower growth of foreign tourists, a slight slowdown of value added in hotels and restaurants is also expected. Construction remained the fastest growing activity; owing to more buoyant construction activity in the autumn months, the contribution of construction to total value added growth will be somewhat larger than anticipated in the Autumn Forecast. The contributions of other market services to this year's value added growth are in line with the Autumn Forecast. The contribution of public services will be somewhat larger according to the data on dynamics of value added in the first three quarters of 2008.

The forecast of value added growth for 2009 was revised to 1.0% from 3.1% predicted in the Autumn Forecast, and for 2010 to 3.1% from 4%. The global financial crisis is expected to contribute to a significant slowdown of value added growth in financial intermediation. Due to the impacts of the crisis, which are mainly reflected in a more limited access of firms to sources of financing and a more notable weakening of foreign demand, we also predict a more pronounced slowdown of value added growth in manufacturing and non-financial market services, as well as a decline in value added in construction instead of an increase predicted in the Autumn Forecast. Financial intermediation will be mainly affected by decreased lending activity of banks due to limited sources of financing and a lack of trust. In order to finance loans, banks are expected to turn to domestic sources of financing to a greater extent than they have in the past. They will thus pursue a more active interest rate policy, which will lead to slower growth of their net interest income and, consequently, slower value added growth. A more limited foreign demand will have the greatest impact on export-oriented activities (manufacturing, goods transport, and hotel and restaurant activity related to exports of travel services), resulting in weaker export growth. Restricted access to sources of financing will, through weaker domestic demand, largely affect activities related to consumption of durable and luxury goods and on consumption connected with borrowing. These activities are mainly retail trade of durable consumer goods and motor vehicles, hotel and restaurant activity dependent on domestic tourism, and real estate. Especially in the latter two activities, but also in certain manufacturing sectors (especially in parts of the metal and food industries), access to sources of financing is also likely to prove to be an important limiting factor on the supply side, given the relatively high dependence of business on bank loans and short-term sources of financing. Due to the slowdown of economic activity, the growth of value added in business services will also slow somewhat more than expected in the Autumn Forecast, especially in those sectors that are most closely related to industry and construction.

Table 3: **Revised autumn forecasts of value added by activity for 2008–2010 and comparison with autumn forecasts for 2008**

Real growth rates in %

	2007	2008		2009		2010	
		Autumn forecast (Sep. 2008)	Revised forecast (Dec. 2008)	Autumn forecast (Sep. 2008)	Revised forecast (Dec. 2008)	Autumn forecast (Sep. 2008)	Revised forecast (Dec. 2008)
A Agriculture, forestry, hunting	-11.1	-2.0	-4.0	3.5	4.5	2.0	2.0
B Fishing	0.6	0.0	-3.0	1.5	1.5	1.5	1.5
C Mining	-3.0	-2.5	-5.0	-0.5	-0.5	-3.0	-3.0
D Manufacturing	7.8	2.1	0.5	2.1	0.0	5.0	2.0
E Electricity, gas and water supply	-6.5	8.0	0.0	-3.0	-3.0	0.0	0.0
F Construction	16.0	14.5	15.5	1.0	-5.5	3.5	4.5
G Distributive trades	5.8	6.0	6.2	4.5	3.4	4.0	4.0
H Hotels and restaurants	8.7	2.5	-0.6	3.0	-1.0	3.5	4.0
I Transport, storage and communications	9.2	6.0	5.0	5.5	3.5	5.5	4.5
J Financial intermediation	13.8	10.0	11.4	7.0	4.5	7.5	5.5
K Real estate, renting and business activities	11.2	6.0	3.4	4.0	1.5	4.5	3.5
L Public administration, defence and social security	1.4	1.0	2.9	1.0	1.0	1.0	1.0
M Education	1.9	1.9	1.8	1.9	1.9	2.1	2.1
N Health and social work	0.9	2.2	2.5	3.0	3.0	3.2	3.2
O Other community, social and personal services	-2.1	1.5	3.0	1.5	1.5	1.5	1.5
P Private households with employed persons	0.6	0.2	1.5	1.0	1.0	1.0	1.0
VALUE ADDED	**6.8**	**4.9**	**4.0**	**3.1**	**1.0**	**4.0**	**3.1**
a) Taxes on products and services	6.0	4.0	4.4	3.4	2.1	4.0	3.5
b) Subsidies on products and services	-2.8	5.0	2.5	4.5	4.5	2.9	2.9
GDP	**6.8**	**4.8**	**4.1**	**3.1**	**1.1**	**4.0**	**3.1**

Source of data: SORS, forecasts by IMAD.

Inflation

Inflation at the end of 2008 will be considerably lower than expected in the autumn, mainly as a consequence of a substantial oil price drop in the global market. The downward revision is a consequence of the rapid decline of oil prices in the global market since July, which resulted in an accelerated decrease of inflation in Slovenia as throughout the euro area. The falling oil prices have had a particularly significant impact on domestic inflation, given that strong oil price growth occurred in the same months of the previous year (base effect). Having reached 6% in August (the latest figure taken into account in the autumn forecast), y-o-y inflation dropped to 3.1% in November. Taking into account the price development up to December, the revised assumptions on oil prices in the period to the end of the year and the increase in excise duties on liquid fuels in December, the prices of liquid fuels for transport and heating are expected to make a negative contribution to inflation at the end of the year (approximately -1.4 p.p.). This is the most important correction with regard to our inflation forecast in the autumn when we predicted a positive contribution of 1.2 p.p. The revised forecast of y-o-y inflation at the end of the year (2.2%) is thus down approximately 3 p.p. in comparison to the autumn forecast, while the revised forecast of average inflation is down 0.5 p.p. (5.7%).[2] Given that economic policy orientation has remained unchanged over the last few months, it will not play a significant role in price changes in Q4.

Inflation in 2009 will also be lower than predicted in the autumn as a result of the considerably lower assumption on oil prices and slower economic growth compared with the autumn forecast. Y-o-y inflation will reach 3.0% at the end of the year. Average inflation will decline to just 1.1% in 2009, as the same factors which have contributed to diminishing inflation due to the calculation method will show with a lag of a few months. Mid-2009, y-o-y inflation is expected to swing well below 3%, a level which is considered as consistent with the real convergence process. A strong swing below the equilibrium level (similar to this year's upswing above the equilibrium level) will not be a result of economic policy measures but will be due to external shocks – this time a drop of oil prices in the global market to the lowest level since the end of 2004. The downward revision of the oil price assumption is also the main reason for the lower inflation forecast (while the assumption on food price growth was left unchanged). At the price of USD 39.8/barrel (on 9 December 2008), the downward revision of the assumption on the average price of Brent crude in 2009

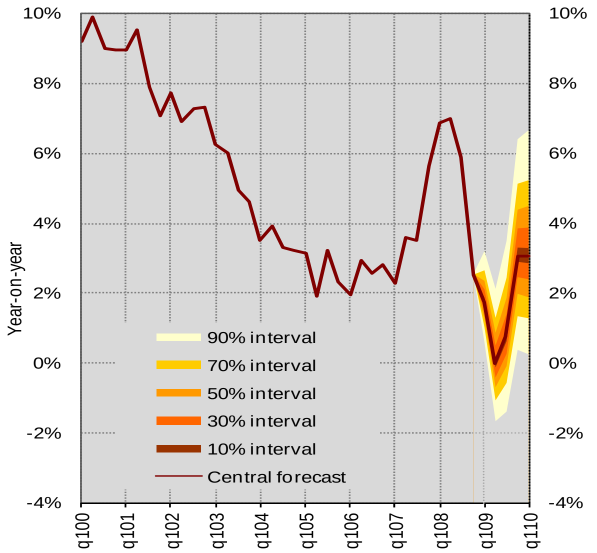
[2] The SORS data on inflation in 2008 were published after the Revised Autumn Forecast had been released. End-year inflation in 2008 was 2.1%, average inflation 5.7%.

from USD 120/barrel in the Autumn forecast to USD 50/barrel in the Revised Forecast entails a contribution to inflation of around 0.2 p.p. in 2009 (instead of 0.3 p.p. according to the Autumn Forecast). A notable deceleration of economic growth will also contribute to the easing of inflationary pressures in 2009.

In 2010, both y-o-y inflation and average inflation are expected to stabilise at a long-term equilibrium level of 3%, as anticipated in the Autumn Forecast. The inflation forecast for 2010 has been left unchanged, under the assumption of the absence of external price shocks and with the same economic policy orientation as assumed in the Autumn Report.

Risks that inflation would deviate from the new forecast remain high and are distributed unevenly. The probability that inflation will be by a certain percentage higher than the central forecast is higher than the probability that it will be lower by the same percentage. Risks are associated with two groups of factors: (i) commodity price trends in the global market and (ii) uncertainty as to the depth and length of the economic slowdown. The realisation of these risks would have an impact in the opposite directions. A higher-than-expected increase of commodity prices in the global market would translate into upward pressures on inflation (and vice versa), while a prolonged moderation of economic activity would exert downward pressures on inflation (and vice versa). The realisation of the risk associated with different-than-anticipated commodity price trends is limited downwards; in such a case, it is likely that a policy of counter-cyclical adjustment of excise duties would be pursued, which is also the main reason for the asymmetrical distribution of risks to the central forecast.

Figure 5: **Central forecast of inflation and the probability of deviations**



Source of data: SORS, forecasts by IMAD.

Wages

Wage growth in 2008–2010 will be smaller than expected in the autumn due to weaker economic growth and, in nominal terms, also due to the expected lower inflation. The revision of the forecast for 2008 is mainly related to wage movements in the private sector, whereas for 2009 we predict a more contained nominal wage growth in both the private and public sector. With the revival of economic activity, wage growth in the private sector is projected to strengthen somewhat again in 2010, while wage growth in the public sector will slow in the wake of a notable increase in 2009. Despite a somewhat lower forecast of nominal growth, wage growth in the public sector will nevertheless remain very strong in 2009 and 2010. In both years, it will be significantly higher in real terms than productivity growth. Given that wage growth is predicted to exceed productivity growth by more than 0.5 p.p., negotiations will have to be carried out to change the shares and dynamics of payments for the elimination of wage disparities in the public sector, as stipulated by the effective Collective Agreement for the Public Sector. The wider gap between real wage growth and real productivity growth than predicted in the autumn is mainly a consequence of significantly weaker real productivity growth (see section "Employment and Unemployment").

In 2008, the gross wage per employee will increase by 0.5 p.p. less in nominal terms than forecast in the autumn, while real gross wage growth remains as originally projected (2.3%). Significant downward revisions took place in the private sector (by 0.7 p.p. in nominal terms) given the faster economic slowdown, largely due to lower 13th month payments and Christmas bonuses expected at the end of the year. Nominal wage dynamics in the public sector remain in line with the autumn forecast. Total gross wage growth will thus exceed labour productivity growth both in nominal and real terms (against a 0.1% lag of real wage growth behind productivity growth as expected in the autumn).

With the continued slowing of economic activity, worse labour market situation and lower inflation forecast, growth of the total gross wage per employee in 2009 will be by a nominal 2.8 p.p. weaker and a real 0.2 p.p. stronger than in the Autumn Forecast. Wage moderation will be more pronounced in the private sector, which is expected to adapt to changes in the economic environment by a greater extent. Among the assumptions on the wage dynamics in the public sector, only the inflation forecast has been revised downwards, which will obviate the January adjustment of basic wages foreseen in the Autumn Forecast.[3] The July

[3] The January adjustment of basic wages would have been carried out if inflation at the end of 2008 had exceeded 4%, the percentage taken into account for the adjustment of wages in July (taking into account

adjustment of wages will also be slightly lower. In nominal terms, the total gross wage per employee will lag behind labour productivity growth (rather than exceeding it, as projected in the Autumn Forecast). In real terms, it will exceed it by more than originally foreseen.[4]

5.3% y-o-y inflation as projected in the Autumn Forecast, wages were to be adjusted by a further 1.3% in January 2009).

[4] Notably stronger gross wage growth compared with real labour productivity is largely a consequence of faster growth of implicit GDP deflator in comparison with inflation as a result of a considerable improvement of the terms of trade. Stronger growth of export prices compared with import prices, largely due to significant revisions of oil and other commodity price trends is reflected in weaker growth of intermediate consumption costs on the one hand, but stronger nominal GDP growth and, consequently, stronger growth of nominal labour productivity on the other. At the same time, nominal wage growth is significantly lower, as it is importantly affected by the downward revision of inflationary expectations.

In 2010, growth of the total gross wage per employee is expected to be slightly weaker compared with the autumn forecast (by 0.2 p.p.) With the projected improvement of the economic environment, nominal growth of gross wages in the private sector remains unchanged from the autumn forecast. A somewhat weaker nominal growth of wages in the public sector (0.9 p.p. lower than the autumn forecast) will be a consequence of a lower base in 2009, as wage adjustment for inflation does not come into effect in January. Gross wage growth will exceed labour productivity growth both in nominal and real terms (while it was expected to lag behind according to the autumn forecasts).

Table 4: **Growth rates of wages and labour productivity**

		2008		2009		2010	
		Autumn forecast (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)	**Autumn forecast** (Sept. 2008)	**Revised forecast** (Dec. 2008)
Nominal growth %	Gross wage per employee	8.6	8.1	7.8	5.0	6.9	6.4
	- private sector	8.5	7.8	6.3	3.0	5.8	5.5
	- public sector	9.4	9.2	11.3	9.9	9.5	8.6
	Labour productivity	6.9	5.6	6.9	5.4	7.4	6.1
Real growth %	Gross wage per employee	2.3	2.3	3.7	3.9	3.5	3.3
	- private sector	2.2	2.0	2.3	1.9	2.4	2.4
	- public sector	3.0	3.3	7.1	8.7	6.0	5.4
	Labour productivity	2.4	1.3	3.1	2.5	3.7	2.8

Source of data: SORS, forecasts by IMAD.

Employment and unemployment

In 2008, employment growth will be higher relative to the autumn forecast due to its high figure in Q3, followed by the expected moderation in Q4. Growth rates of formal employment and employment according to the national accounts methodology in Q3 were in most activities stronger than expected in the Autumn Forecast. Given the expected slowdown of economic activity in certain sectors, we expect a substantial reduction of persons employed for a fixed term in December. In Q4, employment will thus decline, recording about 1.8% growth y-o-y, and 2.8% in total in 2008. With weaker GDP growth and stronger employment growth, productivity will thus grow only by 1.3%, down 1.1 p.p. from the autumn forecast. Given the less registered unemployed persons in Q3 2008 compared with that expected in the autumn, the average registered unemployment rate will be somewhat lower (6.7% instead of 6.8%), but the number of unemployed persons and the registered unemployment rate at the end of the year will be higher than projected in the Autumn Forecast, around 65,200 or 7.0%. The survey unemployment rate for 2008 remains as in the Autumn Forecast (4.6%), since at least half of the employment decline in the period to the end of the year will be due to a decrease of foreigners employed in Slovenia, who are not covered by the definition of the survey unemployment rate.

The forecast of employment for the next two years indicates a major change: a larger drop in 2009 (-1.3%) and weaker growth in 2010 (0% growth). Given the weaker value added growth, especially in manufacturing and construction, but also in some service activities (see also section "Dynamics of value added by activity"), the number of employed persons is expected to decline more notably in 2009 in construction, in the energy sector and certain services (following a further decline in the number of persons employed in manufacturing, agriculture, fishing and mining). The average total number of people in employment in 2009 will be thus 1.3% lower than in 2008. In 2010, employment will continue to decline in agriculture, fishing, mining and manufacturing, while it will increase in other activities. As the investment cycle is expected to rebound, employment will also increase in construction. The forecast of employment growth for 2010 is thus expected to be slightly lower than the autumn forecast (by 0.1 p.p.), totalling 0.3%. Despite weaker employment growth, real labour productivity growth will be lower compared with the autumn forecast due to significantly weaker economic growth. Real labour productivity growth will be 2.5% in 2009, and 2.8% in 2010 (down 0.6 p.p. and 0.9 p.p. from the autumn forecast, respectively). Due to the revision of the employment forecast (particularly for 2009), forecasts of unemployment rates are also higher for both years: registered unemployment rates (7.7% and 8.1%, respectively) and survey unemployment rates (5.2% and 5.4%, respectively).

Price and cost competitiveness

The deterioration of price competitiveness in 2008 will be somewhat less pronounced than projected in the autumn. In 2009, price competitiveness will improve, contrary to our expectations in the Autumn Forecast. The real effective exchange rate deflated by relative consumer prices will increase by an average of 2.9% in 2008 (against the autumn forecast of 3.4%) and drop by 2.0% in 2009 (against 1.2% growth predicted in the autumn). The disparities are mainly a result of the weaker euro and consequent weaker growth of the nominal effective exchange rate in 2008 (0.3% compared with 0.7%) and its more pronounced drop in 2009 (-1.6% compared with -0.3%).[5] For 2008, the relative consumer prices will increase only slightly less than anticipated in the autumn (2.5% compared with 2.6%). In 2009, they will drop (-0.5%), contrary to our expectations in the autumn (1.4% growth).[6]

The deterioration of cost competitiveness in 2008 will also be less pronounced than we estimated in the autumn. In 2009, cost competitiveness will improve, contrary to the expectations in the Autumn Forecast. The real effective exchange rate deflated by relative unit labour costs will increase by 3.7% in 2008 (against the autumn forecast of 4%) and drop by 1.7% in 2009 (2% growth). The disparities in 2008 are a consequence of the weaker euro (see the previous paragraph), while in 2009 they are also largely due to the revised estimate of relative unit labour costs. Contrary to our expectations in the autumn (3.3% growth), relative unit labour costs will slightly decline in 2009 (-0.1%).[7]

[5] A significant drop of the nominal effective exchange rate in 2009 and, consequently, improved price competitiveness are, amid considerable fluctuations of the USD/EUR ratio, a consequence of its fixing (from November 2008 to December 2009) at a significantly lower level than the average realised for 2008.

[6] Our revised inflation forecast for 2008 for Slovenia is very similar to the OECD's revisions for Slovenia's trading partners. Growth of relative prices thus remains practically the same, while our revised forecast for 2009 envisages that the slowdown of inflation will be more pronounced in Slovenia than that predicted by the OECD for Slovenia's trading partners.

[7] A greater slowdown of unit labour costs of Slovenia's economy (to 2.5% against the autumn forecast of 4.5%) in 2009 will be a result of slower growth of compensation per employee (to 5% against the autumn forecast of 7.8%), while the strengthening of labour productivity growth will be somewhat less pronounced than expected in the autumn (to 2.4% compared with 3.1%).

Current account of the balance of payments

In 2008, the current account deficit will reach EUR 2,266 m, approximately the same figure as predicted in the Autumn Forecast *(EUR 2,203 m)****; however, its structure is changing somewhat compared with the expectations in the autumn.*** The trade deficit will widen due to weaker export growth (see “Economic growth”), while the deficit in current transfers will increase as a result of lower absorption of EU funds. The surplus in services balance will be somewhat higher compared with the autumn forecast (see “Economic growth”), mainly due to stronger export growth.

The forecasts of the current account deficit for 2009 and 2010 are lower than the autumn forecasts. In 2009, the deficit in current transactions expressed in EUR is expected to be slightly narrower than projected in the autumn, largely as a result of improved terms of trade (1.5% against 0.6% predicted in the Autumn Forecast). The surplus in the services balance will also be somewhat narrower than predicted, also in line with the expected lower net exports of travel and transport services (see “Economic growth”). The current account deficit will thus be lower than projected in the autumn despite the expected higher deficit in current transfers due to revised assumptions on Slovenia’s obligations to the EU budget. The payments to cover the difference in funds for 2007 and 2008 will also be made in 2009 (EUR 452 m by the current estimate), consistent with the new decision on the system of the European Communities’ own resources.[8] In 2010, the current account deficit expressed in EUR will be somewhat lower than predicted in the autumn, largely due to the basis effect from the previous year. Given the predicted flows of merchandise imports and exports, the trade deficit is expected to be narrower as well.

[8] In June 2007, a new Council Decision on the System of European Communities' Own Resources was adopted, stipulating the basis for determining the obligations of individual Member States to the European budget. Slovenia will presumably ratify the decision in 2009, and will have to settle the balance from 1 January 2007 when the new decision came into force. The decision from 2000 shall cease to be valid after the new decision has been ratified.

Table 5: **Revised autumn forecasts of economic trends in Slovenia and comparison with autumn forecasts**

Real growth rates in % (unless otherwise indicated)

	2007	2008		2009		2010	
		Autumn forecast (Sept. 2008)	Revised forecast (Dec. 2008)	Autumn forecast (Sept. 2008)	Revised forecast (Dec. 2008)	Autumn forecast (Sept. 2008)	Revised forecast (Dec. 2008)
GDP	6.8	4.8	4.1	3.1	1.1	4.0	3.1
GDP (EUR m, in current prices)	34,471	37,725	37,403	40,343	38,905	43,470	41,435
INFLATION (Dec/Dec of the preceding year, %)	5.6	5.3	2.2	3.6	3.0	3.0	3.0
INFLATION (Jan-Dec/Jan-Dec annual average, %)	3.6	6.2	5.7	3.9	1.1	3.3	3.0
GDP deflator (%)	4.1	4.5	4.3	3.7	2.9	3.6	3.3
USD/EUR exchange rate	1.371	1.52	1.46	1.50	1.27	1.50	1.27
EMPLOYMENT according to the SNA (% growth)	3.0	2.3	2.8	0.0	-1.3	0.4	0.3
REGISTERED UNEMPLOYMENT RATE (%)	7.7	6.8	6.7	6.8	7.7	6.7	8.1
ILO UNEMPLOYMENT RATE (%)	4.9	4.6	4.6	4.8	5.2	4.8	5.4
PRODUCTIVITY - GDP per employee (% growth)	3.7	2.4	1.3	3.1	2.5	3.7	2.8
GROSS WAGE PER EMPLOYEE	2.2	2.3	2.3	3.7	3.9	3.5	3.3
EXPORTS OF GOODS AND SERVICES	13.8	6.6	5.8	5.2	1.5	7.4	4.8
- exports of goods	13.1	4.7	3.2	4.6	1.3	6.8	4.1
- exports of services	17.0	15.5	17.6	8.1	2.4	10.2	7.5
IMPORTS OF GOODS AND SERVICES	15.7	6.9	6.5	4.0	0.5	6.5	5.3
- imports of goods	15.1	6.5	6.0	3.2	0.1	6.0	5.3
- imports of services	19.7	9.7	10.4	9.0	3.1	9.5	5.5
CURRENT ACCOUNT BALANCE (EUR m)	-1,455	-2,203	-2,266	-1,900	-1,630	-1,764	-1,717
- as % of GDP	-4.2	-5.8	-6.1	-4.7	-4.2	-4.1	-4.1
GROSS FIXED CAPITAL FORMATION	11.9	8.8	7.0	1.3	-2.0	4.5	5.0
- as % of GDP	27.5	28.3	28.0	27.6	26.5	27.5	26.8
PRIVATE CONSUMPTION	5.0	4.5	3.4	3.5	2.8	3.6	3.8
- as % of GDP	52.2	52.9	52.6	53.2	52.5	52.9	52.7
GOVERNMENT CONSUMPTION	2.5	3.4	3.9	2.2	2.2	2.6	2.6
- as % of GDP	17.7	18.0	18.2	18.5	18.9	18.7	19.2

Source of data: SORS, BS, forecasts by IMAD.

2. ALTERNATIVE SCENARIO OF ECONOMIC TRENDS

With the revised autumn forecasts, we also developed an alternative scenario of economic trends, as (in light of high uncertainty regarding the dimensions and depth of the financial and economic crisis) there is a great risk that in the coming year economic growth might be even lower than predicted. The central forecast predicting a significant slowdown of economic growth in 2009 is consistent with the most recent assumptions about the international environment. However, given the great uncertainty as to the duration and intensity of the economic and financial crisis, economic growth in Slovenia's main trading partners may be even lower than assumed. It remains to be seen how regained confidence, the actual stabilisation of conditions in the financial market and the magnitude of the impacts of the crisis on the real economy will unfold.

The realisation of these risks would result in weaker economic growth and a lower level of employment in the next two years, along with weaker wage growth. The alternative scenario assumes that in the next two years economic growth in our main trading partners will be one percentage point weaker than projected in the baseline scenario. The realisation of these assumptions would entail even weaker growth rates of exports and investment in 2009 and, consequently, a further slowdown of economic growth (by 0.5 p.p. in 2009 and 0.4 p.p. in 2010). As a result of lower economic activity, the drop in employment in 2009 would be more pronounced than predicted in the baseline scenario, but in 2010, growth would remain as predicted, given the lower level in 2009. However, the number of persons in employment will still be lower compared with the baseline scenario. In both years, lower economic activity and deteriorated labour market conditions would also be reflected in weaker total wage growth, mainly as a result of lower rises of private sector wages.

Table 6: **Alternative scenario of economic trends**

Real growth rates (in %)

	2009	2010
GDP	0.6	2.7
Exports of goods and services	0.5	3.9
Imports of goods and services	-0.4	4.5
Private consumption	2.6	3.5
Government consumption	2.2	2.6
Gross fixed capital formation	-3.0	4.4
Inventories, contribution to growth in p.p.	-1.0	-0.2
Employment according to the SNA (increase in %)	-1.7	0.3
Gross wage per employee	3.6	2.8

Source od data: alternative scenario by IMAD.

3. IMPACTS OF ECONOMIC POLICY MEASURES AIMED AT MITIGATING THE CONSEQUENCES OF THE FINANCIAL CRISIS

The Revised Autumn Forecast does not take into account the economic policy measures, aimed at mitigating the economic crisis, which were still in the process of preparation when the forecast was released. A successful implementation of these measures could lead to stronger economic growth than predicted in the baseline scenario of the Revised Autumn Forecast, as well as a lesser deterioration of certain other macroeconomic indicators.

The consistency of short-term and long-term economic policy measures aimed at mitigating the consequences of the financial and economic crisis is, given the openness of Slovenia's economy, essential to achieve positive impacts on economic activity. In Slovenia, the consequences of the financial crisis are shown in: (i) decreasing access of banks to interbank loans, which diminishes financing options for current and investment activities of enterprises; more and more enterprises are thus facing liquidity problems; a contraction or postponement of already adopted investment plans can also be expected; (ii) decline in foreign demand, which has a direct impact on the Slovenian export sector, particularly producers and exporters of durable goods, whereas its indirect consequences will be felt by the economy as a whole. The package of measures aimed at mitigating the consequences of the economic crisis will follow the framework of the *European Economic Recovery Plan* (November 2008), which represents the basis for a coordinated EU approach to stimulating the economy. It includes a fiscal package and direct short-term actions to mitigate the consequences of recession and reinforce the long-term competitiveness of the European economy. These measures mainly involve investment incentives aimed at creating new jobs and restructuring traditional production. Public finance measures are thus complemented by structural reforms in line with the Lisbon Strategy. Stabilisation of the financial system and a rebound in lending will be of crucial importance to ensure immediate effects, while the impact of measures on economic activity will also depend on the consistency of short-term and long-term actions and their adjustment to the openness of Slovenia's economy.

The impacts of individual discretionary fiscal policy measures on economic growth differ in pace and strength. Measures that yield concrete results in a relatively short time, but have no detrimental effects and do not disrupt macroeconomic equilibrium in the long run, will have the greatest stimulus on sustainable economic growth. In the area of fiscal policy, the full operation of automatic fiscal stabilisers will alleviate cyclical trends, but will also entail lower inflows from taxes and increased expenditure and, consequently, a wider budget deficit than envisaged in the adopted budget for 2009. Additional discretionary fiscal measures might stimulate economic growth; how fast the impacts will become apparent and the magnitude of individual stimulus on economic activity will depend on whether the measures involve a reduction of the tax burden or an increase in expenditure. Investment tax relief will have a positive effect on economic growth and employment if it is target-oriented (research and development; job creation). Higher general government investment consumption would bring about stronger growth of gross fixed capital formation than predicted in the baseline scenario. Its positive effects would be greatest in development-oriented projects that support domestic economic activity. Given the public finance restrictions, it would be reasonable to strengthen public-private partnerships in this area. It should be noted that, due to a lower fiscal multiplier in small open economies such as Slovenia's, an increase in expenditure has a relatively limited impact, but widens the general government deficit and, consequently, general government debt regardless of the economy's size: in small open economies, the same increase in general government debt thus results in a smaller incentive for the economy. However, a rise in general government debt increases the risk and risk premiums. Perceptions of Slovenia among stakeholders in the financial market may therefore deteriorate or be relatively worse than the perceptions of other (larger) euro area countries.

Additional discretionary fiscal policy measures will have positive medium-term impacts on economic growth only if they take account of public finance capacities and restrictions. Through higher general government expenditure or smaller inflows, all these measures will bring the budget deficit close to the EU ceiling of 3% of GDP, which is not only problematic from the aspect of fulfilling the provisions of the Stability and Growth Pact, but also, in particular, from the aspect of ensuring the long-term sustainability of public finance. The more funds will be provided from alternative public finance sources and through streamlining other general government expenditure, the smaller the negative consequences of the adopted measures for long-term sustainability of public finance will be. The possible measures to increase the revenue, which would also have positive structural effects, involve an increase in excise duties (the most room to manoeuvre is in excise duties on liquid fuel for transport and heating) and the unification of bases for calculating social security contributions among employees with different statuses; according to the current regulations, social security contributions for certain groups of employees are calculated according to different (lower) bases, even though these employees have comparable incomes (e.g. self-employed persons mainly pay social security contributions based on the minimum wage). A change in the time frame for the elimination of wage disparities would also soften the pressure on general government expenditure and increase the leeway for 'active' measures in the year when the financial crisis is expected to have a most significant impact. Reserves can also be sought in general government expenditures (at both the national and local levels) which have hitherto not been effectively used. This would release resources needed for short-term measures to mitigate the consequences of the financial crisis and, in the long run, enhance the effectiveness of public spending, make room for new obligations Slovenia will have to face in the future and possibly even reduce general government expenditure.

Additional measures in the fields of labour market and industrial policies, and a faster implementation of reforms that have already been planned would stimulate economic activity and offset unfavourable movements in the labour market. Active employment policy measures that might alleviate negative labour market trends include public works, targeted training courses to serve the needs of a known employer and incentives for staying in employment longer. Some experts regard these measures as a more effective poverty-prevention instrument than the minimum wage, the raising of which can also have negative impacts on the labour market (increased unemployment). Industrial policy measures will have greater positive effects on economic activity if they are unified at the state level and focused on promising high-technology-based enterprises with new programmes. It would also be necessary to introduce organisational measures to simplify the long-lasting and costly procedures with regard to required documentation, granting of financial resources (subsidies and state aid) and allocation of resources in very low amounts, which leads to a large number of transactions and a lack of coordination between individual sectors.