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Acronyms & abbriviations in the text have the following meanings:

AP Agency of the Republic of Slovenia for Payments,
BS Bank of Slovenia,
ELES Electro Slovenia,
IMAD Institute of Macroeconomic Analysis and Development,
MF Ministry of Finance,
p.p. percentage points
SORS Statistical Office of the Republic of Slovenia,
Ur.l. RS Uradni list Republike Slovenije (Official Journal of the Republic of Slovenia).

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Main findings of the Spring Report 2005

Economic developments seen in 2004 were favourable. Gross domestic product recorded the highest real increase in the last five years (4.6%) that was stimulated by stronger foreign demand (12.6% rise in total exports) alongside the relatively high growth of domestic consumption (4.7%), both private and investment, sustained from the year before. In the face of pressures from rising oil prices in the global market, the co-ordinated action of the Bank of Slovenia's and the government's economic policies contributed to a further sustained reduction of inflation that fell to its all-time low at the end of the year (to 3.2% over December 2003, and 3.6% on average in 2004). The real growth of the gross wage per employee was just slightly higher than the year before and over 1 p.p. lower than productivity growth, largely due to the real decrease in wages in the public sector. After two years, employment rebounded slightly while unemployment dropped (according to the labour force survey and data on registered unemployment). Compared with 2003, the current account deficit widened primarily due to the less favourable terms of trade as a result of higher oil prices; nevertheless it remained within sustainable limits, below 1% of GDP.

Slovenia became a member of the European Union on 1 May 2004. The accession brought no major shocks to the national economy since the large part of its tradable sector had already adapted to the demands of the common market in the pre-accession process. The undeniably most visible change was the adoption of the EU's common trade policy that abolished the leftovers of the customs protection on sensitive agro-food imports from the EU and simplified the operating conditions by lifting customs formalities. On the other hand, it also brought some new obstacles to the trade with the countries of former Yugoslavia since all free-trade agreements with Croatia, Macedonia and BIH expired when Slovenia entered the EU. The cancellation of these agreements had the strongest effect on trade with Macedonia and BIH since food products make up a large share of Slovenia's exports to these countries, and the customs duties levied on them generally rose after 1 May. Trading with Croatia was less affected since the bulk of products traded between Slovenia and Croatia have been exempt from customs duties since 2004 in accordance with the operative trade agreement. The adoption of the common trade policy had the strongest direct impact on the food industry. On one hand, the abolition of customs protection boosted the supply of cheaper agro-food products from the EU which, coupled with favourable weather conditions, caused food prices to drop; on the other hand, the raising of customs duties on imports of Slovenian agro-food products in the countries of former Yugoslavia aggravated the position of Slovenian exporters in those markets. After accession to the EU, all this resulted in a decline in production and exports in the manufacture of beverages, food and tobacco, where employment also dropped rapidly. In other sub-industries, the new external trade regime had a marginal direct effect. For the successful exporting industries (chemical, metal, paper industries, the manufacture of electrical and optical equipment, machinery and equipment, and transport equipment) that had already adapted to the competitive common market in the 1990s, Slovenia's entry to the EU, coupled with increased demand supported by the EU's economic recovery, was a positive impulse and an opportunity to increase sales in some of the less traditional EU markets. Entering the EU has also not accelerated the deterioration in labour-intensive industries (textile, footwear, leather) where the decline that had been underway for several years continued at a similar or even slightly slower pace, the main reason for it being the insufficient structural adjustment of these industries.

As an EU member, Slovenia is obligated to make payments to the EU budget while it can also draw funds from it to promote its agricultural and rural development and its structural, cohesion and internal policies. However, resource allocation from the EU budget is subject to exact rules and requires well-prepared programmes co-financed by the national budget. In 2004 Slovenia was unsuccessful in acquiring funds from the EU budget which, above all, indicates that its absorption capacity must be raised in the coming years. Slovenia's net budgetary position towards the EU budget in 2004 hence totalled a mere SIT 3.4 bn or less than 10% of the planned amount, noting that even this level was only reached thanks to the slightly lower-than-planned actual payments to the European budget and due to the early remittances of lump-sum payments.

Accession to the EU also involved some macroeconomic risks which, however, did not materialise in 2004. The first risk was linked to the possible substantial and rapid decline of competitiveness in labour-intensive industries in 2004, which would translate into lower growth of domestic production and higher unemployment. The figures on production and employment in labour-intensive industries for 2004 indicate that the risk of a faster fall in their competitiveness did not materialise since the unfavourable trends were in line with the baseline scenario projections. The second risk was associated with the accelerated growth of domestic consumption due to the lowering of nominal interest rates after entry to ERM II which could have triggered macroeconomic imbalances in external trade and inflation. According to the figures for 2004, this risk remained unrealised as well since trends in domestic consumption were in line with expectations and had no inflationary impact.

The stable macroeconomic environment seen in 2004 and the firm commitment of macroeconomic policy-makers to the co-ordinated implementation of the Programme for Entering the ERM II and Introducing the Euro adopted in November 2003 enabled Slovenia to join the Exchange Rate Mechanism ERM II already in the first round at the end of June 2004 (along with Estonia and Lithuania) which should, provided that it fulfils the formal convergence criteria, also enable Slovenia to adopt the euro at the beginning of 2007. The decision for the ERM II had a positive effect on the government's economic policy measures, notably in administered prices and incomes, and on the efficient co-ordination with the Bank of Slovenia, which was reflected in inflation cuts seen in 2003 and especially 2004. In the course of preliminary activities for entering the ERM II that were later formalised in the Programme, the Bank of Slovenia gradually reduced interest rates and slowed the tolar's depreciation down. This also relieved inflationary pressures generated by the tolar's depreciation in the past few years. The lowering of the BS' interest rates was also reflected in cuts of nominal interest rates in banks which, in turn, stimulated the banks' lending activity and, combined with cyclical and economic factors, boosted private consumption.

The economic developments expected in the period preceding adoption of the euro are relatively positive. Given the expected slight slowdown in the growth of total export demand, economic growth is expected to be slightly lower this year compared with 2004 yet is to remain at a relatively high level (3.8%). Domestic consumption is also expected to record lower growth than last year, chiefly due to the foreseen smaller accumulation of inventories while private and investment consumption are expected to record growth rates similar to those of 2004. In the absence of any major price shocks the co-ordinated economic policy measures by the government and the Bank of Slovenia will enable a further fall in inflation and the fulfilment of the Maastricht convergence criterion in mid-2006. Economic trends similar to those seen this year can be expected in 2006 when exports are set to record a stronger increase on the back of the slightly higher growth of foreign demand which will contribute to higher economic growth (4.1%) despite the slightly subdued increase in private and investment consumption.

The adoption of the euro at the beginning of 2007 is a primary goal of macroeconomic policies, demanding their co-ordinated action to fulfil the Maastricht convergence criteria in the next year and a half. However, besides accomplishing nominal convergence this must be achieved in a sustainable way to ensure that macroeconomic equilibria are not undermined after joining the EMU due to the relatively restrictive mix of macroeconomic policies applied until then. This goal is even more challenging since the role of macroeconomic policies has permanently changed since Slovenia joined the EU. At the end of 2004 Slovenia met three out of the five Maastricht criteria, noting that the criterion of the stable exchange rate (requiring the tolar's exchange rate to remain stable for a period of two years) could not be fulfilled since Slovenia has only participated in the exchange rate mechanism since June 2004. Both fiscal criteria were met in 2004 (the budget deficit relative to GDP did not exceed 3%, and public debt was far below the upper ceiling set at 60% of GDP). Slovenia also satisfied the criterion determining the level of interest rates while it failed to comply with the price stability criterion.

Therefore, it will be of the foremost importance to fulfil the inflation criterion up until the middle of 2006; monetary policy can mainly contribute to this goal by preserving the stable exchange rate while other macroeconomic policies must support these efforts. In order to meet the Maastricht criterion the government must thus continue pursuing the adopted policies, notably the restrictive administered prices policy and the counter-cyclical adjustment of excise duties on liquid fuels. At the same time, the Bank of Slovenia should harmonise its interest rates with those of the euro area; here the key policy will be to preserve the consistency between inflation cuts and the lowering of interest rates, i.e. to keep the real interest rate stable.

Notwithstanding fulfilment of the Maastricht criteria, changes are also needed in the fiscal area. A detailed analysis of the current fiscal situation, above all the widening of the structural deficit seen over the past few years, reveals several structural problems that pose a challenge to fiscal policy and necessitate, primarily the earliest possible changes towards more flexible expenditure. The main reason why this is important is that fiscal policy carries a relatively heavier burden in securing macroeconomic stability after entry to the ERM II and EMU while having little leeway to act in the changed macroeconomic circumstances due to the high share of legally fixed budget expenditure. Flexibility in public expenditure is also imperative to allow for the co-financing of inflows from the EU budget: with the strictly set deficit ceiling and the rule that European resources must be co-financed from national budgets, too little room for manoeuvre in the variable part of the budget could block the receipts from the EU budget which may, in turn, stifle the growth of investment. It will also be necessary to increase the target efficiency of social transfers and examine the criteria and legal framework determining their eligibility, adjustment rules and amounts. Within this context the principal concern will be to continue preparing projections for evaluating the long-term financial sustainability of public financing and the need to change the current pension and health insurance systems.

In the delicate period of Slovenia's participation in the ERM II the burden of sustaining macroeconomic stability is also being borne by wage policy. In this period, restrictive wage policy is key to preserving macroeconomic stability and achieving the inflation target; the provisions of the Social Agreement for 2003-2005 should therefore be upheld in 2006 as well. At the same time, however, care should be taken that this guideline is not achieved above the gap between wage and productivity growth over the target set in the Social Agreement, including any widening of this gap in individual sectors. Namely, this could lead to macroeconomic imbalances and trigger requirements for excessive wage increases immediately after entry to the EMU.

Part I

Analysis and forecasts of economic developments

1. Economic developments in 2004

***Economic growth** in 2004 (4.6%) was the highest in the last five years.* The increase started with the recovery in the international environment at the end of 2003, it continued at an accelerated pace until the third quarter of 2004 (5.0% real growth of GDP year-on-year), only to slow down slightly in the last quarter. It nevertheless remained relatively high (4.3%; the slowdown was largely a consequence of somewhat slower growth in investment and the negative contribution of the change in inventories to economic growth)[1]. Gross domestic product thus rose by 4.6% in real terms which can also, according to the SORS' estimates, be attributed to 2004 having 5 more working days than the year before[2]. The higher growth was largely driven by a boost in exports (12.6% real growth, in 2003 3.2%), exceeding even the expectations of the Autumn Report while the real growth in domestic consumption retained the favourable levels of the year before (4.7%).

In 2004, exports to the EU, Croatia, Serbia and Montenegro, and Russia rose considerably. Although partly a result of international economic trends, the changes in the regional structure of trade in 2004 started to reveal the effects of the trade creation and trade diversion following accession to the EU. The year-on-year real growth in total goods exports, which accelerated in the second quarter of the year, also preserved its momentum in the second half of the year and eventually averaged out at 13.2% in 2004. It was spurred on largely by a boost in exports to the "old" EU member states compared to the only modest growth seen in 2003, in particular to Italy, France and Austria, as well as to less traditional trading partners (Belgium, Spain, Ireland and Portugal). Only exports to Germany failed to rise markedly, and they even decelerated towards the end of the year. The growth in exports to the "new" EU member states preserved their high levels achieved over the past years. Of the countries of former Yugoslavia, exports grew markedly to Croatia, and Serbia and Montenegro. The high export levels to Russia even doubled in 2004, whilst exports to the USA dropped from their high levels in 2003. Exports to Bosnia and Herzegovina grew only modestly and exports to FYR Macedonia even shrank, with the monthly export dynamics to both countries obviously reflecting the abolition of free-trade agreements after Slovenia's entry to the EU. While still high in the first four months of 2004, export growth to these countries slumped after May 2004. On the contrary, the termination of the free-trade agreement with Croatia did not bring any significant consequences because of Croatia's Interim Trade Agreement with the EU, according to which a large part of industrial goods imports have been customs-free since 2004.

In 2004, domestic demand was driven by the slightly higher rise in private consumption and lively investment activity, while inventories again contributed

[1] According to data adjusted for seasonal influences and the number of working days, in real terms gross domestic product dropped by 0.4% in the last quarter of 2004 over the previous quarter, while value added in manufacturing was also down by 2.4%.

[2] Nominal growth in gross domestic product was 7.7% in 2004, which is in line with the Autumn Report forecast. The 4.6% figure of real GDP growth therefore means that the implicit deflator of gross domestic product was 3%. This relatively low GDP deflator in 2004 was considerably affected by the deteriorated terms of trade, i.e. a higher rise in import prices than the rise in export prices, largely as a consequence of the accelerated growth of prices of oil and raw materials in 2004.

significantly to economic growth. On the side of domestic demand, the real rise in private consumption strengthened in line with the forecasts (3.5%, in 2003 2.7%), as well as the real rise in gross fixed capital formation, which attained a slightly higher level than the year before (6.8%, in 2003 6.3%), whilst the real rise in government consumption was lower (1.7%, in 2003 2.6%), also compared to our autumn forecast. After the high values achieved in 2002 and 2003, growth in inventories was above the expectations, contributing as much as 0.8 p.p. to economic growth in 2004. In addition to the modest rise in wages and employment, growth in private consumption also relied on the relatively big rise in other remuneration which raised disposable income, as well as on the increase of mostly long-term household borrowing with banks which led to the greater consumption of durable and semi-durable goods. A cut in nominal interest rates related to Slovenia's entry to the ERM II mechanism was another reason for the increased borrowing, presumably along with the repayment of loans taken out in 1999, which again raised the population's credit worthiness. In our estimation, the rise in gross fixed capital formation was underpinned by the growth in investment in machinery and equipment, as well as by the substantial investment in housing construction, at least as shown by the number of building permits issued. Moreover, the scope of investment in engineering construction preserved the high 2003 levels.

Along with the relatively high growth in domestic demand and the boost in exports, imports also rose considerably (12.4%, in 2003 6.8%). Although the contribution of international trade was negative (-0.2 p.p.), it was less negative than in 2003 (-2.2 p.p.) and also less than foreseen last autumn. The modest **current account deficit of the balance of payments** in 2003 increased to EUR 238.3 m or 0.9% of GDP in 2004, largely owing to the bigger trade balance deficit.

*2004 generally saw positive **employment** developments, although the growth in formal employment remained low. However, informal employment surged.* Formal employment (employed people and the self-employed according to the monthly statistics) rose by 0.8% in 2004. Informal employment, however, surged (it is calculated as the difference between employed people according to the Labour Force Survey and the number of formally employed)[3]. The number of employed people according to the survey increased by around 5%, of which the number of informally employed soared by 35%. Employment according to the national accounts statistics rose by 0.1% in 2004, according to the first SORS estimates. The rate of registered unemployment decreased to 10.3% in 2004 (10.9% in 2003)[4], and the survey unemployment was down to 6.3% (6.7% in 2003).

*Real growth in the gross **wage** per employee was 2% in 2004, which exceeded the goal set out in the Social Agreement concerning the lagging of the rise in wages behind the rise in productivity.* The real gross wage per employee in the private sector rose by 3.1%, largely thanks to the economic upturn which resulted in the

[3] According to the IMAD's assessment, this difference mostly incorporates assisting household members, contract work and other forms of informal employment (grey market).

[4] The unemployed who were deleted from the unemployment registers in 2004 represented 24.3% of the total inflow to unemployment (initial situation + new first-time job-seekers + people who lost work). The main reasons for being deleted are by one's own choice, a failure to report or a refusal to take a job or schooling.

payment of end-year bonuses, as well as to the higher number of working days than in 2003. The total rise in real gross wage per employee remained modest largely due to wage trends in the public sector, with the real gross wage in this sector going down by 0.8% in real terms compared to 2003.

*The sustainable reduction of **inflation** over the last two years has been the result of the concerted action of the Bank of Slovenia and the government, related to the Programme for ERM II Entry and Adoption of the Euro.* The year-on-year rise in the prices of consumer goods was 3.2% last December; average inflation also dropped by a round a third in 2004, running at 3.6% at the end of the year. Like in 2003, last year the highest rise was also recorded in the first half of the year (2.8%) but dropped to a mere 0.4% in the second half of the year. The main factor contributing to the reduction of inflation in 2004 was stabilisation of the tolar exchange rate after entering the ERM II mechanism. In June 2004, the year-on-year appreciation of the exchange rate was 2.3% (in June 2003 3.3%), which – taking into account the practically full transfer of the rise of the exchange rate to the rise in prices – contributed 1.0 p.p. less to inflation than in the same period last year, but still around half of the total rise in prices.

The government proceeded by increasing administered prices, through the concerted changing of fiscal burdens and by following the guidelines set out in the Social Agreement in 2004. Unlike in 2003, the basic goal of the policy of administered prices (the rise in administered prices being in line with the rise in non-administered prices) was not achieved in 2004, with the reasons for the faster rise in administered prices (they were up by 9.0%, whilst non-regulated prices only rose by 2.1% in 2004) being largely external factors, i.e. higher prices of oil and liquid fuels for transport and heating (which contributed 1.0 p.p. to inflation). Also the rise in most other administered prices was higher than expected: the prices of basic utility services, non-profit rents and school textbooks grew by more than 10%, contributing 0.2 p.p. more to inflation than foreseen in the Plan of Adjusting Administered Prices. The rise in other administered prices was slower. Because of the relatively stronger influence of changes in oil prices on inflation in Slovenia than in other EU member states, the government continued to apply a non-cyclical adjustment of excise duties on liquid fuels for transport and heating in 2004. In addition the process of harmonising excise duties on tobacco products with the tax system in EU member states continued, contributing an additional 0.2 p.p. to inflation. As for incomes policy, the government succeeded in keeping the rise in wages below the rise in productivity in line with the agreement with the social partners, thus preventing any transfers of wage rises to prices.

Amongst the measures related to Slovenia's entry to the EU, the change in trade regimes also significantly contributed to the cutting of inflation. Changed competitive conditions in the market and the abolition of customs duties led to a drop in food prices. This was, however, also due to the more favourable weather conditions than in 2003. The total effects of these factors resulted in a drop in food prices by 1.1%, reducing inflation by 0.2 p.p. in 2004 (in 2003, high food prices pushed inflation up by 0.8 p.p.).

According to the **consolidated general government accounts** (in line with the GFS methodology of the Ministry of Finance), general government revenues (including central and local budgets and pension and health funds) increased in real terms by 5% in 2004 and accounted for 41.7% of GDP, up by 0.4 of a structural point from 2003. The general government expenditures (consolidated) rose in real terms by 5% including contributions to the EU Budget, and by 3.4% excluding these allocations. Including payments to the EU Budget, they accounted for 43.1% of GDP, up by 0.4 of a structural point from 2003 and, excluding these payments, they reached 42.4% of GDP, down by 0.3 of a structural point from 2003.

Although the economic policy measures were aimed at easing the pressures on the general government expenditures and at assuring stable sources of finance, the **general government deficit**[5] in 2004 reached 1.4% of GDP – the same as in 2003. The central budget deficit (according to the European System of Accounts of 1995 – ESA-95) accounted for 1.9% of GDP according to the preliminary data, down by 0.1 of a structural point from 2003.

[5] The general government deficit is defined as the difference between consolidated revenues and expenditures of the central budget, local budgets and the pension and health funds.

2. International environment

Last year world economic growth was at its highest level in the last thirty years (5.1%). The volume of international trade soared even more, i.e. by 10% compared to the year before, and thus exceeded the autumn expectations. The economic forecasts published by the European Commission and the International Monetary Fund in spring were unchanged from last autumn and foresee lower economic growth in 2005 and 2006 than in 2004 (ranging from 4.1% to 4.4%).

In preparing our spring forecasts of international developments, we took into account the forecasts available by March (the March issue of Consensus and the spring forecast of the European Commission; for Southern European countries also the WIIW spring forecasts), as shown in Table 1. The forecasts published after that (the IMF forecast and the April Consensus) do not deviate from those incorporated in our assumptions.

Table 1: **Assumptions of the IMAD's forecasts on economic growth in Slovenia's main trading partners in 2005 and 2006**

	2004	2005		2006
		Autumn forecast (Oct. 2004)	Spring forecast (April 2005)	Spring forecast (April 2005)
Euro area	2.0	2.0	1.7	2.2
EU	2.4	2.3	2.0	2.4
Germany	1.6	1.6	0.9	1.7
Italy	1.2	1.8	1.2	1.7
Austria	2.0	2.3	2.0	2.2
France	2.5	2.2	2.0	2.3
Great Britain	3.1	2.6	2.8	2.8
Czech Republic	4.0	3.4	3.8	4.0
Hungary	4.0	3.6	3.9	4.1
Poland	5.3	4.5	4.5	4.6
Croatia	3.8	3.5	3.5	3.5
BIH	6.0	4.5	5.0	5.0
Serbia	7.0	3.0	5.0	5.0
Macedonia	2.0	3.0	4.0	4.0
USA	4.4	3.5	3.5	3.4
Russia	7.1	5.5	5.5	5.3

Source: IMAD estimates based on European Commission forecasts, Consensus Forecasts, March 2005, WIIW Research Report No. 314, March 2005.

*The expected **oil prices** are considerably above the autumn assumptions.* After the last Autumn Report came out the world prices of oil started to climb up again to above 50 USD/barrel level in October, only to go down again to 40 USD by the end of the year. In 2004, the average oil price (Brent) was thus 38.3 USD/barrel (the autumn forecast was USD 37). This year the prices have again started to rise and reached the record highs in March (56 USD/barrel). Thus, the average price in the first quarter was 47.6 USD/barrel. In line with the international institutions' forecasts[6] and on the basis of the technical assumption of an unchanged EUR/USD exchange rate, we expect oil prices to gradually drop from the high level recorded at the beginning of the second quarter to 45 USD/barrel by the end of the year. This level is also expected to be preserved next year. Such dynamics means that the prices of oil are to average out at 48 USD/barrel in 2005 and at 45 USD/barrel next year.

Last year ***the calculated effects of oil prices on economic growth*** *proved to be overrated.* As the recent IMF estimate shows, a permanent rise in oil price by USD 5 was supposed to suppress world economic growth by up to 0.3 p.p. But the IMF also claims that last year there was no such effect as the high oil prices were in fact a result of a world economic upturn and the high demand for oil. At the same time, the high prices of oil – although contributing to higher inflation in many oil importing countries – did not cause any secondary effects or additional inflationary pressures that would lead to an additional rise in interest rates and negatively affect domestic consumption.

In 2005 the rise in ***world prices of other raw materials*** *will be much lower than that of oil prices and in 2006 they are even expected to fall.* 2004 already saw a slower rise in prices of other raw materials than oil prices; the highest rise was recorded in the prices of metals (by 36%) and food (14%), and less so for non-food agricultural products and beverages (by 6% and 3%, respectively). This year, the rise in the prices of metals is expected to continue (15%), only to go down in 2006 (-10%); food is expected to be less costly in both years (down by 3-5%). On the other hand, the prices of beverages are expected to go up this year after two years of only modest growth (by 12%) and the newly achieved levels are also to be preserved in 2006.

In line with exchange rate market developments over the last six months, ***the EUR/USD ratio*** *is somewhat higher in the spring forecast (USD 1.306 per EUR 1) than it was in autumn (1.22).* The ratio is in fact the "technical assumption", which means an unchanged ratio over the whole period to which the forecast applies. It is set on the basis of movements over past months (an average from October 2004 to March 2005). The value of USD against the EUR was rising in the spring months and losing value towards the end of the year; thus on average in 2004 the ratio stood at USD 1.24 per EUR 1. In the first three months of 2005, the USD/EUR exchange rate was on average 4.9% higher than in the same period last year, i.e. USD 1.31 per EUR 1.

In 2004, ***the main interest rate of the*** *US central bank was rising yet in the euro area it remained unchanged. In the US, it is seen to further rise in 2005 whilst in the euro area its developments are less predictable.* Since last June, when interest rates were changed for the first time in four years the American FED raised the leading interest rate seven times up to the end of March this year (to 2.75%). According to the Consensus forecasts (April 2005), the interest rates are to rise to a "neutral

[6] The IMF's assumption of the average price of Brent, Dubai and West Texas Intermediate oil for 2005 stands at 46.5 USD/barrel and 43.75 USD/barrel for 2006. The European Commission's assumption regarding the price of Brent oil is 50.9 USD/barrel in 2005 and 48.0 USD/barrel in 2006.

level" of 3.75-4.0% by the end of 2005. On the other hand, the interest rate on the main refinancing operations in the euro area has not been changed since June 2003 and is expected to remain at the 2% level in the coming months. The scope of the potential rise in the second half of the year and in 2006 will, however, depend on the economic activity in these countries.

Table 2: **Forecasts of world economic trends**

	2003	2004	2005		2006
			Oct. 2004	April 2005	April 2005
Economic growth – world (real growth in %)	4.0	5.1	4.3	4.3	4.4
Volume of world trade in goods and services (real growth in %)	4.9	9.9	7.2	7.4	7.6
World prices of raw materials excluding energy* (growth in %)	7.1	18.8	-3.9	3.8	-5.1
6-month LIBOR** interest rates on USD deposits (in %)	1.2	1.8	3.4	3.3	4.1
6-month LIBOR** interest rates on EUR deposits (in %)	2.3	2.1	2.8	2.3	2.9

Source: IMF, World Economic Outlook, October 2004, April 2005.
Note: *Weighted average with regard to the shares in world exports. **LIBOR - London interbank offered rate.

*Also this year the international forecasting institutions foresee numerous **risks in the international environment.*** Risks on the world scale are largely related to oil prices and balance of payments imbalances. Further, economic growth in some regions overly depends on an economic upturn in the USA and China so any marked slowdown in growth in these countries may present a risk for those economies with weak domestic demand growth.

2.1. Review of economic trends in selected countries

*Last year, **the USA** achieved its highest economic growth in the last five years – 4.4%; also the forecasts for 2005 and 2006 have remained largely unchanged since autumn, anticipating around 3.5% economic growth***.** **Last year's growth** was largely driven by high growth in private consumption (3.8%) and a strong rise in gross fixed capital formation (9%). As a result of the weak USD and favourable world economic developments, the exports of goods and services were also boosted (8.5%), however, imports rose even higher and ultimately the contribution of international trade to growth remained negative. Employment, which was shrinking or stagnating over the last three years of economic recovery, again picked up last year. Because of the rise in interest rates and withdrawal of the fiscal stimulus, both contributing significantly to the growth achieved over the last three years, domestic consumption and thereby economic growth in the USA is expected to slow down by almost one percentage point in **2005-2006**. The European Commission's expects this slowdown to be more pronounced in 2006 (3%) than other forecasting institutions (IMF, Consensus), as it takes into account even slower growth in private consumption.

*After two years of only modest economic growth in **countries of the euro area, 2004** eventually saw a rise in gross domestic product by 2.0% (in the EU by 2.4%).*

*The forecasts for **2005** were corrected slightly downward since autumn, foreseeing a slowdown compared to 2004 but for **2006** they still count on an acceleration of economic growth in the euro area.* After promising trends in the first half of last year, the second half of the year witnessed lower economic growth than was expected in autumn, largely owing to more subdued growth in export demand, higher oil prices (on average up by 10 USD/barrel compared to the first half of the year) and accelerated appreciation of the euro (most significantly in the last quarter of the year). Given the weak growth in domestic demand, in particular private consumption (notably in Germany, but also in Italy and Austria), economic growth in the euro area remains heavily dependent on the upturn in the international environment, which is seen to be slightly less favourable in 2005 and 2006 than in 2004. Of Slovenia's most important trading partners, the forecasts of economic growth have deteriorated most markedly for Germany and Italy, whereas the corrections for France and Austria remain less evident (see Table 1, p. 21). Moreover, the number of working days, which in 2004 contributed around one-quarter of a percentage point to the 2% economic growth in the euro area, will be 4 days less in 2005, thereby reducing economic growth by 0.13 p.p.

*In 2004 the economic growth in **Germany** was 1.6%*[7]*, the highest since 2000. Similar growth is not expected to be achieved before 2006, with 2005 even witnessing a marked slowdown.* **Last year's** growth was largely driven by accelerated exports. As regards domestic demand, private and investment consumption again shrank (the former for the third year in a row and the latter for the fourth), and inventories soared. Companies' expectations of economic developments in the coming months, as measured by the IFO business climate indicator, deteriorated in February and March 2005, as did the estimate of the current economic situation. Because of the slow growth in employment and modest growth in wages, this year private consumption is also not expected to recover considerably (in parallel, the savings rate has been on the rise since 2000), and on top of that the contribution of international trade will only be modest, therefore, economic growth is expected to run at a mere 0.9% in 2005.

*Also in **France,** last year's economic growth was the highest since 2000, i.e. 2.5%. In 2005, growth is expected to go down by around 0.5 p.p., while it is expected to pick up again in 2006, presumably to 2.3%.* Economic growth, which in the second half of **last year** already started to slow down, was largely generated by growth in private consumption whilst international trade contributed negatively as a consequence of the deteriorated price competitiveness of French exports. After a two-year decline, investment consumption also recovered last year, which is set to be further stimulated by tax incentives introduced **this and next year.** Another reason behind the slower growth this and next year is the smaller contribution of inventories growth, which last year pushed growth up by 1 p.p.

*The 2% economic growth **in Austria in 2004** was largely export-driven. This and next year, economic growth is due to average out at 2.0-2.2%, despite slower growth in export demand.* Last year saw a boost in investment in machinery and equipment, largely as a result of the favourable macroeconomic environment and the state

[7] The effect of the number of working days is estimated at 0.5 p.p.

investment premiums which could have been applied for by the end of the year. Contrary to developments in Germany and France, the change in inventories had a strongly negative contribution to GDP growth in Austria. **In 2005-2006,** economic growth in Austria will remain at a similar level as last year, ranging from 2.0% and 2.2%. A slight push compared to 2004 is to rest on the expected higher growth in private consumption, spurred on by the tax relief foreseen under the several-year tax reform in addition to further growth in employment. Last year's robust growth in investment in machinery and equipment will slow down considerably but will be partly compensated for by higher construction activity. International trade will have a positive impact on GDP growth, although it will be less pronounced than in 2004 due to the smaller growth of exports foreseen for both years.

*In addition, last year economic growth in **Italy** lagged considerably behind that in the euro area, reaching a mere 1.2%. Acceleration of such growth by around half a percentage point is not expected until next year.* Although the two-year drop in exports came to an end **last year**, the growth achieved remained much lower than in other EU member states. Unfavourable export developments strongly affected industrial production, which last year declined for the fourth year in a row. Also **this year** it is expected to fall, according to the latest forecasts. With the aim of reversing these trends, the government has prepared a set of measures to encourage growth in industrial production (deregulation, greater incentives for establishing small enterprises, R&D investment promotion programmes). Domestic consumption, which was last year the main factor of growth, will not record high growth levels before 2006.

*Like in 2004, also in 2005-2006 Slovenia's important trading partners from among the **new EU member states** (Poland, Czech Republic, Hungary) are expected to generate relatively high rates of economic growth.* In 2004, economic growth in these countries was driven by domestic demand, in addition to the boost in international trade stemming from the recovery in the euro area and their accession to the EU. It is in this segment, in particular in trade in agro-food products, that the direct impacts of EU accession have been most obvious. In other segments they are more intertwined with favourable economic developments in the euro area and in the EU in general. Thus, economic activity in industry was accelerated even before 1 May 2004. Further, data on foreign direct investment inflows reveal that in 2004 they exceeded the modest figures of 2003 but remained below the record values from the 2000-2002 period. Favourable trends in domestic demand and economic growth are also expected to continue in the next short-term period.

***In the countries of former Yugoslavia,** the spring forecasts remained largely unchanged from autumn (Croatia) or were corrected slightly upwards (other countries in this area).* The slow down in economic growth in **Croatia** in 2004 was in particular a consequence of fewer state infrastructural investments, which had fuelled growth in 2001-2003. This and next year, economic growth is to be preserved at the same level (3.5%). In **Serbia** and **Bosnia and Herzegovina,** economic trends exceeded the expectations already in 2004. The weather conditions allowed high agricultural production levels, whilst industrial production was also boosted (in Serbia by 7% and in BIH by 12%). Favourable trends also affected the economic growth forecasts for 2005 and 2006, which is set to average out at 5% in both countries. Only modest economic growth in **FYR Macedonia** in 2004, resulting from restrictive macroeconomic policies (reduction of the general government deficit from 6% of GDP in 2002 to 2% of GDP in 2004 negatively affected investments and growth in public services), is expected to pick up again in 2005-2006 (to 4%). After the slump in industrial production last year (down by a solid 12%), this activity is due to rise again this and next year (3% and 5%, respectively).

3. Analysis of economic developments in 2004 and spring forecasts for 2005 and 2006

*The spring forecast of **economic growth** for 2005 (3.8%) remains unchanged compared with the autumn forecasts while the forecast for 2006 is slightly higher at 4.1% (3.9% in autumn[8]).* While the aggregate change is small the composition of GDP growth in 2005 has shifted slightly towards a larger contribution of external trade to growth, mainly on account of the upward revisions in export growth forecasts (see Table 3). The new forecast of domestic consumption growth in 2005 has been revised downwards due to the slightly lower growth forecasts for government consumption and investment.

Table 3: **Spring forecasts of GDP growth and consumption aggregates and a comparison with the autumn forecasts for 2005 and 2006**

Real growth rates (in %)

	2004	2005		2006	
		Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)	Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)
GROSS DOMESTIC PRODUCT	4.6	3.8	3.8	3.9	4.1
Exports of goods and services	12.6	5.8	7.5	6.6	7.9
Imports of goods and services	12.4	6.5	6.5	6.5	6.6
Private consumption	3.5	3.4	3.4	3.1	3.1
Government consumption	1.7	2.9	2.5	2.9	2.5
Gross fixed capital formation	6.8	7.0	6.7	5.5	4.9

Source: SORS, forecasts by IMAD.

*This and next year are expected to record robust growth of **exports** to EU countries.* Although slightly weaker economic growth than projected in autumn is expected in both years in most of Slovenia's main trading partners in the EU, the forecasts of export growth have been revised upwards (to 7.5% and 7.9%; see Table 3)) mainly due to last year's favourable trends in external trade. Within exports, the growth of exports to the EU-25 is set to decelerate slightly this year over 2004, while a relatively stronger slowdown is expected in exports to Croatia, Serbia and Montenegro, and Russia where high growth rates were achieved last year. Lower increases compared to last year are also expected in exports to other non-member states (except the USA[9]). In 2006, provided that trends in the international environment remain

[8] Since the forecast of real GDP growth for 2005 remained unchanged in the spring forecast compared to autumn, the downward spring revision of the nominal GDP value forecast for 2005 (SIT 6,571,000 m) compared to last year's autumn forecast (SIT 6,626,000 m) is the result of: (i) the slightly lower nominal GDP in 2004 than projected in autumn (by SIT 3.339 m) and (ii) lower implicit GDP deflator forecast for 2005 (2.3% over 3.0% projected in autumn) as a result of the (0.5 p.p.) lower average inflation forecast for 2005 and the deteriorated terms of trade (by 1.2 p.p., as opposed to the 0.1 p.p. improvement projected in autumn). Due to the lower GDP deflator alone, the nominal GDP for 2005 (given the realisation in 2004) is SIT 51.2 bn lower.

[9] In 2004 the growth of exports to the USA was negative due to the strong acceleration in exports seen in 2003 (high comparative basis).

favourable, export growth is expected to retain a similar level. Specifically, growth is projected to strengthen slightly in exports to old EU member states while remaining at a high level in the new member states. On the other hand, export growth to Croatia, Serbia and Montenegro, Russia and other non-EU member states is estimated to decline slightly further. Hence we expect the continuation of the trade creation and diversion process resulting from EU membership.

The growth of ***private, investment and government consumption*** *is projected to roughly sustain the level of the past two years over the forecast horizon.* In both 2005 and 2006, the real growth rate of private consumption is expected to remain above 3% (3.4% and 3.1%, respectively). This forecast is based on the estimated disposable income against the expected wage and employment dynamics, and the relatively small changes in the composition of its spending. The growth of gross fixed capital formation will sustain a relatively high level this year (6.7%) – the accelerated growth of housing investment that began last year is set to continue while investment in non-residential construction is estimated to remain at the high level of the past two years. Investment in machinery and equipment is projected to soften marginally. The planned tax changes regarding investment relief that will enter into force in 2006 are another factor that may boost investment in 2005 and stifle it in 2006. Given the sharp increase in inventories over the past two years and the expected favourable economic trends, this segment is projected to record smaller rises and a neutral overall contribution of changes in inventories to economic growth this and next year. This is the main reason for this year's weaker growth of domestic consumption compared to the previous two years and as forecast in autumn.

Table 4: **Spring forecasts of the current account and a comparison with autumn forecasts for 2005 and 2006**

	2004	2005		2006	
		Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)	Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)
Current account of the BoP, EUR m	-238	-100	-243	-125	69
Current account of the BoP, % of GDP	-0.9	-0.4	-0.9	-0.4	0.2

Source: BS, forecasts by IMAD.

The current account deficit *is projected to remain at the 2004 level in 2005, turning into a modest surplus in 2006.* Despite the upward revision of the forecast export growth, import growth forecasts (6.5% in 2005 and 6.6% in 2006) remain unchanged compared to autumn given the anticipated growth of domestic consumption. The net contribution of external trade is thus expected to be positive in 2005 and 2006 for the first time after 2002 (0.5 p.p. and 0.7 p.p., respectively). As the terms are projected to be slightly worse this year and better next year, the current account deficit is to remain at a similar level as last year in 2005 (0.9% of GDP) and to turn into a modest surplus (0.2% of GDP) in 2006.

Supported by favourable economic growth, the ***labour market's*** *performance is expected to improve gradually in 2005 and 2006.* The pick-up in employment that started last year after a two-year decline is set to continue (0.4% in 2005 and 0.5% in 2006 according to the national accounts). Unemployment should accordingly decrease slightly faster (see Table 5).

Table 5: **Spring forecasts of labour market trends and a comparison with the autumn forecasts for 2005 and 2006**

	2004	2005		2006	
		Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)	Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)
LABOUR MARKET					
Employment according to the SNA (growth in %)	0.1	0.3	0.4	0.4	0.5
Registered unemployment rate (%)	10.3	10.1	9.8	9.6	9.3
ILO unemployment rate (%)	6.3	6.1	6.2	5.9	6.0
Gross wage per employee (real growth in %)	2.0	2.2	2.1	2.4	2.6

Source: SORS, forecasts by IMAD.

The real gross ***wage*** *per employee will increase by 2.1% in 2005: by 2.5% in the private sector and by about 0.9% in the public sector.* Wage policy in 2005 will follow the principle of real gross wage growth lagging behind productivity growth by one percentage point. In the *private sector*, the gross wage per employee is to increase slightly less than last year, partly due to the fewer working days this year (four). The adjustment mechanism for wages in the private sector agreed in the Wages Policy Agreement for the Private Sector for 2004-2005 does not provide for any downward revision (albeit the adjustment mechanism for 2005 takes into account the slightly higher consumer price rises than forecast for 2005). In the *public sector,* the real gross wage growth incorporates the 2% adjustment of all wages agreed between the social partners in the 'Agreement on the Adjustment of Collectively Agreed Basic Wage and Base Wage in 2005', regular promotions and July's wage rises in education. The agreed adjustment means that, considering the 'Agreement on the Adjustment Mechanism for Base Wages and Holiday Allowance for 2004-2005', less funds will be allocated to level out wage imbalances.

The social agreement for 2006 should provide new wage policy guidelines for the ensuing period. The agreed guidelines will be taken into consideration in the talks between the social partners concerning wage policy for both the private and public sectors since the wage policy agreements expire in both sectors in 2005. The 2.6% growth estimate of real gross wage per employee in the spring forecast assumes that the basic guideline, according to which real wage growth should lag behind productivity growth by at least one percent, will remain unchanged. On this assumption, the real gross wage per employee in the private sector is set to rise by about 2.9% mainly thanks to the further pick-up in economic activity. In the public sector, given that wages are disbursed pursuant to the new law the real gross wage would rise by about 1.8%.

After ***inflation*** *fell by over 50% during the past two years it is expected to decelerate further in 2005 and 2006, enabling the fulfilment of the Maastricht criterion by* *mid-2006.* With further implementation of macroeconomic policy measures aimed at cutting inflation and the maintenance of the favourable effects of EU accession we expect the year-on-year inflation to decrease to 2.5% in 2005 and then down to 2.3% in 2006. The same figures are projected for average inflation in both years. *As far as monetary* policy is concerned, we assume that the Bank of Slovenia will keep the tolar's exchange rate stable during the remaining period of participation in the exchange rate mechanism ERM II, thereby ensuring fulfilment of the Maastricht criterion and precluding price fluctuations resulting from changes in the exchange rate. Since the tolar's gradual depreciation has consistently contributed around 50% to the overall annual price increase in the past few years, the tolar's stable exchange rate will eliminate a significant inflationary factor. Continuing the adopted policies in *administered prices and excise duties adjustment* means that the rises of these prices will not exceed the rises of market-determined prices, and that none of the administered prices will substantially deviate from this goal. In line with the effective plan of administered prices adjustments for 2004 and 2005 the increase in administered prices should not overshoot 1.5% this year, which corresponds to a 0.2 p.p. contribution to inflation. Co-ordination between the government and independent regulators involved in price-determining in telecommunications, post and broadcasting, and electricity distribution is aimed at ensuring coherent rises of these and other prices. The contribution of changes in excise duties to inflation is also expected to decrease this year relative to 2004. After having totalled 0.4 p.p. last year, this contribution is expected to amount to 0.2 p.p. in 2005 and 2006, primarily due to the continued harmonisation of excise duty rates on tobacco. In addition, the forecast assumes that the government will continue to counter-cyclically adjust excise duties on liquid fuels to cushion any heavier oil price fluctuations and especially their second-round effects.

Table 6: **Spring inflation forecasts and a comparison with the autumn forecasts for 2005 and 2006**

	2004	2005		2006	
		Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)	Autumn forecast (Oct. 2004)	Spring forecast (Apr. 2005)
Inflation (annual average, %)	3.6	3.0	2.5	2.7	2.3
Inflation (Dec/Dec, %)	3.2	2.9	2.5	2.7	2.3

Source: SORS, forecasts by IMAD.

The inflation forecast also assumes that one-off factors will have smaller repercussions for price dynamics over the forecast horizon. In contrast to 2004, when higher prices of oil and hence liquid fuels for transport and heating made a direct contribution of 1.0 p.p. to inflation, we do not expect any further rises in oil prices above the level recorded at the end of this year's first quarter. The average price of Brent crude is expected to come close to USD 48/barrel in 2005 and drop to USD 45/barrel in 2006. On the other hand, the lifting of customs duties on food products will not cause price reductions during the rest of this year.

Main risks associated with the spring forecasts

The autumn forecast indicated two risks to the realisation of forecasts linked to Slovenia joining the EU which, however, did not materialise. The first risk was the potential rapid decline of competitiveness in labour-intensive industries in 2004 which would translate into the lower growth of domestic output and higher unemployment. The figures on production and employment in labour-intensive industries for 2004 indicate that the risk of a faster fall in their competitiveness has not materialised, as the unfavourable trends were in line with the baseline scenario projections. Similar negative dynamics are expected in these industries in 2005; they are, however, already incorporated in the baseline scenario. The second downside risk was associated with the potentially accelerated growth of domestic consumption due to the lowering of nominal interest rates after entry to ERM II, which could have triggered macroeconomic imbalances in external trade and inflation. Figures for 2004 indicate that this risk did not materialise either and that trends were in line with the baseline scenario expectations.

Since the risk of accelerated growth of domestic consumption cannot for the time being be completely ruled out due to the still active effect of interest rate cuts, especially in the first quarter/half of 2005, the potential consequences of this risk being realised were reassessed during preparation of the spring forecast. Accelerated growth of domestic consumption relative to the baseline scenario in the context of stronger economic growth would undermine the external equilibrium and increase inflationary pressures. Domestic consumption's greater response to lower interest rates, which is still possible but less likely than assumed in the baseline scenario, could push up real growth in gross fixed capital formation by close to 3 p.p. and private consumption by just over 0.5 p.p. The faster growth of domestic consumption would, coupled with higher imports, accelerate economic growth in 2005 by about 0.5 p.p. In this event, the current account deficit would expand by over EUR 100 m (0.4% of GDP) in 2005, nevertheless remaining within sustainable limits. At the same time, the lowering of inflation would be somewhat slower due to increased domestic spending; this effect would amount to around 0.2 p.p. in 2005.

This year's spring forecast contains an additional alternative scenario based on the assumption that economic growth in some, mostly old EU member states, will average out at around 0.5 p.p. below the baseline scenario in 2005. This risk rests on the potentially stronger effect of high oil prices and euro appreciation on economic activity in these countries and the possibility of a further deterioration in global macroeconomic imbalances that would stifle economic growth in the USA and Europe. The European Commission also highlighted these risks in its analyses published in spring this year. For Slovenia, the realisation of these assumptions would translate into a lower rise in export demand in 2005 than assumed in the spring forecast baseline scenario, which would be reflected mainly in a lower real export growth rate (by about 0.7 p.p.) and partly in lower investment consumption (by about 0.6 p.p., largely due to the private sector's investment). Weaker growth of orders would also slow down the growth of manufacturing's production volumes and, consequently, imports of intermediate goods. Imports would therefore also be affected by the lacklustre recovery in international economic activity so that imports would grow at a slower pace than projected in the basic scenario. Were the mentioned

Table 7: **Spring forecasts of main macroeconomic aggregates for 2005 and 2006**

Real growth rates (%) unless otherwise indicated

	2004	2005		2006	
		Autumn forecast (Oct. 2004)	**Spring forecast (Apr. 2005)**	**Autumn forecast (Oct. 2004)**	**Spring forecast (Apr. 2005)**
GDP – real growth rates, in %	4.6	3.8	3.8	3.9	4.1
GDP in SIT m (current prices)	6,191,161	6,626,000	6,571,200	7,066,400	7,039,800
GDP in SIT m (2000 constant prices)	4,836,895	4,993,300	5,018,800	5,190,300	5,223,000
INFLATION (Dec/Dec of the previous year, %)	3.2	2.9	2.5	2.7	2.3
INFLATION (Jan-Dec/Jan-Dec annual average, %)	3.6	3.0	2.5	2.7	2.3
GDP deflator, %	3.0	3.1	2.3	2.6	2.9
USD **EXCHANGE RATE** (BS)	192.4	196.3	183.2	196.3	183.6
EUR EXCHANGE RATE (BS)	238.9	239.6	239.7	239.6	239.7
EUR/USD exchange rate	1.242	1.22	1.308	1.22	1.306
EMPLOYMENT according to the SNA (% growth)	0.1	0.3	0.4	0.4	0.5
REGISTERED UNEMPLOYMENT RATE, %	10.3	10.1	9.8	9.6	9.3
ILO UNEMPLOYMENT RATE (%)	6.3	6.1	6.2	5.9	6.0
PRODUCTIVITY (GDP per employee)	4.5	3.5	3.4	3.5	3.6
GROSS WAGE PER EMPLOYEE	2.0	2.2	2.1	2.4	2.6
EXPORTS OF GOODS AND SERVICES	12.6	5.8	7.5	6.6	7.9
- exports of goods	13.2	6.0	8.1	6.8	8.2
- exports of services	9.4	5.0	5.2	5.8	6.5
IMPORTS OF GOODS AND SERVICES	12.4	6.5	6.5	6.5	6.6
- imports of goods	13.2	6.5	6.7	6.4	6.7
- imports of services	6.6	6.7	5.4	7.0	6.2
Current account BALANCE (EUR m)	-238	-100	-243	-125	69
- as % of GDP	-0.9	-0.4	-0.9	-0.4	0.2
GROSS FIXED CAPITAL FORMATION	6.8	7.0	6.7	5.5	4.9
- as % of GDP	24.7	25.2	25.8	25.6	25.8
PRIVATE CONSUMPTION	3.5	3.4	3.4	3.1	3.1
- as % of GDP	54.0	53.9	54.0	53.6	53.2
GOVERNMENT CONSUMPTION	1.7	2.9	2.5	2.9	2.5
- as % of GDP	19.8	19.8	19.7	19.7	19.4

Sources of data: SORS, Bank of Slovenia (BS), estimates and forecasts by IMAD.

assumptions to be realised, the real GDP growth rate would decrease by around 0.2 p.p. in 2005 relative to the baseline scenario.

The dynamics of oil price rises in global markets seen in March and the beginning of April this year pose a risk to realisation of the spring forecast for 2005. Any longer-lasting oil price rises in the world market would, with conditions remaining the same, lead to decelerated economic growth and faster consumer price rises. The alternative scenario calculation, which takes account of the effect of higher oil prices on the dynamics of macroeconomic aggregates, assumes a USD 10 higher average oil price per barrel in 2005 relative to the baseline scenario. Given its negative impact on the world economy, such a development would slow down the growth of Slovenia's export markets by around 0.5 p.p., which would in turn decelerate real export growth by 0.2 p.p. The smaller export demand and higher costs of intermediate goods would depress value-added growth in manufacturing. Higher oil prices would push up average inflation by around 0.3 p.p. which would, coupled with deteriorated terms of external trade, impact negatively on the real growth of domestic consumption aggregates (particularly of investment and slightly less of private consumption). The overall impact of the described effects would result in about 0.2 p.p. lower economic growth in 2005.

3.1. Gross domestic product

3.1.1. Expenditure structure of gross domestic product

Economic growth in 2004 (4.6%) was the highest in the past five years. In line with the recovery of the international environment, growth started to pick up towards the end of 2003, continued until the third quarter of last year (5% year-on-year GDP growth in real terms[10]), slowed down somewhat in the last quarter but remained at a relatively high level (4.3%)[11]. The real growth of gross domestic product (GDP) in 2004 thus totalled 4.6% according to the first estimate. The main factor contributing to this growth being higher than in 2003 was foreign trade. Although its effect on economic growth was negative (-0.2 p.p.), its negative contribution to GDP growth was 2 p.p. lower last year than the year before, and 0.5 p.p. lower than what was forecast in the Autumn Report.

Export growth gained considerably in 2004 and domestic consumption maintained the sound level of the year before. Higher economic growth was mainly generated by the strong export growth compared to 2003 (12.6% real growth against 3.2% in 2003), which exceeded the expectations of the autumn forecast. Exports increased to the EU, Croatia, Serbia and Montenegro, and Russia. The regional structure of foreign trade was partly due to the trends in the international environment and partly the result of trade creation and trade diversion after accession to the EU (see p. 37). In the area of domestic demand, private consumption saw real growth (3.5% last

[10] 4.1% in the first quarter, 4.9% in the second quarter.

[11] The slowdown was mostly due to the somewhat slower rise of gross fixed capital formation and the negative contribution of changes in inventories to economic growth. Adjusted seasonally and in accordance with the number of working days, the data show that GDP fell by 0.4% in real terms in the last quarter of 2004, and value added in manufacturing dropped by 2.4%.

Table 8: **Contribution to GDP growth in percentage points**

	2001	2002	2003	2004	2005	2006
					Forecast	
GROSS DOMESTIC PRODUCT (%)	2.7	3.3	2.5	4.6	3.8	4.1
Foreign goods and services balance (export-import)	1.7	1.0	-2.2	-0.2	0.5	0.7
Total domestic consumption	1.0	2.3	4.7	4.8	3.3	3.4
- Private consumption	1.4	0.2	1.5	1.9	1.8	1.7
- Government consumption	0.8	0.3	0.5	0.3	0.5	0.5
- Investment in gross fixed capital formation	1.0	0.8	1.6	1.8	1.8	1.4
- Changes in inventories	-2.2	1.0	1.1	0.8	-0.8	-0.2

Source: SORS; IMAD's forecast.

year, 2.7% two years ago) within the scope of the forecast, and real growth was also recorded in gross fixed capital formation, which was slightly higher than the year before (6.8% against 6.3% in 2003). Real growth in government consumption was lower than in 2003 (1.7% against 2.6% in 2003) and lower than the autumn forecast. Changes in inventories rose above expectations and following the high levels in 2002 and 2003 contributed 0.8 p.p. to total economic growth in 2004; their highest contribution occurred in the second quarter, but they gradually declined in the second half of the year. As wages and employment recorded modest growth, private consumption growth also resulted from the relatively high growth of other incomes, which pushed up the compensation of employees, and from the higher volume of household loans taken out from banks; the latter were mainly long-term loans and provided for the increased consumption of durable and semi-durable goods. Higher borrowing was stimulated in particular by the lower nominal interest rates related to Slovenia's joining the Exchange Rate Mechanism**,** ERM II; another factor was the disburdening of household income of the loans taken out in 1999, which enhanced household borrowing capacity. The growth in gross fixed capital formation is

Table 9: **Growth in demand components**

	Real growth in %					
	2001	2002	2003	2004	2005	2006
					Forecast	
Total aggregate demand	3.7	3.4	3.1	6.0	4.8	4.8
of which:						
Foreign demand (export)	6.3	6.7	3.2	12.6	7.5	7.9
Domestic demand	3.1	2.6	3.0	4.2	4.0	3.8
- intermediate consumption	3.1	3.7	2.5	4.4	3.9	4.1
- private consumption	2.3	0.3	2.7	3.5	3.4	3.1
- government consumption	3.9	1.7	2.6	1.7	2.5	2.5
- gross fixed capital formation	4.1	3.1	6.3	6.8	6.7	4.9

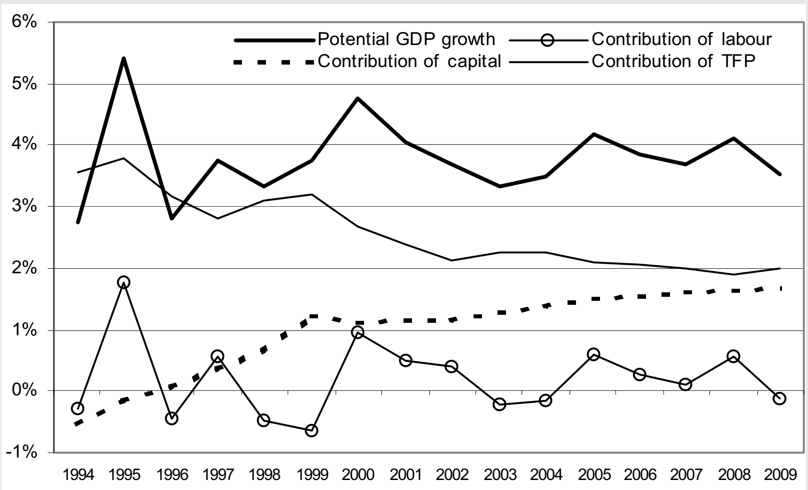
Source: SORS, IMAD's forecast.

Box 1: **Output gap**

The output gap is calculated using the production function method and shows the difference or gap between potential and actual output . The production function method, based on the logic of an economy's supply potential and the Solow growth equation model, allows us to estimate the individual influences of different factors on potential output growth. The potential output or trend growth of an economy's supply potential is an index of the maximum sustainable output at which the level of real GDP is still consistent with a stable inflation rate.

Last year, the actual level of GDP was above the potential one and is expected to again catch up with it by 2009. Due to high real growth in actual GDP (4.6%) compared to trend growth (3.5%), GDP's actual level exceeded the level of potential output in 2004 and consequently changed the sign in front of the output gap from – into +. The estimated output gap in 2004 accounted for 0.1% of GDP. In 2005, the estimated output gap will again be negative because the growth trend (4.2%) will exceed actual growth (3.8%). In the period until 2009, the level of actual GDP is estimated to remain slightly below the potential level, and to catch up with it by the end of that period. The anticipated relatively high potential growth in the coming years (3.8% in 2006, 3.7% in 2007, and 4.1% in 2008) will be mainly due to the higher contribution of capital. As the contribution of labour is expected to be negligible, the contribution of total factor productivity (TFP) will continue to fall, while still remaining the most important contributor to total potential GDP.

Figure 1: **GDP growth potential (in %) and contributions to growth (in percentage points)**



Source: MF.

estimated to have derived mainly from greater investment in equipment and machinery; the data on issued building permits show that investment in residential buildings increased as well, whereas the volume of investment in civil engineering was at the same high level as in 2003. The relatively high level of domestic demand and the boosted growth in exports were accompanied by high import growth (12.4% against 6.8% in 2003).

The spring forecast of economic growth in 2005 (3.8%) remains unchanged compared to the autumn forecast, but is slightly higher for 2006 – 4.1% (autumn forecast: 3.9%). The aggregate change is small, but the structure of GDP growth will change in both years towards the higher contribution of foreign trade, mostly due to the upward corrected forecasts of export growth. The new forecast of growth in domestic demand is lower in both years and in line with the somewhat lower growth forecast in general government consumption and gross capital formation.

This year and next year export growth will remain at the same relatively high level, but the growth in domestic demand will slow down. Although somewhat lower economic growth is expected in both years in most of the main trading partners in the EU compared to the expectations in autumn, last year's trends in international trade, which were highly positive and beyond expectations, raise our forecast of export growth (to 7.5% in 2005, and to 7.9% in 2006). We expect by the anticipated trends in the international environment that the process of trade creation and diversion resulting from EU membership will continue; this means the preservation of high export growth to EU countries, and a slowdown of exports to markets outside the EU. Given the somewhat slower export growth compared to last year, growth in intermediate consumption (3.9% and 4.1%) will be lower than last year (see Table 9). The forecast of private consumption growth, expected to remain at a level above 3% (3.4% and 3.1%, respectively), derives from estimated disposable income and relatively minor changes in the structure of income use. Similarly, the growth of gross fixed capital formation will remain at a relatively high level (6.7% and 4.9%), with a slight slowdown in investment in equipment and machinery. Last year's accelerated growth of investment in residential construction will continue, and investment in non-residential construction is estimated to maintain the high level of the past two yeas. A factor which may boost investment in 2005, but halt it in 2006, are taxation changes in the field of investment relief, which come into force in 2006. In view of the very high growth of inventories in the past two years and the anticipated favourable economic trends this year and next year we expect lower growth in this segment and an on average neutral contribution of changes in inventories to economic growth. This is the main reason for the estimated lower domestic growth than in the past two years. The forecast of higher expenditure on government consumption in both years (2.5%) is in line with the assumptions of the macroeconomic environment and the proposed revision of the 2005 budget. Compared to the autumn forecasts, forecasts of government consumption growth have been changed because of the new benchmark (data for 2004) and changes in the structure of general government expenditure. Despite the forecast of higher export growth, import growth is expected to remain at the level of the autumn forecast (6.5% in 2005, 6.6% in 2006) against the expected growth in domestic consumption. Thus the contribution of net foreign trade this year and next year should again be positive (0.5 p.p. and 0.7 p.p.), for the first time after 2002.

Table 10: **Expenditure structure of gross domestic product**

	Structure in percentages, current prices					
	2001	2002	2003	2004	2005	2006
					Forecast	
GROSS DOMESTIC PRODUCT	100.0	100.0	100.0	100.0	100.0	100.0
External balance of goods and services (exports - imports)	-0.7	1.5	0.0	-0.6	-0.7	0.5
Total domestic consumption	100.7	98.5	100.0	100.6	100.7	99.5
- Private consumption	56.3	54.6	54.4	54.0	54.0	53.2
- Government consumption	20.5	20.2	20.3	19.8	19.7	19.4
- Gross fixed capital formation	24.5	23.3	23.9	24.7	25.8	25.8
- Changes in inventories	-0.6	0.4	1.4	2.1	1.3	1.1

Source: SORS, IMAD's forecast.

The balance of the current account *will turn into a slight surplus next year.* Last year, the current account of the balance of payments showed, for the second year in a row, a deficit of 0.9% of GDP, which was bigger than the year before (0.4% GDP). Given that the surplus in the balance of services was higher and that net factor services was lower, the bigger deficit in the trade balance and lower surplus in the balance of transfers were the main contributors to the deteriorated current account last year. This year, the current account deficit should remain at a similar level as in 2004 and should turn into a minor surplus (0.2% of GDP) next year, given the expected slightly lower growth of private consumption and capital formation expenditure.

3.1.1.1. Exports and imports

Exports were the main vehicle of economic growth in 2004. Last year's strong real growth in exports was based on higher foreign demand, and the growth of import flows was influenced, in addition to higher exports, by the relatively high growth of domestic consumption. Exports of goods and services rose by 12.6% in real terms (against 3.2% in 2003), and imports by 12.4% (against 6.8% in 2003). The foreign trade balance had a negative impact (-0.2 p.p.) on economic growth in 2004, but less than in 2003 (-2.2 p.p.). The volume of foreign trade in goods and services was high throughout the year, and the highest year-on-year growth rates were recorded in the second quarter, to some extent resulting from Slovenia's accession to the EU (see Part II., p. 105).

The export flows in 2004 resulted from demand from the EU-25 countries, the countries of former Yugoslavia (especially Croatia and Serbia and Montenegro) and Russia. The stronger growth of **goods exports to the EU-25 markets** was mainly due to the improved economic activity in these countries, especially in the old members of the EU, and partly also due to trade creation after Slovenia's accession to the EU because EU growth was faster in the second half of the year. Exports to the EU-25 were up 10.2% (measured in EUR), and contributed 60% to the total growth in goods exports. The largest share of exports went to the old EU members (9.6%[12] against 1.3% in 2003), in particular to Austria, France and Italy, whereas exports to Germany declined year-on-year in the last quarter[13]. Beside higher exports to the traditional trading partners, those to less traditional markets in the EU (Belgium, Denmark, Luxemburg, Spain, Ireland, Portugal, Greece, and Cyprus) also increased. The growth of exports to the new EU member states was at a relatively high level (8.7%), although lower than in the past two years (11.1%).

The changed foreign trade regime with the countries of former Yugoslavia had the greatest impact on trade with Bosnia and Herzegovina and with Macedonia. Following high exports in the first four months of 2004, exports fell in terms of year-on-year monthly averages from May to December. This trend mainly resulted from fewer exports of products (food and beverages, leather, wood and paper products, and electrical machinery) effected by the highest increase of customs duties. Exports to Bosnia and Herzegovina and to Macedonia are estimated to have contributed only 0.2 p.p. to the growth in goods exports over the entire year. The expiry of the free-trade agreement had no impact on exports to Croatia because the country has a stabilisation and accession agreement with the EU. In accordance with this agreement, no customs duties were charged on the vast majority of industrial products which Slovenia exported to Croatia after January 1, 2004. Export growth to Croatia saw a strong rise (15.6%, up from 5.5% in 2003) in particular because of the high growth in exports of road vehicles. After stagnating in 2003, exports to Serbia and Montenegro, which has no free-trade agreement with Slovenia nor with the EU, recorded very high growth (31.3%) against the considerable recovery of the country's economic growth in 2004.

Goods exports to Russia also recorded a major rise because the Russian economy strengthened due to high petroleum prices (petroleum accounts for over half of Russia's exports) which pushed up Russia's import demand. Increasing exports of telecommunication, medical and pharmaceutical products also contributed to the 20.6% nominal growth of exports to Russia (in EUR; 8.7% in 2003). Goods exports to the USA declined by 2.7%, mostly due to the high benchmark of the year before that was based on high exports of medicine and pharmaceutical products.

Last year, ***exports of services*** *recorded better results than the year before.* Exports of services increased by 9.4% in real terms in 2004 (in 2003 they fell by 2.4% in real terms). The biggest contribution came from exports of transport services, which

[12] The data on the regional structure of exports in 2004 are not fully aligned with the subsequently corrected aggregate data on goods exports in 2004 (SORS, 31.3.2005). The differences are in the index of export growth to the EU-25 countries, which was subsequently raised to 10.2% (by 0.7 p.p.). Because the correction was published without the structure by individual countries, the abovementioned data which refer to the EU member states derive from the previous publication of regional exports. Since the differences are minor, the aligned data by country will probably not differ much from the present figures.

[13] Germany is Slovenia's most important trading partner, but its share in the country's total goods exports has been declining gradually since 2000 (27.1%). According to preliminary data of the SORS, exports to Germany rose by 2.5% in nominal terms (in EUR) in 2004 and accounted for 21.3% of total goods exports; the trade balance between Slovenia and Germany showed a deficit for the first time last year. Broken down by products, exports of furniture, general industrial machinery and metal products strengthened, but exports of clothes, electrical machinery and equipment, and road vehicles slowed down. In the 1996-2003 period, Slovenia's trade balance with the countries of the EU showed a deficit, but Germany was the only country where a trade surplus was recorded. Though the surplus decreased during the stagnation of the German economy in 2002-2003, it still accounted on average for EUR 375 m.

are strongly connected with goods exports. After a decline in 2003, exports of other services (all other services excluding transport and travels) increased last year, in particular personal, cultural and recreation services, audiovisual and various business, technical and professional services. Despite favourable trends in exports of these services, their share in Slovenia's total services exports (less than 25%) lags behind the share recorded in the EU-15 (over 50%). Slovenia also lags behind the new member states of the EU in this respect.

Import growth strengthened considerably last year. **Goods imports** increased by 13.2% in real terms in 2004 (in 2003 by 7.3%) and, given that domestic consumption growth was the same as the year before, the rise was mostly due to the high growth of exports and consequently of intermediate consumption. Broken down by purpose, imports of intermediate goods increased the most and, in line with the boosted private consumption, imports of consumer goods also saw a major rise. Imports of investment products stagnated year-on-year in the second half of the year. **Imports of services** increased by 6.6% in real terms. The biggest contribution to the increase came from transport services, in particular road, air and sea transport services, resulting from strong growth in international trade. In the other services, the fastest growth was recorded by the import of licences, patents and copyrights, and the strongest decline by the import of construction services.

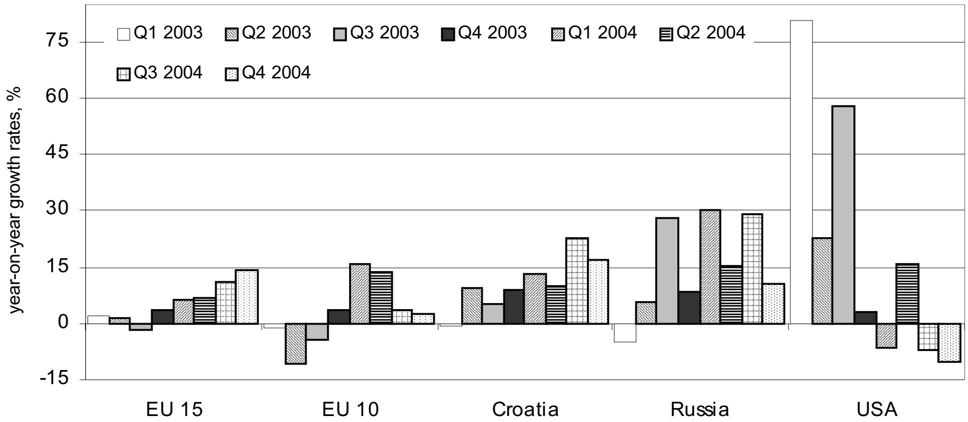
Considering the expected slight slowdown of economic growth in the EU-25 countries (in particular the old EU member states (see p. 21)), we expect international trade to grow more slowly, by 7% **in 2005** (12.5% in 2004). After two years of negative contribution, the balance of trade will have a positive contribution (0.5 p.p.) to economic growth in 2005.

Export growth *will slow down this year, in particular to the non-members of the EU.* Exports of goods and services are expected to increase by 7.5% in real terms in 2005 (goods exports by 8.1%, services exports by 5.2%). In the regional structure, we expect that after last year's rise growth will slow down most in exports to non-members of the EU, in particular to Croatia, Serbia and Montenegro, and Russia, but also to the EU-25 countries. The share of exports to the internal market of the EU[14] will increase by about 1 p.p., that is to 67% of Slovenia's total goods exports. The process of real convergence is expected to cause the relatively faster growth of exports, in particular of industrial products, for instance machinery and equipment, and products classified by material. In the export of services, the highest increase in real terms should occur in other knowledge-based services which have high value added.

Given the slower growth of exports and domestic demand, real ***import*** *growth will be lower.* Imports are expected to increase by 6.5% in real terms (goods imports by 6.7%, services imports by 5.4%). Considering the slightly lower growth in private consumption, the share of imported consumer products should fall somewhat – to 23.1%. The share of imported products for intermediate consumption and investment

[14] According to the latest available data on global goods exports (for 2003), the share of exports of the EU-15 countries in the internal market accounted for 61.5% of their total exports, and the other shares were USA 8.7%, Japan 1.6%, countries in transition 7.8%, Latin America 1.9%, African countries 3.4%, Asian countries 9.5%, and other countries 5.6%.

Figure 2: **Year-on-year growth rates of goods exports to regions or countries (measured in EUR), in %**



Source: SORS.

products will see a slight rise, to 59.3% and 17.5%, respectively. With the first group, the rise will be mostly due to higher petroleum and other primary commodity prices, and with the second group to higher import prices for machinery and equipment. As Slovenia has adopted the common trade policy of the EU and its preferential treatment of imports from some non-member countries, it is expected that the high real growth of goods imports from these countries will continue. Nevertheless, imports from EU countries will contribute most to the total real growth of goods imports in line with the increasing volume of trade between member states. Beside the growth of imported transport and travel services, imports of other services, which are increasing in accordance with the development of the domestic economy, are expected to rise.

Next year, *foreign trade will grow at a relatively high pace and trade with the EU member states will increase.* Given the anticipated improvement of economic conditions in the international environment, the contribution of foreign trade to economic growth will increase slightly (to 0.7 p.p.) in 2006. Real export growth should also see a slight rise, to 7.9% (goods by 8.2%, services by 6.5%). Goods exports to the old EU member states will again pick up, while exports to the new member states will remain at a relatively high level. We thus expect trade in the EU's internal market to further grow and that of exports to Croatia, Serbia and Montenegro, Russia and other non-members to slow down. As domestic demand remains practically unchanged compared to 2005, real import growth will remain at a similar level at 6.6% (6.7%, for goods imports, 6.2% for services imports).

3.1.1.2. Private consumption

Last year, private consumption recorded the second highest growth[15] *in the past nine years.* Consumption increased by 3.5% in real terms as predicted in the autumn

[15] When VAT was introduced in 1999 consumption growth was 5.9%.

Table 11: **Consumption-related indicators, growth rates in %**

	2003	2004
Household income[1, 2]	1.9	5.2
Household loans[1], average[3]	3.0	12.9
Long-term loans	3.6	13.5
Household savings in banks[4], average[3]	7.4	4.5
New car registrations	13.1	3.8
Retail trade revenues in real terms[5]	3.2	3.8
VAT charged on final consumption[1]	0.2	6.1
Travels: import/export (in EUR)	4.5 / 3.8	9.9 / 10.6
Imports of consumer goods (in SIT)	9.2	15.2

Sources of data: Agency for Public Legal Records and Related Services, MF, BS, Internal Administrative Affairs Directorate, SORS, Tax Administration, IMAD's calculations.
Notes: [1]deflated by CPI, [2]net wage bill and other remuneration (payments based on contracts for work and copyright, work-related allowances, other remuneration) according to the Agency for Public Legal Records and Related Services and transfers to individuals and households (according to the consolidated general government revenue and expenditure, MF), [3]average monthly assets, [4]deflated by CPI and the nominal effective currency exchange rate5 , according to the monthly TRG/M survey.

forecasts. With the exception of new car registrations and the difference between the consumption of residents abroad and foreigners in Slovenia, all short-term consumption indicators showed more favourable trends than the year before (see Table 11). Broken down by quarters, the growth of household consumption was the highest in the first quarter (4% year-on-year in real terms), when household income (5.3% in real terms) and new car registrations (17.6%) also reached the highest growth. Besides, the high household consumption abroad (16.1%) was exceeded by the consumption of foreigners in Slovenia by 10.5 p.p. The consumer confidence index[16] reached its lowest value ever in February 2004, but had risen by 23 p.p. by October (the index reached a record level – 11 p.p. above the average of several years).

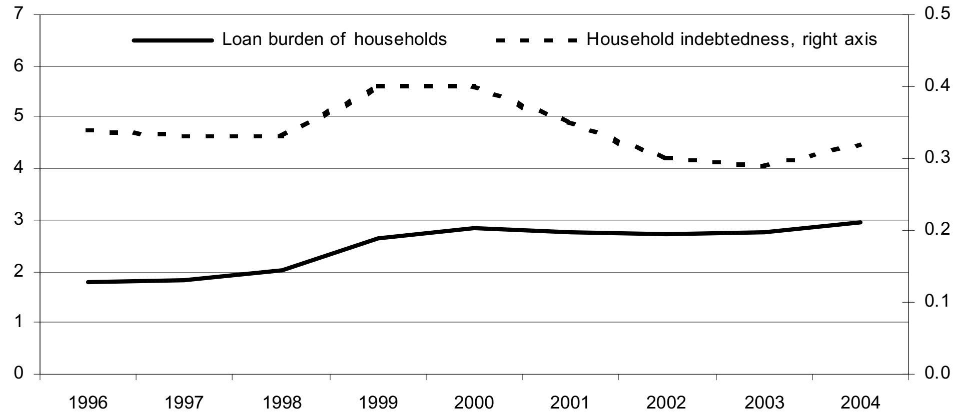
Household borrowing increased considerably last year. Borrowing was stimulated in particular by three factors: lower interest rates; the release of funds from the first National Housing Savings Scheme; and the higher purchases of durable goods[17] following the disburdening of household income of major loans taken out in 1999. The growth in the average monthly stock of loans was highest after 1999 (when it was 34.7%), and was mostly due to the larger volume of long-term tolar loans[18] (also see p. 92). Despite the high income growth, the year-on-year loan growth was 5.2 times higher than income growth. This increased the ratio of the average stock of bank loans to income (the loan burden of households) which achieved its highest value to date – 2.96 (see Figure 3). At the same time, the average monthly stock of household deposits in banks recorded the lowest growth in the past 12 years (also

[16] The consumer confidence indicator shows no significant correlation with consumption.

[17] The growth of new car registrations, which usually indicates a pick-up in the consumption of durable goods, started to slow down year-on-year in the second quarter of 2004 (after a year of accelerated growth), and was negative in the last quarter. We estimate that purchases of other durable goods, e.g. household appliances and furniture (instead of cars) generated last year's growth.

[18] Loans with maturity of over one year.

Figure 3: **Ratio of loans to household income or deposits**



Source: SORS, APLRS, BS, calculations by IMAD.

see Savings, p. 90). As a result, household indebtedness (the ratio of loans to savings) slightly increased compared to 2003 – to 0.32 (see the figure above).

According to the IMAD's estimates, the release of funds from the first NHSS had no major impact on private consumption. One of the risks concerning the high consumption in 2004 was the potential consumption based on these funds and, in particular, by households whose savings under this scheme would not be sufficient to purchase a dwelling[19] and who would instead use the funds to buy consumer goods. In the second half of the year the growth of housing loans indeed accelerated yet the lending potential of the first NHSS is still largely unused (savers have the right to take out loans until the end of July this year; also see p. 92). At the same time, part of the funds was transferred into further saving (housing saving, private pension schemes, and the like) or investments (life insurance, securities, mutual funds etc.), and one part is assumed to have been used to repay earlier loans. All this indicates that the NHSS had no major impact on increasing household consumption in 2004.

The estimated household disposable income increased by 2.4% in real terms in 2004. Given 0.3% growth in the number of persons in paid employment and 2% growth of the real gross wage per employee, as well as the high growth of other remuneration (see p. 69), the compensation of employees rose more in real terms than the year before. According to preliminary data from the Ministry of Finance, transfers to individuals and households rose by 3.1%[20]. Because of reduced savings

[19] An estimated 65%. Some of them, however, already own dwellings and may use the funds from the NHSS to exchange their dwelling for a larger one or to renovate it, and this may be financed over a longer period. This may account for the lower inflow of these funds into private consumption than based on the assumption that the funds from the NHSS, if not sufficient to buy a dwelling, would be spent on consumption.

[20] Total pensions, the highest item, increased by 2.1% in real terms.

in banks and lower interest rates, income from interest fell considerably. Payments of income tax increased by 4.6% in real terms. The propensity to consume (the ratio of private consumption to disposable income) strengthened compared to 2003, while the growth of gross household savings was negative for the second year in a row.

In 2005, consumption growth is expected to remain at a relatively high level (3.4%). It should be driven in particular by the abovementioned purchases of durable and semi-durable goods. Consequently, we anticipate household borrowing to continue in 2005, but at a slightly slower pace. Based on the data on new car registrations it appears that the period of increased car purchases is over for the moment[21]. Purchases of other durable and semi-durable goods, however, are expected to gain, mostly due to the boosted housing construction (see p. 44), the release of savings from the NHSS[22], the higher income of households in lower income brackets[23] and favourable options for financing purchases[24]. Given that wage growth (see p. 69) and employment growth (see p. 73) will be modest, the compensation of employees will increase by 3% in real terms, social transfers will grow less than last year, and income tax payments should fall by 7.0% in real terms (see note 23). Disposable household income is expected to gain 3.8% in real terms. Households' propensity to consume will be slightly lower than last year, and gross household savings will grow in real terms. We expect the structure of savings[25] to continue to change in the next few years; because savings in banks are increasingly less attractive due to the low interest rates, other forms of saving[26] are on the rise (mutual funds, life insurance, pension funds), and they are an increasingly important element providing additional social security to households.

Next year, private consumption will see a slight drop (3.1%). The compensation of employees is expected to increase by a similar percentage, and so will disposable income (3.0%). Slower consumption growth will probably result from repayments of loans taken out in previous years (in particular housing loans because of their relatively high instalments) that will reduce household free funds. Residential construction and the purchases of durable and semi-durable goods it stimulates should further grow, funds from the NHSS will remain at the 2005 level, and we do not expect any major increase in consumption from this source in 2005.

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[21] Last year's fall in registrations continued in the first quarter of this year (-8.9%).

[22] Funds released from the NHSS this year will amount to about SIT 40 bn of potential loans (half the potential loans of last year's scheme).

[23] Resulting from the new Personal Income Tax Act (Official Gazette 54/2004, 56/2004 and 62/2004) that came into force on January 1, 2005.

[24] In particular the option to pay in interest-free instalments offered by retail traders.

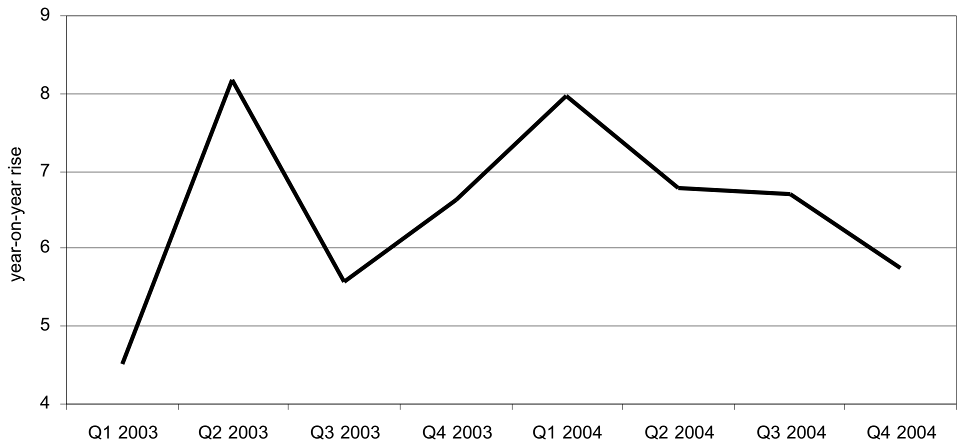
[25] According to the Gral-Iteo survey "New saving habits – an opportunity for banks or insurance companies?", life insurance is the most important financial instrument in personal asset investment for 19% of the respondents (only 0.5 p.p. below the share of bank deposits). Shares and bonds (10%) and pension funds (6%) follow, investment and mutual funds rank only fifth (4%), 36% of the respondents did not invest at all, and 1% invested in other forms.

[26] The average stock of funds in mutual funds increased last year by 2.2 times in real terms (by 1.6 in 2003, see p. 69), life insurance premiums rose by 11% in real terms in 2003, against 38.9% last year. Life insurance premiums accounted for 50% of saving flows in the banks (44% in 2003), and for 36% of the flows in mutual funds (16% in 2003).

3.1.1.3. Gross fixed capital formation

The high real growth of gross fixed capital formation continued ***in 2004*** (6.8% against 6.3% in 2003). The highest year-on-year growth was recorded in the first quarter (8.0%), growth then fell to 5.7% in real terms in the last quarter compared to the same period of the previous year (see Figure 4). Adjusted seasonally and by the number of working days, the data do not reveal any slowdown of gross fixed capital formation towards the end of last year. According to these data, fixed capital formation saw the highest growth, compared to the previous quarter, in the second quarter, and the lowest in the third quarter (1.8%), while it was at the same level in the first and last quarters (1.6%).

Figure 4: **Year-on-year growth of gross fixed capital formation (in %)**



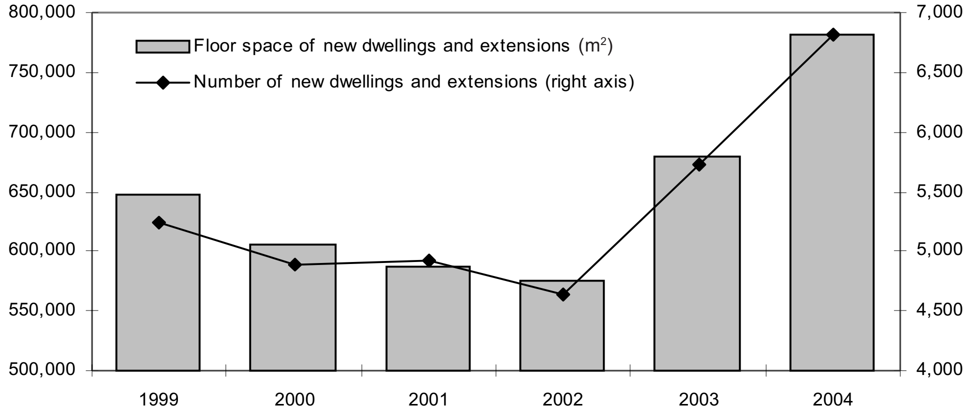
Source of data: SORS.

Investment in machinery and equipment and housing investment picked up last year, but investment in other buildings and facilities remained at the level of 2003. Imports of machinery and transport equipment increased by 10.7% (measured in EUR) last year. According to the IMAD's estimates, which are based on issued building permits and statistical data on construction (see Figure 5), housing investment slightly strengthened last year. Another estimate, based on statistical data on construction, is that the volume of investment in non-residential buildings and facilities was at about the same level last year as the year before; motorway construction however slowed down after the high growth seen in 2003.

This year, investment growth will be maintained at a high level. The real growth of gross fixed capital formation is estimated to be 6.7%. Investment in housing construction will grow fastest[27]. The volume of investment in other buildings and facilities should remain at last year's level, but we expect investment in non-

[27] According to preliminary data, building permits issued last year planned the construction of 6,812 new dwellings, 19.0% more than the year before, and their planned useful floor area was 15.3% larger.

Figure 5: **Planned number of new and enlarged dwellings (planned with building permits) and their useful floor space**



Source: SORS.

residential buildings to grow[28], and according to the Draft Annual Motorway Construction and Maintenance Plan, investment in motorway construction should be at a lower level than in 2004. Investment in equipment and machinery should continue to grow in 2005. This segment of investment will also be influenced by changes in the tax legislation which will considerably reduce relief granted for investment in the next year (the Corporate Income Tax Act came into effect on January 1, 2005, but the highly modified system of investment relief comes into force one year later).

Investment growth will slow down slightly ***in 2006***. Growth in gross fixed capital formation will fall to 4.9%, but investment in new dwellings is expected to continue, while investment in motorway construction is to remain at this year's level. The higher growth of economic activity in the international environment will have a positive effect on investment in the private sector but, due to the new system of relief granted for investment, some investment projects will already occur this year instead of in 2006.

The contribution of changes in inventories and valuables to GDP growth in 2004 accounted for 0.8 p.p. Inventories grew for the third year in a row. The changes in inventories were at the level 2.1% (in current prices) of GDP in 2004. This change was higher in the first half of the year (2.9% GDP) and related to the different foreign trade regime before accession to the EU (see Part II., p. 105). In the second half of the year, the change in inventories was equal to 1.4% of GDP and was still higher than the average of several years (1.0%, in the 1995-2004 period). Some of these inventories is expected to be released in 2005 and on the other hand, stronger changes should occur in the direction of increased inventories in construction (in

[28] Building permits issued in 2004 show that the planned total floor area of non-residential building increased for the third year in a row (by 5.8% against 7.8% and 8.1% in 2002 in 2003, respectively).

view of the anticipated boost in housing construction). Positive changes in inventories are forecast in 2005 but, due to the high increase of inventories in 2004, their contribution to GDP growth will be negative in 2005 (-0.8 p.p.). A similar development is forecast for 2006: higher inventories but their contribution will remain negative (-0.2 p.p.).

3.1.1.4. Government consumption

In 2004, *government consumption increased by 1.7% in real terms according to the first release of data by the Statistical Office, using the method of quarterly accounts.* The fastest rise was recorded by individual government consumption (by 2.1%), and slightly slower growth by collective government consumption (by 1%).

The share of government consumption in GDP dropped in 2004. Because the growth of government consumption was far lower than GDP growth, its share in GDP fell to 19.8% (see Table 12). The share of individual government consumption in GDP dropped to 11.7%, while that of collective government consumption fell to 8.1%. The contribution of government consumption to GDP growth accounted for only 0.3 p.p. in 2004, 0.2 p.p. less than in 2003.

The biggest contribution to government consumption growth came from the increase in the compensation of employees which grew faster than total government consumption in 2004, in particular because of higher employment in the state sector, which again increased by 2%. Intermediate consumption declined (by 0.5%) in real terms in 2004 compared to the previous year.

The growth of government consumption in ***2005*** *is estimated at 2.5% and will lag behind the forecast economic growth.* The share of government consumption in GDP will thus drop to 19.7% and contribute 0.5 p.p. to GDP growth. The forecast of the volume of government consumption is based on macroeconomic assumptions of wage and employment growth in this sector, estimates of general government expenditure (included is that part of expenditure which belongs to government

Table 12: **General government consumption (individual and collective)**

	2000	2001	2002	2003	2004	2005	2006
						Forecast	
Annual real growth (in %)							
Total general government consumption	2.3	3.9	1.7	2.6	1.7	2.5	2.5
Individual consumption	1.3	3.1	2.6	2.4	2.1	2.3	2.7
Collective consumption	3.7	5.1	0.4	2.7	1.0	2.8	2.2
As a % of GDP							
Total general government consumption	19.8	20.5	20.2	20.3	19.8	19.7	19.4
Individual consumption	11.6	12.0	11.9	11.9	11.7	11.6	11.6
Collective consumption	8.2	8.5	8.3	8.4	8.1	8.1	7.8

Source: SORS, IMAD's forecasts.

consumption according to the methodology of national accounts) based on the proposed revision of the 2005 budget, estimated local government expenditure, and on the estimated expenditure of compulsory health insurance in accordance with the financial plan of the Health Insurance Institute for 2005.

The growth of collective government consumption in 2005 will be slightly higher than that of individual government consumption (see Table12). Employment is expected to grow further in the government sector by almost 2%, mainly in the public administration and defence (2.9%), where employment is to be reduced in government bodies, but to grow in the army and police due to the establishment of a professional army and protection of the external border of the EU. In the health sector, employment will grow at about the same pace as in 2004 (by about 2%). The real growth of intermediate consumption is estimated at about 3.0%, including an anticipated modest rise in health services (1.5%) and slightly higher growth in the other activities, in particular on special materials and services for the army (establishment of a profession army, the army's requirements after Slovenia's accession to NATO) and on goods and services in government bodies (higher expenditure due to the accession to the EU).

*In **2006,** government consumption will again grow, by 2.5% in real terms.* Because it will lag behind economic growth, its share in GDP will fall to 19.4%, and its contribution to GDP growth will remain at this year's level – 0.5 p.p. Employment in the government sector will see total growth of 1.9%, slightly faster in the public administration and defence (2.1%) and in the health sector (2.0%) but modest in education (1.5%). Nevertheless a slight reduction of employment is planned in the government bodies except in the army and police, where employment will grow because of the establishment of a professional army and protection of the EU's external border. The new Public Sector Wage System Act will come into effect in 2006 but its estimated neutral effect will not lead to additional pressures on the growth of the compensation of employees. Intermediate consumption is expected to grow modestly (2.5%) in 2006, including the slightly faster growth of expenditure on special materials and services for the army's requirements (obligations incurred through accession to NATO), and on medicines and service-related material expenses in the health sector.

3.1.2. Production structure of gross domestic product

*The accelerated economic activity in **2004** was also reflected in the high real growth of value added.* After 2.5% growth in 2003, value added rose by 4.4% last year. The 5% growth in production activities was stimulated by the favourable international environment (in manufacturing) and by weather conditions that were better than in 2003 (in agriculture, energy, gas and water supply). In market services, growth was 4.6%; major growth was recorded in financial intermediation related to higher borrowing and the growth in the volume of insurance premiums. Value added in public services increased by 3.5% in real terms, less in the public administration and education, but more in health and other services (see Table 13).

In 2005-2006, *real value-added growth is expected to slow down to about 4%.* Because of the impact of slower economic growth in the main trading partners on

Slovenia's exports, value-added growth in manufacturing will be lower by about one percentage point (4.5%) in 2005, but a slight pick-up (to 4.8%) is expected in 2006 in accordance with favourable forecasts of the international environment. Assuming normal weather conditions, growth will be lower in agriculture, and in energy, gas and water supply. In particular, because of the anticipated boost in residential construction this year and next year, higher value-added growth is expected in construction. In market services, growth will be highest in financial intermediation in both years as we expect the favourable trends to continue in both the banking and insurance sectors, and growth should also be higher than in the past two years in hotels and restaurants, real estate, renting and business services. Public services are expected to see the same growth of last year in 2005, but to see it slow down in 2006.

Value added in ***agriculture, forestry and hunting*** *recovered* ***in 2004*** *after the steep decline in the previous drought year, gaining 11.2%.* According to data from the

Table 13: **Growth and structure of value added by sectors, in constant prices 2000**

Real growth rates in %

	2002	2003	2004	2005	2006
				Forecast	
A. Agriculture, hunting, forestry	15.5	-15.4	11.2	1.0	1.0
B. Fishing	-4.2	5.1	-2.9	0.0	0.0
C. Mining	-8.4	5.8	-5.2	-1.0	-1.0
D. Manufacturing	4.8	3.9	5.4	4.5	4.8
E. Electricity, gas and water supply	6.1	-3.1	4.9	1.0	2.0
F. Construction	0.6	3.4	1.6	3.5	3.0
G. Wholesale & retail trade, repair of motor vehicles	3.5	2.9	3.8	4.0	3.4
H. Hotels and restaurants	3.4	3.5	2.3	4.0	4.5
I. Transport, storage and communications	3.1	3.4	3.8	4.0	4.5
J. Financial intermediation	5.8	6.1	10.4	6.0	6.5
K. Real estate, renting and business activities	3.3	3.7	3.8	4.5	5.0
L. Public administration & defence, compulsory social security	3.3	4.4	3.1	3.8	2.5
M. Education	2.6	2.4	2.4	2.5	2.6
N. Health and social work	4.0	3.1	4.9	4.2	4.3
O. Other community, social and personal services	-2.2	1.5	3.9	4.0	4.0
P. Private households with employed persons	-9.8	-34.1	-7.8	0.0	0.0
FISIM	7.0	12.3	8.2	8.8	7.0
1. VALUE ADDED (A …P + FISIM)	**3.7**	**2.5**	**4.4**	**3.9**	**4.1**
2. NET CORRECTIONS (a-b)	0.6	2.5	5.7	2.8	4.1
a) Taxes on products and services	0.9	2.3	5.6	2.7	4.0
b) Subsidies	6.6	-0.6	4.0	2.0	2.3
3. GROSS DOMESTIC PRODUCT (3=1+2)	**3.3**	**2.5**	**4.6**	**3.8**	**4.1**

Source: SORS, IMAD's forecast.

economic accounts for agriculture[29], the volume of agricultural production saw a total increase of 11.7%. The increase was particularly high in crop production (26.5%) but also quite high in animal products (1.7%), whereas the volume of stockbreeding was lower than the year before (-1.3%). The value of agricultural production in basic prices, which included direct payments to farmers, increased less, namely by a total of 2.7%, than the volume of agricultural production because of the lower purchase prices. Value-added growth in the sector was strongly stimulated last year by the lower value of intermediate consumption, which decreased by 4.2% in basic prices.

Assuming normal weather conditions, value added in agriculture, forestry and hunting should increase annually by about 1% **in 2005-2006**. Although there are significant options to increase the relatively low productivity in the sector, higher production will be hard to achieve because of the rigorous environmental restrictions set by the reformed common agricultural policy (see Spring Report 2004, Box 7) which Slovenia will start to implement from 2007. Purchase prices are expected to further decline but this effect should be compensated for by greater financial assistance. The number of agricultural holdings should further decline in the next few years, increasing their average size and improving the low efficiency levels of agricultural producers.

*Value added in **mining** decreased by 5.2% (after the 5.8% growth in 2003) **in 2004**, and a slight decline is also expected in **2005-2006**.* According to data from the SORS, the volume of industrial production in the activity fell by 1.1% last year, and employment dropped by no less than 9.5%. The planned production in the two biggest mines is somewhat lower than last year but, given the higher requirements of the domestic thermal power plants (as already occurred in the first two months of this year due to the below-average production of the hydro-electric power plants), production may in fact reach last year's level. Value added is forecast to fall by 1% in mining **in 2005** and by another 1% **in 2006**.

***In 2004,** the favourable conditions in the international environment had a significant impact on the high level of economic activity in **manufacturing**, the most export-oriented sector of the Slovenian economy.* In 2004, economic growth picked up in most of Slovenia's main trading partners (see p. 21). These trends pushed up total goods exports (see p. 37) and value added in manufacturing to 5.4% growth (1.5 p.p. higher than the year before) in real terms. The higher number of working days[30] contributed 1.2 p.p. to the high growth in 2004. A comparison of year-on-year growth rates by quarters shows that modest value-added growth in the first quarter (4.4%) was followed by stronger growth in the second (7.8%) and third quarters (7.4%), only to slow down in the last quarter (2.2%). Similar dynamics were seen in the growth of production volumes in 2004. As illustrated by Figure 6, the cyclical trend component of production volumes registered a turn in the production cycle already at the beginning of the second half of the year.

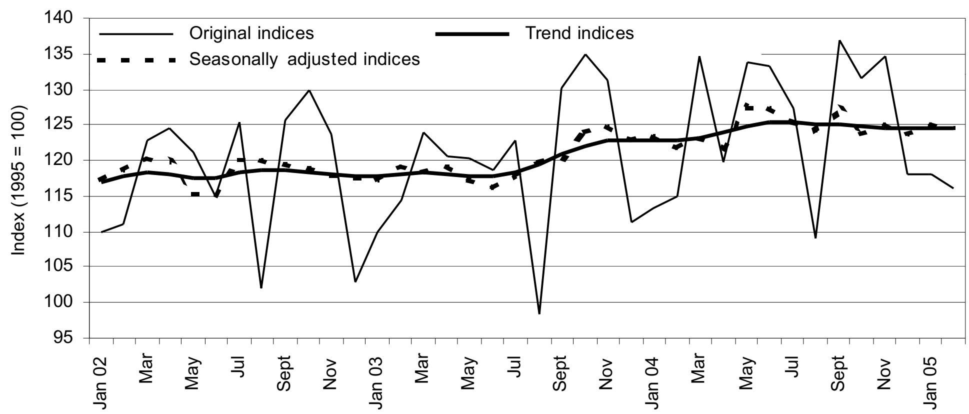
[29] The economic accounts for agriculture, published by the SORS from 2004 onwards, are a sub-account of the national accounts for agriculture. One of the major differences in methodology between the two accounts is the capture of agricultural holdings. Holdings that produce only for their own needs are excluded from the economic accounts for agriculture.

[30] The year 2004 had 5 more working days (256) than 2003.

The best production results in 2004 were again achieved by those subsectors which generate most of their income in foreign markets. The highest growth of production activity (8.2%), accompanied with a 2% increase in employment, was recorded by highly export-oriented industries.[31] Their exports also increased by 14.4% (measured in EUR). In this group, highest growth was recorded by the production of machinery and equipment, where production volumes rose by 9.8%, transport equipment (9.5%), and chemicals and chemical products (8.8%). In mainly export-oriented branches[32], production volumes increased by 5.4%, exports by 10.0%, and employment fell by 1.5% (in particular because of reduced employment in the manufacture of textile products, also see p. 73). The highest growth, 16.5%, was achieved in this group by electrical and optical equipment but at the same time inventories increased by 121.1% in 2004. In the mainly domestic market-oriented branches[33], production activity kept about the same level as in 2003 (+0.3%), exports rose by 1.3%, while employment fell by 2.0%.

At the beginning of 2005 *production activity was slowing down.* According to preliminary data, the production volume in manufacturing increased year-on-year by 4.1% in January, and by 0.8% in February. The total growth in the two months (2.4% year on year) was achieved with the same number of working days. The production activity trend has been stagnating for several months. We expect this

Figure 6: **Trends in manufacturing's production volumes**



Source: SORS, IMAD's calculations using the TRAMO-SEATS method.

[31] Highly export-oriented sectors are those subsectors of manufacturing which, based on the statistical data from their balance sheets and profit and loss accounts (AP), generate over 70% of their net sales revenues in foreign markets (leather and leather products, chemical products, machinery and equipment, transport equipment).

[32] Their average share of net sales revenues generated in foreign markets in total net sales revenues is between 50% and 70%: textiles, textile and fur products, wood production and processing, rubber and plastics industries, metals and metal products, electrical and optical equipment, and furniture).

[33] Their average share of net sales revenues generated in foreign markets in total net sales revenues is below 50%: food and beverages, fibres, paper and publishing, coke, petroleum products and nuclear fuel, non-metallic mineral products).

stagnation to be followed by the modest growth of production activity, as suggested by the business climate indicators, and stronger growth only in the last quarter of 2005. Such dynamics of production activity trends are also indicated by the model of leading indicators and the non-linear econometric model (see Box 2).

The business climate in manufacturing,[34] *at a low level at the end of last year, improved at the* ***beginning of 2005****, but was mostly due to seasonal influences.* The composite confidence indicator improved for the third month in a row, yet the seasonally adjusted series still reveal no growth tendency. In March, the confidence indicator showed a positive value – equal to the average monthly value in 2004 – for the first time this year. The share of companies in the survey which, in March, expected the business climate to improve exceeded the share of companies which expected it to worsen by 2.0 p.p. Business expectations about the growth of exports and total demand in the next three months – these data are not included in the confidence index – were at a much higher level in March than the monthly average of last year, but the seasonally adjusted data do not indicate a significant improvement.

In 2005-2006*, slightly lower growth of production is expected in manufacturing than in 2004.* Given the lower domestic consumption growth and forecasts of subdued economic activity growth in Slovenia's main trading partners and the consequent lower growth rates of goods exports, compared to the previous year we expect the average growth in production volumes to see a moderate decline[35]; real value-added growth will slightly drop (4.5%). If the trends in the EU member states pick up again in 2006, we expect stronger production and export activities and this should push value-added growth up in real terms (to 4.8%).

In ***electric energy, gas and water supply,*** *value added increased* ***in 2004*** *by 4.9%, mostly due to the improved weather conditions for the production of electric energy.* According to data from ELES, the consumption of electric energy grew by 2.5% and production by 9.5%. Because of the favourable hydrological conditions, the production of hydro-electric power plants increased by 35.1% (exceeding the production planned in normal weather conditions by 8.7%), the nuclear power plant by 5.0%, while the production of thermal power plants fell by 0.6%. According to the estimates in the Energy Balance of the Republic of Slovenia, the consumption of district heating decreased by 2.8% and that of natural gas by 5.0% in 2004.

Based on the National Energy Balance, electricity, gas and water supply will record lower value-added growth ***in 2005-2006*** *than in 2004.* Electric energy production will grow modestly in 2005 because the production of hydroelectric power plants and thermal power plants is expected to fall by several percentage points, but production in the nuclear power plant should be much higher (up by nearly 7%), as there will be no regular overhaul in 2005 since the interval between overhauls has been extended. Given the less favourable hydrological conditions, electricity

[34] The business climate estimated by the SORS on the basis of a survey on business trends in manufacturing is illustrated by the composite confidence indicator, the arithmetic average of total order books, stock levels and production expectations.

[35] The slowdown of economic activity in 2005 will also result from the high level of inventories at the end of 2004, which stood at 37% above the level of the previous year in December 2004.

production might even decrease. Value added in electricity, gas and water supply should increase by 1.0% in 2005. In 2006, the upgrading of several hydroelectric power plants will be finished (increasing their capacity), and the first of the five new planned power plants on the Lower Sava should start operating. This will push up value-added growth in electricity, gas and water supply to 2.0% in 2006.

Last year, *real value-added growth in* ***construction*** *slowed down to 1.6% (from 3.4% in 2003), mostly due to reduced activity in civil engineering.* In large companies[36] the value of construction put in place increased by 2.5% (against 8% in 2003) in real terms. Civil engineering fell in real terms by 3.6% compared to the year before, building construction was up 9.2%, mainly because of the 65.4% growth in residential construction. Attention must be drawn to the fact that the large companies included in the survey have a low share of total residential construction.

In 2005 and 2006, *value-added growth in construction should increase, in particular in residential construction.* Value-added growth in 2005 should be 3.5% and 3% in 2006. The anticipated stronger residential construction is based on preliminary data on issued building permits. These data show that the planned number of new dwellings and their total useful floor space increased last year for the second year in a row. In the two-year period, the planned number of new dwellings increased by 46.9%, and their total useful floor space by 35.8%. Stronger growth is also expected in the construction of non-residential buildings: according to the building permits issued last year, the planned total area of non-residential buildings grew for the third year in a row (the total increase over three years was 23.3% or 7.2% annually on average). Civil engineering is expected to stagnate in 2005 and 2006. Motorway construction should be down, but intensive construction activities are expected in the building of other facilities.

Real value-added growth ***in the wholesale and retail trade, repair of motor vehicles, personal and household goods*** climbed to *3.8%* ***in 2004.*** Turnover increased in 2004 in retail and wholesale trade, and the highest growth was recorded in individual shops selling non-food products, connected with the boosted construction of residential buildings and higher purchases of semi-durable and durable goods. Higher turnover was achieved in shops selling furniture, household appliances, construction materials and metal products; sales of motor vehicles also improved.

This year*, value-added growth in the activity should see further growth (up to 4%), but a minor decline next year (3.4%).* Further turnover growth, in particular in shops selling non-food products, will be stimulated by the anticipated high growth of private consumption and boosted residential building construction.

Value added in ***hotels and restaurants*** *increased by 2.3% in real terms* ***in 2004,*** *nearly one percentage point less than in the past two years (3.5% in 2003).* Turnover increased in real terms by 1.7%, most of all in enterprises selling beverages. The number of tourists increased in 2004 compared to the previous year by 4.2%, but

[36] The research survey includes all construction companies whose value of construction put in place according to the final results in 2002 amounted to at least SIT 300 m, to divisions within other enterprises that engage in construction and have at least 20 people in employment, and to some other non-construction enterprises that carry out construction activities.

the number of their overnight stays rose by only 1.1%[37], and this was reflected in the lower growth of turnover in enterprises offering accommodation and related services (only 1.2% higher). In Slovenia (and around the world) the average duration of a tourist visit has been falling in recent years[38]; some people take several short holidays, while others are reducing their holidays because of their financial situation.[39]

This year and next year *value-added growth in hotels and restaurants is expected to accelerate.* Our forecast of value-added growth in 2005 is 4.0%, and about 4.5% in 2006. In the following years, we expect more visitors to take advantage of the air connections offered by low-cost budget airlines. Visits by tourists from those countries which recorded increasing numbers of overnight stays in recent years are expected to grow further; however, the number of guests from some of these countries are still below the figures from the pre-independence period (Great Britain, the Netherlands, France, Italy, Israel, Belgium etc.). At the same time, boosted investment is expected in the tourist industry, stimulated by funds from the European Regional Development Fund. These investments aim to expand the industry's capacities and offer high quality services to compensate for the shorter stays. Preliminary data show that the latter trend continued in the first two months of this year: although the number of tourists equalled that of last year, their overnight stays dropped by 6.6%.

Value added in ***transport, storage and communications*** recorded slightly faster growth ***in 2004,*** *up by 3.8%, mostly due to the high growth in the volume of road goods transport.* Such an increase (by 29.9% measured in tonne-kilometres) was related to last year's strongly boosted goods trade. In goods transport, maritime transport recorded a slightly higher rise (by 30.6%), and transhipment in harbours was up by 12.8%. Passenger transport recorded a further decline of bus passengers in road transport – by 13.1%. Airport passenger traffic, on the other hand, rose by 13.7% (partly due to the arrival of a foreign low-fare airline); the growth of air passenger transport was strong albeit nearly 50% lower than the increase seen in airport traffic. Turnover in auxiliary transport activities, including shipping services, decreased by 12.5% in 2004, partly an expected result following Slovenia's accession to the EU, because its major negative impact affects the activities of forwarding agencies (see Part II., p. 116). Turnover in travel and tourist enterprises, on the other hand, increased (by 13.1%), and the same occurred in postal and telecommunication activities (by 13.3%).

This year and next year, *we expect slightly accelerated value-added growth to continue in this activity* (from 4.0% to 4.5%) because Slovenia's membership in the EU should have a net positive effect on the domestic transport sector, and the continuing liberalisation of the telecommunications sector should stimulate further growth.

[37] The number of overnight stays of domestic tourists fell by 3.0%, that of foreign tourists however increased by 4.5%.

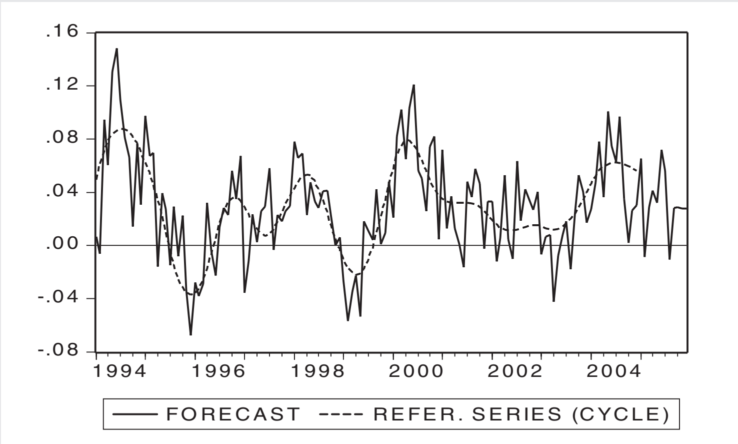
[38] In 1992 tourists stayed on average 3.7 days in tourist accommodation facilities, against 3.2 days in 2004.

[39] 53% of Germany's citizens went on holiday in 2004, but the duration of their holidays was much shorter last year, namely 12.8 days, or about 14% shorter than in 2000 (Kovač Konstantinovič, 2005).

Box 2: **Industrial production forecasts based on the model of leading indicators and the non-linear econometric model***

The model of leading indicators indicates a slowdown of economic activity this year. It is indicated by the composite index (weighted average of the trends of ten leading indicators), which forecast a turning point in economic activity. As a turnaround in the business cycle is expected towards the end of the year, it makes sense to expect boosted economic activity in 2006 when the domestic economy will be well influenced by positive trends in the EU. The diffusion index (the share of leading indicators which show positive growth) confirms the slowdown of economic activity this year, but does not yet indicate a possible turning point leading towards accelerated growth.

Figure 7: **Econometric forecast model**



Note: REFER. SERIES (CYCLE) – annual growth rate of industrial production (cyclical component). FORECAST – current forecast of the annual growth rate of industrial production for twelve months in advance.

The non-linear econometric model also forecasts a slowdown of economic activity until the end of the year, to be followed by a pick-up. The main weakness of the system of leading indicators lies in the fact that it is impossible to accurately determine the turning point because the model has no constant forecast horizon. It is therefore complemented by a non-linear econometric model (Jagrič, 2003); in its calculations it uses nearly 400 monthly time series of key elements of economic activity in Slovenia and the international environment, indicating a slight slowdown of the economy in the course of this year (see Figure 7) that will, however, end in the last quarter, when a turning point is indicated. If the turning point coincides with accelerated growth in the EU, past researches (Jagrič and Ovin, 2004) indicate that it is reasonable to expect boosted economic growth in 2006. Such results are also confirmed by the expectations and assumptions on which the Spring Report is based.

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In 2004, *value added in* ***financial intermediation*** *increased by 10.4%, twice as much as GDP growth, while employment rose by 2.5%.* As a result of the boosted borrowing by households, enterprises and OFOs (see p. 92), the lending activities of banks strengthened, as did the range of new banking services. The latter was reflected in particular in the above-average high growth of net commissions which grew by more than a tenth in nominal terms. The nominal growth of operating costs in the banking sector, on the other hand, continues to slow down and was the lowest to date last year (2.7%). Employment in banks stagnated but grew by 4% and 15.5% respectively in insurance companies and auxiliary activities (nearly a third of total employment in financial intermediation), insurance companies recorded 16.8% growth in the turnover of premiums last year, with a particularly strong rise in life insurance premiums (by 44%), especially of those linked to investment fund units.

Favourable trends will continue in financial intermediation in the ***next two years****.* In this period, value added is expected to grow in services connected with long-term saving, for instance life insurance, additional pension insurance, and mutual funds. Given the continued relatively high growth of domestic consumption, banks' lending activity is expected to further grow in 2005. Value added in financial intermediation should thus grow – given the further development of the banking and financial sectors – by 6.0% in real terms in 2005, and by 6.5% in 2006.

Value-added growth in ***real estate, renting and business services*** *increased in 2004 for the second year in a row – by 3.8%.* Employment growth was faster than in 2003 and the number of people in employment grew compared to 2003 by 4.1%. In the two biggest branches, data processing/computer services and other business activities, which together employ 87.1% of all employees in activity K[40], employment rose by 4.6%. The favourable business results in these two branches are underpinned by the data on their turnover growth (see Table 14) and the data on the export of some

Table 14: **Revenue and number of persons in employment in selected real estate, renting and business activities (K)**

	2004, growth in %			
	Nominal revenue (in SIT)	Employees		
		Total	Employed	Self-employed
Activity K	-	4.1	4.2	2.9
Data processing, data bases and related activities	35.1	6.3	6.3	6.2
Business services[1]	28.8	4.2	4.3	3.2
Business consultancy	17.2	3.2	3.0	4.0
Technical consultancy	41.6	-2.0	-2.3	1.8
Advertising	6.7	5.9	6.2	3.7
Other business services	23.6	9.7	10.5	1.2
Industrial cleaning	26.2	9.0	9.3	4.8

Source: SORS, IMAD's calculations.
Note: [1]The activities of holdings (class 74.15).are not included in business activities.

[40] Employment in the subsector other business activities stands for a little over three quarters of total employment.

business services. Exports of other business services, measured in EUR, increased compared to 2003 by 16.4% (they fell by 1.7% in 2003), and the highest growth was recorded precisely by companies in various business services, professional and technical services, where exports in the surveyed period increased by 38.7% in nominal terms (in 2003 they increased by 18.5%[41]; also see p. 37).

This year and next year, we expect stronger value-added growth in activity K. Similarly to last year, the volume of other business activities should increase and the anticipated introduction of the euro should lead to higher demand for consultancy and the supply of computer software. The January data on employment show higher employment precisely in these two branches[42]. Given such developments, real value-added growth in real estate, renting and business services is expected to be 4.5% this year. The positive trends should strengthen in 2006 and push up value-added growth to about 5.0%.

Real value-added growth in ***public services*** *(activities L–P) picked up again* ***in 2004*** *and rose to 3.5%.* Compared to 2003 (3.0%), the growth's structure improved because it fell mainly in public administration, defence and compulsory social insurance but saw a strong rise in the health sector and in other community, personal and public services (see Table 13).

The slowdown of value-added growth in ***public administration, defence and compulsory social insurance*** in 2004 (from 4.4% to 3.1%) was connected with the slower growth in employment. Most of the new employment in 2004 was associated with the establishment of a professional army and the Schengen border[43], whereas in 2003 employment growth was also high in the civil sectors of the administration. In *education, employment growth* in 2004 was slightly higher than in 2003 (1.7%). Employment again increased in primary education, probably still related to the introduction of the nine-year primary school; high employment growth was also recorded last year in higher education, where several new programmes were introduced and three new vocational colleges opened their doors. The very high value-added growth in the health sector and social work in 2004 was mostly due to the expansion of the network of homes for the elderly (1 new public institution and 4 new private homes with a concession) and day centres and the new employment connected with them. The health sector thus maintained its relatively high employment growth (1.7%). In highly market-oriented other public, community and personal services, value added saw strong growth in 2004 (from 1.5% to 3.9%). Turnover increased (by 16.8% in nominal terms), but employment growth was only 1.0%.

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[41] The share of exports of various business, professional and technical services in the total exports of other business services increased from nearly half in 2002 to nearly three quarters in 2004.

[42] Employment in computer services rose in January 2005 compared to December 2004 by 2.0%, employment in other business services by 2.8%, mostly as a result of the transfer of a public company from another activity that added 2 p.p. to employment in the subsector.

[43] Ministries, government offices and administrative units on average employed 33,981 people in 2004 (68% of total employment in activity L); from 01.01.2004 to 01.01.2005 employment increased by 1,168 people, of which 570 were in the Slovenian Army and 561 in the police forces.

In 2005 and 2006, *we expect real value-added growth in public services to further lag behind the growth of the entire economy; in 2005 growth will be 3.6%, and in 2006 3.2%.* Based on the anticipated growth of employment[44] and wages (see p. 69), real value-added growth in 2005 in public administration, defence and compulsory social insurance is expected to exceed last year's growth (3.8%), and to decline in 2006 (to 2.5%). In education, value-added growth should be maintained in the next two years (about 2.5%), assuming faster employment in adult education in line with the planned higher investment in this segment of education. In the next two years, a slowdown of employment is expected in primary education and growth in higher education will probably be lower than in 2004. In education and social work, slightly lower value-added growth is expected but is set to remain at a high level (about 4.2%) due to the further expansion of the social care network. In other public, community and personal services, positive trends should continue (according to the survey on business trends in the services, these activities expect higher demand as well as higher employment).

Box 3: **Gross savings and investments**

Gross savings[45] *saw a strong rise in 2004.* After accounting for a relatively stable share in GDP (25.0%; see Table 15) in the previous two years, gross saving is estimated to have increased to 25.9% of GDP last year. Based on the available data on trends of corporate tax[46] and estimates of the trends of primary income[47], we estimate that the gross operating surplus[48] generated by the corporate sector (non-financial and financial companies) increased considerably and stands for the highest share in national savings. Last year's growth of gross savings is related to the further development of institutional saving mechanisms (pension and life insurance, housing saving schemes etc.) and the development of financial markets outside the banks. As of April 2004, public servants are paid additional pension insurance premiums together with their wages,[49] and investments in mutual funds also grew last year. According to preliminary data,[50] gross savings in the government sector in 2004, calculated using the ESA 95 methodology, were 5.2% higher in nominal terms than in the previous year (accounting for 1.8% GDP). Present

[44] The Employment Plan 2005-2006 is still being prepared. Taking account of the Employment Plan 2004-2005 that is now in force, employment should increase by 950 people in 2005 in the Slovenian Army and the Police, and employment should fall in the civil sector of the state administration by 1%, that is by about 150 employees.

[45] Gross savings as the share of national disposal income that is not used as expenditure on final (household or government) consumption.

[46] Data on payments of general government revenues in 2004 show a 13.3% nominal increase of this tax compared to the year before.

[47] Comprehensive data from financial statements on primary income in 2004 are not yet available.

[48] Gross operating surplus, including depreciation and excluding taxes on profit, paid dividends, interest etc., is the main source for financing gross fixed capital formation in the corporate sector.

[49] Collective Supplementary Pension Insurance for Civil Servants Act, Official Gazette no. 126/2003

[50] Main aggregates of the government sector, Slovenia, 2000–2004, First Release no. 66/2005.

estimates[51] show that the volume of net borrowing of the entire government sector in 2005 will be at the same level as in 2004 (1.9% of GDP); the volume of gross fixed capital formation in the government sector increased (from 2.8% of GDP last year to 2.9% of GDP this year): this means that we may expect gross savings growth in the government sector this year (to 1.9% of GDP).

The gap between gross savings and gross investments grew last year. Despite the growth, the level of gross national savings was not sufficient (similarly to two years ago) to finance the high level of domestic gross investment capital formation. Due to lower interest rates and favourable economic trends, the latter increased by 1.5 p.p. and exceeded the level of gross national savings (by 0.9 p.p. compared to the previous year). With the worsened terms of trade, the gap between savings and gross investments slightly grew (to 0.9% of GDP or EUR 241 m).

The increase in gross savings will enable the further growth of gross investment this and next year and to narrow the investment-savings gap next year. This year, the share of gross investments in GDP grew in line with the higher share of gross savings (by 0.3 p.p.): net borrowing abroad will remain at the level of last year (0.9% of GDP). Next year, the share of gross investment will decline and as the level of savings will increase, the balance between savings and investment will be re-established. Given the anticipated trends of the shares of gross savings and gross investments in GDP in 2006, we expect a modest surplus in the current account balance (0.3% of GDP).

Table 15: **Formation and distribution of gross national disposable income**

	Structure in % GDP, current prices					
	2001	2002	2003	2004	2005 Forecast	2006 Forecast
GROSS DOMESTIC PRODUCT	100.0	100.0	100.0	100.0	100.0	100.0
Net primary income from the rest of the world	0.2	-0.6	-0.7	-0.4	-0.5	-0.6
GROSS NATIONAL INCOME	100.2	99.4	99.3	99.6	99.5	99.4
Net current transfers from the rest of the world	0.7	0.6	0.4	0.1	0.4	0.3
GROSS NATIONAL DISPOSABLE INCOME	100.9	100.0	99.7	99.7	99.9	99.7
Final consumption	76.8	74.8	74.7	73.8	73.7	72.6
GROSS NATIONAL SAVINGS	24.1	25.2	25.0	25.9	26.2	27.2
Balance of the current account of BoP	0.2	1.4	-0.4	-0.9	-0.9	0.3
GROSS CAPITAL FORMATION	23.9	23.8	25.3	26.8	27.1	26.9
of which : gross fixed capital formation	24.5	23.3	23.9	24.7	25.8	25.8

Source: SORS; IMAD's forecast.

[51] Report on government deficit and debt, March 2005.

3.2. International economic relations

3.2.1. Balance of payments

The deficit in the current account of the balance of payments rose to EUR *238.3 m or 0.9% of GDP in 2004* (against EUR 91.2 m or 0.4% of GDP in 2003). The bigger deficit mainly resulted from the higher **trade deficit;** the surplus in the trade balance with non-members of the EU did not cover the higher deficit in the trade balance with the EU-25 countries. Following considerable growth in goods exports to member states of the EU-25 as well as to non-members, goods imports saw an even stronger rise (see p. 37). The bigger trade deficit was due – in addition to (real) trade volumes – to changes in the terms of trade that worsened from the second quarter onwards in year-on-year terms, largely because of the higher petroleum and primary commodity prices. This caused the value of imports of intermediate goods to increase considerably. Net imports of petroleum and petroleum products in 2004 are estimated to account for no less than two-thirds of the total trade deficit (EUR 839.9 m). Had the terms of trade not changed, the trade deficit would have been approximately EUR 215 m lower.

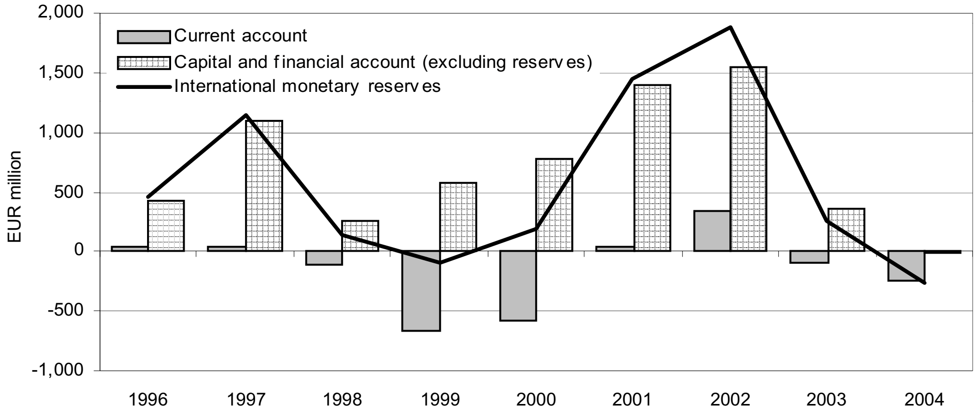
As exports of services rose faster than imports, ***the balance of services*** *recorded the highest surplus to date* (EUR 671.9 m against EUR 538.4 m in 2003). Exports recorded the highest rise in road transport due on one hand to the high growth rates of goods imports and, on the other, to accession to the EU. Following the reduction of administrative procedures, the competitiveness of Slovenian carriers improved compared with carriers from non-members of the EU. Although exports of other services considerably strengthened, their structural share compared to the year before did not increase. Slovenia continues to lag behind contemporary trends in the exports of these services. The highest rise in services imports was recorded by transport services, in line with the growth of goods imports (also see p. 37).

The deficit in ***factor income balance*** *was lower in 2004 (EUR 100.9 m) than in 2003 (EUR 178 m).* Considering capital revenues, interest received on investment in securities rose by nearly a third. The bigger external debt led to higher payments of interest. Reinvested earnings by foreign investors were estimated to be lower than the year before (EUR 67.1 m against EUR 188.9 m in 2003) because the estimate for the current year included the average value of reinvested earnings of the past five years. This was the main reason for the deficit in factor services. Net labour income decreased only slightly compared to last year.

The surplus in the ***balance of current transfers*** *was lower than the year before* (down from EUR 94.2 m to EUR 30.5 m). In the structure of transfers, the net inflow from the other sectors (transfers by expatriates and other transfers) declined, whereas the net outflow from the state sector increased. The latter was mostly due to the lower net inflows from the EU budget. Preliminary data show that Slovenia received only a little over half of the planned revenues (EUR 184.4 m) from the EU budget in 2004 but contributed EUR 170.1 m (or 90.2% of the planned expenditure) to the EU budget.

The net financial flow *(excluding international monetary reserves) showed a net capital inflow of EUR 291.2 m,* considerably less than in 2003 (EUR 456.1 m). The

Figure 8: **Trends in the current account and capital and financial account of the balance of payments, in EUR million**



Source: Bank of Slovenia.

biggest rise was recorded by imports of capital in the form of loans taken out abroad, whereas the biggest capital outflow was recorded in domestic investment in securities abroad.

The main sources of capital inflow in 2004 were loans taken out abroad by domestic commercial banks and enterprises. Other major capital inflows derived from direct foreign investments, cash and deposits by foreign banks, and in the form of short-term commercial loans. Commercial banks took out loans abroad to meet the higher domestic demand for foreign currency loans (EUR 943 m against EUR 659 m in 2003). Domestic enterprises also took out more loans abroad last year (EUR 739 m against EUR 570 m in 2003). The indebtedness of banks and enterprises abroad thus reached its highest level to date. The inflow of foreign direct investment climbed to EUR 421.6 m (EUR 298.8 m in 2003), consisting mostly of equity capital, whereas in 2003 it largely consisted of liabilities to affiliated enterprises. Deposits of foreign banks in domestic commercial banks declined due to the reduced difference between domestic and foreign interest rates on currency deposits. As the volume of goods imports from the member states of the EU-25 increased, short-term liabilities from commercial loans to these countries rose.

The capital outflow mostly consisted of transfers of household cash and deposits from the banking system and investments in securities. Further capital outflows occurred in the form of direct domestic investments abroad, short-term commercial loans and other loans. Investments in foreign securities increased faster than all other forms of capital outflow: compared to 2003, they increased by EUR 410.6 m (to EUR 603.3 m). Investments by enterprises and households in foreign shares and bonds rose, while the payment of Eurobonds by the state sector accounted for more than a third of this outflow. For the third year in a row, capital outflow increased in the form of household cash and deposits. The outflow of short-term commercial loans also grew as a result of the high growth of goods exports to member states of the EU-25 and to non-members of the EU. The outflow of direct domestic investments abroad was at the level of 2003 (EUR 400.7 m). According to data from the Bank of Slovenia, the structure of investments changed because the share of the countries of former Yugoslavia (which is still high) declined and the share of EU-25 member states rose.

This year, the surplus of the current account was lower than in the same period last year up until February. According to preliminary data from the Bank of Slovenia, goods exports increased in nominal terms (in EUR) by 12.2%, and goods imports by 12.5%, in the first two months of this year compared to the same period last year. The deficit in the trade balance was only slightly higher than in the same period last year. Beside the surplus in the balance of services, a surplus was recorded in factor services. The balance of current transfers showed a deficit (in the same period last year it was practically balanced), mostly due to transfers abroad by the state sector. The current account of the balance of payments showed a surplus (EUR 49 m) nearly half of the level in the same period last year (EUR 91.3 m).

Last year's trends in capital flows continued this year. Financial transactions (excluding international monetary reserves) showed a net capital inflow of EUR 156.2 m in the first two months of the year. Capital outflow in the form of direct investment and investment in securities, commercial loans and household cash continued. Liabilities saw the biggest increase in deposits by foreign banks in domestic commercial banks, but enterprises and also domestic banks took out more loans abroad than in the same period last year. The international monetary reserves created by the surplus in current and financial transactions rose by EUR 132.2 m. At the end of February, international monetary reserves stood at EUR 6,711.9 m, and the foreign currency reserves of commercial banks at EUR 1,030.8 m.

***In 2005,** the balance of the current account will be at the same level as last year.* The deficit will be slightly higher (EUR 243 m or 0.9% of GDP) than last year (EUR 238 m or 0.9% of GDP). The trade deficit is estimated to climb to EUR 928 m, resulting among other things from the deteriorated terms of trade (index 98.7), generated mostly by the on average higher petroleum and other primary commodity prices. The surplus in services should also be slightly higher (EUR 716 m), mainly due to the bigger surplus in transport and travel services. The deficit in factor services is expected to slightly rise in 2005; capital revenues will fall slightly due to the low interest rates abroad, and capital expenditure should increase through earnings reinvested by foreign investors in Slovenia. Planned payments of interest on external loans taken out in the past few years will also rise. The surplus in labour income will not be sufficient to cover the deficit in investment income. The bigger surplus in the balance of current transfers will chiefly result from the higher net inflow from the EU budget.

***Next year,** the deficit of the current account will turn into a minor surplus* (EUR 69 m or 0.2% of GDP[52]). If export flows grow faster than import flows, the trade and services balances will show a surplus; compared to 2005, the deficit in the trade balance will decrease and the surplus in the balance of services will continue to rise.

[52] The level is not identical to the calculation of balance of current transactions by the national accounts (see the Box 3 on p. 57) due to the not fully comparable balance of payments and national accounts statistics for 2004 (the balance of payments set the current account deficit at SIT 56 bn, the national accounts at SIT 57.5 bn).

We expect an increase in capital expenditures (dividends, distributed profits, and reinvested earnings), causing a bigger deficit in factor services. In 2006, the anticipated value of inflows from the EU budget will, on average, account for 1.5% of GDP (most of these funds are earmarked for agriculture and structural policies), whereas the value of transfers to the EU budget will account for 1.1% of GDP.

Slovenia's net indebtedness increased considerably last year. At the end of December 2004, Slovenia's **international monetary reserves** stood at EUR 6,541.8 m, and the foreign currency reserves of commercial banks at EUR 1,116.4 m (end December 2003: EUR 6,878.9 m and EUR 1,028.4 m, respectively). The international monetary reserves were sufficient to cover 5 months' worth of imports of goods and services (year-end 2003: 5.9 months). In view of the general rule of 3 months' worth of total imports, and the fact that the international monetary reserves are still sufficient to cover the short-term debt by maturity, Slovenia's standing in terms of monetary reserves is relatively favourable. In 2004, **the gross external debt** accounted for EUR 15,355 m or 59.2% of GDP (54.1% in 2003), gross external assets for 51.6% of GDP (52.2% in 2003), while the **net external debt** of Slovenia increased to EUR 1,988 m or 7.7% of GDP in 2004 (1.9% in 2003).

3.2.2. International competitiveness

The on average lower price and cost competitiveness of the Slovenian manufacturing industry in 2004 resulted from the weak US dollar. Slovenia's bigger market share in the markets of its main trading partners however suggests that the country's export competitiveness is improving.

*Influenced by the depreciation of the US dollar in international currency markets, Slovenia's **price competitiveness** further declined in the currency area of the advanced OECD trading partners in 2004. However, due to the slower growth of relative prices the decline was less pronounced than in 2003.* The growth of domestic consumer prices compared to those abroad slowed down considerably (to 1.6%), the growth of relative industrial producer prices, already modest in 2003, saw no major rise (to 1.8%). Despite the falling nominal value of the US dollar against the euro (by 9.1%, following the 16.6% drop in 2003), the real appreciation of the tolar against the OECD basket of currencies slowed down to about 1% (see Table 16).

In the euro currency area, Slovenia's competitiveness slightly improved last year. Against the euro and measured in relative consumer prices, the tolar fell slightly in real terms (by 0.5%) and, if we take into account the deflator of relative industrial producer prices, the tolar stagnated at the 2003 level although its nominal value against the euro was stable and differed only slightly from the central parity upon joining the ERM II.

Compared to Croatia and the average of the Czech Republic, Hungary, Poland and Slovakia, Slovenia's competitiveness[53] improved last year after worsening in 2003. The tolar depreciated against the Croatian kuna by 1.6 % in real terms (after 2.5% appreciation in 2003), and against the average of the currencies of the other countries by 3.2% (following last year's 4.5% appreciation).

[53] Measured by relative consumer prices.

Table 16: **Indicators of price and cost competitiveness**

Annual growth rates in %	OECD currency area[1]				Euro currency area			
	2002	2003	2004	2005 forecast	2002	2003	2004	2005 forecast
Tolar's effective exchange rate – nominal	-2.9	-0.2	-0.7	0.5	-3.7	-3.2	-2.1	-0.3
Relative prices and costs[2]								
Consumer prices	5.8	3.9	1.6	0.8	5.8	4.0	1.7	1.0
Industrial producer prices	5.1	1.5	1.8		5.0	1.8	2.1	-
Unit labour costs[3]	6.1	3.4	2.5	1.0	5.4	3.7	2.3	1.2
Real effective exchange rate of the tolar – deflator:								
Consumer prices	2.7	3.7	0.9	1.4	1.8	0.7	-0.5	0.7
Industrial producer prices	2.0	1.3	1.1		1.1	-1.5	0.0	-
Unit labour costs[3]	2.9	3.2	1.8	1.6	1.5	0.4	0.1	0.9

Sources: BS, SORS, OECD; the IMAD's calculations and forecast.
Notes: [1]euro, US dollar, Swiss franc, pound sterling; [2]growth of Slovenian prices (costs, in national currency) compared to the price (cost) growth in trade partners (in national currencies): Germany, Italy, France, Austria (euro area), the USA, Switzerland and the UK; [3]in manufacturing.

The decline in the ***cost competitiveness*** *of Slovenia's manufacturing industry slowed down in the currency area of the advanced OECD trading partners in 2004 due to accelerated labour productivity growth*[54] (from 3.4% to 5.7%). The growth was based on the improved growth of production volumes (from 1.6% to 4.9%), which also had an impact on the slower decline of employment. Against the basket of OECD currencies, deflated by relative unit labour costs, the tolar appreciated in real terms (by 1.8%) because together with the stabilisation of the euro exchange rate and the weak US dollar real labour costs per employee (deflated by consumer prices by 4% compared to 1.2%)[55] increased fast. In the euro currency area, the cost competitiveness of Slovenia's manufacturing industry remained at the level of 2003 (see Table 16).

Export competitiveness, measured by the growth of the aggregate ***market share***[56] *in the important markets for Slovenian exporters*[57] *improved in 2004 after one year of stagnation.* The growth of Slovenia's market share (from 0.528% to 0.537%) in EU markets resulted from the country's stronger market position in the euro area (the French, Austrian and Italian markets, but also in the formerly less important Belgian and Spanish markets; also see Part II, p. 110). In the markets outside the EU area, Slovenia's market share saw a major increase in the Croatian market last year (after

[54] Measured by production volume per employee.

[55] Real net wage growth climbed to 3.4% (from 1.8%), other labour-related remuneration to 7.1% (after a 4.9% decrease), taxes and contributions to 3.6% (from 2.5%), because the raised threshold for payroll tax (in September) and the taxes on wages had a relatively minor impact on the tax burden on wages.

[56] The data on the regional structure of exports in 2004 are not yet fully compatible with the subsequently corrected aggregate data on goods exports in 2004 (SORS, 31. 3. 2005). Also see p. 38, note 12.

[57] In Germany, Italy, France, Austria, the Netherlands, Belgium, Spain, Great Britain, the Czech Republic, Slovakia, Hungary, Poland, USA, Croatia, Russia.

having fallen for two years), while the fast growth of the share in the Russian market continued. Slovenia's market share in the most important market of Germany declined last year for the second year in a row, as well as in some EU markets outside the euro area (Czech Republic, Hungary, Poland, Slovakia) after three years of growth, and in the American market after two years of growth.

At the beginning of 2005, Slovenia's price competitiveness in the currency area of the advanced OECD trading partners improved slightly (by 0.7%[58] / 0.6%[59]) as a result of the appreciation of the US dollar and the falling relative prices caused but on the average of the first two months it preserved the same level as a year earlier. Price competitiveness in the euro area saw a minor improvement in year-on-year terms (by 0.5% / 0.3%), because although the tolar's nominal exchange rate against the euro has been stable since entry to the ERM II, its nominal year-on-year depreciation is still gradually slowing down (this is expected to continue until the end of the first half of the year).

Compared to Croatia and the average of the Czech Republic, Hungary, Poland and Slovakia, Slovenia's price competitiveness[60] continued to improve at an even faster pace. In the first two months, the tolar depreciated against the Croatian kuna by 1.8% in real terms and was 3.1% lower in real terms than a year ago; against the average of the currencies of the other countries, the tolar depreciated by 3.9% and 10.5%, respectively.

*The decline in Slovenia's price competitiveness in the currency area of the advanced OECD trading partners will slightly strengthen on average in **2005**, and the cost competitiveness of the manufacturing industry will see a minor slowdown.* On the technical assumption of the euro/USD exchange rate hovering around 1.31, the tolar should appreciate nominally against the OECD basket of currencies by 0.5% (against the euro it will depreciate nominally by 0.3%). If the growth of relative consumer prices continues to decline, the real growth of the tolar's effective exchange rate will be 1.4% (against the euro: 0.7%). Measured by the growth of relative unit labour costs in manufacturing, the real growth of the tolar's effective exchange rate will be 1.6% (against the euro: 0.9%). Under the influence of subdued production growth, labour productivity growth (3.1%) is expected to record a slightly more pronounced slowdown than the growth of real labour costs per employee (2.4%); however, after last year's decline unit labour costs in the main trading partners are set to rise (by 0.8% according to the available estimates).

3.3. Price trends and policy

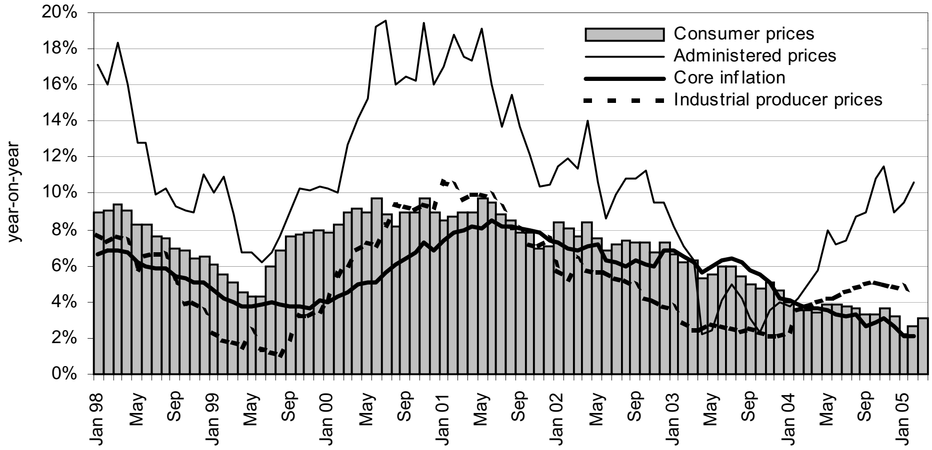
*Following the decline in inflation seen in 2003 its gradual slowdown continued **in 2004***. The 2.6 p.p. decrease in consumer price rises in 2003 was followed by a further fall of 1.4 p.p. in 2004. The year-on-year increase in consumer prices thus

[58] Measured by relative consumer prices.

[59] Measured by relative industrial producer prices.

[60] Measured by relative consumer prices.

Figure 9: **Dynamics of consumer prices, selected price index subgroups and industrial producer prices**



Source: SORS, calculations and estimates by IMAD.

totalled 3.2% in December 2004 while average inflation also dropped by around one-third in 2004 to total 3.6% at the end of the year. Like in 2003, last year's price growth was most pronounced in the first half of the year (2.8%), whereas it only totalled 0.4% in the second half. In spite of its relatively substantial lowering inflation still deviates sharply from the Maastricht criterion. In December 2004, the Maastricht criterion stood at 2.2% while average inflation (measured by the HICP) in Slovenia totalled 3.7% at the end of the year and thus exceeded the Maastricht reference value required for adoption of the euro by 1.5 p.p.

The sustainable lowering of inflation seen in the past two years has resulted from the co-ordinated implementation of measures of the Bank of Slovenia and the government adopted within the Programme for Entering ERM II and Introducing the Euro. The main contributor to the lower inflation in 2004 was the tolar's exchange rate stabilisation upon entry to the ERM II. The Bank of Slovenia continued to gradually slow the tolar's depreciation down in the first half of 2004, which was followed by the tolar's exchange rate stabilisation when entering the ERM II. The year-on-year growth of the exchange rate totalled 2.3% in June 2004 (3.3% in June 2003); taking into account the almost complete pass-through of the exchange rate to price rises, despite being 1.0 p.p. lower than in the same period of 2003 the contribution of this rise to inflation still accounted for about 50% of total price rises. Stabilisation of the tolar's exchange rate upon entry to the ERM II at the end of June 2004 thus eliminated a significant inflationary factor. Due to its gradual depreciation in the first half of 2004 the tolar's year-on-year depreciation totalled 1.3% in December, while its stabilisation is expected to see its full effect on inflation in 2005.

Other macroeconomic policies supported the reduction of inflation. The government continued with implementation of the Administered Prices Rise Plan, the consistent adjustment of fiscal burdens and application of guidelines from the Social Agreement.

Nevertheless, the main goal of the administered prices policy (to ensure harmonised rises in administered and market-determined prices) was, in contrast to 2003, not achieved. The main reason for the faster growth of administered prices (they rose by 9.0% in 2004 while market-determined prices were up 2.1%) was the changed external factors, i.e. higher prices of oil and consequently liquid fuels for transport and heating (their contribution to inflation totalled 1.0 p.p. or 71% of the overall administered prices increase). The rises of most other administered prices also deviated from the plan: the prices of basic utility services, non-profit rents and textbooks rose by more than 10%, contributing 0.2 p.p. more to inflation than projected in the Plan for Adjusting Administered Prices. With the slower growth of other administered prices (their contribution was 0.1 p.p. lower than planned), the increase in administered prices deviated from the plan, contributing less than 0.1 p.p. to inflation. As oil price fluctuations had a comparatively stronger impact on inflation in Slovenia than in other EU countries, the government continued to counter-cyclically adjust excise duties on liquid fuels for transport and heating. At the same time, the harmonisation of excise duties on tobacco products with the EU tax system continued, pushing inflation up by a further 0.2 p.p. In the area of incomes policy, in agreement with the social partners the government continued to keep wage growth below productivity growth in 2004, thereby preventing any potential pass-through of wage rises into prices.

Among measures related to Slovenia's entry to the EU, the lowering of inflation was additionally enhanced by the trade regimes change. The altered competitive conditions in the market and lifting of customs duties, coupled with improved weather conditions compared to 2003, underpinned the falls in food prices. The overall effect of these factors translated to a 1.1% lowering of food prices in 2004, which reduced last year's inflation by 0.2 p.p. After the 4.0% increase in food prices recorded in 2003, which pushed inflation up by 0.8 p.p., the contribution of food prices to inflation fell by 1.0 p.p.

In contrast to consumer price rises, industrial price rises in 2004 were higher than the year before. Following their relatively faster slowdown in 2003 (down 1.6 p.p. to 2.1%), the 4.9% increase in 2004 was mainly due to higher prices of energy and other commodities passing through to domestic prices from abroad both directly and indirectly. The relatively stronger impact of the higher energy prices on industrial producer prices is also linked to the fact that the government does not regulate the prices of energy commodities included in the industrial production index, while energy commodities included in the consumer price index are under various regimes of regulation. Among the separate index groups, the prices of intermediate goods recorded the highest rise in 2004 (6.9%) while less substantial price rises were observed in investment goods (3.3%) and consumer goods (3.0%).

3.3.1. Inflation forecast

Following its over 50% decrease during the past two years, inflation is expected to decelerate further in 2005 and 2006, thus enabling the Maastricht criterion to be fulfilled in the middle of 2006. Provided that the anti-inflationary macroeconomic policy measures applied thus far continue to be carried out and, to a lesser extent, the favourable effects of EU accession are preserved, year-on-year inflation is expected to fall to 2.5% in 2005 and then to 2.3% in 2006. The same figures are projected for average inflation in both years.

Year-on-year inflation will decrease in the first half of 2005, coming close to 2.5% by the end of the year. Consumer prices rose by 2.8% in the first half of 2004, and by only 0.4% in the remaining six months. Since price growth in the first half of 2005 is expected to be lower than in the same period of 2004, year-on-year inflation will decrease to around 2% by the end of the first half-year, rising slightly in the second half to total an estimated 2.5% at the end of the year. The main reason for the rise in inflation in the second half of the year will be the absence of effects related to the EU entry that strongly dampened price growth in last year's second half.

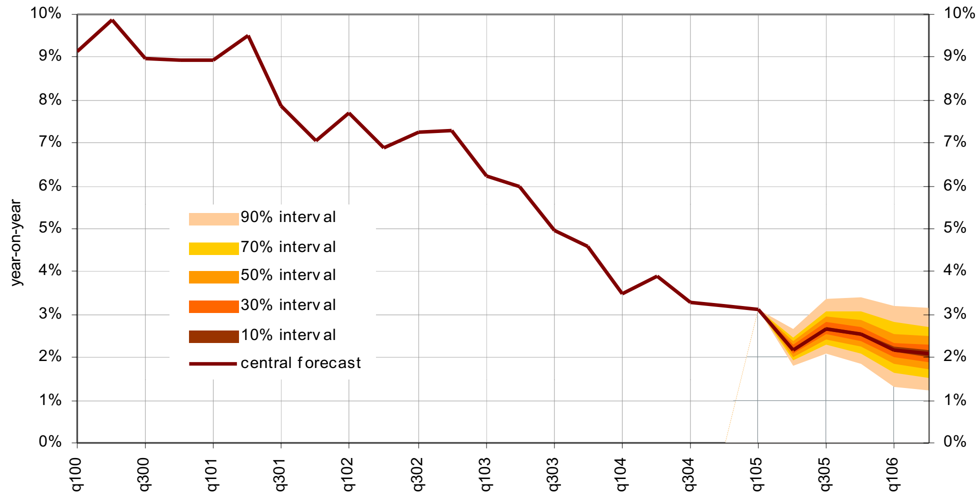
Maintaining the current framework of the macroeconomic policies will be key for the further sustainable lowering of inflation in the next two years. Assuming that the effects with a predominantly one-off character (oil prices and the abolition of customs duties on food prices) will have a weaker impact on price rises in the next two years than in 2004, the continued lowering of inflation will depend crucially on implementation of the adopted orientations in monetary, fiscal, incomes and administered prices policies.

As far as monetary policy is concerned, we assume that the Bank of Slovenia will keep the tolar's exchange rate stable during the remaining period of participation in the exchange rate mechanism ERM II, thereby ensuring fulfilment of the Maastricht criterion and precluding price fluctuations resulting from changes in the exchange rate. Since the tolar's gradual depreciation has consistently contributed around 50% to the overall annual price increase in the past few years, the tolar's stable exchange rate will eliminate a significant inflationary factor.

Government policies are expected to further support the Bank of Slovenia's measures aimed at reducing inflation. After the revised policies concerning administered prices and the adjustment of excise duties helped bring inflation down in 2003 and 2004, we expect that these guidelines will be maintained in 2005 and 2006. In the area of price regulation this means that rises of prices under various regimes of regulation will not exceed the growth of market-determined prices and that none of the administered prices will deviate significantly from this target. In line with the effective plan of administered price adjustments for 2004 and 2005 the increase in administered prices should not overshoot 1.5% this year, which corresponds to a 0.2 p.p. contribution to inflation. Co-ordination between the government and independent regulators involved in price-determining in telecommunications, post and broadcasting, and electricity distribution is aimed at ensuring coherent rises of these and other prices in 2005.

The contribution of changes in excise duties to inflation is also expected to decrease this year relative to 2004. After having totalled 0.4 p.p. last year, this contribution is expected to amount to 0.2 p.p. in 2005 and 2006, primarily due to the continued harmonisation of excise duty rates on tobacco. In addition, the forecast assumes that the government will continue to counter-cyclically adjust excise duties on liquid fuels to cushion any heavier oil price fluctuations and especially their second-round effects.

Figure 10: **Central forecast and the probability of expected deviations**



Source: SORS, forecast by IMAD.

The inflation forecast also assumes that one-off factors will have smaller repercussions for price dynamics in 2005 and 2006. In contrast to 2004, when higher prices of oil and consequently of liquid fuels for transport and heating made a direct contribution of 1.0 p.p. to inflation, we do not expect any further rises in oil prices above the level recorded at the end of this year's first quarter. The average price of Brent crude is hence expected to come close to USD 48/barrel in 2005 and drop to USD 45/barrel in 2006. On the other hand, price reductions during the rest of this year will no longer enjoy the effect of the abolition of customs duties on food products that cut inflation by around 1.0 p.p. after the accession.

Provided that the abovementioned macroeconomic policy measures are consistently implemented, any inflation persisting above the EU average in the next years will be primarily due to the economy's catching-up with the more advanced EU countries. In our estimate, inflation may remain at a level of 1.0 p.p. to 1.5 p.p. above the EU average in the next few years due to the faster productivity growth in the Slovenian economy compared to the average of its main trading partners (the Balassa-Samuelson effect) and due to the structural imbalances that persist in the Slovenian economy. Further sustainable lowering of inflation will therefore necessitate the completion of structural reforms, especially in those sectors where prices are still state-regulated and in the financial and labour markets.

The risks of inflation diverging from the central forecast in 2005 are still evenly distributed. While the risks that inflation will deviate from the central forecast have diminished since the previous forecast, they remain evenly distributed relative to the central forecast. In our estimate, price rises different than projected may occur due to shocks from the international environment, notably further oil price fluctuations. Inconsistent implementation of the already adopted macroeconomic policy measures and a widening of the gap between actual and potential GDP growth are regarded as less likely potential causes of higher price rises.

3.4. Labour market

3.4.1. Wages

Wages policy ensured that wage growth in 2004 was in line with the macro-economic guidelines. The objective in the Social Agreement for the 2003-2005 period, which required real gross wage growth per employee to lag behind labour productivity growth, was in fact exceeded by 1.5 p.p. The lower growth of real gross wages than labour productivity that was achieved prevented additional inflationary pressures; concerning wage trends in the public sector, this contributed to a better balance between general government revenues and expenditure. The forecast assumes that the objective requiring real gross wage growth to rise more slowly than labour productivity growth will be preserved in 2005 and 2006 because it is one of the objectives of the wages policy set out in the Social Agreement for the 2003-2005 period.

The gross wage rose by 2% last year and was 2.5 p.p. lower than labour productivity. According to the SORS' first estimate of the national accounts based on quarterly data, productivity growth climbed to 4.5%. Wage growth lower than productivity growth in annual terms has thus been achieved at different levels (see Table17) in particular years , however it is important important that the objective agreed by the social partners is achieved over the average of several years.

The real gross wage per employee in the ***private sector*** *saw 3.1% growth, that is 1.4 p.p. lower than total labour productivity growth (according to the SORS' preliminary data)*. The real gross wage growth per employee achieved in the private sector was mainly the result of the improved economic environment and the fact that the year had five more working days. High real gross wage growth in the private sector was recorded year-on-year in all four quarters (3.8%, 2.4%, 3.1%, and again 3.1% in the last quarter). With the exception of the second quarter (which had an equal number of working days), every quarter had more working days than the year before.

In November and December of 2004, a total of 21.1% of employees received the ***"13th month's pay"****, that is half a percentage point more recipients than in 2003 (20.6%).* On average, every recipient of the 13th month's pay received about 50% of their average monthly wage, and this did not differ much by activities. Activities

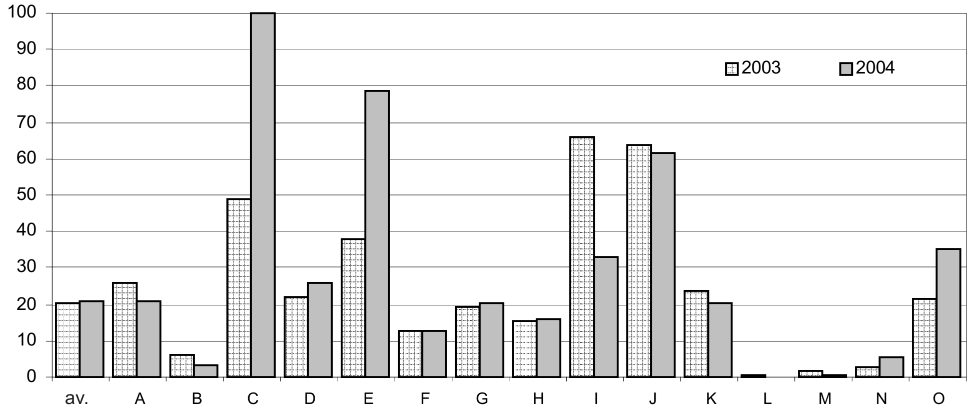
Table 17: **Labour productivity and gross wage per employee in the private and public sectors, 1999–2004**

Real growth in %

	Labour productivity	Gross wage per employee		
		Total	Private sector	Public sector
1999	4.2	3.3	3.2	3.7
2000	3.1	1.6	1.3	2.1
2001	2.2	3.2	2.3	5.1
2002	3.7	2.0	2.3	1.1
2003	2.8	1.8	2.1	0.7
2004	4.5	2.0	3.1	-0.8
1999–2004	3.4	2.3	2.4	2.0

Source: SORS, calculations of labour productivity and gross wages by sectors by the IMAD.

Figure 11: **Share of employees receiving the 13th month's pay by activities in %**



Source: SORS.

which stand out for the share of employees receiving the 13th month's pay are those which do not entirely depend on market conditions (see the figure) e.g. electricity, water and gas supply (E), transport (I) and financial intermediation, a phenomenon recorded since the SORS surveys these payments separately.

The social partners agreed that the 2004 adjustment percentage for wages in the private sector, 3.2%, would be expressed in the same amount for all employees in individual activities. The adjustment mechanism agreed by the social partners in the "Wages Policy Agreement for the private sector for 2004 and 2005" is indeed slightly more complex than in the past because the social partners have to agree on the adjustment amount at the activity level. Agreements were generally reached by the end of September. The idea behind the uniform adjustment amount was the unions' intention to reduce the wage differences in the private sector. The distribution of employees by wages has indeed worsened in the private sector in recent years. The ratio between the gross wage of the ninth decile and the gross wage of the median (see Table 18) has particularly worsened, indicating that high wages are increasing faster than others. The institution of the minimum wage and, in particular, the adjustment mechanism which applies to the minimum wage, continues to fulfil its safeguarding function by preventing a further deterioration of the distribution in the lower wage brackets, and halting the downward trend of the lower wages.

Table 18: **Indicators of wage dispersion in the private sector, 2000–2004**

	2000	2001	2002	2003	2004
9th decile/1st decile	3.22	3.30	3.23	3.32	3.40
median/1st decile	1.61	1.61	1.61	1.63	1.61
9th decile/median	2.00	2.05	2.01	2.04	2.11
Gini coefficient	0.293	0.294	0.286	0.289	0.293
average gross wage/median*100	122.6	123.8	123.2	122.9	123.8

Source: SORS, calculations by the IMAD.

The Wages Policy Agreement also included a safeguard clause in case consumer prices rose by more than 3.6% in 2004: the next adjustment of gross wages would then cover the difference. Consumer prices, excluding alcohol and tobacco, increased by 3.2% between December 2003 and December 2004, that is exactly the amount of the adjustment percentage.

*The lower total growth of real gross wages was largely due to wage trends in the **public sector**.* The real gross wage per employee in this sector was 0.8% below the level of the previous year. During the year (December 2003 - December 2004), its real growth was 1.5% because the collectively agreed basic wage increased by 2.5% in July, based on the Act Amending the Public Sector Wage System Act, and promotions that were made in accordance with regular procedures. The real average annual fall of gross wages, compared to the previous year, chiefly resulted from the non-effected 2.4% adjustment in August 2003; this had a carry-over effect resulting in a 1.4 p.p. lower gross wages in 2004 compared to the previous year. If the August adjustment from 2003 had not been changed into collective supplementary pension insurance, the real gross wage per employee in the public sector in 2004 compared to the previous year would have risen by 0.6%. This would, of course, also mean that the total real gross wage would have recorded 0.5 p.p. higher growth (2.5%) in 2004.

*The real gross wage per employee is expected to rise by 2.1% in **2005**, that is by 2.5% in the private sector, and by about 0.9% in the public sector*. Given the expected 3.4% productivity growth, the real gross wage per employee will lag behind by slightly more than one percentage point. The real gross wage per employee in the **private sector** will increase slightly less than in the previous year, partly resulting from the lower number of working days (four days less), and partly because the revival of the economic environment is forecast to occur towards the end of the year (see Box 2 on p. 54). In 2005, the adjustment mechanism agreed in the Private Sector Wage Policy Agreement for 2004-2005 will apply. The agreed adjustment percentage for 2005 is 2.7%, that is higher than the presently estimated 2.5% rise in consumer prices in 2005, measured from December 2004 to December 2005, but still within the inflationary framework (2.9%) estimated for this period at the time of the Agreement's adoption. The Agreement does not contain a safeguard clause in case the actual growth of consumer prices is less than estimated. This means that a downward correction is impossible in the adjustment mechanism. In the negotiations on the adjustment amount for 2004, the adjustment for 2005 has been determined by the social partners in about one-third of the collective agreements at the activity level.

*The growth in the gross wage per employee in the **public sector** includes the agreed adjustment percentage (2%) for the sector's collectively agreed basic wages and the expected promotions.* It also includes the 3% July increase of wages in education based on the Annex to the Collective Agreement for Education. The adjustment mechanism from the "Agreement on the Adjustment Mechanism for the Base Wage and Holiday Allowance for 2004 and 2005" was based for 2005 on the official estimates of consumer prices trends in Slovenia and the European Union at the time of the Agreement's adoption (July 2003), and included an agreed adjustment percentage of 3.04%, half of which was intended for adjusting all wages in the public sector and half to eliminate disparities. The agreement provided an option to re-examine the estimates used in the adjustment mechanism. The autumn forecast of economic developments in Slovenia and the European Union lowered the estimated inflation for 2005. Based on this difference, the social partners agreed in April this year an adjustment percentage of 2% for all wages, while 0.5% was earmarked for the elimination of disparities. The reason why the adjustment percentage for all wages of public sector employees is more than half of the adjustment percentage mainly lies in the fact that wages will not be paid out in accordance with the "Public Sector Wage System Act" before July of this year. There are two reasons for not spending the entire 2.5% on the adjustment. The first is that certain funds have to be reserved for eliminating disparities, and the second is that the latest estimates of consumer price trends in the spring forecast for Slovenia and the European Union are lower, meaning that the Agreement's adjustment percentage, calculated from the present official benchmarks, would be 2.2%.

This year, the social partners will have to reach a new social agreement for the next period and, as part of that agreement, also define the guidelines of wages policy. Such agreed guidelines will be considered in concrete negotiations between the social partners on wages policy in the public and private sectors for the next period because the agreed wages policy expires in both sectors in 2005.

The growth of the gross wage per employee in ***2006*** *is estimated at 2.6% and will be one percentage point below the predicted 3.6% labour productivity growth.* This estimate takes account of the fact that the basic guideline – at least 1% lower growth in real gross wage per employee than labour productivity growth – will not change. Because of accession to the EMU all possible measures will be required to preserve macro-economic stability and prevent higher inflation. Continued boosted economic activity in the private sector will increase the real gross wage per employee by about 2.9%. The estimate for the public sector takes into account the fact that wages will be paid in accordance with the new act, and this means it will be possible to use the existing funds for the elimination of disparities and that the real gross wage per employee is expected to rise by around 1.8%.

The minimum wage *is determined by the "*Private Sector Wage Policy Agreement for 2004 and 2005*".* The social partners agreed that the minimum wage should be SIT 117,500 in August 2004, a 5.4% rise, and SIT 122,600 in August 2005, a 4.3% rise. The expiry of the Agreement also ends the adjustment mechanism of the minimum wage and the social partners will have to agree on a system for determining the minimum wage. The mechanism which regulates the minimum wage may be laid down by law or the social partners may include the method to determine the minimum wage in individual agreements on wages policy.

The share of ***work-related allowances and other remuneration, payments based on contracts for work or services, and copyright contracts*** in the total net wage bill rose in 2004. The accelerated growth of this kind of payments (15%) far exceeded the growth of net wages (8.5%), and their share in net wages reached 40.6%, which meant a trend opposite to that of the past years when the share decreased (38.3% in 2003, 39.6% in 2002, but 41.2% in 2001). The increased share of these allowances in net wages is more pronounced in the private sector where it rose to 43.6%

(compared with 40.9% in 2003, 42.6% in 2002 and 45.1% in 2001). Their share had been stable for several years in the public sector, but it climbed to 33.8% in 2004 (compared with 32.6% in 2003, 32.8% in 2002, and 32.6% in 2001).

3.4.2. Employment and unemployment

*The boosted economic growth in **2004** mainly led to a high increase in informal employment, while formal employment growth remained modest*. This explains the big differences in employment growth rates according to different statistical sources (see Box 4 on p. 76). According to the **methodology of the national accounts,** employment increased by only 0.1%[61] in 2004. Slightly higher (and higher than in previous years) was the growth in **formal employment**[62] (0.8%). The relatively highest increase was recorded in the number of farmers[63], estimated using new methodology, but the growth of employment (people in employment) was modest – only 0.3%. Employment in enterprises and organisations continued to rise but only in services (excluding transport services), but it is falling in production activities. For the third year in a row, employment in the small business sector (those working for the self-employed) dropped, and for the eighth year in a row the number of private individual entrepreneurs again fell. The average number of people in employment **according to the labour force survey**, on the other hand, was 5.1%

Table 19: **Annual growth rates by employment categories in 2003 and 2004 (in %)**

	2003	2004
Employment according to the national accounts methodology	-0.3	0.1
Employment according to the labour force survey	-1.4	5.1
Formal employment[1]	-0.9	0.8
People in employment	0.1	0.3
- in enterprises and organisations	0.2	0.4
- production activities (A–F)	-1.5	-1.5
- services (G–P)	1.3	1.7
- working for the self-employed	-0.9	-0.8
Formal self-employment	-9.2	4.9
- small business sector	-1.8	-0.6
- own-account workers	3.4	2.1
- farmers	-20.0	13.6
Informal employment (estimate)	-5.6	41.7

Source: SORS; calculations and estimates by the IMAD.
Note: [1]using the new methodology (see Box 4 on p. 76).

[61] According to the first release, 15.03.2005.

[62] Formally employed people are defined as employed and self-employed people in accordance with the monthly data of the SORS.

[63] In spite of the changed methodology which the SORS had used from the period starting with January 2000 to calculate the numbers of farmers to be included in its monthly statistics of self-employed people, the number continues to change unrealistically from year to year. This is one of the reasons for the difference between the growth of the monthly data on formally employed people and the employment growth according to the national accounts, which use more stable sources to estimate the dynamics of the number of farmers (see Box 4).

higher in 2004 than the year before, indicating a strong increase of different forms of **informal employment** which are at least to some extent captured by the survey[64]. Informal employment is the form of employment which, given the relative rigidity of formal employment and self-employment, responds fastest to changing economic conditions. The experiences of recent years show that this trend is closely connected with the dynamics of economic growth.

Employment continues to grow fastest in business and public services, but also continues to drop in industry and construction. According to the preliminary national accounts data, employment in agriculture dropped but the labour force survey and the monthly statistical data based on it reveal the opposite – employment growth in agriculture, as would be expected in view of the increased agricultural production in 2004. Employment saw the highest growth in services in business services, public administration and social work. Employment also increased in some subsectors of manufacturing, while total employment in the branch fell (by 0.8 %). Employment increased in the automobile and machinery industry by 4%, in the manufacture of rubber and plastic products by 2.2%, and in the manufacture of chemicals and chemical products by 0.3%. In the other subsectors of manufacturing, employment fell in 2004, most of all in the textile industry (by 7.0%), the leather industry (by 6.2%) and in the food-processing industry (by 3.3%).[65] Employment in the textile industry, which totalled over 32,000 workers in 2000, has since dropped by a quarter – to 24,000.

*Based on the national accounts, the **growth of labour productivity** was quite high **in 2004**.* Measured by gross domestic product per employee according to the national accounts methodology, productivity increased by 4.5% and reached SIT 6.9 m[66] or EUR 29,020 per employee. Broken down by activities, the highest productivity growth rates were recorded in agriculture[67], financial intermediation, electricity, gas and water supply and manufacturing.

*Slightly lower economic growth is expected to be achieved **in 2005,** given the expected lower productivity growth and higher employment growth than in 2004.* **Employment is to rise by about 0.4%**, resulting from the higher number of people employed in construction and services, while employment in agriculture, mining, manufacturing and electricity, gas and water supply is expected to continue falling. The forecast economic growth would thus be achieved by 3.4% **labour productivity growth**. If

[64] Due to the lack of suitable data, the volume of informal employment is roughly estimated as the difference between the number of people in employment according to the survey and the number of formally employed people (also see Box 4).

[65] The growth rates were calculated on the basis of new, revised data of the monthly statistics on people in employment and therefore differ from the rates published in the Development Report 2005 (Indicator – Employment rate), where older data were used for the calculations.

[66] According to the first release of the national accounts for 2004, 15.03.2005.

[67] Productivity growth in agriculture strongly fluctuates and largely depends, as indicated by the calculations of the national accounts, on the weather conditions which determine the crops. The highest productivity in recent years was recorded in 2002 when excellent crops pushed it up to 18.7%. Due to these favourable crops – accompanied by a 3.6% drop in employment according to the national accounts – productivity was high (15.4%) in 2004, whereas it was negative (-12.6%) the year before as a result of the drought.

favourable economic conditions continue, employment should rise by a further 0.5% and productivity by 3.6% **in 2006**.

Registered unemployment continued to fall in 2004 and so did the registered and survey unemployment rates. On average, **registered unemployment** totalled 92,826 people (90,728 in December) in 2004, the average registered unemployment rate was 10.3%, and the unemployment rate at the end of the year was 10.1% (the comparable registered unemployment rates in 2003 were 10.9% and 10.7%)[68]. **Unemployment according to the labour force survey** remained at the same level in 2004 as in 2003 (64,000). Due to the higher number of people in employment, the survey unemployment rate fell from 6.7% in 2003 to 6.3%.

In the January-December 2004 period, the number of registered unemployed people fell by 5,265 or 5.5%. For the first time in four years, the **outflow of unemployed people into employment** increased (see Table 8 in the Statistical Appendix). 54,257 unemployed people found employment (7.4% more than the year before), about 12,900 of them thanks to active employment policy measures (6,100 were employed under the community employment scheme (public works), and 6,800 under other target-oriented programmes aimed at improving the employability of people with low employment prospects). The **inflow into unemployment due to the loss of employment,** on the other hand, increased slightly (for the sixth year in a row). 69,577 employed people lost their job (1.1% more than in 2003). Among the reasons for losing employment, the most important one remains the loss of fixed-term employment (47.5%), whereas the loss of employment for business reasons is on the rise (15.8% of the total job losses in 2004). **The inflow of first-time job-seekers** again increased - to 25,988. Among them there were 14.8% job seekers with a tertiary education (13.8% in 2003). The number of registered unemployed people thus fell in 2004 mainly because of the continuing high **deletions from unemployment registers** for reasons unrelated to the employment of unemployed people. The number of the latter was 46,573, that is only 1.6 % less than in 2003. The main reason for deletions continues to be a failure to report to the employment office and voluntary deletions (totalling over 17,500), while the next important reason is the re-entry to regular education (7,250 people)[69]. 2,268 people were transferred to a separate register pursuant to other acts[70], while 4,337 unemployed people retired.

[68] A new methodology of statistics of formal employment was introduced in January 2004. According to this methodology formal employment and the number of people in employment increased and so did the number of formally active population (the total of formally employed people and registered unemployed people), which is the basis for calculating the registered unemployment rate. The new calculation for 2004 sets the rate 0.3 p.p. lower than the old calculation.

[69] Most of them through the "Programme 10,000", a joint programme of the Ministry of Education and Sport and the Ministry of Labour, Family and Social Affairs, aimed at including unemployed people in education within the framework of publicly certified programmes in order to increase their employment options and improve the education structure of the unemployed.

[70] This concerns employed disabled people, beneficiaries of the PDII disability allowance who have been registered by the Employment Service for at least two years, were referred to employers in this period but could not find a job due to their disability, who could not find a job although they were involved in active employment policy measures, or for whom no adequate jobs were available in the said period. This register is kept pursuant to the "Rules on the content and manner on keeping official employment registers", published on 4 October 2002 on the basis of amendments to the Employment and Unemployment Insurance Act. In December 2004, 14,306 people were listed on this register.

Box 4: **Data on the number of employees and people in employment**

The SORS publishes three different sets of data on people in employment and the labour force. The internationally harmonised **labour force survey** adds to the people in employment and the self-employed all other people who performed any job against payment, profit or family gain in the reference week. The survey has been carried out regularly since 1993. In the 1993-1996 period it was carried out once a year (for the month of April), and from the second quarter of 1997 four times a year.

The monthly statistics of people in employment only include the number of people in employment and the self-employed. Until December 2004, the basic source of data on employment in enterprises and organisations was the survey "Monthly Report on Earnings and People in Paid Employment (ZAP/M)". The number of farmers was estimated based on data from the labour force survey for the past quarter, and the source of data on other self-employed people and those working for them has been the Statistical Register of Employment (SRDAP) since 1999. As of January 2005 the SORS modified its methodology for calculating these categories. It now also includes the Statistical Register of Employment as a source of employment in enterprises and organisations. Because the register is based on registrations in compulsory social insurance it includes a wider circle of people than the former survey (ZAP/M), which was limited to enterprises with 3 or more employees. The methodology used to calculate the monthly number of farmers has also changed and is now forecast using the ARIMA model based on quarterly data on farmers from past labour force surveys. The new methodology has also been used to recalculate data for previous years – that is from January 2000 onwards.

In addition to these two sets of statistical data, the SORS also calculates statistical **employment according to the national accounts**. These data are based on the Statistical Register of Employment and on the number of farmers who pay social insurance contributions, and on a statistically established ratio between the number of these farmers and the number of persons in paid employment according to the register and the number of other people in paid employment.

*Differences between **the three sets of statistical data** occur due to differences in the range of categories of employment they include.* The Labour Force Survey includes, in addition to formal employment (people in employment and self-employed people with an official status), various forms of informal employment (people working as unpaid family members, people on work contracts, or people working in the grey economy), who are not captured by the monthly statistics, however the statistics of the national accounts estimate their number. The Labour Force Survey indeed captures a relatively small sample (about 8,000 people, four times a year), and this may explain the high fluctuations in the dynamics of the data it provides. On the other hand and due to its sampling method, the survey does not capture foreigners employed in Slovenia but they are included in the monthly statistics and the national accounts statistics.

Through retirement and other deletions from the registers and by subsidising the employment of people with low employment prospects, the ***structure of registered unemployment*** *is slowly changing.* The shares of older long-term unemployed people and unemployed under-skilled people continued to fall in 2004, but the shares of first-time job-seekers, women and unemployed people with a tertiary education increased. The average duration of unemployment is getting shorter (down to 23 months in 2004, two months less than in 2003). Due to their transfer to a special register (see note 70), the number of disabled among the unemployed is also falling. Both rates of unemployed women (registered and survey unemployment rates), however, remain higher than for men (see Table 9 in the Statistical Appendix on p. 160). Unemployment among young people (15-24 years of age) remains relatively high, in particular the unemployment of young women, but it is falling with men. Since 2002 the number of unemployed people with a higher or university education has been growing and, because the total number of unemployed people has been falling, their share in the number of unemployed is growing fast. The number of unemployment cash benefit recipients dropped significantly in 2004 (by 11.0%), whereas the growing trend in the number of unemployment assistance recipients was halted in 2004.

The government continues its efforts to reduce unemployment through the target-oriented measures of its active employment policy. To this end the government adopted the **National Action Employment Programme** for 2004[71], prepared in accordance with the European Employment Strategy. This programme is the basis

Table 20: **Typical groups of registered unemployed people (as a % of the average number of unemployed people)**

	2003	2004
Women	52.8	53.1
First-time job-seekers	23.2	25.2
Youth under 26	26.1	26.2
Higher and university education	6.1	7.2
Under-skilled	44.2	41.6
Unemployed for over a year	48.6	46.2
People over 40	44.1	42.8
People over 50	21.4	21.0
Disabled	10.7	9.2
Recipients of unemployment benefits or assistance	24.8	24.0
People included in active employment policy programmes	53.4	57.5
- education and training	27.7	25.9
- subsidies	5.8	10.8
- measures for the disabled	13.0	14.2
- community employment	6.9	6.6

Source of data: IMAD's calculations based on monthly data from the Employment Service of RS.

[71] This is a new programme aimed at achieving strategic objectives in the labour market and employment in 2005. It differs from the programme with the same title adopted by the government in December 2003 to achieve the employment strategy objectives of 2004.

for the **Programme of Active Employment Policy Measures for 2005**. The programme's key measures are aimed at increasing the education level of people in employment, that is their vocational qualifications; to reduce structural imbalances which would mean a reduction of the share of long-term unemployed people and that of unemployed people without vocational qualifications; to include all young unemployed people who have not found employment within 6 months in the programmes of the active employment policy, as well as the inclusion of all other unemployed people who failed to find a job within 12 months; to reduce regional imbalances in the labour market; to monitor how the unemployed meet their obligations; to prevent work and employment in the grey market; and to further enhance the social partnership.

Regional disparities in unemployment *further decreased in 2004.* The trend is obvious from the difference between the highest and lowest regional unemployment rates, the disparity ratio[72], which has been falling since 2002. In 2004 the unemployment rate fell in all statistical regions, with the exception of the Goriška region, which has had the lowest registered unemployment rate in Slovenia for several years, although it has been growing slowly but steadily since 2002. The highest registered unemployment rate in 2004 was recorded in Pomurska, and the national average was exceeded by the Podravska, Zasavska, Spodnjesavska, Savinjska and Koroška regions. Above-average long-term unemployment and a low education structure are typical of most of these regions. Those regions which have a below-average unemployment rate – these include the Central Slovenia, Goriška, Littoral Karst, Notranjska-Karst and Gorenjska regions – are facing a new structural problem in recent years, that is a growing share of unemployed with a higher or university education.

Unemployment will continue to fall ***in 2005 and 2006***. Given favourable employment conditions, the registered unemployment rate is expected to drop to 9.8% in 2005, and to 9.3% in 2006, and the survey unemployment rate to 6.2% and 6.0%, respectively. Active employment policy measures will be particularly important because they will have to address in particular the problems of further lay-offs in the labour-intensive branches of manufacturing.

3.5. Public finance policy

Public finance policy is one of the principal instruments used by the government to stabilise macroeconomic conditions. Implementing the policy's instruments adjusts both general government revenues (taxes, contributions) and expenditure because it determines their amount and structure and shapes the macroeconomic environment. The revenues and expenditure of the state budget, local government budgets, health insurance and pension insurance funds are analysed separately below. The most comprehensive insight into the government's economic role is provided by the budget of the general government sector as a whole, which also includes public funds. The advantage of this approach is that it fits in with the national accounts and therefore

[72] Measured as the ratio between the standard deviation and the arithmetic average of regional unemployment rates.

conforms to the methodology of the European System of Accounts that, is among other things, used to monitor compliance with the Maastricht convergence criteria in the public finance area. Its disadvantage is the relatively limited availability of data, especially disaggregated data, and the economic account of the general government sector is therefore presented at the end of the chapter.

3.5.1. General government revenues

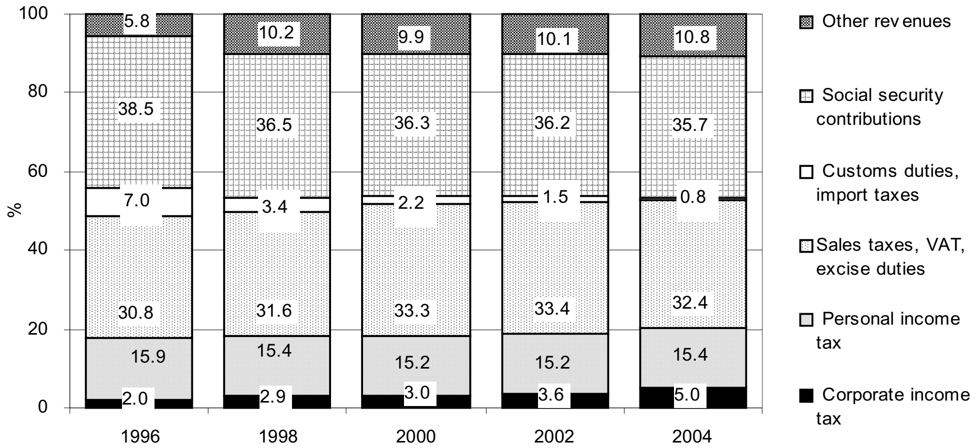
***In 2004**, the taxation system and its instruments saw few changes which, in addition to the macroeconomic environment, affected the amount and structure of general government revenues.* For the sake of alignment with the EU *acquis*, excise duties on tobacco and tobacco products were raised in January and July 2004. In line with its anti-inflationary objectives, the government also intervened by adjusting the level of excise duties on mineral oils throughout the year. The rates of social security contributions as a percentage of the total wage bill were the same as the year before (38.2%). Payroll tax remained a tax source in 2004, the threshold of payroll tax was raised but its progressive scale of tax rates remained unchanged. In 2004, new personal income tax and corporate income tax acts were adopted; the articles of these acts connected with Slovenia's accession to the EU came into force upon accession, and the entire acts came into effect at the beginning of 2005.

*In 2004, **total mandatory levies** rose in real terms by 3.2% compared to 2003, their share in GDP however fell by 0.3 of a percentage point (to 40.2%).* Revenues from value-added tax decreased in real terms, mainly as a result of Slovenia's accession to the EU which changed the method with which value-added tax is computed and paid and caused a liquidity drop in revenues from this particular tax source in the months following accession, as well as slightly lower revenues over the entire year (by 0.7%). Revenues from value-added tax accounted for 8.7% of GDP in 2004, that is about 0.5 p.p. less than the year before.

*Following modest growth in 2003 (0.4% in real terms), revenues from **excise duties** increased by 6.2%* in *2004.* Faster growth than total revenues was recorded by revenues from excise duties on tobacco and tobacco products (14.5% in real terms), because the alignment with EU legislation introduced higher specific and proportionate excise duties. Slower growth was recorded by revenues from excise duties on mineral oils (by 4.3%), whereas revenues from excise duties on alcohol and alcoholic beverages decreased in real terms (by 2.6%). The share of revenues from excise duties in GDP was 3.5% in 2004 , only 0.1 p.p. higher than the year before.

***In 2004**, revenues from **wage-based taxes and contributions** increased by 3.9% in real terms compared to 2003.* Their share in GDP reached 22%, 0.1 p.p. less than the year before. Broken down by source, revenues from **payroll tax** increased faster (by 6.1%) because its progressive taxation scale – in spite of the raised threshold (September 2004) – increased the average taxation rate from 4.7% of the gross wage bill in 2003 to 5% in 2004. Given the unchanged contribution rates, total revenues from **social security contributions** rose by 3.6%. in real terms in 2004. Revenues from **personal income tax** were up 4.5% in real terms in 2004 compared with 2003. Revenues from tax on wages were up 4.2% in real terms, and those from other sub-categories of personal income tax by 6.2%. The final personal income tax

Figure 12: **Structure of general government revenues in %**



Sources of data: Agency for Payments, Public Payments Administration, the IMAD's methodology and calculations.

assessment yielded rebates at the same level in real terms as in 2003. Due to amendments to the Corporate Income Tax Act, revenues from corporate income tax were 11.8% higher in real terms than in 2004.

The significance of revenues from ***customs duties and import taxes*** *as a budget source declined in 2004.* After Slovenia's accession to the EU, customs duties and import taxes are collected only on imports from countries outside the EU, and the revenues from customs duties dropped by 46% in real terms in 2004 compared to 2003, and their share in GDP fell to 0.3% (see Part II, p. 122).

Actual general government revenues in 2004 were lower than anticipated when the state budget was adopted. Revenues from value-added tax were lower, and revenues from customs duties and import taxes were slightly lower as well. The funds drawn from the EU budget were considerably below the anticipated figures in the state budget (see Part II, p.124). Revenues from excise duties and corporate income tax were slightly higher than anticipated.

In 2005*, the new acts on personal income tax and corporate income tax fully came into force and this will slightly change the structure of general government revenues; the alignment of excise duties with the European directives will continue.* Revenues from corporate income tax are expected to rise because of the reduced tax relief and re-determined expenditures, whereas revenues from personal income tax are set to decline owing to higher levels of relief, the changed personal income tax scale and altered base enforced by the amended Personal Income Tax. Alignment with the European directives will further increase excise duties on tobacco and tobacco products in 2005 and 2006.

Given the projected macroeconomic environment in 2005 and 2006 and the taxation system and instruments that have come into force, the **share of mandatory levies**

in GDP is set to range at around 40%. A slightly downward trend will continue: from the achieved 40.2% in GDP in 2004 to around 40% in 2005, and to 39.7% in 2006. Given the unchanged contribution rates, **social security contributions** will increase in line with the growth of the gross wage bill which will, however, lag behind GDP growth because gross wage growth will lag behind productivity growth and because of the very low increase in the number of wage earners. Their share in GDP will shrink from 14.4% in 2004 to 14.2% in 2005, and 14.0% in 2006. The implementation of the new personal income tax law will reduce the share of revenues from **personal income tax** in 2005 from 6.2% in GDP in 2004 to about 5.9% in 2005, and 5.8% in 2006. Revenues from **value-added tax and excise duties** will increase closely in line with the anticipated GDP growth and maintain the 2004 share in 2005 and 2006 (about 12.5%). Because of the accession to the EU, revenues from **customs duties** will further decrease and their share in GDP will drop to 0.1%. **Revenues from corporate income tax** will increase slightly faster than economic growth in 2005 because implementation of the new act should push up the effective taxation rate from the present 13% to about 19%. The share of these revenues in GDP is expected to rise from 2% in 2004 to about 2.5% in 2005 and 2006.

3.5.2. General government expenditure

State budget

In 2004, state budget expenditure, including the contributions to the EU budget, accounted for 25.8% of GDP, up by 0.4 of a percentage point from the year before. Without the contributions to the EU budget, expenditure accounted for 25.1% of GDP or 0.3 p.p. less than in 2003. According to preliminary data, state budget expenditure totalled SIT 1,596 bn, and together with the contributions to the EU budget 5.4% more in real terms than the year before; excluding these funds the rise was 2.7%. Actual expenditure from the state budget was lower than anticipated in the state budget by about SIT 52 bn, chiefly because of the lower than anticipated budget revenues; the funds Slovenia received from the European budget were also much lower than anticipated (see Part II, p. 123).

In 2004, real expenditure on wages, contributions and other personnel expenditure of the employees in state bodies and public institutions rose faster than total expenditure and gained 0.1 p.p. in GDP structure. The share of expenditure on subsidies rose by same amount. Transfers to individuals and households in 2004 preserved the same share of GDP as in 2003. In 2004, the share of transfers to local government municipalities, the share of transfers to the Pension and Disability Fund, interest payments and funds for capital expenditure and capital transfers all decreased (each by 0.1 p.p.). The share of expenditure on goods and services in state bodies and public institutions in GDP fell by 0.4 p.p.

The government is set to submit its proposed revision of the 2005 state budget to the National Assembly. According to the agreed starting-points of the revised 2005 budget, state budget expenditure, including Slovenia's contributions to the EU budget, will account for 26.7% of the estimated GDP, that is 0.9 p.p. more than in

Table 21: **Structure and share of state budget expenditure in gross domestic product by economic classification, in %**

	Structure in %				% of GDP			
	2002	**2003**	**2004**	**2005***	**2002**	**2003**	**2004**	**2005***
TOTAL STATE BUDGET EXPENDITURE	100.0	100.0	100.0	100.0	24.7	25.4	25.8	26.7
Current expenditure	31.0	31.1	28.4	27.8	7.6	7.9	7.3	7.4
Of which:								
Wages and other personnel expenditure	13.5	13.6	13.4	12.7	3.4	3.5	3.4	3.3
Expenditure on goods and services in government bodies	10.7	10.1	9.0	9.3	2.6	2.6	2.3	2.5
Domestic and external interest payments	6.1	6.1	5.5	4.9	1.5	1.5	1.4	1.3
Current transfers	60.7	59.8	60.3	58.6	15.0	15.2	15.5	15.7
Of which:								
Subsidies	4.3	4.4	4.6	4.4	1.1	1.1	1.2	1.2
Transfers to individuals and households	13.6	13.8	13.5	12.6	3.4	3.5	3.5	3.4
Transfer to public institutions	21.8	21.4	21.5	20.5	5.4	5.4	5.5	5.4
Transfers to the pension fund	17.2	16.3	15.5	15.5	4.3	4.1	4.0	4.0
Capital expenditure and transfers	8.3	9.2	8.7	9.4	2.0	2.3	2.2	2.5
Contributions to the EU budget	-	-	2.5	4.3	-	-	0.7	1.1

Source: Ministry of Finance, calculations by IMAD.
Note: *Estimate based on the proposed revision of the 2005 budget.

2004; excluding the contributions to the EU budget, expenditure should increase by 0.5 p.p. Expenditure according to the proposed revised budget for 2005 would total SIT 1,756 bn, that is 10% higher in nominal terms than the realised budget expenditure in 2004 if the contributions to the EU budget are included, and 8.1% higher without these contributions. Compared with the present budget, the revised budget's expenditure would be 1.4% higher and its structure by economic purposes would see some changes.

Local government budgets

The share of local government budgets expenditure in GDP ***in 2005 and 2006*** *will remain at approximately the same level as in 2004 of 5%.* Preliminary data indicate that local government budgets expenditure increased by 2.9% in real terms in 2004, and that its share in GDP was 5% or 0.1 p.p. less than in 2003. Expenditure on goods and services and transfers to individuals and households grew faster than total expenditure, whereas expenditure on wages and contributions in local government bodies and public institutions and capital expenditure saw a slower rise. Domestic interest payments and subsidies decreased in real terms. Slower growth of local government budgets expenditure is expected in 2005 and 2006, and to be below GDP growth in both years.

Pension and disability insurance

In order to implement the rights laid down in the Pension and Disability Insurance Act (excluding contributions for the health insurance of pensioners), 2.4% more funds were used in real terms in 2004 compared to 2003. They accounted for 12.4% of GDP (0.2 p.p. less than the year before). Taking account of the present legislation and the macroeconomic forecasts, the share of expenditure on pension and disability insurance is expected to continue to decrease in **2005 and 2006.** Because the accrual rate is to further drop and the number of beneficiaries to rise only modestly (by 1.6% in 2004 and by 1.7% in 2005), expenditure should account for about 12.2% of GDP in 2005 and 12% in 2006.

Compulsory health insurance

In 2004*, expenditure on compulsory health insurance was 3.4% higher in real terms than the year before and accounted for 6.6% of GDP.* Although the statutory rights arising from compulsory health insurance did not change essentially in 2004, many activities were undertaken to curb expenditure on medicines and rationalise the implementation of health-care programmes. Nevertheless, expenditure on health services rose in real terms by 3.7%, mostly expenditure on hospitalisation (up 4.2% in real terms). Expenditure on medicines and orthopaedic products grew by a mere 1% in real terms, but a substantial rise of 4.3% in real terms was recorded by expenditure on sickness benefits.

In 2005, *the share of compulsory health insurance expenditure in GDP is expected to drop by 0.2. p.p. compared to the year before, or to 6.4% of GDP, the same level as in 2000.* According to the financial plan adopted by the Health Insurance Institute for 2005, funds in compulsory health insurance are expected to rise by only 1.6% in real terms (4.1% in nominal terms). Expenditure on health services should increase by 1.4% in real terms, on medicines and the operation of pharmacies by 2.7%, and on sickness benefits by 4.4%. This will require accelerated activities to further rationalise expenditure in compulsory health insurance in 2005. Estimates which take into account the macroeconomic assumptions indicate that the expenditure on compulsory health insurance will grow in line with GDP growth in 2006 and preserve the anticipated 2005 share in GDP.

3.5.3. General government deficit (according to the GFS-IMF methodology)

Although the economic policy measures taken **last year** eased pressure on general government expenditure and ensured stable sources of finance, the **general government deficit**[73] nevertheless reached 1.4% of GDP, the same level as in 2003.

According to the consolidated general government revenue and expenditure, the general government deficit is estimated at 1.3% of GDP **in 2005**, 0.1 p.p. less than in 2004.

[73] The general government deficit is defined as the deficit of consolidated government revenue and the expenditure of the national budget, local government budgets, and the pension and health budgets.

Box 5: **Breakdown of the general government deficit**

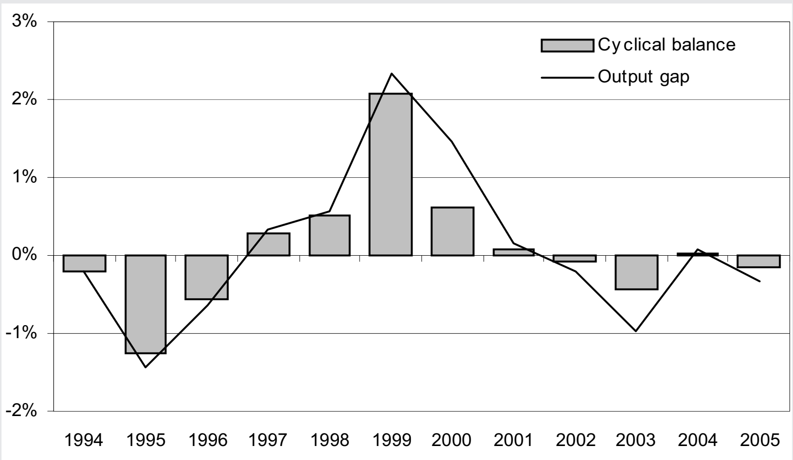
The projected reduction of the general government deficit in the next period will chiefly depend on the completion of structural reforms in the fiscal area. Provided that economic developments are favourable, the cyclical deficit will be relatively low and is expected to turn into a cyclical surplus in 2009. The structural part of the general government sector should decrease by 0.25 p.p. in 2005 or from SIT 87.5 bn, the end-2004 figure, to SIT 76.8 bn at the end of 2005.

Table 22: **Cyclical and structural general government deficits, as a % of GDP**

	Actual surplus /deficit	Cyclical surplus/deficit	Structural surplus/deficit
2000	-1.29	0.63	-1.91
2001	-1.33	0.06	-1.39
2002	-2.94	-0.08	-2.85
2003	-1.37	-0.43	-0.94
2004	-1.38	0.03	-1.41
2005	-1.31	-0.15	-1.16

Sources: IMAD, MF.
Note: the general government sector's deficit was calculated using the modified GFS methodology (employers' contributions to social security are not consolidated).

Figure 13: **Output gap and cyclical component of the general government deficit**



Sources: IMAD, MF.

Table 23: **Consolidated general government revenue and expenditure using the GFS-IMF methodology (as a % of GDP)**

	1996	1997	1998	1999	2000	2001	2002[1]	2003	2004	2005 forecast
General government revenue	40.0	39.3	40.3	41.0	40.6	41.3	39.2	41.3	41.7	42.3
General government expenditure	39.7	40.4	41.1	41.6	41.9	42.6	42.1	42.7	43.1	43.6
Surplus / deficit	0.3	-1.1	-0.8	-0.6	-1.3	-1.3	-2.9	-1.4	-1.4	-1.3

Source: Ministry of Finance, IMAD's calculations.
Note: consolidated employers' contributions to social security. *In 2002, total expenditure of the state budget was effected with 11-month revenues from value-added tax and excise duties, aligning the budget year with the calendar year; the reported general government deficit of 2002 increased by the "compensatory" budget deficit of 1.5% of GDP.

3.5.4. General government sector deficit (according to ESA-95 methodology)

After its accession to the European Union, Slovenia is bound by the provisions of the Stability and Growth Pact which require the general government sector's share in GDP not to exceed 3%. As part of the procedure to determine the government deficit and debt, Slovenia is obliged twice a year to submit to the European Commission its "Report on the Government Deficit and Debt". The report is compiled in accordance with the uniform methodology of the European system of accounts from 1995 (ESA-95)[74] which all member states have to strictly observe. The maximum limit of the deficit of the general government sector (3% of GDP) is also the Maastricht convergence criterion which Slovenia has to comply with in order to accede to EMU (expected to occur at the beginning of 2007). Slovenia met this criterion in the 2001-2003 period and the preliminary data indicate the country will meet it again in 2004.

In 2000 the general government sector deficit accounted for 3.4% of GDP and decreased gradually over the following three years. In the 2000-2003 period, the share of the government sector deficit in GDP fell by 1.4 p.p. from 3.4% of GDP in

Table 24: **Deficit share of the general government sector by sub-sectors according to the ESA-1995 methodology, as a % of GDP**

	2000	2001	2002	2003	2004 prelim.	2005 forecast
General government sector deficit (revenues minus expenditure)	-3.5	-2.8	-2.4	-2.0	-1.9	-1.9
Of which:						
Central government budget	-3.0	-2.5	-2.1	-1.9	-1.8	-2.7
Local government budgets	0.1	0.0	-0.2	0.0	0.0	0.0
Social insurance funds	-0.5	-0.3	-0.1	-0.1	-0.1	0.8

Sources: SORS, MF - Report on the government deficit and debt, March 2005.

[74] In addition to the state and local government budgets, compulsory health insurance, pension and disability insurance the state sector institutionally includes public funds, among them KAD (Slovenian capital company), SOD (Slovenian compensation company) and public agencies. The ESA-95 methodology is founded on the accrual principle and takes account of all revenues and expenditures for the period in which the claims and liabilities of the government take place regardless of when they are paid.

2000 to 2% of GDP in 2003. The biggest decrease was recorded in 2001 when the deficit fell by 0.6 p.p. (to 2.8% GDP), in 2002 and 2003 the drop was 0.4 p.p. (down to 2.4% of GDP in 2002 and to 2% GDP in 2003).

According to the preliminary data, the general government deficit will account for 1.9% of GDP in **2004**; compared to the year before, the deficit shrank by 0.1 p.p. Based on the budget passed for 2005, the Report on the general government deficit and debt estimates the share will remain at the level of 1.9% of GDP in 2005.

3.6. Monetary developments and the capital market

3.6.1. Monetary developments and monetary policy

The Bank of Slovenia's monetary policy in 2004 focused on preparations for entering the exchange rate mechanism ERM II and the entry itself. In the first six months of 2004, the BS continued to carry out the policy set out in the Programme for Entering the ERM II and Introducing the Euro, which concentrated on gradually lowering the tolar's depreciation rate and simultaneously cutting interest rates on the Bank's key instruments. The slower growth of the tolar's exchange rate, taking into account the almost complete pass-through of the exchange rate to price rises, supported the further lowering of inflation and enabled smooth stabilisation of the tolar's exchange rate.

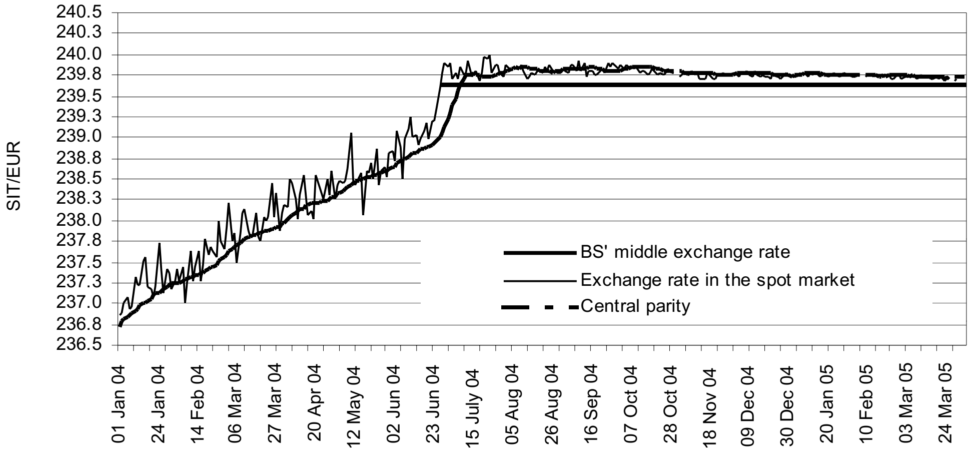
After being an EU member for less than two months, at the end of June 2004 Slovenia entered the exchange rate mechanism ERM II. The BS continued to apply the policy of depreciating the tolar evenly and gradually over the first half of 2004. The exchange rate thus depreciated by 1.0%, while its year-on-year depreciation at the end of June last year totalled 2.3%. After the central parity was set at SIT 239.640 for EUR 1 upon entering the ERM II in June last year, the tolar's exchange rate in the foreign exchange market (based on exchange rates reported by banks) fluctuated in a narrow band below the central parity that did not exceed 0.15%[75].

Stabilisation of the tolar's nominal exchange rate did not significantly affect the dynamics of the tolar's real exchange rate. The simultaneous lowering of inflation that followed entry to the ERM II and was largely enabled by the exchange rate's stabilisation in turn made it possible to preserve the stability of the tolar's real exchange rate against the euro. It depreciated by 0.5% in the 12 months prior to the ERM II entry, while its depreciation thereafter totalled 0.2% in the period until March 2005. Against the ongoing fluctuations of the US dollar's exchange rate, the tolar's real effective exchange rate measured by the CPI appreciated by 0.8% in 2004 and by 0.2% in the first three months of 2005.

Following the cuts in the first half of the year the Bank of Slovenia largely kept its key interest rates unchanged after joining the ERM II. In the first six months of the year the BS lowered its key interest rates several times, thus reducing them by 2.0 p.p. (60-day tolar bills, temporary purchases of foreign exchange/interest rate on

[75] According to the participation rules, the actual exchange rate's deviations from the central parity must not exceed 15%.

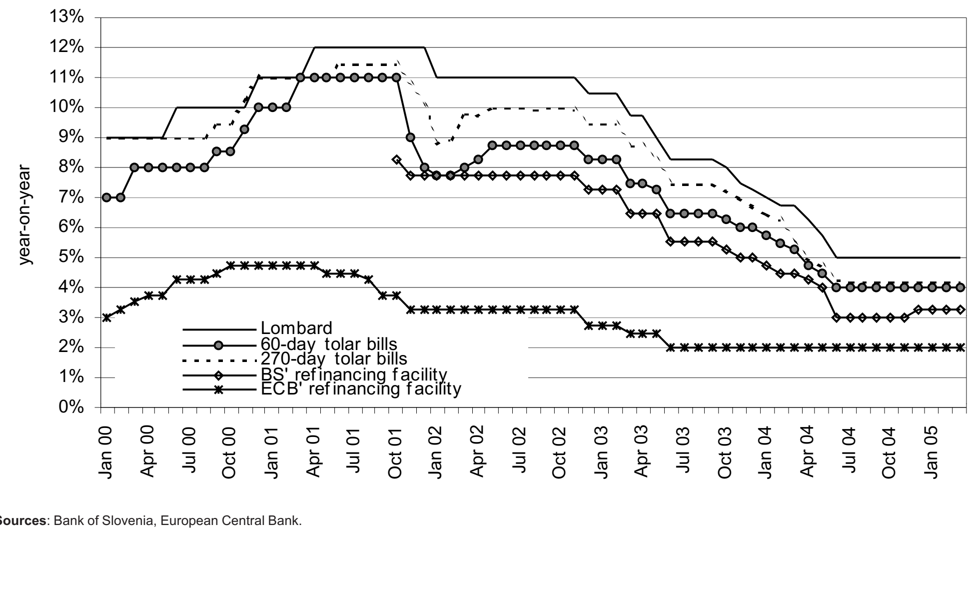
Figure 14: **Tolar exchange rate's stabilisation**



Source: Bank of Slovenia.

swap deals), 2.25 p.p. (lombard rate), or 2.5 p.p. (270-day tolar bills) from December 2003 to end-June 2004. At the end of December 2004 the BS raised the price of temporary purchases of foreign exchange by 0.25 p.p. (to 1.25%), thereby also raising the refinancing rate by the same amount (to 3.25%). Therefore, the gap vis-a-vis the ECB's comparable interest rate (which totalled 2.0% at the end of March) widened. In the first quarter of 2005, the BS left the interest rates on its key tolar instruments unchanged; at the same time, however, it did not report on progress in the harmonisation process between its own and euro-area interest rates which is due to be completed upon adoption of the euro, presumably at the beginning of 2007.

Figure 15: **Dynamics of key BS and ECB interest rates**



Sources: Bank of Slovenia, European Central Bank.

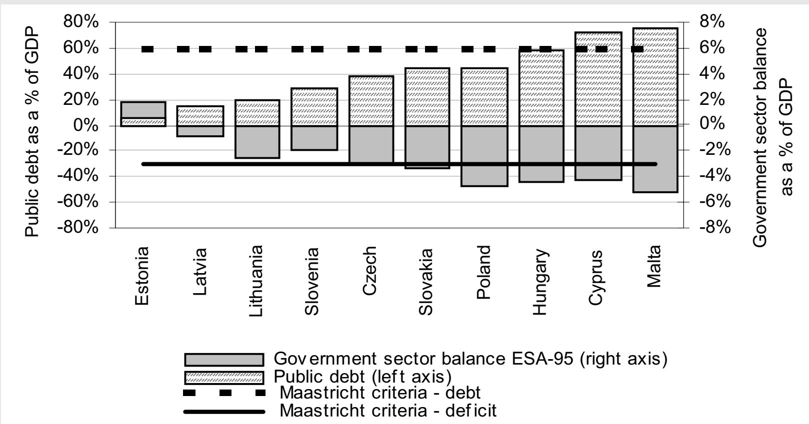
In 2004, the differences in the growth rates of money aggregates widened. The year-on-year growth of the narrow money aggregate M1 rose by 17.1 p.p. to total 27.8% at the end of December 2004 while the year-on-year growth of the M2 aggregate fell by 1.3 p.p. to 4.0%. Growth of the broad money aggregate M3 rose by 1.8 p.p. and totalled 6.8%. The robust growth of M1 was largely underpinned by the increase in tolar deposits while the slower growth of broad money aggregates was partly due to the changed situation in the foreign exchange market since the net financial inflow in 2004 totalled EUR 52 m (EUR 159 m in 2003).

Box 6: **Meeting the Maastricht criteria**

The Maastricht criteria for adopting the euro must be fulfilled by the middle of 2006 at the latest. Two years of successful participation in the ERM II, coupled with fulfilment of the Maastricht criteria regarding inflation, interest rates, public debt and general government sector deficit are the preconditions for adopting the euro and exploiting the advantages of membership in the monetary union.

At the moment Slovenia complies with both fiscal policy criteria. The general government deficit totalled 1.9% of GDP in 2004 and remained below the Maastricht reference value of 3%, including when the safety margin[76] is taken into account. Public debt amounted to 29.4% of GDP[77], i.e. below the Maastricht ceiling set at 60% of GDP.

Figure 16: **General government deficit and public debt in the new EU member states**



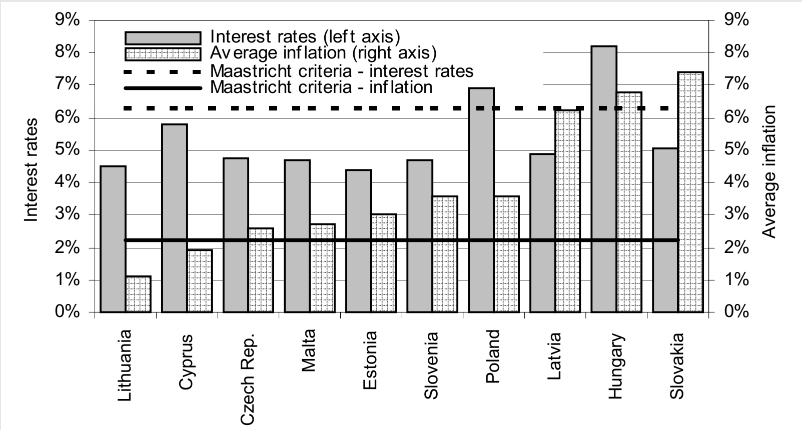
Source: Eurostat.

[76] The safety margin is estimated on the basis of past budgetary fluctuations and thus takes deviations between the actual and planned balance into account.

[77] First notification of deficit and debt data for 2004, 18th March 2005, Eurostat.

Regarding the Maastricht monetary criteria, inflation still exceeds the permitted level while the criterion set for the long-term interest rate has been fulfilled. Taking into account the established calculation method the Maastricht criterion, defined as the average inflation of the three countries with lowest price growth rates, increased by 1.5 p.p. and stood at 2.2% in December 2004, i.e. 1.4 p.p. less than the average (HICP) inflation in Slovenia at that time. Moreover, Slovenia already satisfies the criterion on the long-term interest rate. This criterion stipulates that the average long-term interest rate observed over a period of one year before the examination must not exceed the reference interest rate, defined as the average of the three best performing member states in terms of price stability, by more than two percentage points. The twelve-month long-term interest rate average of the three EU countries totalled 4.3% in December 2004; the Maastricht criterion thus stood at 6.3%, i.e.1.6 p.p. above the twelve-month average of the yield-to-maturity of ten-year government bonds in Slovenia. The last criterion concerns the stability of the exchange rate. Although the tolar's exchange rate has been fluctuating within a much narrower band than the allowed ±15% since entry to the ERM II, Slovenia has still not satisfied the exchange rate stability requirement because it has only been a member of the ERM II for nine months whereas the criterion requires that the exchange rate is stable over a period of at least two years prior to adopting the euro.

Figure 17: **Inflation and interest rates in the new EU member states**



Source: Eurostat.

In the first quarter of 2005 the Bank of Slovenia continued to pursue the policy applied already in the second half of 2004. After joining the exchange rate mechanism ERM II the BS primarily ensured the stability of the tolar's exchange rate which thus fluctuated within an even narrower band in the first quarter of 2005 than in the second half of 2004. At the same time, the BS has kept its key interest rates unchanged this year, thereby preserving the nominal gap between its own interest rates and those of the European Central Bank which also remained unchanged. The dynamics of money aggregates in the first quarter this year still largely depended on movements in the balance of payments flows.

In the period preceding adoption of the euro, no substantial changes are expected in the monetary policy guidelines. Apart from keeping the tolar's exchange rate stable, the primary task ahead of adopting the euro will be a further lowering of the BS' nominal interest rates to harmonise them with those of the European Central Bank, which are currently still approximately 1.25 p.p. lower. Potential shocks that could harm the Slovenian economy more seriously than other economies are viewed as unlikely; nevertheless, we can identify the following main risks associated with membership in the ERM II: the risk of the central exchange rate being set inappropriately, the risk of excessive capital inflows, the risk of excessive lending activity and its related impact on consumption and inflation, and the risk of the economy losing competitiveness (see p. 131, part III and the Main risks associated with the spring forecasts on p. 31).

3.6.2. Financial flows and the capital market

Household savings in banks and mutual funds

Household savings in banks continued to record modest growth in 2004. Up until November their growth was even lower than in 2003 when the lowest increases were recorded. December's high inflows linked, among other things, to the change in tax legislation[78], resulted in the highest monthly growth seen after December 2001[79]. 2004 also saw the release of funds from the five-year National Housing Savings Scheme (NHSS) which had a significant impact on the term structure of tolar household savings.

Tolar savings *in banks as a type of household savings are becoming less significant.* Like the year before, last year again recorded the highest increase in tolar demand deposits due to the lowering of interest rates on tied deposits[80] that recorded their historically lowest levels and sometimes do not even suffice to maintain the savings' real value. The volume of tolar demand deposits thus accounted for as much of 45.2% of total tolar deposits (9.1 p.p. more than in December 2003). The volume of tied deposits generally decreased throughout the year. The only exception was the tolar deposits tied for 31-90 days (they surged by over 40% in real terms) which can be attributed to the release of funds from the NHSS[81]. The overall net inflows from tolar savings totalled SIT 129.2 bn in 2004 (of which demand deposits comprised SIT 176.6 bn – almost 1.7-times more than in 2003) and thus shrank by 6.6% in real terms compared with the previous year.

[78] The amendments stipulate a permanent tax on capital gains from major shares exceeding SIT 60 m for companies with a capital of SIT 200 m and over. Consequently, natural persons exceeding this ceiling sold their shares off and deposited the proceeds in banks.

[79] High inflows deriving from the exchange of european currencies to euros.

[80] Primarily due to the lowering of inflation; see p. 64.

[81] The total amount of funds saved within the NHSS exceeded SIT 43 bn. Tovrstni vezani depoziti pa so samo julija beležili neto priliv v višini 30.9 mrd SIT, kar predstavlja približno tretjino letnih neto prilivov. These tied deposits recorded a net inflow of SIT 30.9 bn in July alone, accounting for about one-third of total annual net inflows.

Table 25: **Household savings in banks and their real year-on-year growth rates**

	SIT bn	Real increase in stock, %					
	Stock on 31 Dec 2004	1999	2000	2001	2002	2003	2004
Total savings	**2,341.3**	**7.5**	**14.8**	**28.1**	**7.0**	**5.3**	**7.5**
Tolar savings	**1,422.3**	**10.9**	**14.2**	**24.7**	**12.6**	**6.6**	**6.6**
Demand deposits	642.8	18.2	6.4	14.1	12.8	10.6	33.6
Short-term deposits	632.1	8.5	22.9	27.3	2.3	5.7	0.7
Long-term deposits	146.2	-1.2	5.8	49.4	53.2	1.4	-35.1
Foreign currency savings	**919.0**	**3.7**	**15.5**	**32.1**	**0.9**	**3.6**	**8.7**
Short-term and demand deposits	829.6	3.2	11.0	34.5	1.2	6.6	8.2
Long-term deposits	89.4	8.4	55.6	16.9	-0.9	-18.2	13.3

Source: BS, calculations by IMAD.

***Foreign currency savings** were on the increase last year despite being less profitable than tolar deposits.* In contrast to 2003, an increase was observed not only in short-term but also long-term foreign currency deposits. The net inflow of foreign currency savings totalled SIT 73.5 bn, which is almost three times as much as in 2003 in real terms.

In the first two months of 2005, the real volume of total household savings in banks remained at the level recorded at the end of 2004. Foreign currency deposits continued to increase and recorded a 0.3% real rise in that period while tolar deposits were down 0.2% in real terms (if we exclude demand deposits, this fall would have been 0.7 p.p. bigger).

*The relatively high yields of **mutual funds** along with the low interest rates on bank deposits stimulated financial investment in mutual funds.* Their net annual inflows amounted to a high SIT 81.2 bn, more than in all previous years together. From end-2003, the number of mutual funds rose from 20 to 33; in addition, investment in foreign mutual funds started last year. The volume of assets managed by mutual funds (SIT 207.8 bn) more than doubled last year. Savings in mutual funds achieved as much as 8.9% of household savings in banks (4.3% in 2003). Although the year-on-year return of mutual funds was predominantly on a decrease in the second half of the year it still came in at 17.7% at the end of the year (16.8% in 2003)[82]. Due to the rising prices of shares (see p. 95) stock mutual funds yielded the highest return (17.7%), bond mutual funds had the lowest yield (6.9%) while the interest rate on long-term deposits totalled 5.7% at the end of 2003.

In this year's first quarter mutual funds registered a net inflow of SIT 14.2 bn, i.e. 18.8% less than in the same period last year. This result was largely the result of the low inflows in March, which were probably related to the negative trends of shares prices in both domestic and foreign capital markets (see p. 95).

[82] Average weighted return where the value of assets managed by each fund is used as a weight.

Loans

Household loans were the main contributor to the increase in tolar loans. The real volume of tolar loans was predominantly rising in 2004 and was hence 7.0% higher at the end of the year than at the end of 2003, chiefly on account of the increase in tolar loans to households (contributing 5.2 p.p.). These loans also recorded their highest increase since 1999 in 2004. Also regarding the term structure of loans, long-term loans contributed the highest share to growth – they were up 10.2% in real terms, the largest part of the rise coming from household loans. The net flows of total tolar loans amounted to SIT 190.8 bn in 2004, i.e. 15.8% more in real terms than in the previous year.

In 2004, borrowing by ***enterprises and OFO*** *in domestic banks and abroad rose by almost one-third in real terms.* Their net flows recorded the value of SIT 530.5 bn, of which almost 90% were foreign currency loans taken out in domestic banks and foreign banks.

The growth of tolar loans to enterprises and OFO was, contrary to 2003, mainly generated by the increase in overdrafts, advances and short-term loans. The growth of long-term loans to enterprises was modest last year while the growth of short-term loans, overdrafts and advances, following the drop in 2003, strengthened (see Table 26). The net inflows of tolar loans to enterprises and OFO totalled SIT 69.4 bn in 2004, i.e. about one-fifth less than the year before in real terms.

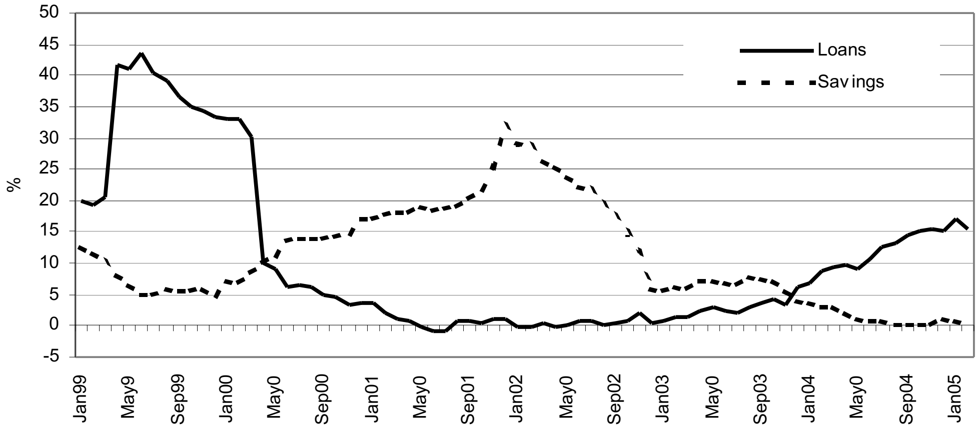
Last year again saw enterprises and OFOs' robust borrowing of foreign currency loans in the domestic market. The growth of these loans, despite recording high

Table 26: **Stock of domestic banks' loans to enterprises & OFO, households and the government and their real growth rates**

	SIT billion	Real increase in loan stock, %					
	Stock on 31 Dec 2004	1999	2000	2001	2002	2003	2004
Tolar loans, total	**2,021.9**	**14.4**	**5.8**	**7.7**	**-1.2**	**4.6**	**7.0**
Loans to enterprises and OFO*	**1,132.3**	**9.7**	**6.6**	**11.2**	**-4.9**	**3.9**	**3.2**
Short-term, overdrafts and advances	600.2	10.7	11.5	10.4	-7.6	-0.2	5.1
Long-term	532.0	8.4	0.9	12.2	-1.5	8.7	1.1
Household loans	**756.9**	**33.4**	**3.6**	**1.1**	**0.4**	**6.3**	**15.0**
Short-term, overdrafts and advances	135.8	42.7	5.8	7.1	-1.1	2.9	3.1
Long-term	621.1	31.3	3.1	-0.4	0.8	7.1	18.0
Government loans	**132.7**	**-26.3**	**13.7**	**14.0**	**28.5**	**2.8**	**-1.6**
Short-term, overdrafts and advances	4.3	-6.8	59.9	-5.9	-2.5	-19.5	-81.9
Long-term	128.3	-31.4	-2.4	25.4	41.7	9.3	15.7
Foreign currency loans							
to enterprises and OFO	910.1	42.8	33.1	33.3	34.5	39.9	45.4
to households	22.9	2,067.1	-2.8	8.5	18.4	47.1	261.3
to the government	43.5	-33.7	-5.4	-77.5	242.0	-36.2	238.6

Source of data: BS, calculations by IMAD.

Figure 18: **Year-on-year growth rates in the volume of household savings in banks (excluding tolar demand deposits) and the real increase in the volume of tolar household loans**



Note: In addition to the introduction of VAT, the surge in 1999 was due to the new methodology according to which households also include individual private entrepreneurs.
Source of data: Bank of Slovenia, calculations by IMAD.

increases in previous years, rose further last year and totalled 45.4% (see Table 26). The net inflows totalled SIT 284.3 bn, almost two-thirds more than in 2003. More favourable foreign currency loans in domestic banks thus remain the main source of corporate debt financing (accounting for over 50% of total corporate loans), which is probably also linked to the BS' decision of October 2003 whereby banks may lend foreign currency to residents for any purpose. The more established enterprises can also take out loans **abroad** on even more favourable terms. The net flows of these loans totalled SIT 176.8 bn in 2004, recording an over 30% real rise compared to 2003.

Within household borrowing long-term loans were particularly on the increase (see Table 26). The BS' figures (for the 8 largest banks) indicate that consumer loans[83] represented a substantial part of long-term loans while housing borrowing registered the biggest rise due to the low basis from the previous year. The increase was more pronounced in the second half of the year after the release of funds from the National Housing Savings Scheme (NHSS). In our estimate, however, a large part of the lending potential is still unexploited[84]. The net inflows of tolar loans to households

[83] Amounting to SIT 61.3 bn which, however, merely represents an estimated third of total consumer loan contracts due to the reporting criteria (OG No. 45, 16.05.03, p. 5183 (4)). The amount of new housing loans in these eight banks totalled SIT 56.7 bn last year. In 2003 there the banks accorded consumer loans worth SIT 51.2 bn (not directly comparable with the 2004 figure due to different coverage in line with the reporting criteria) and housing loans in the amount of SIT 35.8 bn.

[84] According to data for the eight largest banks these loans mainly rose in the second half of the year due to the release of funds from the NHSS and totalled SIT 13.2 bn in that period, indicating that a substantial part of the NHSS potential, which topped SIT 80 bn, is still unused. The most probable reason is that some savers preferred to take out loans with a foreign currency clause or foreign currency loans which are more favourable than tolar loans (especially those tied to the tolar indexation clause) and recorded inflows of SIT 9.1 bn and SIT 6.4 bn, respectively, in the second half of the year.

in the entire banking system totalled SIT 119.4 bn last year, over three-quarters more than in 2003. Of these, SIT 111.3 bn came from long-term loans. The abolition of the abovementioned restrictions also stimulated households to take out foreign currency loans. These amounted to SIT 16.5 bn last year, 8.2-times more than in the previous year in real terms.

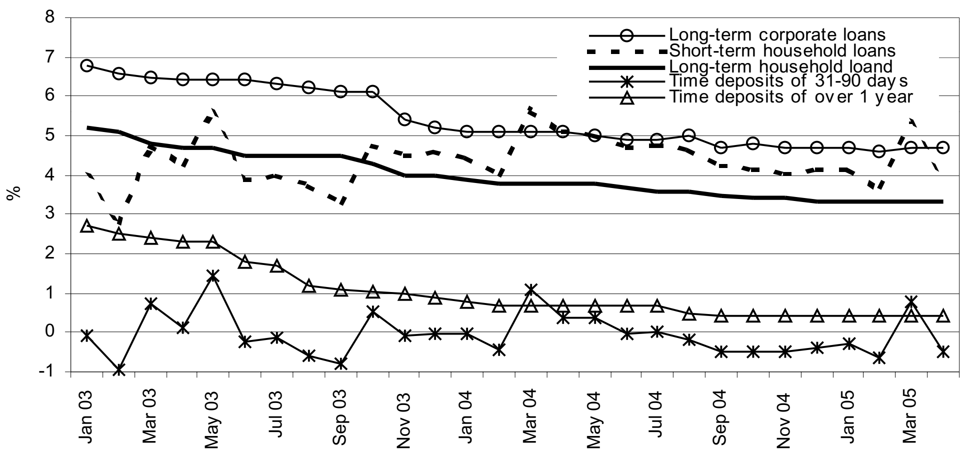
The volume of government borrowing in domestic banks strengthened slightly in 2004. The net flows of lending to the government thus amounted to SIT 32.7 bn after having totalled less than SIT 2 bn in 2003. Over 90% of these flows were generated by foreign currency loans, while tolar lending predominantly consisted of long-term loans. The government meanwhile net repaid its short-term loans.

In the first two months of this year, notably in February, the growth of the tolar loans' volume slowed down slightly. Foreign currency loans, on the other hand, were still on a robust increase, recording an almost 10% real rise in the first two months alone. This was largely due to the borrowing by enterprises and OFO, although higher growth rates were recorded by foreign currency loans to households which, however, represent a small share of the total foreign currency loans (less than 3% of all foreign currency loans).

Interest rates

The lowering of inflation and inflationary expectations along with the falling of real interest rates pushed interest rates down to their lowest levels so far. The average interest rates on tied tolar deposits were down between 1.0 p.p. and 3.4 p.p. in 2004. This lowering was largely due to the lower value of the tolar indexation clause (its average value in 2004 totalled 3.9%), which is used less and less for determining long-term deposit interest rates, while the real part in e.g. long-term interest rates dropped by around 1.2 p.p. While deposit interest rates were falling more rapidly in 2002 and 2003, the cuts in lending and deposit interest rates seen in 2004 were

Figure 19: **Dynamics of real interest rates**



Source:BS, IMAD's calculations.

relatively balanced. Long-term lending interest rates decreased rapidly for the same reason as deposit interest rates (they dropped by 3.4 p.p. on average; see the figure below). The falling of interest rates slowed down in the final quarter of the year.

The lowering of interbank interest rates (SITIBOR) was in line with trends in other interest rates and totalled 2 p.p. on average last year. The interbank interest rates' curve at the end of the year was even slightly gentler than the year before. Their dynamics, however, are not analytically applicable due to the shallowness of the interbank market.

Securities market

At the end of 2004, the main index (SBI20) achieved the level of 4,904.5 points, having gained 24.7% year on year. This rise was slightly higher than in 2003 and the second highest in the last ten years.

The **market capitalisation** of all securities listed on the Ljubljana Stock Exchange (including the shares of investment funds) recorded a corresponding rise of 24.9%. The market capitalisation of shares was up the most, primarily as a result of the rising prices of shares, and achieved the value of SIT 1,705.8 bn (27.6% of GDP) at the end of the year. The rise in market capitalisation of bonds was mainly generated by the newly issued bonds. Non-residents' share in the market capitalisation was mostly on a decrease last year, recording its lowest value in the last few years in October (3.8%), which was followed by a slight rise until the end of the year, to 4.5% (5.9% at the end of 2003).

2004 saw an increase in industrial sector indices, with the exception of the food and beverages index. The rises in individual indices that recorded positive returns varied sharply. The oil index, for instance, rose by less than 10% while the transport index surged almost 40%[85]. The rise in the **BIO bond index** totalled 4.1% and was slightly lower than in 2003 but still high, considering that its value has only risen by an average 1.8% at the annual level since 1996.

Turnover on the Ljubljana Stock Exchange picked up in 2004. It amounted to SIT 396.7 bn, which is 16.6% more than in 2003 yet still *close to one-fifth less than the highest value recorded in 2002.* As the share prices were predominantly rising last year, a shift was observed in the turnover structure: the value of turnover in shares rose substantially and accounted for as much as 56.2% of the total turnover on the Ljubljana Stock Exchange (12.3 p.p. more than the year before). The value of turnover in bonds dropped by 12.4% in 2004 year on year and represented around 25% of the total turnover. **Non-residents' turnover** on the stock exchange market amounted to SIT 18.8 bn last year, i.e. over 50% more than the year before. With the low value of turnover the liquidity of securities on the Ljubljana Stock Exchange remains at a low level: the turnover ratios of bonds and shares (defined as the ratio of annual turnover to market capitalisation) totalled 0.17 and 0.10, respectively, in 2004.

[85] This is the highest increase so far, although the index rose by more than 30% in the last three years.

All main indices around the world rose in 2004 albeit their rises were much lower than in 2003, which was probably largely due to the high oil prices. The biggest increase was recorded in the NASDAQ index (up 8.5%) while the smallest rise was registered in the Dow Jones index (up 3.1%). These movements are also reflected in the value of the MSCI World index which was up 4.7% last year. The indices on the Eastern European stock markets grew faster. The CESI index, composed of blue chip shares listed on the Central European stock exchanges (Ljubljana, Budapest, Prague, Warsaw and Bratislava) surged by 65.4% last year.

Following its steady growth from the third quarter 2003 onwards, the main index on the Ljubljana Stock Exchange (SBI20) fell in the first quarter this year. Despite the 4.6% monthly rise recorded in January its value dropped by 0.9%. The market capitalisation of all securities thus recorded only a slight rise as the market capitalisation of bonds gained 5.1% while the market capitalisation of shares fell by 1.9%. The turnover on the Ljubljana Stock Exchange achieved the value of SIT 104.7 bn in the first quarter, recording a 7.7% increase compared with the same period last year.

Performance of banks and savings banks

At the end of 2004 there were 20 banks operating in Slovenia, two of which were branches of foreign banks (the bank in liquidation is not included). A large part of the market is still controlled by large banks; nevertheless their share is decreasing on account of the rapid growth of small banks. The five largest banks held a 66.3% market share at the end of the year, i.e. around 2 p.p. less than in 2003.

Total assets of the banking sector rose by 11.6% last year, which is 0.5 p.p. more than the year before. The volume of banks' assets thus totalled SIT 5,644.7 bn or 91.2% of GDP (88% in 2003). Due to the changed policy of the Bank of Slovenia (see Part II, p. 118), however, the total assets of the banking sector underwent relatively substantial structural changes. The share of debt securities thus fell by 5.4 p.p. to the level of 24% as a result of the drop in the Bank of Slovenia's volume of short-term securities. The bulk of these assets were invested as a long-term deposit at the Bank of Slovenia, hence the volume of loans to the banking sector achieved the highest, namely 44.9%, growth. Their share rose by 2.1 p.p. to 8.9% while their contribution to the increase in total assets of the banking sector amounted to 3 p.p. Some of the banks' liquidity was used for loans granted to the non-banking sector. The share of these loans was up 3.7 p.p. to total 53.9%. In nominal terms they were up 19.8%, which is the largest increase after 1999, and contributed almost 10 p.p. to the growth of the banks' total assets.

The performance of banks improved again in 2004. Bank profits after tax rose for the fourth consecutive year and were 17.3% higher than in 2003. This trend resulted from higher non-interest revenue on one hand, and a lower rise in operating costs (rising just 2.7%, the lowest increase so far) and lower costs of provisions (they dropped by around 5%) on the other. Other indicators also confirm the banks' improved performance: their return on assets this totalled 1.1% (1.0% in 2003) while the return on capital amounted to 14.2%, i.e. 1.7 p.p. more than the year before.

3.7. Medium-term projections until 2010

The Spring Report's medium-term projections are based on calculations of potential economic growth as well as current economic policies and serve as a realistic basis for medium-term planning. The calculations of potential economic growth based on data and trends from the past decade indicate that Slovenia, considering the quality of its available production factors and the existing institutional environment, and assuming that the current economic policies are preserved and the international environment remains stable in the future, can achieve economic growth rates of about 3.8% on average. The Spring Report's medium-term projections therefore represent the most likely or, in other words, the least risky scenario of Slovenia's future development. Hence, they are also the most realistic basis for the medium-term planning of fiscal policy (general government revenue and expenditure) and other economic policies.

Economic growth is projected to remain at a level slightly below 4% in the period from 2007 to 2010. In addition to domestic developments, a stable and supportive international environment will be a prerequisite for achieving such growth since Slovenia, as a small and open economy and an EU member, is strongly integrated with international economic flows. With the stable economic growth, investment activity is expected to continue growing robustly, especially in the areas of private investment, machinery and equipment, and residential construction. Better equipment will have a positive impact on the Slovenian economy's competitiveness and productivity growth which will retain the 3.5% level. This will also enable the slightly faster growth of wages, which are projected to lag behind the growth of labour productivity less than as seen in the last few years (0.5 p.p.). Improved competitiveness will be based on a higher share of high-technology production which will require higher investment in human capital in the private sector as a whole, rather than just a higher share of highly qualified experts in the best-performing enterprises. Bearing in mind that the share of highly qualified employees is already

Table 27: **Forecasts of the main macroeconomic indicators**

Real growth rates (%)

	2007	2008	2009	2010
Gross domestic product	3.8	3.8	3.9	3.9
Labour productivity	3.3	3.5	3.5	3.5
Gross wage per employee	2.8	3.0	2.9	2.9
Exports of goods and services	6.7	6.9	6.6	6.6
Imports of goods and services	6.6	6.6	6.5	6.4
Final consumption (government and private)	2.9	2.9	3.2	3.2
- private consumption	3.0	3.1	3.4	3.4
- government consumption	2.6	2.3	2.5	2.5
Gross fixed capital formation	6.0	5.5	5.0	5.0
Current account deficit (as a % of GDP)	0.7	0.5	0.6	0.7
Current account deficit (as a % of GDP)	2.4	2.4	2.5	2.5
Unemployment rate by ILO (%)	5.9	5.8	5.8	5.7

Source: IMAD forecasts.

high in the public sector, the real wage per employee in the private sector will consequently grow at a faster pace than in the public sector.

Inflation will remain at a level around 2.5% in 2007-2010. Preserving the currently applied economic policies (in the areas of wages, administered prices, taxes and financial markets de-indexation) and keeping the tolar exchange rate stable will enable further cuts in inflation to about 2.3% in 2006. The Maastricht criteria would thereby be fulfilled and Slovenia could adopt the euro in 2007. Gaps in productivity growth between the tradable and non-tradable sectors[86] resulting from structural imbalances will, however, continue to exert an upward pressure on prices. Inflation will thus continue to exceed the EU average. To bring inflation down further it will be necessary to redress these imbalances, primarily in those sectors where prices are state-regulated, and in the operation of financial and labour markets.

Achieving higher economic growth rates that would enable Slovenia's faster catching-up with the average EU level would, however, necessitate more radical changes in development policies. Calculations made during preparation of the Strategy of Slovenia's Development (SSD) indicate that economic growth could be accelerated to a level above 5%, which would enable Slovenia to meet the objective of real convergence, i.e. achieve the average EU level of economic development, in ten years. Such a development breakthrough would require the restructuring of the economy in favour of a stronger services sector (increasing the share of services in the structure of value added to 67% by 2013), where the level of knowledge-based services would grow appreciably faster than the level of other services. Within knowledge-based services, financial, business and telecommunication services would grow at the fastest pace. At the same time, the optimal implementation of measures as set out in the SSD could also spur a development breakthrough in Slovenian manufacturing towards strengthening high-technology and medium-high-technology industries. These industries would come close to a 50% share in manufacturing's total value added while the overall share of manufacturing industries in GDP's production structure will not increase. Similar development breakthroughs were achieved by Finland and Hungary: the latter effected it with foreign direct investment, the former by engaging human capital and through effective and substantial investment in R&D. Therefore, Slovenia should also meet the European objective of investing 3% of GDP in R&D; at the same time it should also raise investment in education. The main concern, however, should be to increase the economic efficiency of these investments enabling higher competitiveness and greater welfare. Such a favourable economic development would also enable the faster growth of employment, hence Slovenia could attain the 70% target population employment rate by 2013.

3.8. Comparison with forecasts made by other institutions

The differences between forecasts made by domestic institutions are small. In the final stage of preparation, the IMAD's spring forecasts were also presented to other forecasting institutions (the Bank of Slovenia's Analysis and Research Centre, the

[86] The so-called Balassa-Samuelson effect, estimated at around 1.0-1.5 p.p. Estimates for other transitional countries are similar.

Table 28: **Comparison of published spring forecasts of economic trends for Slovenia**

Real growth rates (%) unless indicated otherwise

	2005	2006	2005	2006	2005	2006
	Bank of Slovenia		IMAD		European Commission	
GDP	3.9	4.0	3.8	4.1	3.7	4.0
INFLATION (Dec/Dec of the previous year, %)	-	-	2.5	2.3	-	-
INFLATION (Jan-Dec/Jan-Dec annual average, %)	2.5	2.5	2.5	2.3	2.5	2.5
EXPORTS OF GOODS AND SERVICES	6.7	7.3	7.5	7.9	8.0	7.5
IMPORTS OF GOODS AND SERVICES	7.2	6.8	6.5	6.6	8.2	7.6
Current account BALANCE (% of GDP)	-1.6	-1.3	-0.9	0.2	-1.0	-0.8
GROSS CAPITAL FORMATION	7.0	6.0	3.3	4.1	-	-
GROSS FIXED CAPITAL FORMATION	-	-	6.7	4.9	5.9	6.3
PRIVATE CONSUMPTION	3.5	3.2	3.4	3.1	3.5	3.3
GOVERNMENT CONSUMPTION	2.4	2.1	2.5	2.5	3.0	3.2
EMPLOYMENT according to the SNA (% growth)	0.6	0.3	0.4	0.5	0.1	0.2
UNEMPLOYMENT RATE BY ILO (%)	-	-	6.2	6.0	5.9	5.6

Sources: BS, IMAD, EC.

Department of Economic Analysis and Economic Policy (DEAEP) at the Chamber of Commerce and Industry (CCI)) and compared with the results of the model of leading indicators developed by the School of Business and Economics (EPF) at the University of Maribor (see Box 2 on p. 54). The expectations of these institutions, despite the fact that some of them had not released their official forecasts by that time, were similar: a softening of economic growth is expected this year compared with 2004, followed by a slight acceleration in 2006. Inflation forecasts, projecting a further lowering of inflation, are essentially identical. The EPF's econometric model, like the IMAD's forecast, projects a slowdown in industrial activity until the end of the year, followed by an acceleration at the beginning of 2006, although the IMAD expects a slightly stronger deceleration.

During preparation of the Spring Report 2005, forecasts for Slovenia were released by the ***European Commission*** *(EC), the* ***International Monetary Fund*** *(IMF) and the* ***Bank of Slovenia*** *(BS).* Compared with the IMAD's forecast, the EC expects higher inflation next year (see the Table 28). The second substantial deviation concerns the dynamics in international trade: while the EC projects slightly higher export growth it also expects it to slow down next year, in contrast to the IMAD. Import growth should record similar trends according to the EC's forecast whose upward deviation from the IMAD's forecast is even bigger. According to the EC, the level of the current account deficit recorded this year will thus be preserved in 2006.

The **IMF**'s forecasts (World Economic Outlook) are slightly more optimistic than others, projecting 4% economic growth both this and next year. This growth will be underpinned by domestic demand to an even greater extent than projected by other forecasts since the IMF expects a higher current account deficit this year (1.4% of GDP) which will, contrary to other forecasts, widen further next year (to 2.2%). On the other hand, the IMF projects an even faster lowering of inflation: it should drop to 2.3% in 2005 and 2.0% in 2006 (on average).

Similarly to the EC's and IMF's forecasts, the **BS** expects economic growth in 2005 to be driven by domestic spending while external trade's contribution to growth is projected to be negative in 2005 and neutral in 2006 (contrary to the other two forecasts, according to which a negative contribution is also expected in 2006). The current account deficit forecast is consequently appreciably higher; in 2006 the deficit is expected to narrow only slightly. According to the BS, inflation should remain at the level of 2.5% next year (see the table above).

A forecast of economic growth was also prepared by the DEAEP at the Slovenian **Chamber of Commerce and Industry** in May. It projects economic growth at the level of 4% in both years; compared with the IMAD's forecast, however, the DEAEP expects slightly more balanced import and export growth rates and somewhat more lively investment activity. The DEAEP's forecast of the expected dynamics in wages this year is in line with the IMAD's forecast, while being slightly more reserved for next year. The DEAEP projects an average annual inflation rate of 2.9% this year and 2.3% in 2006.

The **Economic Institute of the Faculty of Law (EIFL)**, which publishes its forecasts solely on the subscribers' website of the ISI Emerging Markets[87] company, projects 3.8% economic growth for this year, followed by a stronger acceleration to 4.4% in 2006. The EIFL's forecast of the current account deficit is the highest among all forecasts (1.9% of GDP in 2005 and 1.6% of GDP in 2006), while its inflation forecast is, similarly to the DEAEP, slightly higher for this year (2.8%) and slightly lower for next year (2.2%) compared with other institutions.

[87] http://www.securities.com/macro/editor.html?pc=SI&view

Part II

Effects of Slovenia's accession to the EU on economic trends in 2004

1. Main findings

Slovenia became a full member of the European Union (EU) on 1 May 2004. Generally speaking, the situation since then has not changed dramatically for the majority of economic subjects – the accession did not lead to a structural break, hence its estimated aggregate effect was relatively small. To a large extent, the Slovenian economy and especially its tradable sector had already adapted to the demands of the common market in the pre-accession process. Moreover, most changes that took place in the Slovenian economy over the last few years were also part of the transition and restructuring process and can hardly be solely attributed to compliance with the EU's requirements.

Nevertheless, the first assessment of the effects of EU accession on economic trends in 2004 can be made after one year of Slovenia's membership in the EU. The economic effects of the accession can be considered from several angles. The harmonisation of Slovenian economic legislation with the EU's legal order, which had already played an important role in Slovenia's integration with the common market in the pre-accession process, is certainly an important effect of the accession. In the long run, EU membership is significant for its expected positive impact on economic growth which will, however, depend on Slovenia's ability to seize its development opportunities arising from full EU membership. The common market and later on the common currency area certainly offer possibilities for increased international trade, the transfer of technologies and easier access to knowledge and resources. This analysis mainly focuses on estimating the effects of Slovenia's accession to the EU that impacted on movements in macroeconomic aggregates and economic activity in certain sectors already in 2004.

In a more detailed analysis, these effects were divided into direct and indirect ones both of which are characteristically closely intertwined with the effects of other factors underpinning economic trends in 2004 (see Chapter 1 on p. 17). Hence it is often difficult to precisely specify and quantify their impact. The three main direct effects are the change of the foreign trade regime, participation in the Exchange Rate Mechanism ERM II and the consequences for general government revenue and expenditure. A special sub-group involves one-off effects linked mainly to adoption of the common trade policy and the changed regulations on VAT collection, which in addition to their long-term impact on VAT evasion also caused liquidity shortfalls in tax revenue from this source in 2004. The indirect effects of entering the EU on economic developments have been present for a longer period and can be observed in a number of areas. Both categories of effects are presented below in greater detail.

Direct effects. First, adoption of the EU's common trade policy affected the regional structure of external trade (increase in trade with the EU, falls in exports to BiH and Macedonia), the volume of trade in agricultural products (a fall in exports and an increase in imports), food prices and revenues from customs duties in the budget (the latter dropped by about SIT 15 bn). It also simplified the operating conditions by lifting customs formalities. With regard to the increased exposure to competition, entry to the EU brought no major changes for most exporters. The potential negative effects of entering the EU's customs union (trade diversion[88]) were thus substantially reduced. Effects arising from the abolition of customs protection on the bulk of agro-food products upon entry to the EU were somewhat stronger and influenced the structure of trade in these products and consequently production activity in the food-processing industry (a 6.8% drop in 2004). The latter was additionally affected by the expiry of free-trade agreements with the countries of former Yugoslavia resulting in the raising of customs duties on Slovenian agro-food products which represent a significant share of exports to these markets. *Second*, the possibility of an early entry to the ERM II is also regarded as a direct effect of EU membership that was used by Slovenia in the first round at the end of June, which led to changes in its monetary and exchange rate policies. The direct effect of entering the ERM II was the exchange rate's stabilisation and its favourable impact on inflation, whereas for policy-makers it primarily meant a commitment to continue and enhance the co-ordinated implementation of macroeconomic policies and create the conditions to join the EMU. *Third*, EU membership brought about changes in Slovenia's obligations regarding payments to the EU budget and disbursements from it, which affected the volume of general government revenue (receipts from the EU budget totalled SIT 44 bn) and expenditure (payments to the EU budget amounted to SIT 40.6 bn). *Fourth*, the special sub-group of direct effects comprises one-off effects that primarily affected the dynamics of import-export flows and the payments of value-added tax into the budget during the year (liquidity shortfall; also see p. 78). Their overall impact at the annual level, especially on export-import flows, was relatively small; due to last year's changed dynamics, however, they will also affect the year-on-year growth dynamics this year.

Indirect effects. Indirect effects of Slovenia's entry to the EU comprise a number of changes in different areas that have been underway for a long time, starting in the accession process, which are further intertwined with the restructuring process that would have taken place regardless of Slovenia's EU membership. These changes mainly include shifts in the structure of manufacturing industries, the national agricultural policy reform, the harmonisation of excise duties on tobacco products that affected their price dynamics, and the structure and dynamism of employment in the public sector. Further significant indirect effects include the liberalisation of trade with the EU after 1997 and the gradual phasing out of capital restrictions following enforcement of the EU Association Agreement in 1999, which enabled the Slovenian economy to start participating equally in European economic and financial flows even before Slovenia formally became an EU member. Due to its longer-lasting effect, the lowering of interest rates may also be regarded as an indirect effect: although primarily linked to the expected entry to the ERM II it had already begun in 2003, stimulating the banks' credit activity and the consequent increase in domestic consumption which, however, did not exceed expectations.

Accession to the EU also involved some macroeconomic risks yet they did not materialise in 2004. The first risk was a substantial and rapid decline of competitiveness in labour-intensive industries in 2004 which would have translated into the lower growth of domestic output and higher unemployment. The second risk was associated with the accelerated growth of domestic consumption due to the

[88] Similarly, analyses of earlier EU enlargements show that the trade creation effect was much more significant than the trade diversion effect (except in trade in agricultural products) (Ješovnik, 2003, p. 12).

lowering of nominal interest rates after joining the ERM II, which could have triggered macroeconomic imbalances in external trade and inflation. Yet the figures on production and employment in labour-intensive industries for 2004 indicate that the risk of a faster fall in their competitiveness did not materialise, as the trends, although unfavourable, were in line with the baseline scenario projections (Spring Report 2004 and Autumn Report 2004). Concerning the risk of the strongly accelerated growth of domestic consumption, the figures for 2004 indicate that this risk did not materialise either – the movements were in line with the expectations.

A detailed analysis of the effects of Slovenia's entry to the EU is presented below. It is divided into the following areas: (i) *changes in the foreign trade regime*, where we discuss their impacts on the trade's regional structure and partly the structure of traded goods, and the dynamics of market shares; (ii) *the effects of EU membership on manufacturing industries*, including the dynamics of employment, on *agriculture, transport and tourism*; (iii) *entry to the ERM II*, including the analysis of changed monetary policy, the impact of EU and ERM II membership on inflation and price competitiveness, and the impact on the banks' lending activity, savings and the growth of private consumption stemming from changes in interest rates; (iv*) the effects of EU membership on general government revenue and expenditure*, both indirect and direct; and (v) *the impact on the foreign direct investment flows (FDI)*, where we observe that the FDI inflows did not increase after accession which was broadly in line with the expectations since these effects usually only surface after a longer period.

1.1. Changes in the foreign trade regime

Slovenia's entry to the EU in May 2004 brought about changes to the foreign trade regime as the Slovenian market became part of the EU's internal market and Slovenia adopted the EU's common trade policy as one of the key areas in which national powers are transferred to the transnational level. The adoption of the common trade policy includes all trade agreements concluded between the EU and third countries by that day. The main agreements for Slovenia are the two stabilisation and accession agreements with Croatia and Macedonia and the European agreements with Romania and Bulgaria, in addition to the Euro-Mediterranean and other agreements[89]. For Slovenia, the adoption of the EU's foreign trade regime on 1 May 2004 not only meant the application of the EU's common customs tariff and liberalisation of trade in sensitive products, but also the abolition of border controls and formalities and consequently lower trading costs. The changed regime also affected the level of budget revenue from customs duties (this is dealt with in greater depth in the chapter on the effects of EU membership on general government revenue and expenditure, p. 122).

The beginnings of trade liberalisation between Slovenia and the EU actually date back to the association agreement signed by Slovenia and the EU in 1996. Membership itself therefore did not bring about any drastic changes in the form of a structural break in international trade. The regional restructuring of Slovenian

[89] Slovenia is participating in negotiations on trade agreements to be concluded with the Mercosur countries, the Gulf countries, Albania and some other states conducted by the European Commission on behalf of the EU.

Table 29: **The EU's shares in Slovenian exports and imports in 1996-2004 (%)**

	1996	1997	1998	1999	2000	2001	2002	2003	2004*
EXPORTS									
EU 15	64.6	63.6	65.5	66.1	63.9	62.2	59.3	58.4	-
EU 10	5.4	5.7	6.0	6.8	7.4	7.3	8.0	8.5	-
EU 25	**70.0**	**69.3**	**71.5**	**72.9**	**71.3**	**69.6**	**67.3**	**66.9**	**66.1**
IMPORTS									
EU15	67.6	67.4	69.4	68.6	67.8	67.6	68.0	67.3	-
EU 10	6.5	7.3	6.7	7.6	8.1	8.4	8.3	8.4	-
EU 25	**74.1**	**74.7**	**76.1**	**76.2**	**75.9**	**76.1**	**76.3**	**75.6**	**82.2**

Source: SORS.
Note: *The calculation of shares is based on revised aggregate data on exports and imports in 2004 (SORS, 31.03.05); more detailed data were not available at the time when the analysis was being prepared.

foreign trade began in the early 1990s when Slovenia lost the Yugoslav market. Prior to enforcement of the association agreement between Slovenia and the EU on 1 February 1999, trade between the signatories was based on a temporary agreement that entered into force in 1997. Thereby customs duties and quotas on exports of Slovenian industrial products to the EU were lifted on 1 January 1997 (for some specified products on 1 January 2000). In Slovenia's merchandise imports from the EU, customs duties on goods not manufactured in Slovenia were lifted on 1 January 1997. Customs duties on other products were reduced gradually by 1 January 2001[90]. In trade with agricultural products, which are some of the most sensitive commodities, no major concessions were agreed. Most import duties on sensitive agro-food products from the EU were not lifted before Slovenia's accession. Similarly, free-trade agreements between Slovenia and most other new member states already existed prior to accession (except with Cyprus and Malta, yet these two countries accounted for just 0.04% of total exports and 0.1% of total imports in 2004). On the basis of these agreements, customs duties on industrial products and some agricultural products were mutually abolished. The share of Slovenia's trade with the EU in its total merchandise trade thus achieved relatively high levels even before Slovenia's entry to the Union (69% of exports and 76% of imports, average for 1996-2004). No major changes were therefore expected after the accession. After 2000, the share of Slovenia's exports to the EU declined while the share of imports hovered around the average, recording a pick-up in 2004. In the entire period the shares of new member states in both exports and imports recorded a relative increase.

The analysis of the regional structure of export-import developments recorded before and after Slovenia joined the EU reveals certain shifts which can, however, not be attributed solely to the changes in the foreign trade regime. Simpler operating terms resulting from the abolition of customs formalities and Slovenia's greater visibility, especially in countries where trade with Slovenia used to be relatively modest, had a favourable impact on the increase in trade with the EU. To a limited extent, the expiry of free-trade agreements upon accession impacted on the lowering of exports

[90] Two separate protocols regulated the trade in iron and steel, and textiles (exports of Slovenian products were liberalised while customs duties on imports of goods from the EU to Slovenia were lifted on 1 January 2001).

to the markets of former Yugoslavia. However, the monthly dynamics of total exports and imports in 2004 was also driven by several other factors, primarily last year's performance in Slovenia's trading partners, alongside some other reasons unrelated to Slovenia's EU membership[91].

The available figures on trade between Slovenia and the EU in 2004 indicate that after Slovenia joined the EU its exports to the old member states rose relatively faster than exports to the new member states. This was chiefly the result of the accelerated growth of exports to France (on the back of increased car exports from Revoz, which was not directly affected by the accession) and Italy; apart from that, export growth to several old EU members that were not Slovenia's traditional trading partners in the past (Greece, Belgium, Denmark, Ireland, Sweden and Portugal) grew robustly throughout the year, which was probably partly due to Slovenia's full membership in the EU. Export growth to new member states slowed down, mainly on account of the slower rise in exports to Poland, Slovakia and the Baltic states.

The adoption of the EU's foreign trade regime had a direct effect especially on exports to Macedonia and BiH since the free-trade agreements with these two countries were abolished after the accession. The expiry of the free-trade agreement with Croatia, on the other hand, had no significant impact on Slovenian exports to Croatia as most of the trade between the EU and Croatia is already liberalised. The rise in exports to BiH was modest throughout 2004 (3.5%) while exports to Macedonia even fell (-2.6%); the monthly dynamics of exports to both countries were, however, strongly affected by the abolition of free-trade agreements when Slovenia became a member of the EU. Therefore, robust export growth rates were achieved in the first four months (mainly in food and beverages, leather, wood and paper products, and electrical machinery), only to drop rapidly after May 2004. In contrast, the abolition of the free-trade agreement had no pronounced effect on exports to Croatia thanks to the interim trade agreement concluded between Croatia and the EU whereby most imports of industrial products from the EU, which predominate in Slovenia's exports to Croatia, have been exempt from customs duties since the beginning of 2004. Even though Macedonia concluded a stabilisation and association agreement with the EU, the impact of adopting the EU's common trade policy on Slovenian exports to Macedonia was more noticeable. The reason is that a relatively bigger share in exports to Macedonia comprises agro-food products subject to customs duties on imports from Slovenia which have mostly been changed since 1 May 2004. BiH still has no stabilisation and association agreement concluded with the EU, therefore Slovenian exporters have been facing full customs duties on their exports to this market since Slovenia's entry to the EU. However, in the estimate of the Ministry of the Economy[92], this effect is relatively small because these customs duties are basically low. Therefore, while the estimated overall effect of the abolition of free-trade agreements on the growth in total exports was relatively small it had a

[91] In case of the USA, for instance, where Slovenia's accession to the EU also had no impact on the trade dynamics (the regime remained the same), the fall in the year-on-year rate of Slovenian imports in the period from May to November was largely due to fuel elements for the nuclear power plant being imported in different months in 2003 (May) and 2004 (April).

[92] European Union and the Western Balkan countries: Analysis of the Stabilisation and Association Agreements and Autonomous EU Trade Measures for Countries Participating in the Stabilisation and Association Process. (2004). Ljubljana: Ministry of the Economy.

Table 30: **Export growth (in EUR) by countries and groups of countries before and after Slovenia's membership in the EU (year-on-year rates in %)***

	Share in total exports (2004, %)	EXPORTS		
		Jan-April 2004/ Jan-April 2003	May-Dec 2004/ May-Dec 2003	Jan-Dec 2004/ Jan-Dec 2003
Austria	7.4	20.9	8.3	12.5
Belgium	1.1	43.9	49.4	47.8
Denmark	1.0	19.3	23.2	21.9
Finland	0.2	6.9	6.0	6.3
France	6.4	-4.2	41.7	25.6
Greece	0.5	89.6	41.3	56.4
Ireland	0.2	51.3	-1.1	14.2
Italy	12.9	-4.7	17.9	9.6
Luxembourg	0.3	23.3	36.3	31.8
Germany	21.3	3.6	2.0	2.5
Netherlands	1.5	-6.4	-6.3	-6.3
Portugal	0.2	12.2	14.7	13.9
Spain	1.5	51.5	3.4	15.9
Sweden	1.0	13.7	15.6	15.0
UK	2.2	-3.0	19.7	11.3
EU 15	**57.7**	**4.8**	**12.2**	**9.6**
Cyprus	0.0	21.5	136.5	86.2
Estonia	0.1	53.8	13.8	25.1
Latvia	0.1	101.8	-38.5	-2.9
Lithuania	0.2	2.2	-13.0	-8.1
Malta	0.0	-17.5	-14.4	-15.6
Czech Republic	1.9	13.7	17.1	16.0
Hungary	1.9	11.0	7.9	8.8
Poland	2.7	14.4	4.5	7.6
Slovakia	1.3	17.7	-1.4	4.4
EU 10**	**8.3**	**14.9**	**5.9**	**8.7**
EU 25**	**66.1**	**6.0**	**11.4**	**9.5**
Bosnia & Herzegovina	3.9	20.2	-3.5	3.9
Croatia	9.3	13.2	16.7	15.6
Macedonia	1.1	28.6	-15.2	-2.6
Serbia & Montenegro	3.6	16.9	36.9	31.3
Former Yugoslav states	**17.9**	**16.6**	**13.2**	**14.3**
Russia	3.3	14.5	23.0	20.6
USA	3.2	-9.5	1.2	-2.7
Other countries	**9.6**	**16.8**	**20.1**	**19.0**
TOTAL EXPORTS	**100.0**	**8.2**	**12.5**	**11.1**

Source: SORS.
Notes: *The preliminary figures on the regional structure of exports in 2004 in Table 30 are not yet fully harmonised with the revised aggregate data on goods exports in 2004 (SORS, 31.03.05). There are differences in the index of export growth to the EU-25, which is 0.7 p.p. higher according to a later release. On the import side, the differences are much bigger, hence the regional structure of imports is not shown in the table; **excluding Slovenia.

Table 31: **International trade in agro-food products, 2003 and 2004**

	2003		2004		2004/2003	
	Exports EUR m	Imports EUR m	Exports EUR m	Imports EUR m	Exports growth in %	Imports growth in %
01 Live animals	3.6	6.1	2.9	11.8	-20	93
02 Meat and edible meat offal	28.2	49.9	30.2	64.7	7	29
03 Fish, crustaceans	1.0	22.3	1.4	24.0	44	8
04 Dairy products, eggs, honey	48.6	17.4	50.8	25.8	5	48
05 Animal products	0.2	4.0	0.4	4.1	96	2
06 Live trees, bulbs, cut flowers	2.3	25.5	2.8	24.8	23	-3
07 Edible vegetables	1.2	49.8	1.4	53.5	14	7
08 Edible fruit	8.7	71.8	6.4	76.9	-26	7
09 Coffee, tea, spices	2.0	15.5	1.8	17.1	-7	11
10 Cereals	1.8	52.1	2.4	60.9	31	17
11 Products of the milling indus.	1.4	22.1	1.4	19.3	1	-13
12 Oil seeds and fruits	11.5	11.3	12.8	15.1	11	34
14 Vegetable plaiting materials	0.1	0.4	0.1	0.3	-2	-11
15 Fats and oils	7.3	41.6	6.0	38.7	-17	-7
16 Meat preparations	47.9	15.3	46.7	18.2	-3	18
17 Sugars and confectionery	13.3	29.5	18.8	35.0	42	19
18 Cocoa and preparations	6.3	43.9	8.4	47.4	33	8
19 Prep. of cereals, flour, starch	19.9	53.3	20.3	58.2	2	9
20 Prep. of vegetables, fruit	14.0	44.0	13.1	42.9	-6	-2
21 Miscellaneous edible prep.	24.8	63.3	24.3	65.9	-2	4
22 Beverages, spirits, vinegar	123.8	34.7	77.8	44.0	-37	27
23 Residues and waste, fodder	12.5	62.7	13.5	67.0	8	7
24 Tobacco	19.7	29.8	8.0	44.7	-59	50
Total 01-24	403.2	772.9	353.5	866.1	-12	12

Note: Agro-food products are classified in groups 1-24 in the combined nomenclature of the customs tariff. Figures for 2004 are provisional.

comparatively stronger impact on those sectors that are highly dependent on exports to these markets (notably the food industry; further details are given in the following chapter).

On the import side, a strengthening in year-on-year growth rates was also observed. The two most manifest direct effects of EU membership that especially impacted on the monthly dynamics of imports were, first, the strong increase in imports from Russia prior to accession (especially imports of aluminium that were subject to zero customs duty until 1 May 2004 whereas a 6% rate applies thereafter) and, second, the postponement of merchandise imports from the EU-25 until after the entry to the EU due to the more favourable VAT payment regulations, which also contributed to the robust growth of imports from the EU-25 after Slovenia became a full member. Apart from that, the faster increase in total imports seen after the accession was also driven by the rise in domestic consumption and exports in this period.

Due to the similar external trade structure in Slovenia and the EU[93], Slovenia's entry to the EU did not have a pronounced direct effect on the structure of goods in trade. More perceptible effects of the accession were observed mainly in international trade in agro-food products. Imports of these products rose while their exports dropped. In 2004, total trade in these products rose by 3.7%. Their overall imports were up 12.1%; notable rises in the import value of the main import commodities were seen especially in the groups dairy products and eggs, meat, meat preparations, and beverages (up 48%, 29%, 18% and 27%, respectively). Exports, on the other hand, dropped by 12.3%, particularly in the group beverages (37%), and somewhat in meat preparations (3%), while exports of dairy products and eggs increased (by 5%). As indicated by changes in the structure of merchandise trade with different groups of countries, these dynamics were the result of the changed foreign trade regime. Exports to the markets of former Yugoslavia fell by 15% due to the abolition of free-trade agreements and a large share of export subsidies. Exports to the EU-15 markets fell less markedly (by 4%) while imports from these countries, which are Slovenia's main partners in its imports of agro-food products, rose by more than 25%. The change in the relative burden on imports of agro-food products has therefore had a certain effect on the reorientation of these imports from other countries towards EU member states. Nevertheless this was not a major structural change since Slovenia used to import around 90% of agricultural products and around 80% of food products from the EU-25 even before it became a member.

Market shares

The change in the foreign trade regime upon Slovenia's entry to the EU had a limited impact on the growth of Slovenia's market shares in its main export markets in 2004 since the changes in market shares were largely generated by the increase in Slovenian export flows (which were relatively more influenced by other factors of the international environment) and the growth of the total import dynamics in the main trading partners. The slower growth of Slovenia's market share in the EU-25 internal market after the accession was probably partly due to the accelerated increase in imports in Slovenia's main trading partners within the EU, as well as to Slovenia's limited supplies. A similar development was seen in 1999-2000 when import demand in the EU-25 was above the average level and Slovenia recorded falls in its market shares in these markets.

Considering that the liberalisation process in Slovenian foreign trade began years before Slovenia joined the EU, it is also reasonable to estimate the changes in the market shares over a slightly longer period. In the four-year period before Slovenia entered the EU, its market share in the markets of its main EU trading partners (i.e. the EU-12) fell slightly, primarily due to the fall in Slovenia's share in the German

[93] A comparison of Slovenia's and EU-15's export structures in the two-digit SITC classification done in 1995, i.e. before the trade agreement entered into force, already revealed a close correspondence between the two. The correlation coefficient between the export structures of Slovenia and the EU-12 totals 68, which is close to the value of the Netherlands (66) and much higher than the correlation coefficients of Greece (18), Portugal (44), Ireland (34) or Denmark (36). At the same time, Slovenia correlates closely with some advanced EU countries, e.g. Italy (75), Germany (65), France (61), and Belgium and Luxembourg (both 62). Among the transitional countries only the Czech Republic has a similarly high correlation (64) while other countries lag further behind (Ješovnik, 2003, pp. 15-16).

Table 32: **Increase in Slovenia's market shares in its main EU trading partners (annual rates, %)**

	2000	2001	2002	2003	2000-2003	2004	Jan-April 2004	May-Dec 2004
Total 15*	**-6.4**	**4.4**	**5.7**	**0.0**	**0.8**	**1.7**	**2.5**	**1.3**
EU 12	**-5.4**	**1.6**	**3.7**	**-0.3**	**-0.2**	**0.4**	**1.4**	**-0.1**
Germany	-13.7	4.6	4.7	-6.7	-3.1	-4.9	1.3	-7.9
Italy	-6.3	-2.0	3.5	11.0	1.3	3.7	-3.4	8.0
France	17.9	4.6	10.2	-14.2	3.9	18.7	-3.4	29.6
Austria	4.4	1.9	0.7	0.6	1.9	4.6	13.9	-0.1
Netherlands	-0.6	6.6	6.4	6.9	4.8	-14.5	-7.9	-17.5
Belgium	-31.8	1.7	-17.6	-2.8	-13.7	33.7	36.2	32.2
Spain	-3.7	8.0	14.4	34.0	12.3	6.8	47.0	-6.9
UK	3.9	42.8	-6.0	-0.5	8.5	4.2	-7.8	11.3
Czech Republic	-14.6	-2.7	0.8	-4.1	-5.3	-3.5	2.0	-5.8
Slovakia	0.7	2.7	33.2	8.1	10.5	-12.4	0.4	-17.7
Hungary	1.5	-11.3	5.2	7.5	0.5	-4.9	-2.4	-6.0
Poland	11.0	4.8	7.6	-1.1	5.5	-9.5	-4.1	-11.8

Sources: SORS, Eurostat, WIIW, US Census Bureau.
Note: *including USA, Croatia and Russia.

market. The developments in the EU-12 market can be summed up by three main findings: (1) Slovenia's market position in its main export markets in the euro area (France, Italy, Austria) improved moderately, except in the German market; (2) Slovenia's market shares in the hitherto less important EU markets increased, both in those markets included in the calculation of Slovenia's aggregate market share (the UK, the Netherlands, Spain) as well as in those not included (Luxembourg, Ireland, Portugal, Sweden, Finland, and also Greece)[94]; and (3) Slovenia's market position in important new export markets within the EU improved (notably in Slovakia and Poland).

After the slight average fall in 2000-2003, 2004 recorded a modest increase in Slovenia's market share in the markets of Slovenia's main trading partners in the EU-12 (with the exception of Germany where Slovenia's market share dropped). Tables 32 and 33 indicate Slovenia's market shares in its main partners before and after Slovenia's membership. The figures also provide a relatively good picture of the export dynamics in this period. However, one-sided conclusions based on these data may be misleading since a number of factors underlying market share growth during that time were unrelated to the accession. Therefore, an analysis of the market share dynamics for 2004 as a whole is more appropriate here. Such analysis reveals a further strengthening of Slovenia's market shares in the French and Austrian markets and the hitherto less important EU markets on one hand, and a drop in Slovenia's market share in Germany and new EU member states on the other.

[94] The criterion for the inclusion of trading partners in the calculation of Slovenia's aggregate share is that the partner state had a 1% share in Slovenia's total merchandise exports in 2000-2003. Of all trading partners within the EU there were 12 such countries in the analysed period (see Table 32). The shares of other EU countries in Slovenia's total merchandise exports totalled less than 1%, hence they are not included in the calculation.

Table 33: **Increase in the market shares of new EU member states in global and EU 25 markets**

Annual growth rates, %	The world	EU 25*			
	2000-2003	2000-2003	2004	Jan-April 2004	May-Dec 2004
Slovenia	3.2	0.9	1.8	2.8	1.4
Czech Republic	9.0	8.4	15.8	14.3	16.4
Estonia	8.9	8.1	9.5	13.1	7.7
Cyprus	-8.4	-2.7	-	7.7	-
Latvia	6.2	6.7	11.0	14.9	9.2
Lithuania	16.3	12.9	18.8	10.3	21.8
Hungary	6.6	6.4	3.8	8.6	1.5
Malta	-1.5	-3.8	-4.0	-3.9	-4.0
Poland	10.3	10.4	13.6	19.0	11.1
Slovakia	12.9	11.5	6.5	12.2	3.8

Source: Eurostat Newcronos.
Note: *market shares are calculated as export shares of the analysed EU-25 countries in total EU 25 imports (internal and external).

In 2004 the annual growth of Slovenia's market share in the internal EU-25 market was again the lowest among the new member states (both before and after the accession), the only exception being Malta whose market share in the EU-25 internal market continued to drop[95]. These trends point to Slovenia's relatively poorer export competitiveness in comparison with the new EU member states.

1.2. Effects of EU membership on manufacturing, agriculture, transport and tourism

Manufacturing industries

Full EU membership has brought no major novelties for the Slovenian manufacturing sector as a whole. The institutional changes of foreign trade regimes linked to the accession have not significantly affected the operating conditions in manufacturing. Its economic activity in 2004, bearing in mind that this is the most export-oriented sector of the Slovenian economy, was largely influenced by the favourable economic trends in Slovenia's main trading partners.

The effects of EU membership on manufacturing were partial and surfaced only in some sub-industries. To identify the partial effects on the level of economic activity after Slovenia's entry to the EU's internal market, it is reasonable to disaggregate the entire manufacturing sector according to the NACE Rev. 1 and to first analyse its 14 sub-industries separately and then, based on business results, join them in 4 larger groups[96].

[95] Figures for Cyprus for 2004 are not available as yet; in the period from 2000 to 2003, however, Cyprus's market share in the EU-25 market was falling.

[96] It is difficult to classify the wood-processing sub-industry (DD) in any of these groups, despite the improved products and export results in 2004. The business results here were highly variable in the last five-year period.

- *The first group comprises those industries that increased their production volumes and export activities throughout the accession period,* and have maintained similar production and export dynamics since Slovenia's formal accession. This group includes the manufacture of chemicals and chemical products (DG), metals and metal products (DJ), electrical and optical equipment (DL), and conditionally also the manufacture of rubber and plastic products (DH) which generally recorded an improving trend in its business results with only minor deviations. With the exception of the latter, these sub-industries can be classified in the group of high- and medium-technology industries according to the OECD methodology[97].

- *The sub-industries classified in the second group have raised their levels of production and export activity in the period since Slovenia joined the EU.* These include the manufacture of pulp, paper, and publishing (DE), other non-metal mineral products (DI), machinery and equipment (DK) and transport equipment (DM). Still, the accelerated growth of economic activity in these industries, taking into account their growth dynamics in production levels and export flows in the past five-year period, can hardly be attributed exclusively to Slovenia's accession to the EU. It is very likely that this effect is closely intertwined with the higher increase in domestic consumption, and favourable impulses from the international environment that stimulated export growth in the mentioned sub-industries in the second and third quarters.

- *The third group includes some labour-intensive industries that were most seriously affected by the process of Slovenia's integration into the internal EU market due to their structural maladjustment, and the accession did not substantially change their situation.* These sub-industries, employing low-skilled workers and low-technology working processes, have been facing structural problems and faltering competitiveness for a longer period. The main industries in the group are the manufacture of textiles and textile products (DB), leather and leather products (DB)[98], and the manufacture of furniture, other manufacturing and recycling industries (DN). The manufacture of coke, petroleum products and nuclear fuel (DF), although a capital-intensive industry, also faces similar structural problems.

- *Highly negative impacts on economic activity since Slovenia's entry to the EU were observed in the manufacture of food, beverages and tobacco products (DA).* In 2004 as a whole, production volumes in this industry fell by 6.8% over the previous year (from May to December the year-on-year drop was even bigger, 9.1%), while the first four months of 2004 they still recorded a 0.1% year-on-year rise. Within the food-processing industry, the most strongly affected sectors were the manufacture of milk and dairy products, and the manufacture of

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Usually, a year in which production volumes and exports increased was followed by a year in which economic activity declined. In 2004, for example, the production volume increased by 4.0% following a 3.5% drop in 2003, while exports in 2004 exceeded the 2003 level by 0.7%.

[97] For more information, see Hatzichronoglou (1997).

[98] We expect that certain additional negative effects on production and export activity levels in the textile industry will surface as late as 2005 and 2006, particularly because of trade liberalisation after 1 January 2005 stipulated by the WTO regulations.

beverages. Similar trends were observed in exports. In 2004, the value of exports (expressed in euros) in the manufacture of food, beverages and tobacco products (DA) dropped by 13.8% (in the period from May to December 2004 even by 23.3%), while the period from January to April 2004 still recorded a 8.1% year-on-year increase. The latter was chiefly driven by April's 'stocking up on exports' – the value of exports expressed in euros surged by 37.3% over the same month of 2003 after recording negative year-on-year growth in January, February and March. With this large one-off contingent of exported goods, companies in this industry tried to at least partly compensate for the anticipated drop in export activity resulting from the changed foreign trade regime with countries of former Yugoslavia in force from 1 May 2005.

Employment in the manufacturing industries

The effect of Slovenia's membership in the EU on employment is generally difficult to discern and even harder to quantify since the available data also reflect long-term processes on one hand and seasonal developments on the other. Nevertheless, in manufacturing's sub-industries and some major sectors the effects of the accession could already be seen in 2004: *negative effects* were mainly observed in the food-processing industry, while *positive impacts* were recorded in the manufacture of transport equipment, rubber and plastic products, metal industry and the manufacture of furniture. The positive effects were further helped by other factors, notably the robust export activity of those industries driven by the dynamics seen in export markets. Although employment also dropped in the textile industry (particularly the manufacture of textiles), leather industry, wood processing, publishing, printing and paper industries, this cannot be simply attributed to the direct effects of the accession since those industries face problems related to their sluggish restructuring. It is also difficult to ascribe the drop in employment observed in the chemical and, within that the pharmaceutical industry, to EU membership since these industries count as propulsive – their year-on-year export growth has picked up slightly more since the accession.

The actual dynamics of the levels of production and employment in the manufacturing industries recorded in 2004 generally confirm the results of macroeconomic model analysis (see Spring Report 2004, p. 131) that was used to evaluate the consequences of exogenous changes in the competitiveness of the Slovenian economy resulting from the changed foreign trade regime, especially for the less cost-effective sectors and their employment. The analysis of past structural changes in foreign trade already showed that similar reductions in the degree of protectionism (concluding the free-trade agreement with the EU, joining the CEFTA free-trade area, signing trade agreements with ex-Yugoslav republics) did not affect the Slovenian economy in such a way that increased exposure to foreign competition would cause simultaneous drops in demand and employment. On the basis of this evidence, we also assumed that the likelihood of any stronger negative macroeconomic effects of EU membership and the adoption of the common trade policy on the Slovenian economy was low, which proved to be an accurate assumption. Difficulties facing the textile, footwear and leather industries are mainly linked to the economy's sluggish restructuring in the past decade rather than EU membership. The food-processing industry is in a similar position, with the distinction that it used to be the most

Table 34: **Employment growth rates in manufacturing sub-industries, 2000-2004 (%)**

	1999	2000	2001	2002	2003	2004	2004 Q1/Q4	2004 Q2/Q1	2004 Q3/Q2	2004 Q4/Q3
Manufacturing sub-industries										
DA. Manuf. of food, beverages, tobacco	**-1.4**	**-0.1**	**-1.2**	**-1.4**	**-1.3**	**-3.0**	**-0.8**	**-0.6**	**-2.2**	**-0.7**
DB. Manuf. of textiles, textile prod., fur	**-3.7**	**-5.5**	**-3.8**	**-4.9**	**-8.8**	**-6.6**	**-2.0**	**-1.9**	**-1.8**	**-1.1**
17. Textiles	-4.3	-4.8	1.8	-4.2	-5.2	-4.5	-0.6	-2.0	-2.8	-2.3
18. Wearing apparel	-3.1	-6.1	-8.4	-5.6	-11.8	-9.1	-3.5	-1.9	-0.9	-0.4
DC. Manuf. of leather and leather prod.	**-11.6**	**-4.0**	**0.6**	**-0.3**	**-5.9**	**-5.0**	**-0.2**	**0.6**	**-1.9**	**-5.3**
DD. Manuf. of wood and wood processing	**2.1**	**1.8**	**-0.8**	**-2.1**	**-2.1**	**-2.0**	**-1.2**	**0.0**	**0.1**	**-2.1**
DE. Manuf of paper, publishing, printing	**-1.8**	**-0.2**	**-0.4**	**2.3**	**-1.4**	**-0.7**	**0.0**	**-0.2**	**-0.7**	**-1.9**
21. Paper	-6.2	-2.7	-3.3	-1.7	-0.6	-1.1	-1.6	0.2	-0.7	-2.6
22.1 Publishing	7.5	2.8	0.2	3.9	1.4	0.8	1.8	0.4	-2.0	-1.6
22.2 Printing	-0.9	0.6	2.8	5.9	-3.7	-1.1	0.8	-1.1	0.0	-1.4
DF. Manuf. of coke & petroleum prod.	**93.9**	**8.1**	**-3.2**	**-3.0**	**-61.2**	**-62.8**	**-19.2**	**-38.1**	**-1.6**	**0.4**
DG. Manuf. of chemicals & chem. prod.	**-2.4**	**-1.7**	**0.0**	**1.9**	**4.1**	**0.2**	**0.9**	**0.7**	**-0.4**	**-1.2**
24.4 Pharmacy	-0.7	-0.9	2.3	2.9	5.6	2.0	0.6	0.4	-0.1	-0.9
DH. Rubber and plastic products	**0.1**	**0.0**	**3.1**	**6.2**	**1.8**	**2.7**	**-0.3**	**2.4**	**0.8**	**1.1**
DI. Manuf. of other non-metallic prod.	**-2.5**	**0.2**	**0.3**	**-1.6**	**-3.3**	**-1.1**	**-0.8**	**0.3**	**-0.1**	**0.0**
DJ. Manuf. of metals and metal prod.	**3.4**	**4.4**	**4.0**	**1.9**	**-0.9**	**-1.0**	**-2.3**	**-0.4**	**0.9**	**1.1**
DK. Manuf. of machinery and equipment	**-3.0**	**-0.4**	**1.8**	**3.1**	**1.2**	**4.2**	**2.2**	**1.4**	**-0.3**	**0.5**
DL. Manuf. of electrical & optical equip.	**-1.5**	**4.5**	**2.2**	**3.7**	**-0.5**	**-0.4**	**-1.2**	**0.7**	**0.0**	**0.2**
DM. Manuf. of transport equipment	**-4.4**	**-6.7**	**6.3**	**2.2**	**0.0**	**5.4**	**1.4**	**2.1**	**2.8**	**2.4**
DN. Other manufacturing industries	**-3.5**	**0.2**	**1.6**	**4.3**	**0.9**	**-1.5**	**-0.8**	**0.1**	**-0.5**	**1.1**
36.1 Furniture		2.9	2.3	5.2	0.3	-1.9	-0.4	-0.2	-0.8	1.5

Source: SORS.

protected branch before Slovenia became an EU member and hence felt the changed operating conditions after 1 May 2004 most acutely.

Agriculture

Slovenia's membership in the EU did not bring about any significant novelties in the guidelines of the national agricultural policy[99]. This policy already underwent a reform in the pre-accession period, followed by the harmonisation of national legislation with the EU's legal order and the setting-up of the institutional framework needed to implement the reformed policy. In the last few years, the national agricultural policy has increasingly converged with the common agricultural policy, also in terms of implementation. The number of comparable measures and amounts of financial aid given to agricultural producers have gradually risen.

[99] The effect of Slovenia's EU membership on the volume and structure of trade in agro-food products is analysed in the chapter 'Changes in the foreign trade regime'.

Higher financial aid prevented the farmers' income position from deteriorating, which was one of agricultural policy's primary goals. The situation did not worsen after Slovenia's accession since the shortfalls in income due to the lagging of purchase price rises behind inflation growth were largely offset by higher subsidies. In 2004 agriculture's factor income, also comprising subsidies for production, in addition to the income earned in the market, recorded a 19.5% increase in 2004 following the 27.7% drop seen in 2003. The volume of agricultural production was up 11.7% in 2004 while purchase prices fell by 1.1% on average. Purchase prices of crops dropped by 9.6% (most sharply in potatoes and vegetables) while the prices of animals and animal products, which represent the largest share in the structure of purchase prices, rose by 3.2% (poultry prices jumped the most). However, it is difficult to explain these dynamics of purchase prices as a consequence of Slovenia's entry to the EU. They were mainly the consequence of the better meteorological conditions in 2004, causing the relatively high purchase prices from the drought-affected 2003 to fall back to the 2002 level. The increase in animal prices can also be attributed to the same cause since the supply of livestock shrank in 2004 following the increased slaughter levels of 2003 when animal feed was scarce, hence the demand for it rose in 2004 in both domestic and European markets. The overall lower purchase prices in agriculture, combined with the abolition of customs protection after Slovenia's entry to the EU, resulted in lower food prices (this development is dealt with in greater detail in the chapter estimating the effect of EU membership on prices).

Transport, storage and communications

Within the transport, storage and communications sector, EU membership has had, as expected, the most negative impact on the shipping industry while a favourable effect was observed in road freight transport recording robust growth even at the beginning of the year. After 1 May 2004, companies whose activities include shipping, organisation and provision of transport services have registered a substantial drop in their turnover from services involving customs operations with the current EU member states[100]. Conversely, road freight transport saw a robust increase from at least the middle of 2004. On the basis of quarterly figures on transport volumes it is difficult to exactly define the effects of EU membership. However, since the year-on-year increase in freight transport totalled 36.3% in the first quarter of 2004, and less than that in the second and third quarters together (25.2%), we may infer that the formal accession itself did not result in any substantial boost despite the fact that some remaining administrative barriers in international transport with EU countries were removed by Slovenia's formal accession. The BS' figures on trade in transport services are similar[101]. The arrival of the first low-fare airline (at the end of April 2004), which strengthened the growth of domestic airport traffic and slightly reduced the growth of domestic air transport, was probably also linked to Slovenia's

[100] According to the SORS' data, turnover in auxiliary transport activities rose by 10.0% from January to April 2004 over the same period of 2003, only to drop by 21.5% from May to October 2004 compared with the same period of the previous year. While turnover recorded a year-on-year rise almost every month from January to April (-0.3%, 16.5%, 23.7% and 1.9%, respectively), it steadily dropped year on year in the following six months (-12.4%, -17.2%, -20.9%, -20.8%, -23.6%, and -32.0%, respectively).

[101] The trade balance in international road transport services measured in current EUR rose by 25.8% in the first four months of 2004 over the same period of 2003, and slightly less in the period from May to October (by 21.4%).

entry to the EU. In the first four months of 2004 compared to the same period of 2003, the volume of airport traffic increased by 4.9% while air transport rose by 13.6%. From May to November 2004 compared to the same period of 2003, the increase in airport traffic rose to 15.6% while the growth of air transport dropped to 5.8%.

Tourism

In our estimate Slovenia's membership in the EU has had a positive impact on Slovenian tourism by dispelling certain doubts concerning the arrival of tourists to Slovenia due to the country being unknown. At the same time, the belief that Slovenia can compare itself to other EU countries has gained ground. European media played an important role in this development by covering the new member states more closely. The positive effects were observed particularly in the tourist markets where Slovenia was previously a less known destination since the number of visitors from Slovenia's traditionally most important tourist markets (Germany, Italy, Austria and Croatia) in 2004, although being slightly higher than in 2003, did not exceed its usual level. There was lively interest in Ljubljana which recorded the largest increase in the number of foreign visitors last year (26.4% more than in 2003). Apart from growing interest in the capital city of a new EU member state, this rise is largely attributable to the regular flight connection between Ljubljana and London launched by the first low-fare operator in Slovenia. In addition, Slovenia was voted the 'Favourite European Tourist Country' in the British media. As a result, 64.3% more Britons visited Slovenia in May 2004 than in the same month of the previous year, and this high growth was sustained in all months until the end of the year[102]. November 2004 saw the opening of a low-fare airline between Ljubljana and Berlin. An above-average interest in Slovenia among Europeans was also manifested by tourists from Scandinavia[103], Belgium and France. From the beginning of the year onwards, and especially from May on, the numbers of tourists from faraway countries – the USA, Israel, Japan, Canada, Australia and other non-European countries[104] increased as well. The enhanced interest of tourists in the months following Slovenia's entry to the EU is also confirmed by figures from the balance of payments showing receipts from travel recorded a 5.5% nominal year-on-year increase in the first four months of 2004 and a 12.3% corresponding increase from May to December (measured in current EUR).

Further, EU membership has also brought Slovenian tourism access to resources from structural funds for the co-financing of development projects in tourism, most of which have already been approved and are to be disbursed in 2005-2007[105]. Based on a public tender for acquiring funds from the European Regional Development Fund to promote the development of tourist destinations, 18 proposed projects were

[102] In the period from May to December 2004, 58.9% more British tourists visited Slovenia compared to the same period of 2003.

[103] In May 2004 over May 2003, the number of Dutch, Finnish and Swedish visitors to Slovenia rose by 78.1%, 73% and 32%, respectively.

[104] The number of tourists from other non-European countries surged by 164% in May 2004 over May 2003.

[105] The proposal to amend the development programmes – to include SPD projects in development programmes – structural funds (Ministry of the Economy, 10.02.05).

approved in 2004, and a further one by March 2005. To date, funds have been allocated to 15 projects in the area of tourist infrastructure, amounting to a total value of SIT 18.7 bn, while the amount of co-financing has totalled SIT 6.4 bn, and to 4 projects in the area of organisation structures development worth SIT 369 m (with co-financing totalling SIT 152 m). The total available funds for 2004-2006, which must be used by 2008, amounted to SIT 8.3 bn. For the mentioned 19 projects, funds allocated for the promotion of tourist destinations were approved in an amount close to 80% of the amounts applied for. Slovenia will receive the structural funds for the approved investment projects in 2005-2007 (the disbursement arrangements differ from project to project).

1.3. Membership in the ERM II

In the Programme for Entering the ERM II and Introducing the Euro the government and the Bank of Slovenia argued for an early entry to the exchange rate mechanism ERM II and swift adoption of the euro, and committed themselves to continue implementing co-ordinated economic policies in order to fulfil the Maastricht convergence criteria in the reference period set for adoption of the euro. The decision in favour of the ERM II had a positive effect on the government's economic policy measures, notably in administered prices and incomes, and on the efficient co-ordination with the Bank of Slovenia which was reflected in the lowering of inflation seen in 2003 and especially 2004. In the course of preliminaries for entry to the ERM II, later on formalised in the Programme, the Bank of Slovenia gradually cut interest rates and slowed down the tolar's depreciation. This also relieved inflationary pressures induced by the tolar's depreciation in the past few years. Further, the lowering of the BS' key interest rates resulted in lower nominal interest rates in banks which, in turn, stimulated the banks' lending activity and, combined with cyclical factors and general economic situation, boosted private consumption.

Changes in monetary policy due to ERM II membership

Slovenia's participation in the exchange rate mechanism ERM II from end-June 2004, following accession to the EU, has effected a change in the Bank of Slovenia's monetary policy. After joining the ERM II, the BS stabilised the tolar exchange rate while keeping its key interest rates unchanged[106]. Already during the preparatory period for entry to the ERM II, the BS also adjusted its policies regarding transactions used to control the exchange rate's depreciation. The effects of these changes were especially manifest in the lowering of price rises, with inflation in the second half of the year totalling just 0.4% (1.1% in the same period of 2003). The changes were also reflected in the banking system's operation.

[106] After they were lowered in the first half of 2004 by 2.0 p.p. (60-day dollar bills, temporary purchase of foreign exchange and the interest rate on swap deals) to 2.5 p.p. (270-day tolar bills), the key interest rates have remained at the achieved level since entry to the ERM II. At the end of December 2004 the BS raised the interest rate on temporary purchases of foreign exchange by 0.25 of a percentage point. As a result, the BS' refinancing rate also increased by the same amount and totalled 3.25% at the end of December, while the ECB refinancing interest rate remained unchanged (2.0%).

After joining the ERM II the Bank of Slovenia stabilised the tolar's exchange rate. The BS replaced the tolar's gradual depreciation policy applied until then by stabilising the tolar exchange rate around the central parity set at 239.64 tolars per 1 euro. After the tolar gradually depreciated in the past few years (in 2003 by 2.8%), depreciation was still in progress in the first half of 2004 (totalling between 0.1% and 0.2% at the monthly level). Its value approached the central parity in July 2004 (after entry to the ERM II it depreciated by a further 0.3%) as a result of the central parity being set below the tolar's market value at that time. Since July 2004 the tolar's exchange rate has fluctuated within a narrow band below the central parity; its fluctuations (based on the exchange rates in foreign exchange markets reported by banks) did not exceed 0.15% and averaged out at 0.06%.

The monetary policy change of the BS brought about by joining the ERM II has already affected the structure of banks' balance sheets. The share of non-tradable debt securities thus fell by 5.5 p.p. to 23.9%, in comparison with 2003. This decrease was due to the level of the BS' securities which fell by SIT 235.6 bn (within that, tolar bills alone dropped by SIT 225 bn). This period also saw a decrease in the stock of swap deals, which were at their highest level in August 2003 (SIT 670 bn), after which they dropped to SIT 275 bn by the time of entry to the ERM II, and further to SIT 226 bn by the end of 2004. These dynamics, apart from reduced interest rates, also improved the possibilities to increase credit activity that was limited in the past due to activities linked to sterilisation of foreign exchange inflows and maintenance of the tolar's depreciation[107]. However, this effect is only partial. In order to put off the liquidity increase resulting from the maturity of tolar bills until after the euro is adopted the Bank of Slovenia began to offer the banks a long-term deposit – however, its interest rate, which totalled 4.2% in March, is two p.p. higher than the rate on 60-day tolar bills. Long-term deposits in banks' balance sheets totalled SIT 156.8 bn at the end of 2004, which is more than two-thirds of the assets released as tolar bills. This value is expected to increase further in 2005.

Effects of EU and ERM II membership on inflation

Entry to the EU and the ERM II supported the lowering of inflation. The stabilisation of the tolar's exchange rate had a significant effect on price dynamics in Slovenia. Although the Bank of Slovenia justified the tolar's gradual (and anticipated) depreciation with its favourable impact on preserving the economy's competitiveness, (the policy was applied to ensure a stable tolar's real effective exchange rate), the approach had a negative effect on price rises. Taking into account the calculations that the exchange rate's pass-through to price rises was almost complete[108], the tolar's depreciation contributed about 50% to total price rises in the last few years. The stabilisation of the tolar's exchange rate at the end of June 2004 thus eliminated a significant inflationary factor. Although the tolar's gradual depreciation in the first half of 2004 still added to price rises, its contribution was more than 50% lower than in previous years, totalling around 1.0 p.p. Apart from its direct effect, the exchange rate's stabilisation also reduced inflationary expectations while its overall effect will only be seen this year, bearing in mind the delayed pass-through. The

[107] This is also noted in Jazbec and Masten (2004).

[108] Coricelli, Jazbec and Masten (2003).

effect of the tolar's exchange rate's stabilisation affected most product and service groups included in the consumer price index. Rises in most groups of the price index were hence lower in 2004 than in the previous year, with exceptions that can be explained through one-off factors (e.g. higher prices of liquid fuels).

The lowering of inflation was also significantly helped by the change in trade regimes. The changed competitive situation in the market and the lifting of customs duties, coupled with improved weather conditions compared with 2003, underpinned the falls in food prices. The overall effect of these factors was reflected in the 1.1% lowering of food prices in 2004, which reduced last year's inflation by 0.2 p.p. After the 4.0% increase in food prices recorded in 2003, which contributed 0.8 p.p. to inflation, the contribution of food prices to inflation fell by 1.0 p.p.

Favourable long-term effects on the lowering of inflation can also be expected due to the increased competition after joining the EU. Due to the impacts of EU membership and planned adoption of the euro in 2007 on the increase in trade flows, a further lowering of prices can be expected in some goods (and partly services) markets due to tougher competition in these market segments.

The harmonisation of excise duties on tobacco is one of the measures linked to Slovenia's EU membership that has had a substantial negative impact on price dynamics. Before Slovenia joined the EU the Government of the RS made a commitment to harmonise the level of excise duties on tobacco products with the *acquis communautaire* by 2008. Until the end of 2004 this harmonisation, begun in 2001, contributed 1.7 p.p. to inflation; in the next three years, during which excise duties should be equalised with those applied in the EU, their rises are estimated to add a further 0.5 p.p. to inflation.

Price and cost competitiveness

Slovenia's entry to the exchange rate mechanism ERM II did not impact on a deterioration of Slovenia's price and cost competitiveness in the euro currency area (or more precisely, against Slovenia's four main partners in the euro area) *due to the parallel slowdown in the growth of relative prices and costs* Although the tolar has been stable against the euro since Slovenia entered the ERM II (in June 2004), deviating only marginally from the central parity (SIT 239.64 per euro), Slovenia's year-on-year price competitiveness was even slightly better in last year's second half over the first. This improvement was due to the massive deceleration in relative price rises (see Table 35). Although Slovenian cost competitiveness measured by relative unit labour costs in manufacturing declined slightly in the second half of 2004 due to the fluctuating labour productivity growth at the year-on-year level, it nevertheless remained at the 2003 level for 2004 as a whole. Notwithstanding the occasional more or less pronounced fluctuations, Slovenian price and cost competitiveness in the euro currency area, against the background of a steady gradual slowdown of the tolar's nominal depreciation against the euro, has been stable since 2003 and even recorded a slight improvement on the back of the concurrent somewhat more substantial easing of relative price rises (particularly in consumer prices).

Table 35: **Indicators of price and cost competitiveness in the euro currency area**

Annual growth rates, %	2002	2003	2004	Jan-June 2004	July-Dec 2004
Tolar's exchange rate of EUR - nominal	**-3.7**	**-3.2**	**-2.1**	**-2.5**	**-1.8**
Relative prices and costs*					
CPI	5.8	4.0	1.7	2.0	1.3
PPI	5.0	1.8	2.1	2.7	1.7
ULC - manufacturing	5.4	3.7	2.3	1.9	2.5
Tolar against the euro - real					
CPI deflator	1.8	0.7	-0.5	-0.5	-0.6
PPI deflator	1.1	-1.5	0.0	0.2	-0.2
Deflator ULC - manufacturing	1.5	0.4	0.1	-0.6	0.6

Sources: BS, SORS, OECD; calculations by IMAD.
Note: *Slovenian price (cost) rises (in national currency) compared with price (cost) rises in Slovenia's 4 main partners in the euro area (Germany, Italy, France and Austria; in national currencies)

Impact of EU membership on loans and savings

The dynamics of bank interest rates were in line with the Bank of Slovenia's key interest rates. Nominal interest rates on short-term and long-term tolar loans (the rate on the latter is mostly still determined on the basis of the tolar indexation clause) dropped by about 2 p.p. in 2004, which contributed to the strengthening of tolar household borrowing from banks (the volume of these loans rose by almost SIT 120 bn and was thus nearly 15% higher in real terms than at the end of 2003). Apart from the lowering of interest rates, the increase in household loans was also supported by the release of funds from the National Housing Savings Scheme, unrelated to EU membership, and the generally improved credit worthiness of households after the repayment of loans taken out before VAT was introduced (on 1 July 1999), which triggered a new borrowing cycle. The lowering of interest rates had a smaller impact on the growth of tolar loans to enterprises and OFO whose real increase in 2004 was slightly less than the year before (3.2% in 2004, 4.0% in 2003). Due to the more favourable conditions, enterprises and OFO preferred to take out foreign currency loans from domestic banks. These loans recorded a 45.4% real rise, which was largely related to the tolar's slower depreciation and later on its stabilisation following entry to the ERM II. The more favourable terms for corporate borrowing had a positive impact on the growth of investment in machinery and equipment.

The lower interest rates also affected household savings. The volume of savings in banks has been growing at extremely low rates; at the same time the maturity structure of bank deposits has shortened considerably, most probably as a result of the narrowing gap between interest rates on deposits of different maturities. These differences have become negligible and the premium for savers has become too small to compensate for the lower liquidity of tied deposits. People have therefore increasingly opted for demand deposits. These trends also stimulated interest in other forms of saving (mutual funds, direct investment in securities, life insurance and voluntary supplementary pension insurance) that are generally more profitable than bank deposits and mainly intended for long-term saving.

Private consumption

2004 recorded the stronger growth of private consumption; among the factors underpinning household consumption two indirectly or directly linked to EU membership are particularly noteworthy: the lowering of interest rates and increased consumer optimism. The latter is estimated to have been additionally boosted by the improved economic outlook (for more on the factors of private consumption in 2004, see p. 40). Although the effects of these factors are difficult to quantify, lower interest rates in household loans impacted on increased household borrowing in banks. The loans taken out were partly used for consumption. According to the BS' figures[109] the volume of new consumer loans taken out rose by 15.6% over the year before. 2004 also saw increased consumer optimism that can be partly attributed to the improved expectations following EU entry. Already one month before the accession the consumer confidence indicator[110] recorded a rise slightly above the average of many years, followed by a sharp increase in May to a high level that was retained in the following few months. Its overall value rose to the highest level to date in October (-7, i.e. 11 p.p. above the year-long average), only to fall again slightly in the last two months of the year, although it was still 2 p.p. above the long-lasting average in December.

Nevertheless private consumption did not record strongly accelerated growth in 2004 that could have caused a rise in inflation and a bigger trade deficit, which represented one of the macroeconomic risks linked to EU membership. The observed trends were also in line with the expectations since the IMAD had estimated the risk of accelerated growth of domestic consumption due to the lowering of interest rates as relatively small. The analyses underlying this estimate took a number of factors into account, such as the anticipated dynamics of the ECB's and BS's interest rates, the risk of too rapid wage increases, the calculated historical links between domestic interest rates and consumption, the results of foreign empirical studies on the correlation between interest rates and consumption, and the experience of some previous ERM II entrants (Spring Report 2004, p. 133).

1.4. Effects of EU membership on general government revenue and expenditure

Slovenia's entry to the EU also poses new challenges and new development opportunities for public finance. By becoming an EU member state, Slovenia assumed the obligation of paying traditionally own resources (customs, taxes on agricultural products), VAT and gross national income based contribution and the UK rebate to the EU budget. On the other hand, Slovenia can draw funds for its agriculture, regional development, the structural, cohesion and internal policies from

[109] The BS' figures comprise data on eight banks selected according to the criterion of the banks' total assets. The reporting on consumer loans is limited by the criteria of loan amounts and/or the number of contracts reported on. Other types of loans are included in full.

[110] The SORS conducts its survey of consumer opinion each month. The figures are available from March 1996. The consumer confidence indicator is the weighted average of answers to questions on the expected financial situation in the household, the expected economic situation in the country, as well as the expected unemployment rate and savings in the next 12 months.

the EU budget. Further, lump-sum payments for 2004-2006 earmarked to strengthen the cash flow and relieve the budgetary situation of new member states upon accession have been negotiated.

The budgetary effects of EU membership can be divided into direct and indirect ones. The direct results are expressed in the financial flows between the European and the national budgets. The indirect effects are observed in the reduced revenue of the national budget on one hand (which increases the risk the budget deficit might expand), and in an additional pressure to cut and restructure general government expenditure on the other. In the following paragraphs we mainly discuss the direct results of the realised inflows from the EU budget and payments from the RS budget to the EU in 2004. Further, we present an estimate of the decrease in the national budgetary revenue in 2004 related to EU membership.

Financial flows between the state budget and the EU budget

Slovenia is planned to be a net recipient of EU funds in 2004-2006. According to the first financial perspective adopted for 2004-2006, Slovenia's direct liabilities to the EU budget total SIT 201 bn, while the ceiling for the funds Slovenia may acquire from the EU budget is SIT 343 bn. Assuming the optimal absorption capacity, Slovenia is expected to secure the position of a net recipient of European funds for each year in this period (also see the Convergence Programme Update 2004, January 2005, p. 20). Immediately after joining the EU (in May 2004) Slovenia began to meet its liabilities to the EU budget on a regular monthly basis, and they will be fully discharged by end-2006. Disbursements of funds from the EU budget, on the other hand, may be prolonged by two years (until 2008). The rules on acquiring EU funds are strictly defined and require that prepared programmes are co-financed from the national budget. Consequently, this calls for a restructuring of budgetary expenditure and indicates a time lag between the approved budgetary commitments and the actual spending of funds (also see the effects of EU membership on tourism). The first financial perspective also appropriates lump-sum payments for Slovenia that can be used within the budget without any particular procedure or separately laid down intended uses.

<u>Payments from the national budget to the EU budget in 2004</u>

In 2004, a total of about SIT 4.5 bn less funds than appropriated in the adopted state budget for 2004 (SIT 45 bn) were paid into the EU budget. Slovenia paid SIT 40.6 bn (0.7% of GDP) to the European budget in 2004, SIT 27.8 bn (68.4%) of which came out of the gross national income, a further SIT 6 bn (14.7%) out of VAT, close to SIT 3 bn (7.2%) out of the traditional own resources (customs duties, special duties on imports of agro-food products), and close to SIT 4 bn (9.5% of total payments) out of the payments for the UK rebate. Payments from all resources were lower, except in the payments for the UK rebate whose amount was slightly higher. The lowering of actual liabilities relative to the amounts planned in the annual budget for 2004 were due to the transfer of the surplus in the EU budget from 2003 to 2004, hence the liabilities of the member states, including Slovenia, to the EU budget were reduced. Another reason was the gap between the preliminary and later estimates of price rises, gross domestic product and gross national income

Table 36: **Slovenia's net budgetary position vis-a-vis the EU budget in 2004 (SIT m)**

	Planned budget 2004	Realised budget 2004	Realisation % relative to planned budget 2004	Structure, %
Revenues of national budget from EU budget				
Pre-accession EU funds	21,132.7	10,871.9	51.5	24.7
Common agricultural policy	11,207.8	5,505.1	49.1	12.5
Structural policy	7,697.0	0.0	0.0	0.0
Cohesion policy	6,600.0	0.0	0.0	0.0
Internal policy	9,193.5	0.0	0.0	0.0
Lump-sum reimbursements	24,533.2	27,023.7	110.2	61.3
Other funds from the EU budget	0.0	411.2	-	0.9
Funds received from other European institutions	0.0	245.7	-	0.6
Total revenues from the EU budget	**80,364.2**	**44,057.6**	**54.8**	**100.0**
Expenditure from national budget to EU budget				
Customs duties	3,603.9	2,928.0	81.2	7.2
Special import duties on agro-food products	0.0	25.1	-	0.1
Value-added tax	6,607.2	6,015.6	91.1	14.7
Gross national income	31,334.2	27,799.8	88.7	68.4
UK rebate	3,503.8	3,868.3	110.4	9.5
Total payments to the EU budget	**45,049.1**	**40,636.8**	**90.2**	**100.0**
Slovenia's net budgetary position vis-a-vis the EU budget	**35,315.1**	**3,420.8**	**9.7**	**-**

Source: Ministry of Finance, calculations by IMAD.

and the slightly lower realisation of revenues from customs duties than was planned at the time of adopting the budget.

Revenues of the Slovenian budget received from the EU budget in 2004

In 2004 Slovenia received only slightly over half of the EU funds that were projected in the budget. The state budget for 2004 projected that Slovenia would receive funds totalling SIT 80.4 bn or (1.3% of GDP)[111] from the EU budget, while it actually received just SIT 44.1 bn (0.7% of GDP), i.e. 54.8% of the expected funds. As much as 61.3% of the received funds were lump-sum payments that were provided for in the Act of Accession as lump-sum payments for strengthening the cash flow and lump-sum payments for budgetary compensation. The actually disbursed lump-sum payments were higher than planned because part of the funds appropriated for 2005 was already disbursed at the end of 2004. The disbursed pre-accession aid (PHARE, ISPA, SAPARD) totalled SIT 10.9 bn, which is just over 50% of the amount projected in the state budget. Aid disbursed under the heading of common agricultural policy totalled SIT 5.5 bn, i.e. less than half the amount foreseen in the budget for 2004 (49.1%).

[111] The funds Slovenia expected to receive from the European budget were appropriated for implementing the common agricultural policy, structural policy, cohesion policy and internal policy. Some of the funds provided comprised pre-accession aid, the agreed lump-sum payments and funds from other European institutions.

EU funding for structural, cohesion and internal policies remained untapped in 2004. The spending of European funds depends on detailed programmes for the implementation of the common European policies which are, as a rule, partly financed by funds from the national budget. Due to its poor absorption capacity, Slovenia was unsuccessful in acquiring European funds in 2004. Therefore, more active engagement in order to spend EU funds and a concomitant restructuring of the state budget expenditure in favour of EU-oriented programmes will be required in future.

Slovenia's net budgetary position vis-a-vis the EU budget in 2004

In 2004 Slovenia was unsuccessful in acquiring European funds for structural, cohesion and internal policies. Hence its absorption capacity must be increased in the next few years in order to improve Slovenia's net budgetary position relative to the EU budget. The adopted state budget for 2004 projected that Slovenia would generate a budgetary surplus of SIT 35.3 bn relative to the EU budget. In the first four months of the year, Slovenia (as an associate member) generated a net surplus of SIT 6.8 bn. In the period of Slovenia's full membership (after May 2004) when it began to pay its contributions to the EU budget, its net budgetary position was negative (SIT 3.3 bn). Slovenia's net budgetary position vis-a-vis the EU budget in 2004 as a whole thus totalled SIT 3.4 bn or less than 10% of the planned amount, noting that even this was achieved solely due to the slightly lower actual payments to the European budget than projected and due to the early disbursement of lump-sum payments. The situation in 2004 calls for the urgent enhancing of Slovenia's absorption capacity over the next few years.

Indirect effects of Slovenia's EU membership on its public finance

The indirect impacts of Slovenia's EU membership on its public finance that are not covered by financial flows between the EU budget and the state budget include the lowering of the state budget revenue from VAT and from customs duties. Prior to accession, Slovenia harmonised its taxation regulations for goods and services with the *acquis* in compliance with the sixth directive on the harmonisation of VAT in the EU. After Slovenia's accession to the EU imports from the EU became part of internal community trade. Fiscal borders between member states were lifted, hence border controls of the accuracy of VAT statements of account was no longer possible – such control may be exercised later on by taxable persons or by the member states' tax administrations whose workload has consequently increased, while the workload of customs administrations has reduced. The weaker control and the changed VAT calculation and collection system is causing a certain level of evasion of this tax. Estimates of VAT evasion due to EU membership vary between 0.2% and 0.4%. With Slovenia joining the EU customs duties and import taxes were restricted to imports from third countries while all trade within the Community became the EU's internal trade. In 2004 imports from the EU accounted for 79.3% of Slovenian imports, therefore customs duties and import taxes only applied to the remaining 20% of imports from third countries after 1 May 2004. The shortfall of budgetary revenue from customs duties in 2004, taking into account the estimated macroeconomic developments in 2004 and the slightly lower customs duty rates agreed in specific trade agreements, is estimated to have totalled about SIT 15 bn.

1.5. Effect of EU membership on FDI inflows

In the long run, membership in an economic integration leads to higher flows of foreign direct investment (FDI). According to economic theory, economic integration brings an increase in FDI flows due to both the reduced risk that opens up new investment opportunities and the emergence of economies of scale on the back of the expanded market; this is, however, largely true in the longer run. A similar development can be expected in the new member states whose FDI inflows are certain to increase in the long run[112]. Yet, in the short run the situation is not so clear. The theory and most studies[113], on the reduction of risks and transaction costs, and partly the experience from past enlargements (see Table 37), point to a short-term rise in FDI to new member states; however, it is hard to say to what extent this increase is due to EU membership or to the general growth in FDI flows in the periods of previous enlargements.

Since foreign investors generally anticipated the future membership of countries in the EU ahead of the enlargement, no short-term effects of the accession can be

Table 37: **Average annual FDI inflows to new EU member states before and after EU membership; USD m, % of total inflows to the EU**

		Before membership		After membership		
		4-6 years	1-3 years	0-2 years	3-5 years	6-8 years
Denmark	Value	-	131	240	-8	102
	Share in the EU	-	2.5	2.5	-0.1	0.7
Ireland	Value	-	29	87	228	275
	Share in the EU	-	0.6	0.9	2.4	1.8
UK	Value	-	1,490	3,470	3,743	7,490
	Share in the EU	-	28.5	35.7	39.2	48.6
Greece	Value	239	571	465	468	781
	Share in the EU	2.7	3.7	3.6	3.8	1.6
Portugal	Value	158	205	542	2,265	1,559
	Share in the EU	0.9	1.6	1.4	2.8	2.1
Spain	Value	1,661	1,787	5,014	11,635	10,260
	Share in the EU	9.9	13.9	13.0	14.3	14.0
Austria	Value	533	1,079	2,055	5,449	3,703
	Share in the EU	0.6	1.4	1.9	1.2	1.0
Finland	Value	343	950	1,238	4,879	6,440
	Share in the EU	0.4	1.2	1.2	1.0	1.7
Sweden	Value	3,382	3,323	10,030	34,643	11,431
	Share in the EU	3,9	4.2	9.5	7.4	3.0

Source: UNCTAD.

[112] The Economist Intelligence Unit estimates that the share of the eight Central European countries that joined the EU last year, plus Bulgaria and Romania, in the worldwide stock of inward FDI will rise from 2.2% in 2000 to 3.2% in 2007 (World Investment Prospect, 2003).

[113] Bevan and Estrin, 2000; Dunning, 2004; Merlevede and Schoors, 2004; Hunya, 2003; UNCTAD, 2003; UNCTAD, 2004.

Table 38: **Annual FDI inflows to countries that joined the EU in 2004, 2000-2003; USD m; % of total inflows to the EU 15**

	EU 10, total		Slovenia	
	Value	Share in the EU 15	Value	Share in the EU 15
2000	21,774	3.2	137	0.02
2001	19,325	5.4	369	0.1
2002	22,774	6.1	1,606	0.4
2003	12,670	4.3	181	0.06

Source: UNCTAD.

expected. In relative terms (inflows of FDI to new member states as a share of total EU inflows), FDI inflows to new member states generally rose already before they joined the EU rather than after that (see Table 37). This indicates that foreign investors had anticipated the countries' future membership in the EU. In the shorter run, trends of FDI inflows to new member states will therefore be strongly contingent on the intensity of FDI flows in the EU and worldwide. Further decisive developments in future will include how the processes of nominal and real convergence proceed in the new member states, how fast production costs grow (particularly labour costs) and how swiftly and successfully the new member states manage to adapt their FDI promoting policies to the new situation (state aid regulations, acquisition of funds from EU funds).

Slovenia similarly recorded no substantial increase in its FDI inflows in 2004. It is also difficult to ascribe the observed increase to EU membership. The FDI inflow to Slovenia in 2004 totalled EUR 421.6 m, following the modest inflow in 2003 and the record-high inflow in 2002 related to the privatisation of the NLB bank and the takeover of Lek. FDI outflows from Slovenia, on the other hand, have been on a steady increase; in 2003 Slovenia was even a net direct outward investor. Without an improvement in both the investment climate and business environment and a more determinant policy for attracting FDI, no significant increase in greenfield

Table 39: **Flows and stocks of inward and outward FDI[1] in Slovenia in 1994-2004[2], EUR m**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Inward FDI										
Year-end stock	1,376.0	1,611.6	1,999.8	2,369.5	2,675.0	3,109.8	2,952.4	3,967.9	5,069.7	-
Annual inflow[3]	117.4	138.2	294.9	194.3	99.2	149.1	412.4	1,750.4	298.8	421.6
Stock as % of GDP	9.5	10.7	12.4	13.6	14.2	15.1	13.5	16.9	20.7	-
Outward FDI										
Year-end stock	382.3	370.6	416.2	542.8	624.7	825.3	1,139.2	1,461.5	1,848.9	-
Annual outflow[4]	7.8	-5.6	-27.7	4.9	-44.7	-71.7	-161.2	-168.1	-413.7	-400.7
Stock as % of GDP	2.6	2.5	2.6	3.1	3.3	4.0	5.2	6.2	7.5	-

Source: Bank of Slovenia.
Notes: [1]FDI whereby a foreign investor holds a 10% or higher share in a company; [2]From 1996 onwards the FDI in enterprises in a direct second affiliation is also included; [3]Inflows are generally lower than changes in stock because international payment transactions only cover some changes in stock. The main difference is that inflows do not cover changes in net liabilities to a foreign investor, and also do not include figures on companies in a second affiliation. From 1995 onwards data on reinvested earnings are also included in inflows; [4]The minus sign indicates an outflow.

FDI can be expected in future. In the short run, even EU membership does not substantially change this situation. In fact, the opposite may be true since membership in an economic integration encourages foreign investors to concentrate their activities in the most attractive regions within the integration, which can hardly be said to include Slovenia. Foreign takeovers are, of course, another story. They will largely depend on the continuation of privatisation and the need of companies to form strategic partnerships with enterprises from abroad.

Part III

Challenges of economic policies ahead of the adoption of the euro

Challenges of economic policies adead of the adoption of the euro

The primary goal of economic policy in the next year and a half is to achieve sufficient nominal convergence that will enable the euro to be adopted at the beginning of 2007. In the Programme for Entering the ERM II and Introducing the Euro adopted by the Bank of Slovenia and the government of the RS in November 2003, both institutions committed themselves to rapid entry to the exchange rate mechanism ERM II and early adoption of the euro at the start of 2007. This, however, means that the Maastricht fiscal criteria for adopting the euro must already be met by the end of 2005 while the monetary criteria must be satisfied by mid-2006.

Of the five Maastricht criteria, Slovenia still does not meet the criteria regarding price and exchange rate stability. At the end of 2004 Slovenia satisfied three of the five Maastricht criteria, noting that one of the two remaining requirements could not be fulfilled for technical reasons – since Slovenia has participated in the exchange rate mechanism for just nine months (the requirement is that the exchange rate must be kept stable for a minimum of two years). Both criteria concerning the country's fiscal position have been met since the general government deficit did not overshoot the allowed 3% of GDP[114] while public debt did not exceed 60% of GDP. Slovenia has also fulfilled the interest rate criterion while the price stability criterion remains to be met, since average inflation totalled 3.6% at the end of 2004 (to meet this criterion it would have to be cut to 2.2%).

In order to meet all Maastricht criteria and ensure the preservation of macroeconomic equilibria even after the euro has been adopted, some adjustments to the key macroeconomic policy guidelines will be required. Due to the clearly set euro adoption date most macroeconomic policies are geared towards achieving this goal; however, such policies do not necessarily ensure that macroeconomic equilibria will be preserved after the euro has been adopted and may have to be adequately modified thereafter. Besides accomplishing nominal convergence the Maastricht criteria should therefore be satisfied in a sustainable way. This goal is even more challenging for macroeconomic policymakers since the role of economic policies permanently changed when Slovenia became an EU member. Monetary policy now has less leeway to respond to changes in the macroeconomic environment while other policies, especially fiscal policy, have gained in importance. To preserve the sustainability of the established equilibria, some short-term macroeconomic policy guidelines aimed at meeting the Maastricht criteria as soon as possible should therefore be adjusted.

The revision of some macroeconomic policies will already be required before the end of this year while other changes should be postponed until after the euro's adoption. To maintain fiscal stability even in the period preceding adoption of the euro it is vital to ensure the stability of general government revenue on one hand and to increase the flexibility of general government expenditure on the other, thereby improving fiscal policy's ability to react to potential shocks. At the same time, the

[114] All fiscal data in this chapter are in line with the ESA 95 methodology.

reforms concerning general government revenue which would affect the structure of the tax system and thus increase the risk of additional revenue volatility should be deferred until the euro has been adopted. Concerning monetary policy, the convergence of interest rates must be ensured no later than at the time of adopting the euro, even though the Bank of Slovenia may maintain relatively higher interest rates in the meantime due to differences in inflation rates and the level of risk premia on one hand, and in order to ensure a stable tolar exchange rate on the other. Similarly, swap deals will have to be closed by the time of adopting the euro. As regards incomes policy, the adopted Social Agreement reduces the risk of breaching the Maastricht criteria; therefore it is reasonable to uphold its main guidelines in 2006. However, after the euro's adoption they should be realigned to comply with the sustainable macroeconomic framework.

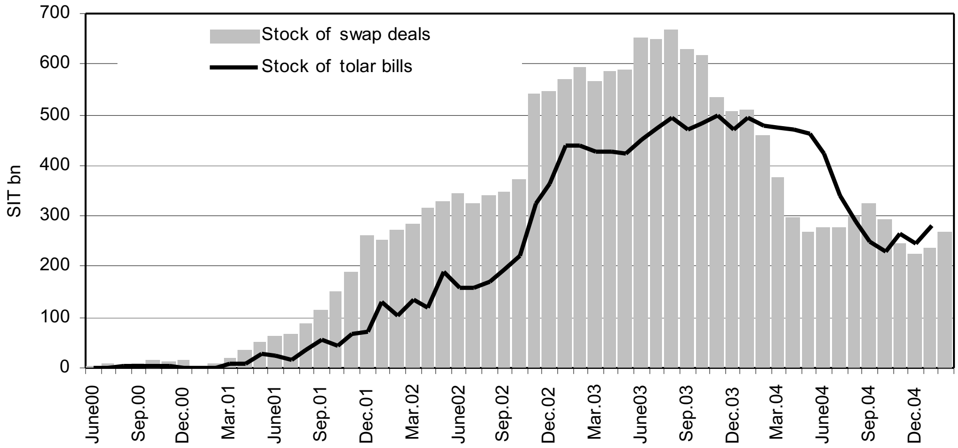
Monetary policy's primary goal is to meet the inflation criterion. Despite the gradual lowering of inflation, and in particular core inflation, seen over the last few years, the key task of macroeconomic policies until mid-2006 remains to ensure further lowering of price rises. Monetary policy can primarily help achieve this goal by maintaining a stable tolar exchange rate. At present, the Bank of Slovenia mainly ensures the stability of the tolar exchange rate with swap deals, which is however not in line with the euro area practice. The accumulated stock of swap transactions, which still exceeded the volume of base money in circulation at the end of this year's first quarter, will therefore have to be eliminated before adoption of the euro.

Further, the Bank of Slovenia should align its interest rate levels with the interest rates of the euro area by the time the euro is adopted. At the end of the first quarter of 2005, the BS' refinancing rate was 1.5 p.p. higher than the European Central Bank's refinancing rate. This gap, which should be eliminated by the time of adopting the euro at the beginning of 2007, is partly the result of the BS controlling the exchange rate with swap deals and maintaining these at a relatively high level even after stabilisation of the tolar's exchange rate. In order to secure the co-operation of commercial banks the Bank must maintain a relatively higher interest rate. The gap is also partly due to macroeconomic circumstances, especially the differences in inflation rates and risk premia levels. To lower interest rates it will be crucial to simultaneously reduce both inflation and interest rates, thereby ensuring a stable real interest rate and preventing potential pressure from inflation cuts on increased spending and the consequent price rises.

Other macroeconomic policies have supported the lowering of inflation. Although the inflation criterion has not been met, the policies supporting the Bank of Slovenia's measures to reduce price rises have reached a high level of co-ordination during the past few years, resulting in inflation falling by about one-third annually in the last two years. To meet the Maastricht criterion in July 2006, the government will therefore have to proceed with the adopted policies, especially its restrictive administered prices policies and the counter-cyclical adjustment of excise duties on liquid fuels to cushion any excessive (relative to other EU countries) effects of oil price volatility and, in particular, their second-round effects.

Ensuring a stable exchange rate by means of swap deals requires the considerable involvement of commercial banks in the central bank's operations. As a result,

Figure 20: **Stock of swaps and tolar bills of the Bank of Slovenia**



Source: Bank of Slovenia.

commercial banks place less emphasis on developing other forms of transactions, which has a negative impact on both the financial sector's development and economic growth (in recent years, economic growth was estimated to be up to 1.0 p.p. lower for this reason; Jazbec and Masten, 2004, p. 95). Although the stock of swaps began to decrease in the second half of 2004, in order to put off a liquidity increase resulting from the maturity of tolar bills until after the euro has been adopted the Bank of Slovenia began to offer the banks a long-term deposit with an interest rate just 0.2 p.p. higher than the rate on 60-day tolar bills. In this way, the BS compensated for about two-thirds of the fall in swaps. However, such measures further reduce other investment activities of banks and hinder any deepening of the financial sector.

Greater competition and the reduced dependence of banks on transactions with the central bank will increase the risk in banking operations, especially after joining the EMU. The further lowering of interest rates and increased competition in the banking market, and the fact that the exchange rate's stability will no longer be controlled through swap deals and long-term deposits, will change the operating conditions faced by commercial banks. The long-lasting involvement of commercial banks in transactions with the Bank of Slovenia may put their ability to be efficient financial intermediaries in the changed circumstances at risk since the banking market in Slovenia is still shallow – the share of bank assets to GDP is still below the level estimated to be equilibratory for Slovenia relative to its level of economic development (Jazbec and Masten, 2004, p. 93). This also indicates that banks are still incapable of providing all the services needed to support faster economic growth; therefore deepening of the banking sector along with the financial sector as a whole is a vital development objective that will also contribute to higher economic growth.

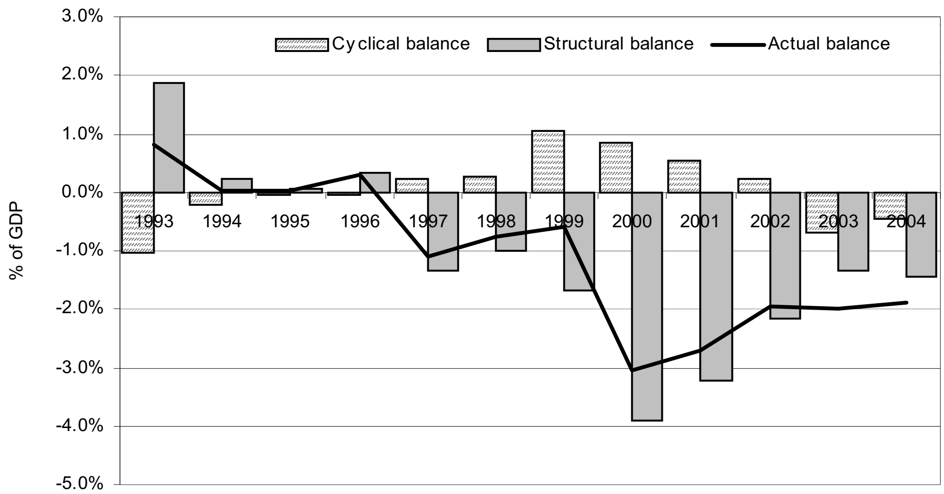
Changes to the fiscal area are needed even though the Maastricht criteria in this field have been met. Provided that the spring forecast baseline scenario (see Part I) is realised, both fiscal criteria will remain within the Stability and Growth Pact's framework rules. The realisation of some macroeconomic risks in 2005 (see Main

Risks to the Spring Forecasts on p. 31) that are deemed possible albeit less likely than the baseline scenario assumptions could deteriorate the government's fiscal position and push its deficit close to the upper reference value of 3% of GDP. Even in that event, however, the likelihood of the reference value being exceeded is small. Nevertheless, this does not mean that no changes are needed in the fiscal area. Calculations indicate that similar fluctuations in economic growth rates, provided that other circumstances remain unchanged, may cause the 3% ceiling to be overshot due to the developments in the international environment as witnessed in the last five years. A more detailed analysis of the current fiscal situation reveals some structural problems that pose a challenge to the fiscal policy and require its rapid reaction, especially in view of the fact that after entering the ERM II and EMU fiscal policy takes on a relatively bigger responsibility to ensure macroeconomic stability.

The main indicator showing that fiscal policy guidelines need to be adjusted is the widening of the structural deficit observed over the last few years. In 2004 the government deficit remained at approximately the same level as in 2003 which, considering the robust economic growth achieved last year (4.6%, see Economic developments in 2004) implies that Slovenia's structural budget deficit, first registered after 1996, rose by about one-half last year to total 1.4% of GDP. The fiscal policy's room for manoeuvre, however, is very limited because of the high share of fixed general government expenditure stipulated by law. If, for instance, macroeconomic circumstances change during the year due to external shocks, fiscal policy can intervene merely within a narrow range representing 10%-20% of total budget expenditure, which usually translates into cuts in the government's investment funds at the end of the fiscal year.

Further, general government expenditure should also be flexible to make room for the co-financing of EU receipts. Apart from the above reasons, the current rigidity

Figure 21: **Breakdown of the general government deficit**



Source: Ministry of Finance, calculations by IMAD.

of expenditure, even if macroeconomic assumptions from the baseline scenario are realised, represents a serious impediment to Slovenia's ability to acquire European structural resources in future years (even assuming its improved administrative absorption capacity). Bearing in mind the strict deficit ceiling on one hand and the required co-financing of European resources from the national budget on the other, too little leeway in the variable part of the budget may finally block the disbursement of EU receipts which may, in turn, hamper investment growth. These considerations call for a restructuring of general government expenditure to allow for its greater flexibility, which will be particularly important during the next financial perspective.

Apart from its rigidity, the high share of expenditure on wages is a key problem of general government expenditure. The share of expenditure on wages in the structure of budgetary expenditure remained high in 2004 despite the real fall in the average wage per employee due to the still strong growth of employment. This, however, shows that merely changing the predetermined wage adjustment mechanisms cannot solve the problem of expenditure on wages as one of the main drivers of the increased general government expenditure. It will therefore be necessary to increase employment flexibility in the public sector and integrate the determining of wages more closely with the efficient management of human resources.

In the area of social transfers, the main task is to increase their target efficiency. Apart from wages, transfers to households have been the most rapidly growing part of general government expenditure in recent years. While a commensurately high share of transfers is characteristic of the social state, it also entails the risk of generating poverty and unemployment traps[115] and implies that redistribution instruments are also used to achieve goals that are not always connected to ensuring social security. In view of this the criteria and legal bases determining entitlement, adjustment rules and the amount of transfers should be reviewed. Further, the greater transparency of transfers must be ensured with the instrument of central or connected databases. Within this context it is imperative to continue assessing the long-term financial sustainability of public financing and the need to change the current pension and health insurance systems by making the relevant projections.

Concerning general government revenue the primary goal in the period prior to adopting the euro is to keep it as stable as possible. The economic policy's key task in this period is to minimise the volatility of general government revenue using the legally available instruments, thereby reducing the risk that the Maastricht fiscal criteria will not be met. More radical tax system reforms introduced during participation in the exchange rate mechanism ERM II would, however, increase the uncertainty related to achieving fiscal convergence due to the potentially lower budget revenue.

In the delicate period of Slovenia's participation in the ERM II, the burden of sustaining macroeconomic stability is also borne by labour market policy, especially wages policy. In 2003 the social partners concluded the Social Agreement for 2003-2005. It sets out the objective of real gross wage growth lagging behind productivity

[115] Such a social transfer and tax system enables unemployed people to receive a net income in an amount similar to what they would receive for simple work, which is why they are not motivated to become active even if they have the opportunity.

growth by one percentage point to prevent excessive wage rises that could result in increased inflationary pressures, worsened cost competitiveness and the excessive growth of general government expenditure on wages. The Agreement also states that such wage growth would be instrumental in increasing or at least maintaining employment and increasing investment, yet it does not provide for any control mechanisms to monitor the achievement of this objective.

In 2003 the objective set out in the Social Agreement was met, while in 2004 the gap between wage growth and productivity growth widened to about 2.5 percentage points. This deviation from the adopted guidelines was also the result of the increased differences in wage rises across sectors. While wage rises in the private sector lagged behind productivity growth by almost 1.5 p.p., wages in the public sectors fell by almost 0.8 p.p. and hence lagged behind overall labour productivity by almost 5.3 p.p. In the long-run perspective, the growth of wages in the private sector is thus no longer ahead of the private sector's wage growth, something that characterised the period between 1999 and 2001 (see Table 17 on p. 69).

Up until the entry to the EMU it is reasonable to preserve the main guidelines of the Social Agreement while preventing the creation of excessive imbalances since the widening of the gap between wage and productivity growth increases macroeconomic risks after adoption of the euro. Applying restrictive wages policy during participation in ERM II supports the maintenance of macroeconomic stability and the achievement of the inflationary objective. Therefore, the provisions of the Social Agreement for 2003-2005 stipulating the adjustment of wages in line with future inflation in Slovenia and the euro area should also be preserved in 2006. Assuming that overall productivity growth is driven by productivity growth in both the private and public sectors it is also reasonable to assume parallel wage growth in both sectors. The expected faster recruitment of better qualified people in the private sector, and the levelling out of internal inequalities, stimulative promotion and general government possibilities in the public sector should, of course, be taken into account. On the other hand, one should also bear in mind that an overly restrictive wages policy, i.e. a bigger gap between wage and productivity growth than stipulated in the Social Agreement, or a widening of cross-sectoral gaps in the period preceding entry to the EMU, may trigger demands for excessive wage increases immediately after joining the EMU and hence lead to potential macroeconomic disequilibria.

The long-term lagging of wage growth behind productivity growth would also run counter to the general recommendations of the Broad Economic Policy Guidelines, according to which the medium-term growth of wages should be consistent with price stability and with trend rises in productivity, taking account of the particularities of the national labour markets and differences in education. This means that in the period after the euro has been adopted the current wage-determining guidelines will have to be adjusted to the prevalent guidelines in the EMU.

The high tax burden on labour has a significant impact on cost competitiveness. Slovenia's rate of tax burden on labour, calculated according to the OECD's methodology[116], is among the highest in Europe (Vodopivec, 2005) which deteriorates

[116] The ratio between personal income tax, total social security contributions and payroll tax on one hand, and the gross wage, employers' social security contributions and payroll tax on the other.

cost competitiveness measured by unit labour costs. In 2002 the tax burden on labour totalled 48.2% in Slovenia, being higher only in Belgium and Germany. It should be noted that payroll tax is a particularity of Slovenia (although Hungary and Poland also have this tax their rates are appreciably lower), representing a significant cost for the employer despite the September 2004 increase in the wage taxation threshold from SIT 130,000 to SIT 165,000. The high tax burden rates are partly due to the complicated personal income tax system causing the tax base to escape and consequently narrow, and to the inadequate structure of taxation. The taxation system should be made simpler, allowing for the further disburdening of labour and stimulating employment and competition.

Labour market policy should place more emphasis on increasing the flexibility of the labour market. Apart from wages policy, other challenges facing labour market policy are to create a flexible labour market capable of responding to external shocks and enhancing the economy's flexibility in view of its growing exposure to competitive pressures in the common market. The need for greater flexibility should, however, not be interpreted in a negative way since flexible legislation enables firms to adapt rapidly to changed operating conditions while also preparing the grounds for rapid job creation, since new employment is more cost-efficient. Low labour market flexibility is often associated with strict employment regulations, which are regarded as the main reason for labour market rigidity. An analysis of the Employment Protection Legislation Index (EPLI) for Slovenia[117] by its components shows that Slovenia's only deviation in international comparisons with regard to labour legislation rigidity appears in its regulation of collective dismissals. This component includes the definition of collective dismissals, the notification of trade unions and competent public institutions, the required negotiation procedures, dismissal criteria and severance pay amounts.

It is important to find a balance between flexibility and security of work. By its share of fixed-term employment Slovenia does not stand out in international comparisons; the analysis of labour market flows, however, indicates that employers largely ensure a flexible number of workers by employing them for a fixed-term[118]. High dismissal costs (severance pay) are the main reason for this situation in which fixed-term employment is practically the only channel for employing unemployed and inactive people. According to the EPLI for permanent employment, Slovenia's gap vis-a-vis other EU-15 countries is not as big as in the EPLI for collective dismissals. A comparison of the severance pay amounts, however, shows that severance pay is relatively high in Slovenia since it is not stipulated by law in a number of countries. In seeking the right balance between flexibility and security the amount of severance pay should therefore be a central issue since analyses show

[117] The Employment Protection Legislation Index (EPLI), which was developed by the OECD (OECD Employment Outlook 1999 and OECD Employment Outlook 2004), was calculated for Slovenia in 2002 by the IMF. It totalled 3.5 when assessing the old legislation and 2.3 when assessing the draft new legislation now in force (Silva-Jauregui, C. et al., 2002). The evaluation of Vodopivec (2005) was close to that of the IMF (2.4). According to the EPLI, which enables an international comparison of labour legislation, Slovenia is ranked around the EU-15 average from the late 1990s, albeit its regulations are stricter than in the Czech Republic (2.1), Hungary (1.7) and Poland (2.0).

[118] Some authors use the term 'numerical flexibility' to denote the adjustment of labour in line with demand in the labour and goods markets.

that strict employment protection regulations protect existing jobs and may reduce the employment prospects of the unemployed while increasing long-term unemployment.

Part IV

Validity assessment of the IMAD's forecasts

Validity assessment of the IMAD's forecasts

A comparison with the forecasts made by other forecasting institutions repeatedly shows that the IMAD is successful in forecasting economic categories. This year the IMAD had the lowest calculated values of absolute accuracy measures of economic growth forecasts – both for mean absolute errors (MAE) and root mean square errors (RMSE)[119] – among all institutions that produce forecasts of Slovenian economic trends. In inflation forecasts only the Bank of Slovenia achieved slightly better results. The same holds for the standardised values (MAE/sd and RMSE/sd). Compared with the European Commission's forecasts for old EU member states, the absolute accuracy measures are slightly higher, whereas in relative accuracy measures the differences are marginal (for methodological explanations, see Spring Report 2004, Box on p. 142).

All institutions underestimated the economy's real growth in their forecasts ***for 2004.*** *The 2003 autumn forecast errors ranged from 0.7 p.p. to 1.6 p.p. while the 2004 spring forecast errors ranged between 0.8 p.p. and 1.5 p.p.* In spring 2004, the IMAD left the 3.6% real GDP growth rate forecast in autumn 2003 unchanged, thereby underestimating the actual growth rate by 1.0 p.p. or 22%. Table 40 shows that only the WIIW, having underestimated economic growth by 0.7 p.p. or 15% in its autumn forecast for the following year, and by 0.8 p.p. or 17% in its spring forecast for the current year, made a more accurate forecast of Slovenian GDP growth than the IMAD. In comparison with other institutions, the IMAD had the smallest error in the economic growth forecast. Minor errors were detected in the forecast of nominal economic growth which is made solely by the IMAD: in autumn 2003 it was overestimated by 0.3 p.p. (4%), whereas in spring 2004 it was underestimated by 0.5 p.p. (6%). Small errors in nominal growth forecasts are

Table 40: **Errors made by forecasting institutions in the forecasts of real economic growth for 2004**

Real economic growth	Year ahead autumn forecast			Current year spring forecast			Current year autumn forecast
	Forecast	Error p.p.	Error %	Forecast	Error p.p.	Error %	Forecast
Realised	**4.6**	**-**	**-**	**4.6**	**-**	**-**	**4.6**
IMAD[1]	3.6	1.0	22	3.6	1.0	22	4.0
DEAEP[2]	3.5	1.1	24	3.5	1.1	24	3.9
BS[3]	3.2	1.4	30	3.1	1.5	33	3.8
IMF[4]	3.0	1.6	35	3.5	1.1	24	3.9
EC[5]	3.1	1.5	33	3.2	1.4	30	4.0
WIIW[6]	3.9	0.7	15	3.8	0.8	17	3.8

Viri:
[1]Spring Report, 1997-2004; Autumn Report, 1997-2004.
[2]Economic Trends, 2003-2004.
[3]Short-term implementation of medium-term monetary policy framework, 2003-2004; Monetary Policy Report 2004.
[4]World Economic Outlook, 2003-2004; Country Report, 2003-2004.
[5]Economic Forecasts, 2003-2004; Economic Forecasts for the Candidate Countries, 2003.
[6]Research Reports, 2003-2004.

[119] For definitions of accuracy measures *see* Spring Report 2004.

Table 41: **Errors made by forecasting institutions in year-end forecasts of year-on-year inflation for 2004**

Year-on-year inflation	Year ahead autumn forecast			Current year spring forecast			Current year autumn forecast
	Forecast	Error p.p.	Error %	Forecast	Error p.p.	Error %	Forecast
Realised	**3.2**	**-**	**-**	**3.2**	**-**	**-**	**3.2**
IMAD	4.5	-1.3	-41	3.3	-0.1	-3	3.5
DEAEP	N/A.	-	-	N/A	-	-	N/A
BS*	3.5	- 0.1	-3	3.2	0.2	6	3.5
IMF	5.0	-1.8	-56	3.7	-0.5	-16	3.7
EC	N/A	-	-	N/A	-	-	N/A
WIIW	N/A	-	-	N/A	-	-	N/A

Vir: see Table 40.
Note: *The Bank of Slovenia releases the year-on-year inflation figure as a % of the change in the current year's final quarter over the previous year's final quarter; the comparable realisation used in all comparisons totals 3.4.

favourable in view of budgetary planning; the discrepancies are attributable to errors in deflator estimates.

In autumn 2003, all institutions overestimated the year-on-year inflation for 2004; errors ranged between 0.1 p.p. (3%) and 1.8 p.p. (41%). In spring 2004, all institutions made downward revisions to their forecasts. Table 41 shows that the downward corrections totalled between 0.3 p.p. and 1.6 p.p., while errors ranged from 0.1 p.p. (6%) and 0.5 p.p. (16%). The IMAD's year-on-year inflation forecast was 4.5% in autumn 2003; in the next two forecasts, it was revised: in spring 2004 the forecast was lowered by 1.2 p.p. to 3.3%, only to be revised upwards again to 3.5% in autumn. The IMAD's last forecast thus overestimated the year-on-year inflation by 0.3 p.p. or 9%.

Like with year-on-year inflation, most institutions overestimated the average inflation for 2004 in autumn 2003, and subsequently all of them lowered their forecasts in spring 2004. We can see in Table 42 that absolute errors in the forecasts made in

Table 42: **Errors made by forecasting institutions in forecasts of average inflation for 2004**

Average inflation	Year ahead autumn forecast			Current year spring forecast			Current year autumn forecast
	Forecast	Error p.p.	Error %	Forecast	Error p.p.	Error %	
Realised	**3.6**	**-**	**-**	**3.6**	**-**	**-**	**3.6**
IMAD	4.9	-1.3	-36	3.3	0.3	8	3.6
DEAEP	4.5	-0.9	-25	3.7	-0.1	-3	3.7
BS	4.0	-0.4	-11	3.4	0.2	6	3.6
IMF	N/A	-	-	N/A	-	-	N/A
EC	5.2	-1.6	-44	3.6	0.0	0	3.9
WIIW	3.5	0.1	3	N/A	-	-	4.0

Source: see Table 40.

autumn 2003 ranged from 0.1 p.p. to 1.6 p.p. while errors in the forecasts for the current year were smaller, ranging from 0.0 p.p. to 0.3 p.p. in absolute terms. The IMAD's forecast of average inflation was 4.9% in autumn 2003; in the next two forecasts, this figure was revised. Average inflation was underestimated by 0.3 p.p. in spring and therefore revised upwards by the same amount in autumn 2004 (see Autumn Report 2004); the actual average inflation forecast was thereby made accurate.

In the 1997-2004 period *errors in economic growth forecasts were small; they averaged out at close to zero for both real and nominal growth rates.* Over the forecast horizon, real growth rates were more often overestimated than underestimated in the forecasts for the current year (the average error totalled -0.04 p.p.), whereas in real growth rates for the year ahead and in nominal GDP growth rates for both years, over- and underestimations were roughly equally common (error averages totalled 0.01 p.p., -0.08 p.p. and 0.14 p.p., respectively).

In the forecasts for the year ahead, both year-on-year and average inflation were more often overestimated than underestimated. The same goes for the forecasts of average inflation for the current year, while year-on-year inflation estimates for the current year were more often too low rather than too high. The average error was higher than in economic growth forecasts, i.e. 0.34 p.p. in average inflation forecasts for the year ahead and 0.13 p.p. for the current year. Average errors in the forecasts of year-on-year inflation were slightly higher, 0.69 p.p. for the year ahead and 0.15 p.p. for the current year.

The accuracy measures of the IMAD's economic growth forecast are relatively low, and their standardised values are even about 50 % lower. The IMAD's mean absolute errors in forecasts of real and nominal GDP growth total between 0.64 p.p. and 0.89 p.p., while root mean square errors are just slightly higher, ranging between 0.84 p.p. and 1.06 p.p., which reflects the IMAD's high level of accuracy in forecasting these variables. Although the IMAD's relative accuracy measures for real GDP growth are slightly higher, this also holds for all other institutions that made forecasts of economic growth in the analysed period. Conversely, the relative values of accuracy measures in nominal economic growth forecasts are more than 50% lower.

The absolute accuracy measures of the IMAD's inflation forecasts for 1997-2004 are slightly higher than the accuracy measures of economic growth forecasts. Again, the relative accuracy measures of the IMAD's forecasts are about 50% lower. The mean absolute errors are lower in the forecasts of average inflation, totalling 0.48 p.p. in the forecasts for the current year and 0.94 p.p. in the forecasts for the year ahead. The IMAD's root mean square error for average inflation totals 0.61 p.p. for the current year and 1.26 p.p. for the year ahead. The mean absolute error in the year-on-year inflation forecasts amounted to 1.05 p.p. for the current year and 1.63 p.p. for the year ahead. The root mean square errors are also higher in year-on-year inflation forecasts, totalling 1.38 p.p. for the current year and 2.23 p.p. for the year ahead.

The accuracy measures of inflation forecasts made for a shorter span, from 2001 onwards, are considerably lower, reflecting the improved methodology used in

Table 43: **Comparison of errors in economic growth and inflation forecasts made by forecasting institutions for the current year**

	Current year - spring forecast				
	ME	MAE	MAE/SD	RMSE	RMSE/SD
Real economic growth					
IMAD, 1997–2004[1]	-0.04	0.64	0.71	0.84	0.93
IMAD, 2002–2004[1]	0.03	0.63	0.55	0.74	0.64
DEAEP, 1997–2004[2]	0.13	0.73	0.80	0.87	0.96
BS, 2002–2004[3]	0.30	0.77	0.66	0.96	0.83
IMF, 1998–2004[4]	0.11	0.88	0.90	0.95	0.97
ECFIN 1969(70)–2001[5]	-0.09	0.51	0.29	0.75	0.42
ECFIN, forecasts for member states[5]	-0.69–0.4	0.55–1.66	0.28–0.57	0.75–1.99	0.37–0.78
ECFIN, 1997–2001[5]	-0.10	0.34	0.53	0.52	0.81
Nominal economic growth					
IMAD, 1997–2004[1]	-0.08	0.89	0.38	1.06	0.46
Average inflation					
IMAD, 1997–2004[1]	0.13	0.48	0.25	0.61	0.32
IMAD, 2001–2004[1]	0.23	0.28	0.13	0.34	0.16
DEAEP, 1997–2004[2]	0.30	0.65	0.34	0.78	0.41
ECFIN 1969(70)–2001[5]	-0.02	0.35	0.11	0.51	0.16
ECFIN, forecasts for member states[5]	-0.26–0.15	0.32–1.04	0.11–0.24	0.43–1.40	0.16–0.31
ECFIN, 1997–2001[5]	-0.04	0.16	0.57	0.23	0.82
Year-on-year inflation					
IMAD, 1997–2004[1]	0.15	1.05	0.50	1.38	0.66
IMAD, 2001–2004[1]	-0.08	0.58	0.30	0.66	0.34
BS, 2002–2004[3]	0.03	0.17	0.09	0.17	0.09
IMF, 1998–2004[4]	0.78	1.12	0.60	1.68	0.90

Sources:
[1]Spring Report, 1997-2004; Autumn Report, 1997-2004.
[2]Economic Trends, 1997-2004.
[3]Medium-term monetary policy framework, 2001; Monetary policy implementation report, 2002-2004; Monetary Policy Report 2004.
[4]World Economic Outlook, 1998-2004; Country Report, 1998-2004.
[5]Keereman, F. (2003). forecasts for the current year cover the 1969-2001 period; forecasts for the year ahead cover the 1970-2001 period (data exclude Austria, Finland and Sweden; data for Denmark, Ireland and the UK cover the period from 1973(74) onwards; data for Greece the period from 1981(82) onwards; and data for Spain and Portugal the period from 1986(87) onwards); calculations by IMAD.
Note: negative values indicate an overestimation, positive values indicate an underestimation.
Abbreviations:
· ME ... Mean Error
· MAE ... Mean Absolute Error
· SDR ... Standard Deviation of Realisations
· MAE/SD ... Standardised Mean Absolute Error
· RMSE ... Root Mean Square Error
· RMSE/SD ... Standardised Root Mean Square Error

forecasting this variable. Indicatively only, we also give accuracy measures for inflation forecasts for a shorter period (from 2001 on). There are two reasons for this: first, changed forecasting methodology and, second, comparability with the forecasts made by the Bank of Slovenia, which had not released its own forecasts prior to that period. Both absolute and relative accuracy measures of the inflation forecasts for 2001-2004 are appreciably lower than for the entire period and are comparable with the accuracy measures of economic growth forecasts. Compared with the Bank of Slovenia, the IMAD's accuracy measures are slightly higher, which is not surprising in view of the BS' specific position.

Table 44: **Comparison of errors in economic growth and inflation forecasts made by forecasting institutions for the year ahead**

	Year ahead - autumn forecast				
	ME	MAE	MAE/SD	RMSE	RMSE/SD
Real economic growth					
IMAD, 1997–2004[1]	0.01	0.81	0.83	0.91	0.93
IMAD, 2002–2004[1]	-0.27	0.93	0.81	1.02	0.88
DEAEP, 1997–2004[2]	-0.05	0.98	1.00	1.18	1.21
BS, 2002–2004[3]	0.17	0.97	0.83	1.08	0.93
IMF, 2000–2004[4]	-0.18	1.14	1.11	1.20	1.17
ECFIN 1969(70)–2001[5]	-0.32	0.89	0.54	1.28	0.78
ECFIN, forecasts for member states[5]	-0.76–0.63	0.32–1.04	0.50–0.68	1.05–2.82	0.63–0.88
ECFIN, 1997–2001[5]	-0.20	0.52	0.80	0.76	1.16
Nominal economic growth					
IMAD, 1997–2004[1]	0.14	0.84	0.39	1.03	0.48
Average inflation					
IMAD, 1997–2004[1]	0.34	0.94	0.51	1.26	0.67
IMAD, 2001–2004[1]	0.13	0.78	0.36	0.90	0.42
DEAEP, 1997–2004[2]	0.64	1.16	0.62	1.53	0.82
ECFIN 1969(70)–2001[5]	0.25	0.91	0.27	1.41	0.42
ECFIN, forecasts for member states[5]	-1.21–0.18	0.72–1.89	0.21–0.46	0.78–2.84	0.31–0.58
ECFIN, 1997–2001[5]	-0.18	0.26	0.89	0.32	1.10
Medletna inflacija					
IMAD, 1997–2004[1]	0.69	1.63	0.83	2.23	1.13
IMAD, 2001–2004[1]	-0.08	0.83	0.43	1.02	0.53
BS, 2002–2004[3]	0.23	0.63	0.34	0.81	0.43
IMF, 2000–2004[4]	1.70	2.26	1.03	2.65	1.21

Note: abbreviations and sources see Table 43.

Statistical Appendix

Table of Contents

Table 1: **Main macroeconomic indicators of Slovenia**

- Real growth rates in %

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
											forecast	
GROSS DOMESTIC PRODUCT	4.1	3.6	4.8	3.6	5.6	3.9	2.7	3.3	2.5	4.6	3.8	4.1
GDP in mil. SIT (current prices)	2,372,657	2,728,199	3,110,075	3,464,889	3,874,720	4,252,315	4,761,815	5,314,494	5,747,168	6,191,161	6,571,200	7,039,800
GDP in mil. EUR	15,496	16,093	17,240	18,602	20,011	20,740	21,925	23,492	24,592	25,919	27,414	29,369
GDP in mil. US$	20,019	20,154	19,476	20,856	21,317	19,096	19,616	22,121	27,749	32,182	35,869	38,343
GDP per capita in EUR	7,797	8,082	8,677	9,383	10,088	10,425	11,007	11,775	12,319	12,979	13,722	14,695
GDP per capita in US$	10,073	10,122	9,802	10,519	10,746	9,599	9,848	11,088	13,900	16,115	17,954	19,185
GDP per capita (PPS)*	10,400	11,200	12,000	12,700	13,700	14,700	15,900	16,800	16,400	-	-	-
INTERNATIONAL TRADE - BALANCE OF PAYMENT STATISTICS[1]												
Exports of goods and services- real [2]	1.1	2.8	11.3	7.4	1.6	13.0	6.3	6.7	3.2	12.6	7.5	7.9
Exports of goods	3.0	2.4	13.1	9.4	2.7	12.9	7.0	6.5	4.4	13.2	8.1	8.2
Exports of services	-6.3	4.4	3.8	-1.9	-3.7	13.6	3.1	7.9	-2.4	9.4	5.2	6.5
Imports of goods and services- real [2]	11.3	2.3	11.5	10.3	8.0	7.6	3.0	4.9	6.8	12.4	6.5	6.6
Imports of goods	13.1	2.1	13.0	10.8	8.6	7.7	3.2	4.4	7.3	13.2	6.7	6.7
Imports of services	-1.2	3.5	1.9	6.5	4.2	6.9	1.9	8.1	3.3	6.6	5.4	6.2
Exports of goods and services in mil. EUR	8,021	8,375	9,248	9,893	9,867	11,626	12,632	13,522	13,883	15,529	16,760	17,998
As a % of GDP	51.8	52.0	53.6	53.2	49.3	56.1	57.6	57.6	56.5	59.9	61.1	61.3
Imports of goods and services in mil. EUR	8,302	8,534	9,372	10,154	10,701	12,364	12,781	13,174	13,890	15,697	16,973	17,848
As a % of GDP	53.6	53.0	54.4	54.6	53.5	59.7	58.4	56.1	56.5	60.6	61.9	60.8
Trade balance in mil. EUR	-281	-160	-123	-261	-835	-738	-149	347	-7	-168	-213	150
As a % of GDP	-1.8	-1.0	-0.7	-1.4	-4.2	-3.6	-0.7	1.5	0.0	-0.6	-0.8	0.5
Current account balance in mil. EUR	-52	32	43	-108	-664	-583	38	335	-91	-238	-243	69
As a % of GDP	-0.3	0.2	0.3	-0.6	-3.3	-2.8	0.2	1.4	-0.4	-0.9	-0.9	0.2
Foreign exchange reserves in mil. EUR	2,703	3,326	3,965	4,080	4,104	4,705	6,514	7,842	7,703	7,484	-	-
External debt in mil. EUR	4,275	5,381	6,165	6,459	8,012	9,490	10,403	11,455	13,305	15,355	-	-
As a % of GDP	27.6	33.4	35.8	34.7	40.0	45.8	47.4	48.8	54.1	59.2	-	-

- Cont. on the next page.

Table 1: **Main macroeconomic indicators of Slovenia**

- Real growth rates in %

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
											forecast	
EMPLOYMENT, WAGES AND PRODUCTIVITY												
Employment in full-time equivalent	1.0	-2.0	-2.1	0.0	1.4	0.8	0.5	-0.4	-0.3	0.1	0.4	0.5
Registered unemployed (annual aver. in thousand)	121.5	119.8	125.2	126.1	119.0	106.6	101.9	102.6	97.7	92.8	88.0	83.5
Rate of registered unemployment[3] in %	13.9	13.9	14.4	14.5	13.6	11.8	11.2	11.3	10.9	10.3	9.8	9.3
Rate of unemployment by ILO in %	7.4	7.3	7.4	7.9	7.6	7.0	6.4	6.4	6.7	6.3	6.2	6.0
Gross wage per employee	5.1	5.1	2.4	1.6	3.3	1.6	3.2	2.0	1.8	2.0	2.1	2.6
Labour productivity (GDP per capita)	3.1	5.6	6.9	3.6	4.2	3.1	2.2	3.7	2.8	4.5	3.4	3.6
FINAL DOMESTIC DEMAND – NATIONAL ACCOUNTS STATISTICS												
Final consumption	7.4	2.8	2.5	3.6	5.2	0.9	2.7	0.7	2.7	3.0	3.2	2.9
As a % of GDP	79.3	78.6	77.0	76.7	76.9	76.9	76.8	74.8	74.7	73.8	73.7	72.6
in which:												
Private consumption	9.1	2.6	2.5	3.0	5.9	0.4	2.3	0.3	2.7	3.5	3.4	3.1
As a % of GDP	59.6	58.9	57.7	57.3	57.6	57.1	56.3	54.6	54.4	54.0	54.0	53.2
Government consumption	2.5	3.4	2.4	5.4	2.9	2.3	3.9	1.7	2.6	1.7	2.5	2.5
As a % of GDP	19.7	19.7	19.4	19.4	19.3	19.8	20.5	20.2	20.3	19.8	19.7	19.4
Gross fixed capital formation	16.8	11.3	13.5	9.9	21.0	0.6	4.1	3.1	6.3	6.8	6.7	4.9
As a % of GDP	20.6	21.7	22.8	23.8	26.3	25.1	24.5	23.3	23.9	24.7	25.8	25.8
CONSOLIDATED GENERAL GOVERNMENT REVENUES, EXPENDITURES AND FINANCING; GFS - IMF METHODOLOGY												
General government revenue (per cent share, relative to GDP)	40.4	40.0	39.3	40.3	41.0	40.6	41.3	39.2	41.3	41.7	-	-
General government expenditure (per cent share, relative to GDP)	40.4	39.7	40.4	41.1	41.6	41.9	42.6	42.1	42.7	43.1	-	-
Surplus/deficit (per cent share, relative to GDP)	0.0	0.3	-1.1	-0.8	-0.6	-1.3	-1.3	-2.9	-1.4	-1.4	-	-
EXCHANGE RATE AND PRICES												
Average exchange rate SIT/US$ (annual average)	118.5	135.4	159.7	166.1	181.8	222.7	242.7	240.2	207.1	192.4	183.2	183.6
Average exchange rate SIT/EUR[4] (annual average)	153.1	169.5	180.4	186.3	193.6	205.0	217.2	226.2	233.7	238.9	239.7	239.7
Effective tolar exchange rate[5]	10.3	-2.9	0.7	4.0	-0.7	-1.9	-0.1	2.7	3.7	0.9	1.4	0.8
Inflation (end of the year)[6]	8.6	8.8	9.4	6.5	8.0	8.9	7.0	7.2	4.6	3.2	2.5	2.3
Inflation (annual average)[6]	12.6	9.7	9.1	7.9	6.1	8.9	8.4	7.5	5.6	3.6	2.5	2.3

Source of data: SORS, BS, Ministry of Finance, *Eurostat-New Cronos, forecasts by IMAD.
Notes: [1]The BS figures for 2004 are not fully harmonised with the SORS' quarterly national accounts [2]Balance of payments statistics (exports F.O.B., imports F.O.B.); real growth rates are adjusted for inter-currency changes and changes in prices on foreign markets, [3]Changed methodology used since 2000, [4]Figures in ECU until 1999, thereafter in EUR, [5]Growth in index denotes appreciation of tolar and vice versa, [6]Retail prices as a measure of inflation until 1998, after 1998 consumer price index.

Table 2a: **Value added by activities and gross domestic product**

- SIT million, prices 2000

		2000	2001	2002	2003	2004	2005	2006
							forecast	
A.	Agriculture, hunting, forestry	118,746	104,272	120,446	101,842	113,222	114,411	115,555
B.	Fishing	732	743	712	748	727	727	727
C.	Mining and quarrying	25,567	24,172	22,145	23,429	22,211	21,989	21,769
D.	Manufacturing	1,013,226	1,064,428	1,115,848	1,159,400	1,222,437	1,278,058	1,340,043
E.	Electricity, gas and water supply	105,521	112,897	119,751	116,032	121,773	123,052	125,574
F.	Construction	237,291	232,127	233,595	241,492	245,344	254,054	261,802
G.	Wholesale, retail, trade, repair	421,961	431,909	447,215	460,104	477,770	497,120	514,271
H.	Hotels and restaurants	87,811	93,518	96,735	100,168	102,466	106,616	111,467
I.	Transport, storage, communications	264,215	277,298	285,786	295,508	306,881	319,310	333,839
J.	Financial intermediation	186,798	198,686	210,216	222,939	246,182	261,049	278,110
K.	Real estate, renting and business activities	559,948	582,945	602,379	624,736	648,275	677,771	711,999
L.	Public administration and com. soc. sec.	230,632	242,794	250,784	261,763	269,769	280,155	287,159
M.	Education	206,452	210,929	216,427	221,514	226,835	232,620	238,668
N.	Health and social work	191,869	196,781	204,589	210,867	221,210	230,611	240,528
O.	Other community and personal activities	134,172	137,986	134,936	136,968	142,286	148,049	154,018
P.	Private households with employed persons	1,369	1,540	1,388	915	843	843	843
	FISIM	-106,919	-119,970	-128,382	-144,202	-156,003	-169,654	-181,530
1. TOTAL VALUE ADDED (A … P + FISIM)		3,679,390	3,793,055	3,934,570	4,034,223	4,212,229	4,376,781	4,554,841
2. CORRECTIONS (a-b)		572,924	573,166	576,845	591,080	624,666	642,019	668,158
a) Taxes on products and services		597,109	596,482	601,697	615,785	650,353	668,207	694,936
b) Subsidies		24,185	23,315	24,853	24,705	25,687	26,188	26,777
3. GROSS DOMESTIC PRODUCT (3=1+2)		**4,252,315**	**4,366,221**	**4,511,414**	**4,625,302**	**4,836,895**	**5,018,800**	**5,223,000**
TOTAL VALUE ADDED		3,679,390	3,793,055	3,934,570	4,034,223	4,212,229	4,376,781	4,554,841
in which:								
1. Agriculture, forestry, fishing (A+B)		119,478	105,016	121,158	102,590	113,949	115,137	116,282
2. Industry and construction (C+D+E+F)		1,381,604	1,433,625	1,491,339	1,540,354	1,611,765	1,677,152	1,749,188
- Industry (C+D+E)		1,144,313	1,201,498	1,257,744	1,298,862	1,366,421	1,423,099	1,487,386
- Construction F		237,291	232,127	233,595	241,492	245,344	254,054	261,802
3. Services (G…P)		2,285,227	2,374,384	2,450,455	2,535,480	2,642,518	2,754,145	2,870,901
4. FISIM		-106,919	-119,970	-128,382	-144,202	-156,003	-169,654	-181,530

Source of data: SORS, forecasts by IMAD.

Table 2b: **Value added by activities and gross domestic product**

- Real growth rates in %, prices 2000

		2001	2002	2003	2004	2005	2006
						forecast	
A.	Agriculture, hunting, forestry	-12.2	15.5	-15.4	11.2	1.0	1.0
B.	Fishing	1.6	-4.2	5.1	-2.9	0.0	0.0
C.	Mining and quarrying	-5.5	-8.4	5.8	-5.2	-1.0	-1.0
D.	Manufacturing	5.1	4.8	3.9	5.4	4.5	4.8
E.	Electricity, gas and water supply	7.0	6.1	-3.1	4.9	1.0	2.0
F.	Construction	-2.2	0.6	3.4	1.6	3.5	3.0
G.	Wholesale, retail, trade, repair	2.4	3.5	2.9	3.8	4.0	3.4
H.	Hotels and restaurants	6.5	3.4	3.5	2.3	4.0	4.5
I.	Transport, storage, communications	5.0	3.1	3.4	3.8	4.0	4.5
J.	Financial intermediation	6.4	5.8	6.1	10.4	6.0	6.5
K.	Real estate, renting and business activities	4.1	3.3	3.7	3.8	4.5	5.0
L.	Public administration and com. soc. sec.	5.3	3.3	4.4	3.1	3.8	2.5
M.	Education	2.2	2.6	2.4	2.4	2.5	2.6
N.	Health and social work	2.6	4.0	3.1	4.9	4.2	4.3
O.	Other community and personal activities	2.8	-2.2	1.5	3.9	4.0	4.0
P.	Private households with employed persons	12.5	-9.8	-34.1	-7.8	0.0	0.0
	FISIM	12.2	7.0	12.3	8.2	8.8	7.0
1. TOTAL VALUE ADDED (A … P + FISIM)		3.1	3.7	2.5	4.4	3.9	4.1
2. CORRECTIONS (a-b)		0.0	0.6	2.5	5.7	2.8	4.1
a) Taxes on products and services		-0.1	0.9	2.3	5.6	2.7	4.0
b) Subsidies		-3.6	6.6	-0.6	4.0	2.0	2.3
3. GROSS DOMESTIC PRODUCT (3=1+2)		**2.7**	**3.3**	**2.5**	**4.6**	**3.8**	**4.1**
TOTAL VALUE ADDED		**3.1**	**3.7**	**2.5**	**4.3**	**4.0**	**3.9**
in which:							
1. Agriculture, forestry, fishing (A+B)		-12.1	15.4	-15.3	9.7	1.0	0.9
2. Industry and construction (C+D+E+F)		3.8	4.0	3.3	5.3	4.5	4.3
- Industry (C+D+E)		5.0	4.7	3.3	5.9	4.6	4.5
- Construction F		-2.2	0.6	3.4	2.5	4.0	3.5
3. Services (G...P)		3.9	3.2	3.5	3.7	4.1	4.0
4. FISIM		12.2	7.0	12.3	8.3	8.8	7.0

Source of data: SORS, forecasts by IMAD.

Table 3: **Expenditure on gross domestic product**

-SIT million, prices 2000

		2000	2001	2002	2003	2004	2005 forecast	2006 forecast
1	GROSS DOMESTIC PRODUCT (1=4+5)	4,252,315	4,366,221	4,511,414	4,625,302	4,836,895	5,018,800	5,223,000
2	EXPORTS OF GOODS AND SERVICES	2,387,289	2,537,244	2,707,409	2,794,195	3,146,263	3,382,232	3,649,429
3	IMPORT OF GOODS AND SERVICES	2,538,115	2,614,934	2,742,110	2,927,676	3,290,043	3,503,896	3,735,153
4	EXTERNAL BALANCE OF GOODS AND SERVICES (4=2-3)	-150,826	-77,690	-34,701	-133,482	-143,780	-121,663	-85,724
5	TOTAL DOMESTIC DEMAND (5=6+9)	4,403,141	4,443,912	4,546,115	4,758,784	4,980,675	5,140,463	5,308,724
6	FINAL CONSUMPTION (6=7+8)	3,269,505	3,358,774	3,381,022	3,471,855	3,576,597	3,689,360	3,797,708
7	PRIVATE CONSUMPTION	2,426,039	2,482,266	2,489,914	2,557,919	2,647,519	2,737,055	2,821,595
	- households	2,373,578	2,427,231	2,431,984	2,499,588	2,587,514	2,675,490	2,758,430
	- non-profit institutions	52,461	55,035	57,931	58,332	60,005	61,565	63,165
8	GOVERNMENT CONSUMPTION (individual and collective)	843,466	876,508	891,107	913,936	929,078	952,305	976,113
9	GROSS CAPITAL FORMATION (9=10+11)	1,133,636	1,085,138	1,165,093	1,286,929	1,404,078	1,451,103	1,511,016
10	GROSS FIXED CAPITAL FORMATION	1,066,779	1,110,612	1,144,797	1,216,528	1,298,901	1,385,927	1,453,838
11	CHANGES IN INVENTORIES AND VALUABLES	66,857	-25,474	20,296	70,401	105,177	65,176	57,178
					Real growth rates in %			
1	GROSS DOMESTIC PRODUCT (1=4+5)	-	2.7	3.3	2.5	4.6	3.8	4.1
2	EXPORTS OF GOODS AND SERVICES	-	6.3	6.7	3.2	12.6	7.5	7.9
3	IMPORT OF GOODS AND SERVICES	-	3.0	4.9	6.8	12.4	6.5	6.6
4	*EXTERNAL BALANCE OF GOODS AND SERVICES [1]*	-	*1.7*	*1.0*	*-2.2*	*-0.2*	*0.5*	*0.7*
5	TOTAL DOMESTIC DEMAND (5=6+9)	-	0.9	2.3	4.7	4.7	3.2	3.3
6	FINAL CONSUMPTION (6=7+8)	-	2.7	0.7	2.7	3.0	3.2	2.9
7	PRIVATE CONSUMPTION	-	2.3	0.3	2.7	3.5	3.4	3.1
	- households	-	2.3	0.2	2.8	3.5	3.4	3.1
	- non-profit institutions	-	4.9	5.3	0.7	2.9	2.6	2.6
8	GOVERNMENT CONSUMPTION (individual and collective)	-	3.9	1.7	2.6	1.7	2.5	2.5
9	GROSS CAPITAL FORMATION	-	-4.3	7.4	10.5	9.1	3.3	4.1
	in which:							
	GROSS FIXED CAPITAL FORMATION	-	4.1	3.1	6.3	6.8	6.7	4.9
	CHANGES IN INVENTORIES AND VALUABLES [1]	-	*-2.2*	*1.0*	*1.1*	*0.8*	*-0.8*	*-0.2*

Source of data: SORS, BS, forecasts by IMAD.
Note: [1]contribution to real GDP growth (percentage points).

Table 4: **Expenditure on gross domestic product**

- SIT million, current prices

		2000	2001	2002	2003	2004	2005 forecast	2006 forecast
1	**GROSS DOMESTIC PRODUCT (1=4+5)**	**4,252,315**	**4,761,815**	**5,314,494**	**5,747,168**	**6,191,161**	**6,571,200**	**7,039,800**
2	EXPORTS OF GOODS AND SERVICES	2,387,289	2,744,468	3,060,345	3,245,428	3,710,849	4,018,235	4,315,022
3	IMPORT OF GOODS AND SERVICES	2,538,115	2,776,503	2,981,749	3,247,262	3,748,543	4,067,177	4,276,966
4	EXTERNAL BALANCE OF GOODS AND SERVICES (4=2-3)	-150,826	-32,035	78,596	-1,834	-37,694	-48,943	38,057
5	TOTAL DOMESTIC DEMAND (5=6+9)	4,403,141	4,793,849	5,235,897	5,749,003	6,228,855	6,620,142	7,001,744
6	FINAL CONSUMPTION (6=7+8)	3,269,505	3,656,738	3,973,047	4,293,961	4,569,106	4,842,486	5,107,601
7	PRIVATE CONSUMPTION	2,426,039	2,682,049	2,900,011	3,127,977	3,341,843	3,547,432	3,742,141
	- households	2,373,578	2,621,790	2,830,439	3,053,907	3,261,294	3,461,483	3,650,871
	- non-profit institutions	52,461	60,259	69,572	74,070	80,549	85,949	91,270
8	GOVERNMENT CONSUMPTION (individual and collective)	843,466	974,689	1,073,036	1,165,984	1,227,263	1,295,054	1,365,460
9	GROSS CAPITAL FORMATION (9=10+11)	1,133,636	1,137,111	1,262,851	1,455,041	1,659,749	1,777,657	1,894,143
10	GROSS FIXED CAPITAL FORMATION	1,066,779	1,164,431	1,239,153	1,373,343	1,529,058	1,694,237	1,819,018
11	CHANGES IN INVENTORIES AND VALUABLES	66,857	-27,320	23,698	81,698	130,691	83,420	75,125
					Structure in %			
1	GROSS DOMESTIC PRODUCT (1=4+5)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2	EXPORTS OF GOODS AND SERVICES	56.1	57.6	57.6	56.5	59.9	61.1	61.3
3	IMPORT OF GOODS AND SERVICES	59.7	58.3	56.1	56.5	60.5	61.9	60.8
4	EXTERNAL BALANCE OF GOODS AND SERVICES (4=2-3)	-3.5	-0.7	1.5	0.0	-0.6	-0.7	0.5
5	TOTAL DOMESTIC DEMAND (5=6+9)	103.5	100.7	98.5	100.0	100.6	100.7	99.5
6	FINAL CONSUMPTION (6=7+8)	76.9	76.8	74.8	74.7	73.8	73.7	72.6
7	PRIVATE CONSUMPTION	57.1	56.3	54.6	54.4	54.0	54.0	53.2
	- households	55.8	55.1	53.3	53.1	52.7	52.7	51.9
	- non-profit institutions	1.2	1.3	1.3	1.3	1.3	1.3	1.3
8	GOVERNMENT CONSUMPTION (individual and collective)	19.8	20.5	20.2	20.3	19.8	19.7	19.4
9	GROSS CAPITAL FORMATION	26.7	23.9	23.8	25.3	26.8	27.1	26.9
10	GROSS FIXED CAPITAL FORMATION	25.1	24.5	23.3	23.9	24.7	25.8	25.8
11	CHANGES IN INVENTORIES AND VALUABLES	1.6	-0.6	0.4	1.4	2.1	1.3	1.1

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

Table 5: **Main aggregates of national accounts**

- SIT million, current prices

		2000	2001	2002	2003	2004	2005	2006
							forecast	
1	**GROSS DOMESTIC PRODUCT**	4,252,315	4,761,815	5,314,494	5,747,168	6,191,161	6,571,200	7,039,800
2	Net primary incomes from the rest of the world	6,009	9,333	-34,427	-41,152	-27,268	-33,079	-42,187
3	GROSS NATIONAL INCOME (3=1+2)	4,258,323	4,771,148	5,280,067	5,706,016	6,163,893	6,538,121	6,997,614
4	Net current transfers from the rest of the world	25,746	31,166	32,180	22,073	7,406	25,648	22,772
5	GROSS NATIONAL DISPOSABLE INCOME (5=3+4)	4,284,070	4,802,314	5,312,247	5,728,090	6,171,299	6,563,769	7,020,386
6	FINAL CONSUMPTION EXPENDITURE	3,269,505	3,656,738	3,973,046	4,293,961	4,569,106	4,842,486	5,107,601
	-private consumption	2,426,039	2,682,049	2,900,011	3,127,977	3,341,843	3,547,432	3,742,141
	-government consumption	843,466	974,689	1,073,036	1,165,984	1,227,263	1,295,054	1,365,460
7	GROSS SAVING (7=5-6)	1,014,565	1,145,575	1,339,201	1,434,129	1,602,193	1,721,283	1,912,786
8	GROSS CAPITAL FORMATION	1,133,636	1,137,111	1,262,852	1,455,041	1,659,749	1,777,657	1,894,143
	in which:							
	-gross fixed capital formation	1,066,779	1,164,431	1,239,153	1,373,343	1,529,058	1,694,237	1,819,018
	-changes in inventories and valuables	66,857	-27,320	23,698	81,698	130,691	83,420	75,125
9	SURPLUS ON THE CURRENT ACCOUNT WITH THE ROW (9=7-8)	-119,071	8,464	76,349	-20,912	-57,556	-56,373	18,642
					Structure in %			
1	**GROSS DOMESTIC PRODUCT**	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2	Net primary incomes from the rest of the world	0.1	0.2	-0.6	-0.7	-0.4	-0.5	-0.6
3	GROSS NATIONAL INCOME (3=1+2)	100.1	100.2	99.4	99.3	99.6	99.5	99.4
4	Net current transfers from the rest of the world	0.6	0.7	0.6	0.4	0.1	0.4	0.3
5	GROSS NATIONAL DISPOSABLE INCOME (5=3+4)	100.7	100.9	100.0	99.7	99.7	99.9	99.7
6	FINAL CONSUMPTION EXPENDITURE	76.9	76.8	74.8	74.7	73.8	73.7	72.6
	-private consumption	57.1	56.3	54.6	54.4	54.0	54.0	53.2
	-government consumption	19.8	20.5	20.2	20.3	19.8	19.7	19.4
7	GROSS SAVING (7=5-6)	23.9	24.1	25.2	25.0	25.9	26.2	27.2
8	GROSS CAPITAL FORMATION	26.7	23.9	23.8	25.3	26.8	27.1	26.9
	in which:							
	-gross fixed capital formation	25.1	24.5	23.3	23.9	24.7	25.8	25.8
	-changes in inventories and valuables	1.6	-0.6	0.4	1.4	2.1	1.3	1.1
9	SURPLUS ON THE CURRENT ACCOUNT WITH THE ROW (9=7-8)	-2.8	0.2	1.4	-0.4	-0.9	-0.9	0.3

Source of data: SORS, forecasts by IMAD.

Table 6: **Balance of payments**

- EUR million

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
										forecast	
I. CURRENT ACCOUNT	32	43	-108	-664	-583	38	335	-91	-238	-243	69
1. TRADE BALANCE	-671	-684	-708	-1,164	-1,227	-684	-269	-546	-840	-928	-635
1.1. Exports F.O.B.	6,671	7,438	8,088	8,103	9,574	10,454	11,082	11,414	12,736	13,789	14,770
1.2. Imports F.O.B.	7,342	8,122	8,796	9,267	10,801	11,139	11,351	11,960	13,576	14,717	15,405
2. SERVICES	511	561	447	330	489	536	616	538	672	716	785
2.1. Receipts	1,704	1,810	1,804	1,763	2,052	2,178	2,440	2,469	2,793	2,971	3,228
- Transport	384	412	481	490	534	559	635	680	807	849	906
- Travel	989	1,048	971	900	1,045	1,105	1,143	1,186	1,312	1,394	1,511
- Other	331	350	352	373	473	514	663	603	674	729	811
2.2. Expenditure	1,193	1,249	1,357	1,434	1,562	1,642	1,823	1,930	2,121	2,256	2,443
- Transport	327	327	366	357	385	356	385	418	486	510	543
- Travel	481	463	501	512	556	601	635	667	732	764	804
- Other	385	459	490	565	621	685	804	845	903	982	1,096
1-2. BALANCE OF GOODS & SERVICES	-160	-123	-261	-835	-738	-149	347	-7	-168	-213	150
Exports	8,375	9,248	9,893	9,867	11,626	12,632	13,522	13,883	15,529	16,760	17,998
Imports	8,534	9,372	10,154	10,701	12,364	12,781	13,174	13,890	15,697	16,973	17,848
3. INCOME	122	66	49	58	29	43	-154	-178	-101	-138	-176
3.1. Receipts	330	346	368	400	471	511	480	517	547	552	564
- Labour income	187	182	183	194	204	197	206	207	202	211	215
- Investment income	143	165	184	206	268	314	274	310	345	341	349
3.2. Expenditures	208	281	319	342	442	468	634	695	648	690	740
- Labour expenditures	19	23	24	23	29	30	36	43	46	50	50
- Investment expenditures	189	257	294	319	413	438	597	652	602	640	690
4. CURRENT TRANSFERS	70	101	104	112	125	144	142	94	31	107	95
4.1. Receipts	200	230	266	316	371	436	478	448	543	772	785
4.2. Expenditure	130	129	162	203	245	293	336	354	513	665	690
II. CAPITAL AND FINANCIAL ACCOUNT	-34	-111	53	625	542	-148	-142	26	369	-	-
A. CAPITAL ACCOUNT	-1	1	-1	-1	4	-4	-164	-165	-178	-	-
1. Capital transfers	1	2	0	0	1	1	-163	-164	-179	-	-
2. Non-produced non-financial assets	-2	-1	-1	-1	3	-5	-1	-2	0	-	-
B. FINANCIAL ACCOUNT	-32	-112	54	625	538	-144	21	192	547	-	-
1. Direct investment	133	267	199	55	77	251	1,582	-115	21	-	-
- Foreign in Slovenia	138	295	194	99	149	412	1,750	299	422	-	-
- Domestic abroad	-6	-28	5	-45	-72	-161	-168	-414	-401	-	-
2. Portfolio investment	508	212	82	324	185	80	-69	-218	-619	-	-
3. Financial derivatives	0	0	0	0	0	0	0	0	-1	-	-
4. Other investment	-209	549	-81	159	462	964	393	788	890	-	-
4.1. Assets	-344	230	-405	-540	-576	248	-703	-836	-1,368	-	-
4.2. Liabilities	134	319	324	699	1,038	716	1,097	1,624	2,258	-	-
5. International reserves	-463	-1,141	-146	88	-187	-1,439	-1,885	-264	256	-	-
III. STATISTICAL ERROR	2	68	55	40	41	110	-193	65	-130	-	-

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

Table 7: **Employment (according to the national accounts methodology) and productivity**

	2000	2001	2002	2003	2004	2005	2006
						forecast	
PERSONS IN EMPLOYMENT (full-time equivalent) in thousand	**894.8**	**898.9**	**895.3**	**892.6**	**893.2**	**897.1**	**901.6**
Annual growth rate (in %), Total:	**0.8**	**0.5**	**-0.4**	**-0.3**	**0.1**	**0.4**	**0.5**
Production activities (A:F)	**-0.2**	**-0.7**	**-2.0**	**-2.2**	**-1.7**	**-1.0**	**-1.0**
Mainly market-oriented services (G:K)	**2.4**	**1.3**	**1.1**	**0.8**	**0.7**	**1.4**	**1.7**
Public & personal services (L:P)	**0.8**	**1.9**	**1.3**	**2.6**	**3.2**	**2.4**	**1.9**
A Agriculture, hunting, forestry	-3.2	-3.3	-2.7	-3.3	-3.6	-2.4	-1.9
B Fishing	0.0	0.0	0.0	-1.0	-2.2	-0.1	-0.1
C Mining and quarrying	-16.2	-7.0	-5.7	-6.0	-8.4	-6.4	-6.4
D Manufacturing	0.0	0.4	-1.9	-2.3	-1.0	-0.8	-0.9
E Electricity, gas and water supply	-3.2	-0.8	0.8	0.0	-1.9	-0.7	-1.0
F Construction	6.5	0.0	-1.2	-0.3	-1.1	0.5	0.2
G Wholesale, retail, trade, repair	1.5	-0.3	0.4	0.1	0.1	0.3	0.3
H Hotels and restaurants	7.1	-0.3	-1.0	-1.3	0.5	0.5	1.5
I Transport, storage, communications	1.2	1.5	1.1	-0.6	-1.5	0.4	0.8
J Financial intermediation	4.2	2.5	1.5	0.0	2.2	1.6	2.1
K Real estate, renting & business activities	2.2	4.4	3.0	4.1	2.9	3.9	4.3
L Public administration & com. soc. sec.	4.1	3.4	2.9	3.9	4.9	2.9	2.1
M Education	1.9	1.5	1.6	1.4	1.6	1.6	1.3
N Health and social work	0.5	1.6	2.4	3.0	4.9	2.9	2.5
O Other community and personal activities	-5.6	1.0	-3.4	2.8	1.1	1.9	1.9
P Private households with employed persons	14.3	0.0	0.0	-36.8	-8.2	-3.8	-3.8
LABOUR PRODUCTIVITY							
a) GDP per person in employment							
thousand SIT (current prices)	**4,752**	**6,489**	**5,936**	**6,439**	**6,932**	**7,325**	**7,808**
in EUR (current prices)	**23,178**	**29,879**	**26,239**	**27,551**	**29,020**	**30,557**	**32,575**
Real* annual growth (v %)	**3.1**	**2.2**	**3.7**	**2.8**	**4.5**	**3.3**	**3.6**
b) Value added per person in employment							
thousand SIT (current prices)	**4,112**	**5,640**	**5,138**	**5,579**	**5,904**	**6,297**	**6,673**
in EUR (current prices)	**20,055**	**25,968**	**22,712**	**23,873**	**24,719**	**26,272**	**27,841**
Real* annual growth (v %)	**3.5**	**2.6**	**4.1**	**2.8**	**4.3**	**3.4**	**3.6**
Total A:K	**3.4**	**3.2**	**5.0**	**3.9**	**5.6**	**4.2**	**4.3**
A+B Agriculture and Fishing	4.1	-9.1	18.6	-12.4	15.3	3.5	3.0
C:F Industry and construction	6.3	3.6	5.9	5.2	5.8	4.7	5.1
G:P Services, total	1.0	2.3	2.0	2.0	2.5	2.4	2.4
- mainly market oriented services (G:K)	-0.7	2.8	2.6	2.9	3.9	3.1	3.0
- public and personal services (L:P)	4.0	1.4	1.0	0.4	0.2	1.3	1.3

Source of data: SORS, forecasts and calculations by IMAD.
Note: *real growth rates in SIT at constant 2000 prices.

Table 8: **Labour force flows**

- Numbers in thousands, indicators in percents

	2000	2001	2002	2003	2004	2005	2006
						forecast	
FORMAL LABOUR FORCE, year-end (in thousand)	**873.1**	**886.4**	**881.5**	**870.7**	**873.9**	**871.6**	**873.3**
Formal employment	768.5	782.1	781.9	774.7	783.0	786.6	793.3
Registered unemployment	104.6	104.3	99.6	96.0	90.9	85.0	80.0
Registered unemployment rate, end of year (%)	**12.0**	**11.8**	**11.3**	**11.0**	**10.4**	**9.8**	**9.2**
New first-time job seekers	**24.9**	**21.3**	**24.3**	**23.9**	**26.3**	**25.4**	**23.5**
of whom became unemployed	20.5	21.9	21.4	25.4	26.0	23.1	20.0
- in % of the generation	*82.4*	*102.6*	*88.1*	*106.3*	*98.8*	*90.9*	*85.1*
Additional number of work permits for foreigners	**2.9**	**-6.4**	**2.1**	**3.5**	**0.9**	**0.5**	**0.6**
- share of foreigners in formaly active population	*4.6*	*4.3*	*4.0*	*4.5*	*4.6*	*4.7*	*4.8*
Employed having lost their jobs	**61.8**	**65.8**	**66.0**	**68.8**	**69.6**	**66.7**	**64.5**
- na 100 formalno delovno aktivnih	*7.7*	*8.2*	*8.2*	*8.6*	*8.6*	*8.2*	*7.9*
Registered unemployed having found a job	**60.2**	**52.7**	**52.2**	**50.5**	**54.3**	**56.2**	**57.9**
- on 100 persons in formal employment	*7.5*	*6.5*	*6.5*	*6.3*	*6.7*	*6.9*	*7.1*
Retirements (-)	**14.8**	**14.6**	**14.8**	**15.1**	**15.4**	**15.8**	**16.3**
of which: registered unemployed persons	7.0	7.6	6.9	5.0	4.3	4.1	3.9
Deaths (-)	**2.6**	**2.7**	**2.6**	**2.6**	**2.5**	**2.5**	**2.5**
Other inflows into formal labour force (net)	**-17.8**	**15.6**	**-13.9**	**-20.5**	**-6.1**	**-10.0**	**-3.6**
of which:other persons who found a job (net)	6.8	43.0	18.8	21.6	35.7	25.2	23.9
other deleted from unemployment registers (-)	24.6	27.4	32.8	42.1	41.8	35.1	27.4
- on 100 registered unemployed	23.1	26.9	31.9	43.1	45.0	39.9	32.9
Education structure of school-leavers coming to the labour market (in %)							
- with lower education or less	*28.9*	*18.0*	*18.8*	*22.6*	*17.8*	*17.5*	*13.6*
- with vocational secondary education	*18.5*	*19.4*	*15.9*	*19.1*	*15.7*	*15.6*	*15.8*
- with general or tehnical secondary education	*26.0*	*31.3*	*31.6*	*21.3*	*30.4*	*29.7*	*30.2*
- full-time graduates	*26.6*	*31.3*	*33.6*	*37.0*	*36.1*	*37.2*	*40.4*

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

Table 9: **Population and labour force**

- Numbers in thousands, indicators in percents

	2000	2001	2002	2003	2004	2005	2006
						forecast	
POPULATION, as at 30 June (in thousand)	**1990.3**	**1992.0**	**1995.7**	**1996.8**	**1997.0**	**1997.8**	**1998.6**
Age structure (in perc.s): 0–14 years	*15.9*	*15.6*	*15.2*	*14.8*	*14.5*	*14.2*	*14.0*
15–64 years	*70.1*	*70.1*	*70.2*	*70.4*	*70.4*	*70.4*	*70.3*
65 years and more	*14.0*	*14.3*	*14.6*	*14.9*	*15.2*	*15.4*	*15.7*
LABOUR FORCE (A) (A=B+C1)	**968.0**	**979.0**	**971.0**	**962.0**	**1007.0**	**998.2**	**1001.7**
Persons in employment (B)	**901.0**	**916.0**	**910.0**	**897.0**	**943.0**	**936.1**	**941.2**
Persons in paid employment (B1)	715.4	722.1	721.4	722.1	724.4	730.5	734.9
Formally self-employed persons (B2)	85.1	84.2	87.3	79.2	83.1	81.0	80.2
Informally employed (B3=B-B1-B2)**	100.5	109.7	101.3	95.6	135.5	124.5	126.1
Survey unemployed – ILO standard (C1)	**68.0**	**63.0**	**62.0**	**64.0**	**64.0**	**62.2**	**60.5**
Registered unemployed persons (C2)	**106.6**	**101.9**	**102.6**	**97.7**	**92.8**	**88.0**	**83.5**
LABOUR MARKET INDICATORS (%)							
Participation rate (15–64 years)	***67.8***	***68.3***	***67.8***	***67.1***	***69.8***	***69.0***	***69.4***
men	*72.2*	*73.1*	*72.5*	*72.0*	*74.4*	*73.8*	*74.0*
women	*63.2*	*63.5*	*63.0*	*62.1*	*65.0*	*64.1*	*64.6*
Participation rate (65 years and more)	*8.3*	*8.2*	*7.2*	*6.2*	*8.9*	*9.2*	*8.4*
Employment rate (15–64 years)	***62.9***	***63.9***	***63.4***	***62.6***	***65.6***	***64.6***	***65.1***
men	*67.2*	*68.7*	*68.2*	*67.4*	*70.4*	*71.2*	*71.4*
women	*58.5*	*58.9*	*58.6*	*57.6*	*60.3*	*60.0*	*60.6*
Employment rate (55–64 years)	*22.5*	*25.0*	*24.4*	*23.5*	*28.3*	*30.0*	*31.5*
Unemployment rate – ILO definition (C1/A)	***7.0***	***6.4***	***6.4***	***6.7***	***6.3***	***6.2***	***6.0***
men	*6.8*	*5.9*	*5.9*	*6.4*	*5.9*	*5.7*	*5.5*
women	*7.3*	*7.0*	*6.8*	*7.1*	*6.9*	*6.9*	*6.6*
young people (15–24 years)	*16.8*	*18.1*	*16.7*	*17.4*	*15.6*	*15.4*	*15.0*
Registered unemployed rate (C2/(B1+B2+C2))	***11.8***	***11.2***	***11.3***	***10.9***	***10.3***	***9.8***	***9.3***
men	*10.6*	*10.1*	*10.0*	*9.4*	*8.8*	*8.6*	*8.3*
women	*13.1*	*12.6*	*12.7*	*12.6*	*12.1*	*11.3*	*10.5*
Structure of persons in employment according to Survey							
in agriculture	*9.8*	*10.2*	*9.1*	*8.3*	*9.9*	*9.2*	*9.0*
in industry and construction	*37.4*	*37.9*	*38.2*	*37.3*	*35.8*	*36.3*	*35.8*
in services	*50.9*	*50.2*	*51.4*	*53.0*	*52.6*	*54.6*	*55.3*
ANNUAL GROWTH RATES (%)							
Persons in employment (according to Survey)	**1.7**	**1.7**	**-0.7**	**-1.4**	**5.1**	**-0.7**	**0.5**
Persons in paid employment*	1.8	0.9	-0.1	0.1	0.3	0.8	0.6
Formally self-employed persons	-2.7	-1.1	3.6	-9.2	4.9	-2.5	-1.1
Informally employed**	-21.2	9.1	-7.6	-5.6	41.7	-7.8	0.9
Registered unemployed	**-10.4**	**-4.5**	**0.8**	**-4.8**	**-5.0**	**-5.2**	**-5.1**
Labour force according to Survey	0.9	1.1	-0.8	-0.9	4.7	-0.9	0.3
Working age population	0.5	0.1	0.3	0.3	0.0	0.0	0.0
Population	**0.2**	**0.1**	**0.2**	**0.1**	**0.0**	**0.0**	**0.0**
Population, 65 years and more	2.2	2.4	2.5	1.7	2.0	1.8	1.7

Source of data: SORS, ESS, forecasts by IMAD.
Notes: *According to monthly statistics in January 2005, the SORS adopted a new methodology of obtaining data on persons in paid employment. The new source of data for employed and self-employed persons excluding farmers is the Statistical Register of Employment (SRE), while data on farmers are forecast using the ARIMA model based on quarterly figures for farmers from the Labour Force Survey. Data for previous years dating back to January 2000 have also been calculated according to the new methodology, **estimates IMAD.

Table 10: **Indicators of international competitiveness**

- Annual growth rates in %

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 estimate	2005 forecast
Effective exchange rate [1]											
Nominal	-0.5	-9.8	-5.4	-2.6	-5.5	-8.1	-5.8	-2.9	-0.2	-0.7	0.5
Real [2]	10.3	-2.9	0.7	4.0	-0.7	-1.9	-0.1	2.7	3.7	0.9	1.4
Unit labour costs in manufactoring [3]											
In SIT nominal	10.0	7.1	7.4	5.9	7.4	4.2	8.5	6.3	3.4	1.9	1.9
In the basket of currencies [4]	9.5	-3.4	1.6	3.2	1.5	-4.2	2.2	3.2	3.2	1.2	2.4
In the basket of currencies - relative [5]	10.2	-5.2	4.3	4.4	0.8	-3.1	0.0	2.9	3.2	1.8	1.6
Components [4]											
Compensation of employees - real [6]	4.9	3.9	3.4	3.4	2.9	2.6	1.8	2.3	1.2	4.0	2.4
Net wages and other remunerations	6.8	7.7	4.3	3.1	2.5	1.9	0.8	1.6	0.3	4.2	2.5
Tax burden on wages [7]	-0.6	-2.6	-0.5	0.6	0.4	0.6	0.6	0.4	0.3	0.1	-0.1
Labour productivity	8.2	6.6	4.3	5.4	1.7	7.2	1.8	3.4	3.4	5.7	3.1
Prices/effective exchange rate	12.9	-0.8	2.5	5.1	0.3	0.1	2.1	4.3	5.4	2.9	3.0

Sources of data: APP, BS, SORS, EC, OECD, calculations, estimate and forecast by IMAD.
Notes:
[1] Growth in index value denotes appreciation of tolar and vice versa,
[2] Measured by relative consumer prices,
[3] For enterprises and companies with 3 or more employees,
[4] Only domestic factors,
[5] Relative to growth in unit labour costs in 7 main OECD trading partners,
[6] Deflated by consumer prices,
[7] The ratio of gross wages and employers' contributions to net wages.

Table 11: **Consolidated general government revenues; GFS – IMF Methodology**

- SIT million, current prices

CONSOLIDATED GENERAL GOVERNMENT REVENUES	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 provision.
TOTAL GENERAL GOVERNMENT REVENUES	**958,186**	**1,091,815**	**1,222,587**	**1,397,903**	**1,590,017**	**1,726,724**	**1,967,786**	**2,083,860**	**2,375,840**	**2,584,354**
TAX REVENUES	**916,328**	**1,032,285**	**1,156,099**	**1,302,752**	**1,499,430**	**1,599,594**	**1,798,344**	**1,909,595**	**2,189,486**	**2,348,196**
TAXES ON INCOME AND PROFIT	160,370	196,930	227,624	252,936	273,818	311,429	357,877	395,045	460,520	506,878
Personal income tax	147,429	174,639	194,062	213,342	231,641	259,634	289,102	319,822	353,126	382,523
Corporate income tax	12,941	22,291	33,562	39,593	42,177	51,795	68,775	75,223	107,394	124,355
SOCIAL SECURITY CONTRIBUTIONS	363,000	376,184	400,630	448,398	496,371	552,574	620,908	681,816	737,632	800,702
TAXSES ON PAYROLL AND WORKFORCE	3,829	18,259	37,491	45,905	55,416	68,071	83,369	93,897	107,424	117,676
Payroll tax	809	14,943	33,994	42,058	51,454	63,849	79,031	88,994	102,968	113,189
Tax on contracting work	3,020	3,316	3,497	3,847	3,962	4,222	4,338	4,903	4,456	4,487
TAXES ON PROPERTY	12,343	14,628	19,589	27,722	26,597	26,513	32,965	34,428	34,419	39,513
DOMESTIC TAXES ON GOODS AND SERVICES	298,159	349,451	412,094	479,713	601,470	602,895	673,380	672,703	814,577	856,604
TAXES ON INTERNATIONAL TRADE AND TRANSACTIONS	78,176	76,593	58,463	47,291	45,657	38,089	29,607	31,341	34,653	19,339
OTHER TAXES	451	241	208	787	100	23	238	365	261	7,484
NON-TAX REVENUES	**39,564**	**56,851**	**60,924**	**88,230**	**79,825**	**110,035**	**148,455**	**144,877**	**157,113**	**169,522**
CAPITAL REVENUES, VOLONTARY DONATIONS	**2,294**	**2,678**	**5,565**	**6,920**	**10,762**	**17,095**	**20,987**	**29,388**	**29,241**	**22,798**
RECEIPTS FROM THE EU BUDGET										**43,838**
Employers' social security contributions (consolidated within the general government balance)	42,687	43,894	47,491	52,723	59,212	66,804	80,439	92,540	101,585	98,703

Cont. on the next page.

Table 11: **Consolidated general government revenues; GFS – IMF Methodology**

- Per cent share, relative to GDP

CONSOLIDATED GENERAL GOVERNMENT REVENUES	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 provision.
TOTAL GENERAL GOVERNMENT REVENUES	**40.4**	**40.0**	**39.3**	**40.3**	**41.0**	**40.6**	**41.3**	**39.2**	**41.3**	**41.7**
TAX REVENUES	**38.6**	**37.8**	**37.2**	**37.6**	**38.7**	**37.6**	**37.8**	**35.9**	**38.1**	**37.9**
TAXES ON INCOME AND PROFIT	6.8	7.2	7.3	7.3	7.1	7.3	7.5	7.4	8.0	8.2
Personal income tax	6.2	6.4	6.2	6.2	6.0	6.1	6.1	6.0	6.1	6.2
Corporate income tax	0.5	0.8	1.1	1.1	1.1	1.2	1.4	1.4	1.9	2.0
SOCIAL SECURITY CONTRIBUTIONS	15.3	13.8	12.9	12.9	12.8	13.0	13.0	12.8	12.8	12.9
TAXSES ON PAYROLL AND WORKFORCE	0.2	0.7	1.2	1.3	1.4	1.6	1.8	1.8	1.9	1.9
Payroll tax	0.0	0.5	1.1	1.2	1.3	1.5	1.7	1.7	1.8	1.8
Tax on contracting work	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
TAXES ON PROPERTY	0.5	0.5	0.6	0.8	0.7	0.6	0.7	0.6	0.6	0.6
DOMESTIC TAXES ON GOODS AND SERVICES	12.6	12.8	13.3	13.8	15.5	14.2	14.1	12.7	14.2	13.8
TAXES ON INTERNATIONAL TRADE AND TRANSACTIONS	3.3	2.8	1.9	1.4	1.2	0.9	0.6	0.6	0.6	0.3
OTHER TAXES	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
NON-TAX REVENUES	**1.7**	**2.1**	**2.0**	**2.5**	**2.1**	**2.6**	**3.1**	**2.7**	**2.7**	**2.7**
CAPITAL REVENUES, VOLONTARY DONATIONS	**0.1**	**0.1**	**0.2**	**0.2**	**0.3**	**0.4**	**0.4**	**0.6**	**0.5**	**0.4**
RECEIPTS FROM THE EU BUDGET										**0.7**
Employers' social security contributions (consolidated within the general government balance)	1.8	1.6	1.5	1.5	1.5	1.6	1.7	1.7	1.8	1.6

Source of data: MF, Ministry of Finance Bulletin and Government Finance Accounts of the Republic of Slovenia, calculations by IMAD.

Table 12: **Consolidated general government expenditure; GFS – IMF Methodology**

- SIT million, current prices

CONSOLIDATED GENERAL GOVERNMENT EXPENDITURE	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 provision.
TOTAL EXPENDITURE	**957,273**	**1,083,586**	**1,256,668**	**1,423,494**	**1,613,314**	**1,781,444**	**2,030,977**	**2,239,883**	**2,454,309**	**2,669,457**
CURRENT EXPENDITURE	**169,751**	**192,816**	**223,184**	**262,658**	**298,448**	**342,767**	**406,696**	**449,259**	**491,297**	**512,296**
WAGES, SALARIES AND OTHER PERSONNEL EXPENDITURE IN GOVERNMENT AGENCIES AND LOCAL COMMUNITIES	66,826	81,983	96,725	104,147	116,560	131,911	155,275	174,026	195,541	217,902
PURCHASES OF GOODS AND SERVICES IN STATE BODIESAND LOCAL COMMUNITIES	76,102	77,928	90,037	106,076	130,943	149,900	178,612	191,705	203,095	202,453
INTEREST PAYMENTS	25,598	31,121	34,686	41,721	50,945	60,956	72,809	83,528	92,661	91,941
CURRENT TRANSFERS	**694,218**	**783,390**	**914,039**	**1,031,185**	**1,147,096**	**1,267,732**	**1,425,336**	**1,583,717**	**1,730,010**	**1,872,463**
SUBSIDIES	41,747	34,547	39,961	49,239	63,088	58,951	63,161	60,435	69,470	77,581
CURRENT TRANSFERS TO INDIVIDUALS AND HOUSEHOLDS	391,785	444,184	519,109	573,820	648,071	731,077	821,358	910,392	986,100	1,053,367
CURRENT TRANSFERS TO PUBLIC INSTITUTIONS AND PUBLIC UTILITIES	251,597	294,132	341,157	379,320	398,925	441,645	508,292	566,881	613,995	668,443
OTHER CURRENT DOMESTIC TRANSFERS	10,315	12,311	13,813	28,806	37,012	36,059	32,525	46,009	60,445	73,072
CAPITAL EXPENDITURE TOTAL	**93,304**	**107,379**	**121,181**	**140,364**	**167,770**	**170,945**	**198,945**	**206,907**	**233,002**	**244,061**
CAPITAL EXPENDITURE	57,376	63,643	67,637	82,206	109,476	111,003	127,996	128,733	142,131	151,051
CAPITAL TRANSFERS	35,928	43,736	53,545	58,158	58,294	59,942	70,949	78,174	90,871	93,010
PAYMENTS TO THE EU BUDGET										40,637
SURPLUS / DEFICIT	**913**	**8,230**	**-34,081**	**-25,591**	**-23,297**	**-54,720**	**-63,191**	**-156,023**	**-78,469**	**-85,103**
Employers' social security contributions (consolidated within the general government balance)	42,687	43,894	47,491	52,723	59,212	66,804	80,439	92,540	101,585	98,703

Cont. on the next page.

Table 12: **Consolidated general government expenditure; GFS – IMF Methodology**

- Per cent share, relative to GDP

CONSOLIDATED GENERAL GOVERNMENT EXPENDITURE	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 provision.
TOTAL EXPENDITURE	**40.4**	**39.7**	**40.4**	**41.1**	**41.6**	**41.9**	**42.6**	**42.1**	**42.7**	**43.1**
CURRENT EXPENDITURE	**7.2**	**7.1**	**7.2**	**7.6**	**7.7**	**8.1**	**8.5**	**8.5**	**8.5**	**8.3**
WAGES, SALARIES AND OTHER PERSONNEL EXPENDITURE IN GOVERNMENT AGENCIES AND LOCAL COMMUNITIES	2.8	3.0	3.1	3.0	3.0	3.1	3.3	3.3	3.4	3.5
PURCHASES OF GOODS AND SERVICES IN STATE BODIESAND LOCAL COMMUNITIES	3.2	2.9	2.9	3.1	3.4	3.5	3.8	3.6	3.5	3.3
INTEREST PAYMENTS	1.1	1.1	1.1	1.2	1.3	1.4	1.5	1.6	1.6	1.5
CURRENT TRANSFERS	**29.3**	**28.7**	**29.4**	**29.8**	**29.6**	**29.8**	**29.9**	**29.8**	**30.1**	**30.2**
SUBSIDIES	1.8	1.3	1.3	1.4	1.6	1.4	1.3	1.1	1.2	1.3
CURRENT TRANSFERS TO INDIVIDUALS AND HOUSEHOLDS	16.5	16.3	16.7	16.6	16.7	17.2	17.2	17.1	17.2	17.0
CURRENT TRANSFERS TO PUBLIC INSTITUTIONS AND PUBLIC UTILITIES	10.6	10.8	11.0	10.9	10.3	10.4	10.7	10.7	10.7	10.8
OTHER CURRENT DOMESTIC TRANSFERS	0.4	0.5	0.4	0.8	1.0	0.8	0.7	0.9	1.1	1.2
CAPITAL EXPENDITURE TOTAL	**3.9**	**3.9**	**3.9**	**4.1**	**4.3**	**4.0**	**4.2**	**3.9**	**4.1**	**3.9**
CAPITAL EXPENDITURE	2.4	2.3	2.2	2.4	2.8	2.6	2.7	2.4	2.5	2.4
CAPITAL TRANSFERS	1.5	1.6	1.7	1.7	1.5	1.4	1.5	1.5	1.6	1.5
PAYMENTS TO THE EU BUDGET										0.7
SURPLUS / DEFICIT	**0.0**	**0.3**	**-1.1**	**-0.8**	**-0.6**	**-1.3**	**-1.3**	**-2.9**	**-1.4**	**-1.4**
Employers' social security contributions (consolidated within the general government balance)	1.8	1.6	1.5	-0.8	1.5	1.6	1.7	1.7	1.8	1.6

Source of data: MF, Ministry of Finance Bulletin and Government Finance Accounts of the Republic of Slovenia, calculations by IMAD.

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