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**The Impact of Structural Reforms on the Macroeconomic  
Situation in Slovenia**

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## **Abstract**

The aim of this text is to present the situation in which Slovenia found itself after stabilization of the economy and liberalization of trade during the transition process from central planned economy to market economy. The Strategy of the development of Slovenia (SRS) which defines the vision and objectives of the development and five key developmental priorities for the period 2006–2013 as the response to this situation is explained. In the period 2005 – 2007 the great deal of structural reforms were implemented. After the first sub period and after the first year of the second mid–term sub period the results themselves show that the development as far as economic growth and employment are concerned went very much in the direction which the SRS presupposed. The economic growth and employment increased but in 2007 two economic imbalances also happened – excessive inflation and current account deficit. Despite the fact that these two can be clearly on the large scale ascribed to the foreign shocks, it is clear that the economic development in the target period of SRS will very much depend on the continuation of the structural reforms and on appropriateness of fiscal policy.

**Key words:** Structural reforms, sustainable development, economic growth, employment, price stability, the current account

## ***1.) Introduction:***

Slovenia is a new member of the European Union, which is fully integrated in the Euro-Atlantic integrations, and is in these days concluding more than successful presidency of the European Council. The way Slovenia has taken from central planning economy to the market economy differs from other transition countries. As far as structure of the economy is concerned Slovenia was in a more favourable position than other transition countries but it was due to political problems in the countries of former Yugoslavia in the first years of transition in a very difficult situation. Most of the market collapsed and Slovene companies found new markets in the countries of the European Union. The Slovene economists would have described our way to market economy as a gradual approach. In the absence of international reserves the policy of flexible exchange rate regime was chosen which was in favour of stimulating export which was in the environment of high interest rates the main driver of economic growth. The economy was stabilised, trade liberalized, competition on product market increased. Inflation was by restrictive fiscal and monetary policies in the year 1995 brought to one digit number. Although Slovenia was well on course as far as nominal convergence is concerned, the general perception was that the real convergence is too slow. This was mainly because of obsolete developmental pattern which encompassed emphasises on macroeconomic and social balance, regulation of markets, bureaucratization, closeness of financial markets, rigidity of labour market, collectivity of system of social security, bureaucratic and hierarchic system of public services. If a gradual approach was a good solution at the beginning of the transition it was completely inappropriate for the new millennium. In June 2005 the government confirmed the Strategy of development of Slovenia (SRS) as strategy for sustainable development which also means a transformation of Lisbon goals to a national environment. The SRS was in November 2005 followed by the frame work of economic and social reforms which involves 67 concrete measures to be implemented in 2006 and 2007. After two years of work a great deal of structural reforms were implemented and Slovene economy has got new acceleration. The economic growth after 4,1% growth in the year 2005 accelerated to 5,7% in the year 2006 and to 6,1% in the year 2007. Because of higher economic growth the rate of employment is significantly higher and the unemployment rate according to the ILO methodology dropped to one of the Europe's lowest rates of 4,6%. Despite this very favourable situation Slovenia is currently facing economic imbalances. The first one is increased inflation and the second is the excessive

current account deficit. Economists have now different views about the causes for these imbalances and obviously different views about the measures necessary to be undertaken. The transition period is briefly described in the text followed by the outline of the new strategy of the development in Slovenia. Further in the text it is described how the implementation of the reforms had been going, how Slovenia was assessed and what recommendations were given by the European commission. Examination of key macroeconomic indicators for the first sub period of the reform process is done. The year 2007 which represents the first year of the second sub period is also analysed. At the end of text there is a discussion on possibilities for sustainability of the reform process. Different views are presented and compared to some historical economic developments.

## 2.) *The period of transition:*

The development of Slovenia in the years during the transition from central planning economy to market economy was fairly successful. The transition of Slovenia was in many ways in comparison to Eastern European countries different and specific. In Slovenia a difficult economic situation was accompanied by a very uncertain political situation. In 1992 and 1993 employment dropped for 10%.

Although *the real sector* in Slovenia was less “rigid” in comparison to other transition countries the emphasis was still on labour intensive and heavy industry. The service and retail sector started to expand in the transition period. Because of political turmoil in the countries of former Yugoslavia the Slovenian companies were forced to find new markets.

In the year 1991 Slovenia was left with a negligible amount of international reserves and the flexible exchange rate was thus the only choice left. In the transition period inflation in Slovenia was higher than in other transition countries. Nominal depreciation of the Slovene Tolar was causing additional inflationary pressures. As a response, *the monetary policy* was fairly restrictive targeting money supply. Inflation was brought from more than 200% in the year 1991 to fewer than 10% in the 1995. Inflationary pressures remained and inflation in the year 2002 remained high as 7%. Real appreciation of the Tolar by sterilization of inflows of foreign currency was moderate. This had positive effects on export demand. In such an economic environment with high interest rates export was

importantly driving the economic growth. In the year 2001 Bank of Slovenia adopted the double pillar framework of the ECB. Some economists argue that after sufficient international reserves build – up fixed exchange rate should have been put in place in order to reduce inflationary pressures. However, this happened when Slovenia entered the Exchange rate mechanism II. During the transition period Slovenia did manage to attain favourable external balance. In the period 1991 – 1998 the current account was on average in surplus. Despite the situation explained above this was because of surplus in services. In the following years the current account with some exceptions remained in deficit. After the capital control was completely removed FDI previously at low level also increased.

The fiscal policy in Slovenia was until 1997 according to the IMF methodology characterized by relatively balanced budgets. The situation after 1997 deteriorated. Further to that, according to the ESA – 95 methodology, the fiscal policy was in the 1999 and 2000 very expansionary with the deficits of 3,8% and 4% of GDP respectively. In the combination with the accommodating monetary policy this resulted in level of inflation as high as 9% in the year 2000. The introduction of VAT also added to that.

The economic growth was not the highest among transition countries but it was the most stable and it was achieved without excessive economic and social imbalances. Although Slovenia during the years 1993 and 2003 with 3,8% average real economic growth achieved significant real convergence, the lagging behind the old member countries still remained. It is necessary to say that the development gap was bigger in economic rather than in the social sense and in the field of ecology. The economic growth in particular slowed down during 2001 – 2003 mainly because of inability of restructuring of the economy and weak development policies taking into the account the fact that economic activities also slowed down in the countries economic partners. However, the slowness of the restructuring process was mainly the result of a gradualist approach which was typical of Slovene transition process. Less innovativeness, weak entrepreneurial activities, too high a portion of labour intensive production, too low a portion of the technologically demanding products in export, too slow growth of market services and financial intermediation and in less effective non–tradable sector as a consequence prevented the Slovene economy from achieving higher and sustainable growth.

### 3.) *The Strategy of development of Slovenia (SRS):*

As a response to this situation the government in its first year of the mandate in June 2005 confirmed the new Strategy of the development of Slovenia (SRS). The SRS defines vision and objectives (goals) of the development and five key development priorities. The SRS puts welfare of an individual in the centre and does not focus only on economic issues but also on social, environmental, legal and cultural issues. Because of this the SRS is the strategy for sustained development. In brief:

- a) *The SRS defines political and economic vision of Slovenia* as a development model to interconnect liberal market oriented economy with more economically effective and adaptable but social and partner state. The new vision makes a point of sustainable development, liberalization and deregulation, growth of enterprises, openness of markets and competition, flexibility of labour markets, public – private partnership, individual needs and personal responsibility;
- b) *The SRS sets four objectives: Economic developmental objective* – to attain average development of the EU; *Social developmental objective* – to improve the level of living and welfare for all citizens; *Intergenerational developmental objective* – to put forward principles of sustainability in all areas of development including sustainable revival of population; *Developmental goal in the international community* – recognition of Slovenia in the international community on the basis of its own development merits and its unique contribution to the development of global community;
- c) *The SRS* defines five key *developmental priorities* to realize the political and economic vision of Slovenia and to achieve the four main objectives: Competitive economy and higher economic growth; Effective creativeness, two-way flow of knowledge between economy and academia and greater usage of knowledge; More effective and inexpensive state; Modern social state and higher employment; Linkage of provisions to achieve sustainable development.

The SRS, which also means transition of Lisbon goals to national environment, is also accompanied with the assessment<sup>1</sup> of *the feasibility of achievement of the goals*. This assessment mainly focused on the first goal of the SRS which says to attain the rate of development of the EU27 by 2013. As this would require in the period 2006 – 2013 growth which would be by 3 percentage points above the growth of EU27, this was assessed as an ambitious goal. The goal is on upper level of attainability reachable at optimal implementation of the SRS and also in a favourable economic environment. In other words, the natural economic growth in the period should have been 5% instead of 3,7%. However the period regarding the implementation of the SRS was divided into three sub periods. 1.1.2007 was the date when Slovenia introduced Euro as its currency. This subsequently required appropriate economic policies with stabilization effects in order to fulfil Maastricht's criteria for inflation and exchange rate stability. The implementation of the SRS in this period focused on short term measures with aim only moderately to accelerate economic growth. It was the year 2007 when economic growth would have surpassed 5% as a result of short-term measures undertaken in 2005 and mainly in 2006 enabling Slovene economy to be more productive and competitive on domestic and foreign markets. After full implementation of the SRS natural growth would have been near 5%.

In order to achieve this on *the supply side* of the Slovene economy restructuring in the direction of increased share of services in the structure of aggregate value added of the whole economy is necessary. In other words, knowledge based services (*finances, business, telecommunications, education, research, and health*) need to increase faster than other services. Appropriate restructuring to increase the share of medium and high technological branches up to 50% of the Slovene manufacturing industry is also necessary. Such a restructuring of the manufacturing industry and services requires engagement and improvement of the human capital, higher expenditures for research and development and also higher employment.

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<sup>1</sup> *IMAD – Institute for macroeconomic analysis and development of RS* by econometric analysis of the aggregate production function has made projections of economic growth. The production function is based on four production factors: Work, human resources, capital and technical progress. *In the first step* the production function was on the basis of data from the transition period calibrated and tested. *In the second step* the projection of economic growth was made under assumption that production factors will follow the historic pattern. *In the third step* the economic growth sensitivity to production factors influenced by the development policy was tested.

The supposition of the target developmental scenario was that *the demand side* would not have been a restrictive developmental factor. The structural changes on the supply side would have invigorated foreign demand, enabled the Slovene economy to increase market shares and also domestic private and investment demand.

#### 4.) *The implementation of the structural reforms:*

The Strategy of the development of Slovenia (SRS) was followed by the framework of economic and social reforms which comprises enlistment of the concrete measures for execution of the Strategy of the development of Slovenia. It was confirmed by the government in November 2006. More than 200 experts from economy and academia were involved in preparation. 67 measures were proposed to be implemented through the change of legislation in 2006 and 2007. The framework focused on the first four developmental priorities of the SRS. The fifth developmental priority written in the SRS regarding sustainable development is involved in the program of reforms for implementation of Lisbon strategy which involves all five priorities.

*The implementation of the structural reforms* was a matter of consent with social partners and political parties and proved to be a very demanding job. The government which ultimately passes on the legislation encountered many obstacles and resistance. Despite a lot of efforts and willingness to implement the reforms the success is only partial. On the other hand the government rather wisely revisited re-examined particular reformatory measures and stepped backward. This is particularly true regarding tax reform and privatization. However, numerous of legislation acts were passed on. The government prepared an assessment of the implementation which says that 30 out of 67 reformatory measures were implemented, 28 were implemented only partially and 9 were not implemented.

The purpose of this text is not to list all measures taken but to discuss those which influenced the current macroeconomic situation in Slovenia the most. The measure number one suggests reducing public expenditures by 2 percentage points in the period 2004 – 2008, which the government is pursuing better than expected. The tax reform is a very important part of the reform package with the aim to lower the heavy tax burden for

the economy and in the period 2004 – 2009 includes abolition of the payroll tax<sup>2</sup>, lowering of corporate tax and personal income tax. The reform had been also foreseen in the direction of enforcement of flat tax. Very important issue regarding the tax reform was simplification of the system itself. The tax reform was implemented in the form of the six laws which were put to force on 1.1.2007. The analysis<sup>3</sup> showed that the most appropriate solution is instead of the introduction of the flat tax to lower progressivism of the personal tax to three rates of 16, 27 and 41%. The corporate tax is going to be reduced from 25% to 20% by 2010. The reform substantially simplified the tax system and tax proceedings. The developmental moment of the tax reform is the abolition of the tax relief for investments and introduction of the tax relief for research and development<sup>4</sup> with the regional component<sup>5</sup>. The purpose of this measure is to enhance expenditures in this field.

Regarding the privatization, the process was rather slower than expected. But still the strategy of transformation of two Para–state funds KAD and SOD was confirmed by the government. This foresees the transformation of these two to portfolio investors with max. allowed share of 10% in a particular asset. In this respect the investments were classified into the three categories. These are *marketable assets* with the selling time horizon of 24 months, *non – marketable* assets with selling time horizon of 30 months and strategic<sup>6</sup> investments where selling time is not appropriate. The number of enterprises owed by KAD and SOD in the period 2004–2007 was reduced from 436 to 170. The progress regarding the strategic investments was slow. In this respect which also goes in the direction of the development of the capital market the IPO<sup>7</sup> of the second biggest bank NKBM was made and Telecom of Slovenia was listed on the Ljubljana stock exchange (LJSE). The important step regarding ownership structure of the insurance company

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<sup>2</sup> *The progressive tax paid by an employer. The highest marginal TAX rate (personal tax + payroll tax) was before the tax reform 70%.*

<sup>3</sup> *For the purpose of structural economic reforms among other tools available the dynamic recursive model of the Slovene economy was developed for estimation of short and mid – term effects of tax reform, reform of social transfers and public expenditures. The model which includes economy, households, state, foreign countries on macro and micro level, estimates impact of the structural reforms on GDP, production, consumption, investments, foreign trade, employment and unemployment etc.*

<sup>4</sup> *Those liable to the corporate taxation are according to the new reformed legislation entitled to assert right of reduction of tax base to the amount of 20% of the expenditures for research and development.*

<sup>5</sup> *The regional component foresees the reduction of 30 or 40% in those regions which are below the developmental average in Slovenia.*

<sup>6</sup> *List of strategic companies includes the two major banks (NLB, NKBM), the biggest Slovene insurance company (Triglav), Slovene Telecom, electro industry, Slovene steel industry. The government is going on a long run to retain 25% + 1 share.*

<sup>7</sup> *49% of the NKBM bank was sold to domestic retail investors and to domestic and foreign institutional investor. 51% is still owned by the Republic of Slovenia, KAD and SOD.*

Triglav was recently made. The 55% share of the Slovene steel industry<sup>8</sup> was sold. Further steps are foreseen in this field.

Regarding the measures for more knowledge based economy apart from already mentioned tax incentives for R&D, permanent increase of the expenses for R&D and for education in the budget is planned. Platforms as means for cooperation of economy, academia and research institutions were co-financed from the budget. The government also co-financed construction of the Technological park of Ljubljana. Young researchers are also co-financed. Public agency for technological development was established. Council for competitiveness was established and development group for key technological area which will stimulate development. Legislation regarding protection of intellectual property was harmonised with the EU legislation. Lifelong learning vocational training was modernised. Greater emphasizes was given to practical training, flexibility of contents, informal knowledge. The fund for development of human resources was established.

In the field of entrepreneurship and competitiveness public agency for entrepreneurship and foreign investments was established. Measures to remove administrative obstacles were taken and a period to establish enterprise was shortened. Under new tax legislation excessive tax burden is gradually being removed from the Slovene economy what will enhance competitiveness of the Slovene economy on the domestic and foreign markets. Venture fund to provide growth capital for risky conceived companies was established. Office for competition was given more authorization and possibility to pass substantial fines for cartel agreements. On 1.7.2007 the liberalization of the electro energy sector happened. Reorganization of the electro energy sector started in order to establish two independent and self – sufficient providers of electro industry, one of which is to be privatized.

Important measures regarding more effective, active policy of employment were taken. In this context the program for long term employment was confirmed. Important financing source is also provided by operative plan of development of human resources for period 2007 – 2013. Working legislation was improved in the direction of more flexible labour market which realizes the concept of so-called flexible security. System of social

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<sup>8</sup> *The Slovene steel industry (SIJ) is organized in the holding company. It went through very successful reorganization and was in 2007 sold to Russian steel company Koks.*

compensation is much more linked to individual's ambition to seek employment. Reorganization and modernization of the institution for employment in order to join a demand and supply of labour more efficiently is going on.

Various European institutes assess the achievement of the Lisbon goals for member countries. These rank Slovenia from third (*Ambroseti*) to tenth place (*Centre for European reform*). The European Commission for the year 2007 assigned good progress for Slovenia. Slovenia was **positively** assessed<sup>9</sup> because of the involvement of social partners and the parliament in the reform process, for successful adoption of Euro, for shortening of time necessary to establish an enterprise, for removal of administrative burden, for reinforced linkage between education and economy and for improvement of lifelong learning and for reform of system of higher education. **Negatively** it was assessed for rigidity of the budget, for wage development in the public sector, for pension reform, for employment of elderly population, for R&D target expenses achievement, for insufficient competitiveness and for insufficient deregulation of regulated professions, for energy inefficiency and for CO2 emissions. **Recommendations** of the European commission regarding the reform process go in the direction to reform the pension system and to stimulate active ageing, to stimulate more flexible work contracts, to reinforce activities of employment institutions particularly for people with worse possibilities for employment. Slovenia will thus have to, according to the European Commission, reinforce implementation of national strategy for R&D, focus on competitiveness in services (retail, finance, public services, regulated professions), enhance energy efficiency and reinforce the link between educational system and labour market.

##### 5.) **The fulfilment of the short – term objectives of the SRS:**

The main aim of economic and social reforms was to increase the economic growth and employment as the pre-condition necessary to fulfil other three main developmental objectives. As already said in this text, the period 2006 – 2013 was divided into three sub periods. In the first period until 2007 the economic policies were stabilizing in order to fulfil the last Maastricht criterion for inflation. The government of Slovenia with the broader consent of general public, social partners, Slovene economy and political partners

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<sup>9</sup> OECD assigned the highest mark for implementation of the TAX reform in 2006.

with coordinated economic policies did manage for the very first time in November 2005 to reduce inflation under the required criteria. **The monetary policy focused** on stability of the nominal exchange rate. During the ERM II period the exchange rate was very stable what indicates appropriate real appreciation targeting in the past. Final interest rates convergence was achieved when the ECB was increasing its main refinancing rate. Since 1.1.2007 when Slovenia as the first new member state introduced Euro as single currency Bank of Slovenia has made numerous of structural adjustments regarding instruments of monetary policy. **The fiscal policy** in the years 2005 and 2006 in accordance with the measures of economic and social reforms went well in the direction of the cheaper and more effective state. The deficit (ESA – 95) was from –2,3% of GDP in the 2004 reduced to –1,5% of GDP in 2005 and to –1,2% in 2006. This was mainly achieved by reducing the budget expenses (ESA – 95) by 1,2 percentage points. The general governmental debt was in these two years reduced by 0,6 percentage points to 27,7 % of GDP. In 2006 gross foreign debt growth after in the period 2000 – 2005 increased from 45,3% to 71% of GDP slightly slowed down. At the end of 2006 gross foreign debt amounted to 79% of GDP. After average current account balance in the period 2000 – 2005 of –1,2% of GDP, it increased to –2,6% of GDP in 2006. This was mainly because of deficit in the trade balance (–3,7%) and factor income balance (–1,2%). The conditions of payment between the import and export prices did not deteriorate (99,9 – index).

Under the SRS scenario the acceleration of **the GDP growth** in this first period under stabilization economic policies was meant to be moderate. After the economic growth in the year 2005 was 4,1%, in the year 2006 the growth of GDP was 5,7%. The growth was in the first half of the 2006 mainly driven by export demand, while in the second half also by investment demand. Household consumption stayed on the same level as in two previous years despite higher employment and better credit conditions on the market. The export in 2006 in real terms increased by 10% while import in real terms by 10,4%. The growth of value added was after 4,4% in 2005 6% in the year 2006. In the European monetary union only Luxemburg performed better than Slovenia. The value added growth was the highest in financial intermediation, civil engineering, traffic and manufacturing. Productivity growth was by 6% in Slovenia the highest in the European monetary Union. The labour market reacted very positively to accelerated economic activity. The employment growth in 2006 was 1,3%, the employment in Slovenia was therefore 66,6% (63,3% - female and 70,8% - male). Set back to this result is employment of young (15 –

24) and old which is despite growth still under the EU average. Unemployment according to the ILO methodology was in 2006 6%. Share of long – term unemployed is also decreasing but it is still high. Women, old and less educated represent majority of long – term unemployed in Slovenia. The share of temporary employments is high. In 2006 Slovenia applied the larger number of European patents. Number of companies in Slovenia which asserted the right for R&D tax relief more than doubled. The deteriorating trend of competitiveness in comparison to European Union countries was in 2006 slowed down. But it did not slowed down in comparison to Euro zone countries. Flow of FDI to Slovenia slowed down. Outflow of DI from Slovenia increased.

This very favourable economic situation in the year 2006 can be assigned to successful tax reform, low interest rates, and high economic activity in the partner countries and to substantial budget financed investment project. From the main macroeconomic indicators it can be concluded that Slovenia fully achieved **the short term developmental objective** (*the first sub period*) of the Strategy of development of Slovenia (SRS) regarding economic growth and growth of employment.

#### 6.) **The mid – term developmental prospective:**

The year 2007 according to the Strategy of development of Slovenia (SRS) means the beginning of the mid – term or the second sub period. This is the period in which the results of the short term measures undertaken in 2005 and 2006 would need to yield the results. This indeed happened as in 2007 **the real growth of GDP** was 6,1%<sup>10</sup>. Euro stat estimates which say that Slovenia will achieve around 91% of GDP of EU27 or 22300 € per capita measured by purchasing power are likely to be surpassed. The economic growth was driven by export and investment demand. The export of goods and services in 2007 increased with respect to 2006 by 13% in real terms. The export in 2007 is estimated on 73% of GDP, which positions Slovenia among very open<sup>11</sup> economies. Because of high import component in the export and investment the import also increased (14,1%). Productivity growth remained near 4%. If we consider the productivity side of the GDP we see that manufacturing contributed the most to the GDP growth as value added was growing at 8,3%. 18,3% growth of value added was in civil engineering, 12,1% in

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<sup>10</sup> 7,2% - Q1, 6% - Q2, 6,3% - Q3 and 4,7% - Q4.

<sup>11</sup> In 1995 the export was 51% of GDP.

financial intermediation, 7,6% in trade, 6,2% in traffic and 3,7% real estate and business services. The labour market in 2007 responded by 2,7% growth of employment. Unemployment measured by ILO methodology in 2007 dropped to 4,6% what is also one of the lowest rates in European monetary union.

The year 2007 is the first year in the European monetary union. This is environment where fiscal, wage, labour market, competition, etc. policies are even more important. Slovenia was in 2007 implementing these policies in order to keep the economy balanced and in accordance with the objectives of the SRS to enhance natural growth. **The fiscal policy** thus went in the direction to decrease the public expenditures. These went down by 2,1 percentage points of GDP in 2007 and by 3,3 percentage points of GDP in the period 2004 – 2007<sup>12</sup>. The real growth of state expenditures in 2007 was 1,3% in comparison to 4,4% in 2006. The budget (ESA – 95) was in deficit of 0,1% GDP (structural deficit was – 0,2%) and the general public debt (ESA – 95) is estimated to be 24,1% of GDP. The European Commission assessed that Slovenia in the year 2007 met its middle term fiscal objective<sup>13</sup>.

However, despite this very fast development and favourable public finance figures the economic imbalances in 2007 happened. Slovenia in November 2005 for the first time fulfilled Maastricht criterion for inflation but this in April 2007 started to rise again. **The HICP annual inflation JAN08/JAN07** was in Slovenia 6,4% while 12 month average HICP in January was 4,1%. The reasons for excessive inflation are supply shock<sup>14</sup> due to increased oil and food prices on the world markets, insufficient competition and possible cartel agreements among merchants. Inflationary expectations induced further persistence of inflation. Food prices<sup>15</sup> in 2007 increased by 13,7% and contributed 2,3 percentage points while in 2006 this contribution was due to 3,6% rise 0,6 percentage points. The increase of the Brent oil price by 35\$ in 2007 contributed 1,2 percentage points to inflation<sup>16</sup> in Slovenia.

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<sup>12</sup> The expenditures (ESA – 95) were 46,5% of GDP in 2004 and went down to 43,2% in 2007.

<sup>13</sup> Structural deficit (cyclically adjusted deficit net of one – off and other temporary measures) of 1% of GDP.

<sup>14</sup> The first shock happened when in April 2007 when seasonal products appeared on the market for the first time in Euros. The second shock happened in the second half of the year when oil and food prices started to rise.

<sup>15</sup> Food prices in the CPI and HICP indexes represent 22% of all prices.

<sup>16</sup> The food and oil ponder in the CPI and HICP indexes is in Slovenia on average of the Euro zone countries higher for 5,7 percentage points and for 11,3 percentage points higher than in Austria.

**The real effective exchange rates** in 2007 appreciated what decreased competitiveness of Slovene economy with respect to trade partners. The real effective exchange rate (CPI deflator<sup>17</sup>) appreciated for 2,3%. Increased rise of relative prices amounted two thirds to this while strong Euro one third. The real effective appreciation (CPI) with respect to Euro countries was 1,5% while with respect to other non – Euro countries 4,1%. The real effective exchange rate (CPP deflator<sup>18</sup>) appreciated for 2,1%. The real effective exchange rate deflated by the expenses of labour per unit of production appreciated for 1,6%. The real effective exchange rate deflated by the expenses of labour per unit of production in manufacturing sector appreciated for 0,4%. This says that competitiveness in the manufacturing sector which realizes great deal of the Slovene export did not worsen significantly<sup>19</sup>. It is mainly because of decreased but still high 7,6 %<sup>20</sup> productivity growth in manufacturing industry in 2007.

In 2007 **the current account deficit** was an excessive 4,9% of GDP. The main reason for the deterioration from 2,8% of GDP in 2006 is increased trade deficit and deficit of the factor income due to increased interest and dividend payments to outside from Slovenia. On the other hand there were increased net inflows of funds. Because of this gross foreign debt increased for 35,5%. Net foreign debt<sup>21</sup> in 2007 increased to 18,9%<sup>22</sup> Because of accelerated economic activities in Slovenia there was increasing demand for credit and loans by Slovene business sector. Demand for credits was driven by high investment activities, M&A, MBO, financing of companies in Balkan states. The rate of credit growth to non – banking sector was in 2007 around 40 %, around 85% for M&A and MBO and 30% to households. Deposits growth was lagging well behind the credit growth thus that Slovene banks financed credit activity by foreign sources<sup>23</sup>. Aggregate liabilities to foreign banks increased on 32% of the aggregate balance sheet of Slovene banks what increased dependence of Slovene banks to developments on international financial markets. Overall risk to **the financial stability** in Slovenia is also reflected in increased liquidity risk mainly as a consequence of development on international markets. The ability of Slovene owed banks of getting long – term financial sources on the foreign

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<sup>17</sup> Among the highest rate in comparison with the EMU countries.

<sup>18</sup> Among the lowest rate in comparison with the EMU countries.

<sup>19</sup> Real effective exchange rate in 2006 deflated by the expenses of labour per unit of production depreciated by 2,6%.

<sup>20</sup> 10,4 % in 2006

<sup>21</sup> Regarding this it is necessary to say that in the period 1995 – 2006 Slovenia was having on average 2,1% of GDP surplus of net foreign liabilities.

<sup>22</sup> 10% of GDP in 2006;

<sup>23</sup> This is mainly consequence of low passive interest rates and thus lower growth of deposits.

markets decreased. Off – balance sheet activities of Slovene banks increased. In other words this means that ability of Slovene Banks to meet possible obligations worsens. Credit risk of Slovene banks also increased. This was mainly because of increased exposure to highly leveraged construction and real estate sector. Banks in Slovenia also increased dependence to big customers. The solvency<sup>24</sup> of Slovene banks worsened with respect to 2006. On the other hands Slovene banks by variable interest rates transferred a great part of risk on real sector and by denomination in Swiss francs and also variable interest rates on households. The Slovene banks increased their profits for 50% but this was in great part along with interest rates revenues a result of increased non – interest<sup>25</sup> rates revenues. Along with this the situation on the capital market in the year 2007 as far as financial stability also wasn't favourable. There was very high growth of the Slovene stock exchange index SBI20 which increase in the period *AVG 2006 – AVG 2007* for 120%<sup>26</sup>. Because of this capitalization on the Ljubljana Stock exchange (*LJSE*) in this period increased for more than 64%. In addition to this important part of outflow of funds from Slovenia financed by foreign funds was invested to risky portfolio investments abroad.

It is clear that Slovenia in 2007 which is the first year of the second or mid – term sub period achieved further acceleration of the economic growth which was also positive from developmental prospective. The structure of economic growth which based on export, investment demand and civil engineering increased natural economic growth. This suggest that economic growth despite decrease to 4,7% in the Q4 of the 2007 is in the forthcoming years is still going to close to the mid sub period target of 5%<sup>27</sup>. The employment in 2007 reached 68% what is close to the Lisbon goal of 70%. On the other hand the economy has got of the balance to certain extent. As far as inflation is concerned it is mainly consequence of increased food and oil prices on world markets and also because of lower degree of competitiveness on the Slovene markets. The whole European Union has this problem while in Slovenia is because of the HICP structure more sensitive in this respect. As Slovenia achieved high rate of real convergence toward EU average the Balassa – Samuelson effect is significant factor regarding inflation. On the other hand high credit

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<sup>24</sup> *Banks owed by Slovene residents are better of in this respect that banks owed by non – residents. Capital adequacy of foreign owed banks decreased to 10,1%.*

<sup>25</sup> *In great part this is a result of trade with tradable assets and revaluation.*

<sup>26</sup> *P/E ratio of 34,6 indicate that this level of prices is not sustainable.*

<sup>27</sup> *The revisited estimation of economic growth of IMAD is 4,4%. The evidence shows that past estimates were fairly conservative.*

growth increased aggregate supply of money what added to the inflation. The real effective exchange rate appreciation in Slovenia in comparison to other EMU members by CPI deteriorated the most. The REER deflated by the expenses of labour per unit of production in manufacturing sector among EMU countries appreciated the least what means that the Slovene manufacturing sector remains competitive. The real exchange appreciation could have been assigned to the effects of structural reforms, tax reform, and improved fundamentals but also to increased demand in non – tradable sector, the productivity differential<sup>28</sup> between tradable and non – tradable sector, capital inflows. Considering the foreign balance we see that because of the substantially increased current account deficit both gross and net foreign debt increased. Market penetration of Slovene banks and thus increased aggregate debt leverage of real sector and households increased substantially. But on the other hand Slovenia is in the Euro area the country with the lowest gross foreign debt in terms of percentage of GDP. This says that current account deficit is for now sustainable. The fiscal situation with low public debt and budget surplus in Slovenia was solid. It is worth also to mention that economic performance of the Slovene companies representing SBI20 was very good.

#### **7.) Outlook for the future and economic policy debate:**

Economic activity in Slovenia in the first quarter of 2008 was in the conditions of rather more pessimistic economic environment further driven by high level of export. Import also remains at very high level or for 3,1 percentage points higher than export. This is keeping the current account deficit at excessive rate. Inflation also remains at excessively high level. Terms of trade because of high oil and food prices worsen. Industrial production after three months of decline in February 2008 again increased (7,5% annually) what is mainly because of increased production in the manufacturing sector. Engineering investments remained at very high level. The development on the labour market is still positive thus that employment (3,5% - FEB 2007/ FEB 2008) is rising and unemployment is still falling. The costs of production increased. Credit activity both to business sector and households remained at high level. Deposits are rising. This is due to increased interest rates and development on the Ljubljana Stock exchange. The stock exchange index from 1.1.2008 fell for 25% thus that domestic and foreign analysts already

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<sup>28</sup> *The productivity growth in Slovenia in 2007 it was 3,3% while it was 7,6% in the manufacturing sector.*

recommend buying Slovene blue chips. P/E ratio is currently in much more reasonable framework. This is because of improved profitability and falls on the stock exchange.

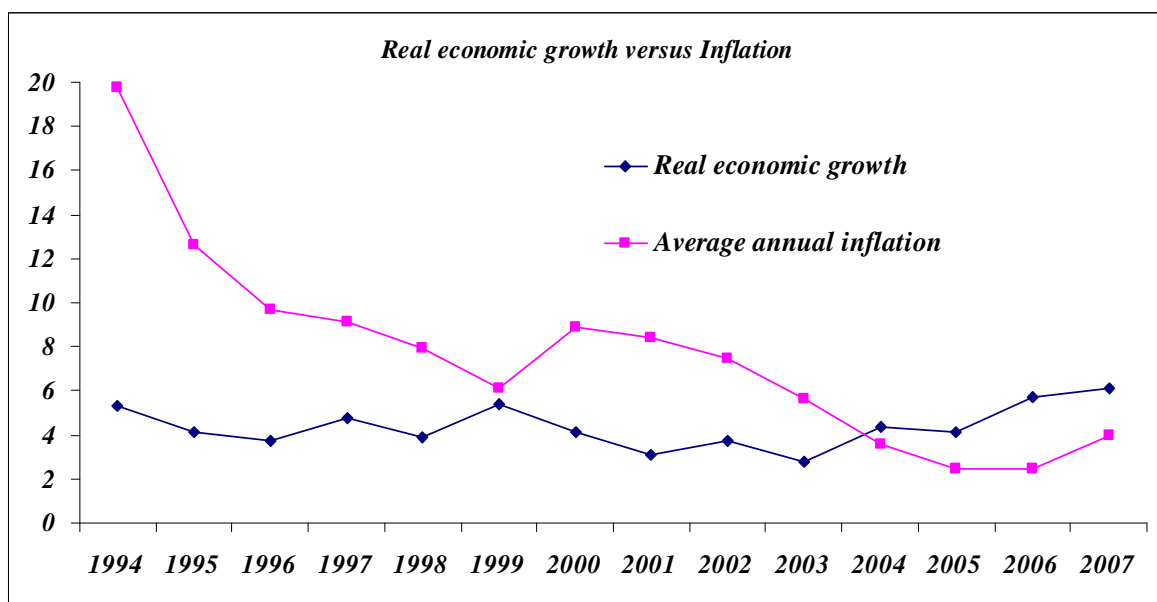
**The forecast for economic growth** in the year **2008** is according<sup>29</sup> to *IMAD* 4,4% of GDP. On the demand side export will be main driver of the economic growth. Investments are to be slightly slowed down but consumption and governmental spending are to be increased. On the supply side engineering, manufacturing, trade and financial intermediation will grow the most. Employment growth is to slow down to 1,1% annual rate and wages are in 2008 to grow at 2,4%. Annual inflation will slow down while annual average inflation will in 2008 remain high. The current account deficit is in 2008 expected to remain at 4,6% of GDP. In **2009** the economic growth is forecasted to be 4,1% of GDP where export will remain main driver of economic growth, while investments will slow down significantly. Export is to slow down too. Consumption is to remain at high level while governmental spending is to slow down. The current account deficit is expected to return to sustainable level. Both annual and average annual inflation is to return to or near Maastricht's framework. In **2010** because of recovered international environment and because of cyclic revival economic growth is expected to be at 4,4% of GDP. Apart from high level of export and also import investments in machinery and equipment are going to increase. Consumption is to increase but governmental spending is expected to be at lower growth. Inflation is expected to be at around 3%. Risks that this forecast would not be achieved are associated with dept of the current global financial crisis, oil and raw material prices and also unsustainable<sup>30</sup> wage increases.

In Slovenia in the period 1994 – 2007 there has been fairly recognizable correlation between economic growth and inflation. When inflation was lower economic growth was higher and vice versa. This can be fairly good seen on the graph below.

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<sup>29</sup> *Bank of Slovenia and IMF are forecasting the economic growth at slightly lower level.*

<sup>30</sup> *Unsustainable means that wages to grow at higher percentage than productivity.*



Source: SURS

This implies that appropriate economic policies for further development and growth will be crucial. In Slovenia prior to EMU entrance people responsible did manage to ensure strong coordination between monetary and fiscal policy. It resulted in the effective decrease of inflation below Maastricht's criteria. As Slovenia passed monetary policy on the ECB fiscal policy and structural reforms will be very important. We have now two different views about the fiscal policy in Slovenia. Bank of Slovenia, opposition and IMF<sup>31</sup> economist are saying that the fiscal policy should have been more restrictive and that the government directly by spending and indirectly by bail – outs substantially increased aggregate demand what additionally influenced already excessive inflation due to oil and food prices increases on the world markets. On the other hand the government economists are saying that fiscal policy did not add to inflation and that it was both restrictive and anti – cycling. However inflation in great part remains monetary problem. In the case of Slovenia price shocks, lack of competition and BS effect, increased aggregate supply of money because credit growth with its multiplication resulted in excessive inflation. In the period of monetary independence the Bank of Slovenia did manage to sterilize this effect although that the capital inflows were happening on a smaller scale. On the other side increased inflation and current account deficit and subsequently gross domestic debt were by the economists predicted before the entrance to the EMU II mechanism. This development was predicted on the basis of lower expected interest rates and integration to EMU so that we should not be surprised. The fiscal policy

<sup>31</sup> IMF aftermath of the Asian crisis proposed restrictive fiscal policy what brought crisis countries even deeper into the recession.

in conjunction with the ECB monetary policy for sustainable low inflation should have been conducted in a way that it would have been able to support the objectives of the Strategy of the development of Slovenia in terms of sufficient expenses for *R&D*, education, environmental and infrastructure projects.

The development policy as part of fiscal policy remains the main challenge also for Slovenia. In this context research and development *R&D* will play the centre role. Slovenia is increasing the expenses for *R&D* as percentage of GDP. In the year 2006 1,59% of GDP<sup>32</sup> was spent for *R&D*. This means improvement in comparison to previous years. Structure of *R&D* expenditures improved as well thus that private sector already represents 59,3% of total expenses. The private sector need further to increase its share in total *R&D* expenses. The additional tax relief for *R&D* with its regional component introduced is already bearing results. As far as research and development is concerned further improvements are necessary. The total expenses for *R&D* will need further to increase along with increasing part of the private sector in it. The effectiveness of use of budget financed part of *R&D* expenses will need to improve. In order to achieve this institutional changes are necessary. Slovenia achieved good level of expenses for investments in human resources and high percentage of people are participating in life long learning. Number of innovation per million of people is significantly above new member states average but also significantly below EMU average. Expenses for development of telecommunication sector are comparable to EMU countries. Regarding Slovene development policy there are further possibilities for improvement. There is still low level of investments in information technologies and also low of high tech products in total export. The availability of venture capital is low.

## 8.) **Conclusion:**

Slovenia in the period of transition went from central planning economy to market economy fairly successfully. Today it is member of European monetary union and NATO and in the year 2005 it was for the very first time by international institutions considered as developed country. In the transition Slovenia did manage to ensure nominal convergence and to reach certain level of real convergence towards old member states of

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<sup>32</sup> 1,85% of GDP in the EMU.

the European Union and was in the same time able to ensure major economic balances. However, the need for new developmental pattern was widely recognised. *The Strategy of the development of Slovenia (SRS)* from 2005 defined vision and objectives of the development and five key development priorities. It was followed by the framework of economic and social reforms with 67 concrete measures for structural improvement and institutional changes. A great part of the reforms were implemented and the results are in terms of increased economic growth and employment obvious.

On the other hand the inflation and current account deficit increased. The critics who are mainly representatives of the gradual approach say that Slovenia is paying a high price for the economic growth and that the economy is overheating. They are also pointing on financial stability matter. They claim that the government directly by spending and indirectly by bail-outs substantially increased aggregate demand what additionally boosted already high inflation due to oil and food prices increases on the world markets. However, Slovenia with entrance to ERM II mechanism in June 2004 and on 1.1.2007 to the European monetary union transferred monetary policy to European central Bank. Slovenia lost exchange rate as an instrument for macroeconomic adjustment which was in the past successfully using. It became part of much interconnected European economic environment which induced export and investments. This subsequently mainly because of private sector needs caused substantial inflow of funds what by increased aggregate money supply along with high oil and food prices added to the inflation. High inflation is along with foreign shocks, lack of competitiveness on the market rather monetary problem as fiscal policy was appropriate.

Slovenia in 2006 and 2007 did manage according to the SRS and also Lisbon strategy by high level of investments to fulfil its main short – term goal to increase natural or potential economic growth and level of employment. In order to achieve long – term SRS objective continuation of structural reforms will be crucial. The fiscal policy under unfavourable global economic conditions will be of great importance. In order to maintain desired level of economic growth and employment rather more relaxed fiscal policy would have been appropriate. Solid fiscal situation and low public debt leave space financially to support the SRS among others in terms of sufficient expenses for *R&D*, education, environmental projects. On the other hand other anti-inflation measures like income policy, labour market flexibility, competition on the market will be of great importance.

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