

Republic of Slovenia: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Slovenia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Republic of Slovenia, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 13, 2004**, with the officials of Slovenia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 19, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 7, 2004 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Slovenia.

The document listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the 2004 Consultation with the
Republic of Slovenia

Approved by Alessandro Leipold and G. Russell Kincaid

April 19, 2004

- The consultation discussions were held in Ljubljana during January 12–23, 2004. The mission met with Finance Minister Mramor, Bank of Slovenia Governor Gaspari, other senior officials of the government and Bank of Slovenia, parliamentarians, and representatives of trade unions and the business, financial, and academic communities.
- The mission comprised Messrs. Banerjee (head), Soikkeli, and Sommer (all EUR). Mr. Prader, Alternate Executive Director for Slovenia, attended the concluding policy meeting.
- A joint press conference was held with the authorities at the end of the mission. The authorities released the mission’s concluding statement and have agreed to the publication of the staff report.
- Slovenia has accepted the obligations of Article VIII, sections 2, 3, and 4, and maintains no restrictions on the making of payments and transfers for current international transactions, except for those imposed in compliance with applicable UN Security Council resolutions. All such restrictions have been notified to the Fund pursuant to Decision 144(52/51).
- Slovenia has subscribed to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance.
- Parliamentary elections are scheduled for October 2004.

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I. BACKGROUND

1. **With Slovenia scheduled to accede to the European Union (EU) on May 1, 2004, the authorities plan to enter ERM2 in the course of the second half of 2004 with the aim of adopting the euro in January 2007.** The authorities' program and policy strategy for euro adoption has been discussed domestically in various fora.¹ There is broad consensus of all political parties and social partners on these goals.

2. **Slovenia is well poised to enter the euro area in many respects.** Real convergence in per capita income and productivity is comparable to that of some noncore euro countries. Slovenia stacks up well on optimal currency area properties, particularly with regard to business cycle correlation, similarities in production structure and share of intra-industry trade, and strong trade links. In addition, Slovenia already meets the Maastricht criteria for long-term interest rates and the fiscal deficit and debt ratios.

3. **However, significant policy challenges lie ahead for successful participation in the monetary union.** The inflation rate, though falling, is still above the EU average and thus distant from the Maastricht criterion; wage-setting mechanisms are not sufficiently flexible; the expenditure side of the budget needs to be adjusted to enhance the flexibility of fiscal policy; and the current exchange rate arrangement entailing steady depreciation needs to be relinquished for a stable

Selected Indicators of Optimal Currency Area Properties			
GDP per capita in purchasing power standard (Index relative to EU; 2002)		Correlations of indicators of economic activity with Germany	
Slovenia	69	Industrial production (1996-2000)	
Greece	71	Slovenia	0.54
Portugal	71	Core euro countries, average	0.61
		Noncore euro countries, average	0.53
Sectoral distribution of GDP (In percent; 2001)		GDP (1993-99)	
Slovenia		Slovenia	0.80
Agriculture	3	Core euro countries, average	0.75
Industry	37	Noncore euro countries, average	0.63
Services	60	Manufacturing intra-industry trade	
Euro area		(In percent of total mfg. trade; 1996-2000)	
Agriculture	2	Slovenia	74.6
Industry	27	Core euro countries, average	72.8
Services	71	Noncore euro countries, average	57.1
Manufacturing asymmetry indicator 1/		Trade links	
Slovenia	25.3	(share of total trade with euro area in percent, 2000-02)	
Germany	21.5	Slovenia	60.7
Greece	49.8	Greece	43.9
Portugal	52.2	Portugal	67.3

Sources: Eurostat; and *Adopting the Euro in Central Europe—Challenges of the Next Step in European Integration* (forthcoming IMF Occasional Paper).
1/ Sum of absolute values of the differences between the shares of gross manufacturing output by industry and euro-area shares. The higher the indicator, the greater is the deviation from the average manufacturing structure of the euro area. Data are for 2000, except for Greece (1999).

Maastricht Criteria and Slovenia's Current Position					
	Average inflation (percent)	Average long-term interest rate (percent)	Gen. govt. deficit (percent of GDP)	Gen. govt. debt (percent of GDP)	Exchange rate
Convergence criterion	2.8 1/	6.13 2/	-3.0	60.0	Stable around central parity
Slovenia's current position (2003 unless otherwise specified)	4.9 3/	5.75 4/	-1.8 5/	27.0	Crawling band

Sources: Slovene authorities; Eurostat; and IMF staff projections.
1/ WEO projection of the three lowest inflation rates in the EU during 2005–06 plus 1½ percentage points margin.
2/ Average for the 12-month period ending February 2004 for the three lowest inflation rate countries in the EU plus 2 percentage points margin.
3/ Average annual inflation for the 12-month period ending March 2004.
4/ Coupon rate on 10-year government bond issued in October 2003.
5/ ESA-95 basis. On GFS-basis, the deficit is estimated at 1.4 percent of GDP.

¹ See *Programme for ERM II Entry and the Euro Adoption*, available at http://www.bsi.si/html/eng/publications/europe/ERM2_BS_Vlada_200311.pdf

exchange rate around central parity. These challenges have to be met in an environment of looming risks of a domestic demand boom, which could pose particular difficulties once in ERM2.

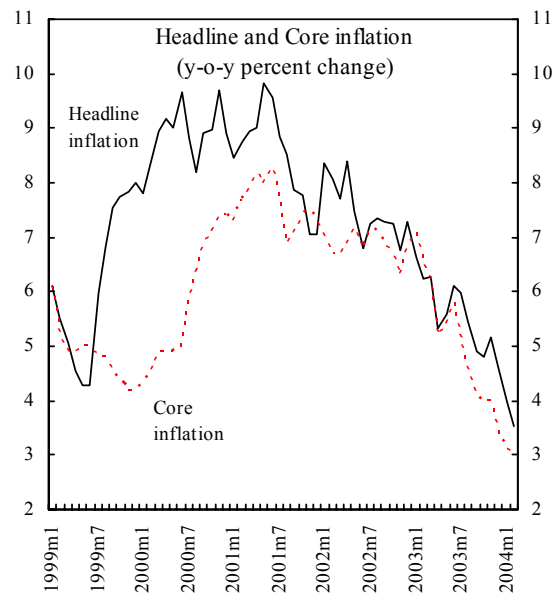
4. Domestic demand rebounded strongly in 2003 after three anemic years, though the weak external environment continued to be a drag on overall growth.

All components of domestic demand strengthened appreciably, fueled by declines in interest rates and associated pickup in bank credit to the private sector. However, there was a large negative swing in the contribution of net foreign demand to real GDP growth, which slowed to 2¼ percent, and the output gap widened. Exports to the EU remained subdued, and exports to the main non-EU destinations slowed markedly, reflecting the weaker macroeconomic situation in these countries. With imports being boosted by the pickup in domestic demand, the external current account position receded from a sizeable surplus in 2002 to approximate balance in 2003 (Figure 1 and Table 1).

	Average				
	1996-1999	2000	2001	2002	2003
Real GDP	4.5	4.1	2.9	2.9	2.3
Domestic demand	5.8	1.5	1.0	2.1	4.0
<i>Of which:</i>					
Private consumption	3.5	0.3	2.4	1.1	3.1
Gross capital formation	13.1	3.3	-4.2	4.1	7.0
Net foreign demand contribution					
to growth (percentage point)	-1.4	2.5	1.8	0.8	-1.8
Merchandise exports	6.9	12.9	6.9	6.5	4.5
Merchandise imports	8.6	7.7	3.2	4.4	6.8
External current account balance (in percent of GDP)	-0.9	-2.8	0.2	1.4	0.1
Output gap (in percent of potential GDP)	0.2	1.5	0.5	-0.3	-1.6
Bank credit to private sector	13.4	8.9	10.6	3.8	10.7

Sources: Statistical Office; and IMF staff estimates.

5. Progress with disinflation was more than envisaged by either staff or the Bank of Slovenia (BoS). Year-on-year headline inflation declined from 7.2 percent in December 2002 to 4.6 percent in December 2003, and fell further to 3.5 percent in March 2004. Core inflation fell to below historical lows at end-2003. Staff analysis suggests that the widening of the output gap associated with the economic slowdown was the dominant driving force behind disinflation in 2003. Other contributory factors, albeit to a small degree, were a moderation of the pace of depreciation of the tolar, lower increases in regulated prices and indirect taxes, and excise tax adjustments to offset increases in international oil prices. Wage developments contributed little to disinflation. While the economy-wide real wage increase in 2003 was broadly similar to that in 2002, the gap



Sources: Statistical Office of the Republic of Slovenia; and Bank of Slovenia.

between wage and productivity growth narrowed, to below the threshold norm of 1 percent specified in the Social Agreement (Figure 2).

6. The fiscal outturn in 2003 implied a withdrawal of stimulus (0.6 percentage point of GDP), complementing the authorities' disinflation effort.

The general government deficit—1.4 percent of GDP—was slightly smaller than that envisaged in the mid-year supplementary budget and broadly similar to the outturn in the past three years. Collections in most tax categories surpassed expectations despite slower-than-expected growth. However, expenditure on goods and services and use of contingency reserves (a one-off payment to compensate farmers for drought) exceeded the budgeted levels, and were partly offset by a cutback in investment spending plans (Table 2).

Productivity and Real Wages (Percent change)				
	2000	2001	2002	2003
Productivity (entire economy)	2.9	2.4	3.5	2.5
Real wages				
Entire economy	1.6	3.3	2.1	1.9
Public services	2.1	5.1	1.1	0.7
<i>Of which: Public administration</i>	0.3	5.1	0.0	1.5

Source: Statistical Office of the Republic of Slovenia.

7. Monetary conditions at the policy level remained broadly stable. The BoS continued with its monetary and exchange rate policy framework in which interest rates are adjusted in response to inflation dynamics and inflation expectations, while the exchange rate is also managed to avoid widening the uncovered interest parity with the aim of discouraging interest-sensitive capital inflows. Prompted by the deceleration in inflation, European Central Bank (ECB) rate cuts, and a perception of falling country-risk premium, the BoS lowered its key policy rate (on 60-day bills) steadily by a total of 3½ percentage points since December 2002 to 4¾ percent in April 2004. Meanwhile, the pace of depreciation of the tolar vis-à-vis the euro slowed from an annualized rate of 3.3 percent in December 2002 to 2 percent in March 2004, equivalent to a virtually unchanged bilateral real exchange rate (Figures 3 and 4).

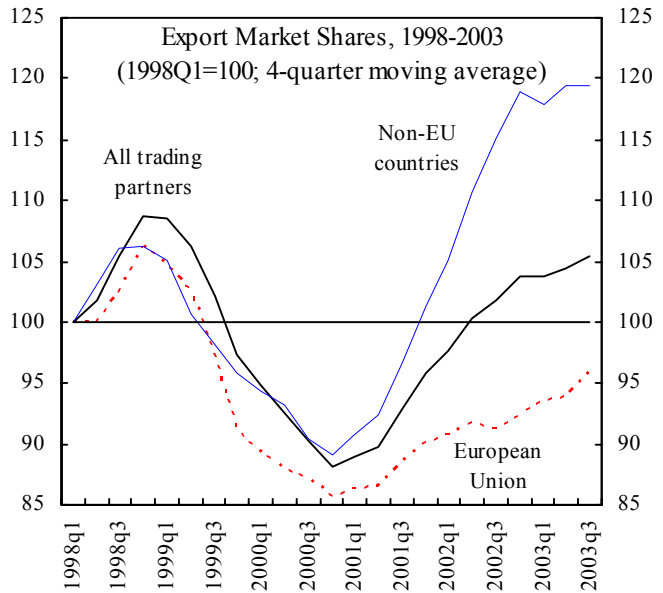
8. Lending rates of banks fell in real terms in 2003, and private credit demand and interest-sensitive capital inflows picked up. With the elimination of indexation of financial instruments, lending rates of banks became more sensitive to competition and movements in the interest rate on foreign-currency denominated loans. It would appear that for a large segment of blue-chip corporate customers, aggressive pricing by foreign-owned banks has already resulted in convergence with nominal interest rates abroad. These banks are typically charging EURIBOR plus a margin of 60–80 basis points on foreign-currency denominated loans; tolar loans are priced equivalently after adjusting for expected depreciation. About two-thirds of the expansion of credit to enterprises in 2003 was foreign currency denominated (primarily in euros), and financed by rising bank borrowing from abroad. Overall, foreign

currency-denominated lending to households was minimal, though such transactions jumped in the fourth quarter following the liberalization of regulations (Figure 5 and Table 3).²

9. Competitiveness and other external vulnerability indicators remain satisfactory.

The unit labor cost-based real effective exchange rate and relative profitability index have remained broadly unchanged since early 1998 (Figures 6 and 7).

Slovenia's market exchange rate as a ratio of the PPP exchange rate (relative to the euro area) also was stable during 1998–2002. Over the past two years, Slovene exporters have regained the loss in EU market shares experienced during 1999–2000 and have progressively increased their presence in non-EU countries, though the latter appears to have plateaued. With the increased resort to external financing by banks and enterprises, total external debt increased to about 53½ percent of GDP at end-2003. Short-term external debt (on residual maturity basis) in 2003 was about two-thirds the level of gross official reserves, and external debt service payments were about 15½ percent of exports of goods and nonfactor services (Table 4).



Source: Direction of Trade Statistics.

II. REPORT ON THE DISCUSSIONS

10. The discussions focused on the vulnerabilities during the run-up to euro adoption, and on the policy requirements for achieving a successful transition and strong performance in monetary union. The main challenges are to implement policies that will lower average inflation to a rate that meets the Maastricht criterion (estimated at 2¾ percent during the assessment period³) and that thereafter avoids loss of competitiveness once the central parity is fixed; and to maintain exchange rate stability within “the normal fluctuation margins” of ERM2 for at least two years. The authorities’ policy strategy centers

² In Q4, 2003, 10 percent of the expansion in household credit was foreign currency denominated, compared with about 1 percent in earlier periods.

³ June 2005–May 2006. Given Slovenia’s intention to adopt the euro in 2007, the convergence report will have to be submitted by no later than end-June 2006.

around keeping the current monetary and exchange rate framework until ERM2 entry, continue addressing the cost-push factors that have contributed to inflation inertia over the past years, enhancing wage flexibility, and maintaining fiscal discipline and modifying the indexation mechanisms for social transfers. The authorities' strategy paper considers the risks inherent in the euro adoption process to be manageable and the macroeconomic scenario underlying the budget for 2004–05 does not anticipate a domestic demand boom. The staff viewed this scenario as overly benign, and placed a higher likelihood on a credit-financed demand boom, with implications for the achievement of the Maastricht inflation criterion. Thus, while generally supportive of the authorities' overall policy framework, the staff advised a more deliberate role for monetary policy in the period up to ERM2 entry, faster progress in enhancing wage and fiscal policy flexibility, and further strengthening of bank supervision.

11. Over a number of years, the authorities have generally heeded the Fund's policy advice, though with differences persisting on how monetary policy could best contribute to disinflation. During the past year, the authorities made progress in implementing structural and fiscal policies emphasized by Executive Directors at the conclusion of the last consultation on April 16, 2003 (Box 1).

Box 1. Policy Recommendations and Implementation

In concluding the last Article IV consultation discussions with Slovenia, Executive Directors focused on policies to address two main challenges: lowering inflation sharply before entering ERM2, and returning in 2004 to the previously planned path of fiscal adjustment (<http://www.imf.org/external/pubs/ft/scr/2003/cr03108.pdf>).

During the past year, in line with Fund advice, the authorities enhanced policy coordination on administered prices, eliminated indexation of financial contracts, and initiated steps to weaken wage indexation. However, the BoS did not adopt a more aggressive disinflation effort through accepting a stronger tolar, as advised by the Fund, out of concerns that this would trigger capital inflows, and kept monetary conditions broadly unchanged. Nevertheless, for reasons explained in ¶5, progress in disinflation was better than expected.

On the fiscal front, the time horizon for achieving the medium-term goal of structural balance has lengthened, because of fiscal pressures connected with EU accession. Still, as per Fund advice, the authorities have focused on restraining increases in the wage bill and social transfers. Furthermore, they sought and obtained technical assistance from the Fund in November 2003 to identify further means of expenditure rationalization.

On financial structural issues, the authorities have implemented most of the recommendations of the 2001 FSAP. A FSSA update was undertaken in November 2003 (Box 4).

A. Macroeconomic Outlook

12. **The staff pointed to various factors that suggested a high likelihood of a credit-financed demand boom in the offing, similar to that experienced by noncore euro-area countries in the late 1990s prior to euro adoption.** The strong upturn in domestic demand in Slovenia in 2003 likely represents the early stages of a demand boom. In the period ahead, further demand-side impetus to external borrowing and bank credit is likely to come from favorable business and consumer expectations triggered by EU accession and prospective euro adoption, and from a convergence-related decline in interest rates. Domestic demand is also likely to be fueled by the release of funds from the housing savings scheme beginning in mid-2004. Dynamic simulations for Slovenia carried out by Fund staff, applying the parameters of a model of credit growth in the euro area, also suggest a potentially rapid acceleration in credit in the next few years.⁴ Senior policy makers conceded that a demand boom was a potential risk, but did not consider it as their baseline scenario.

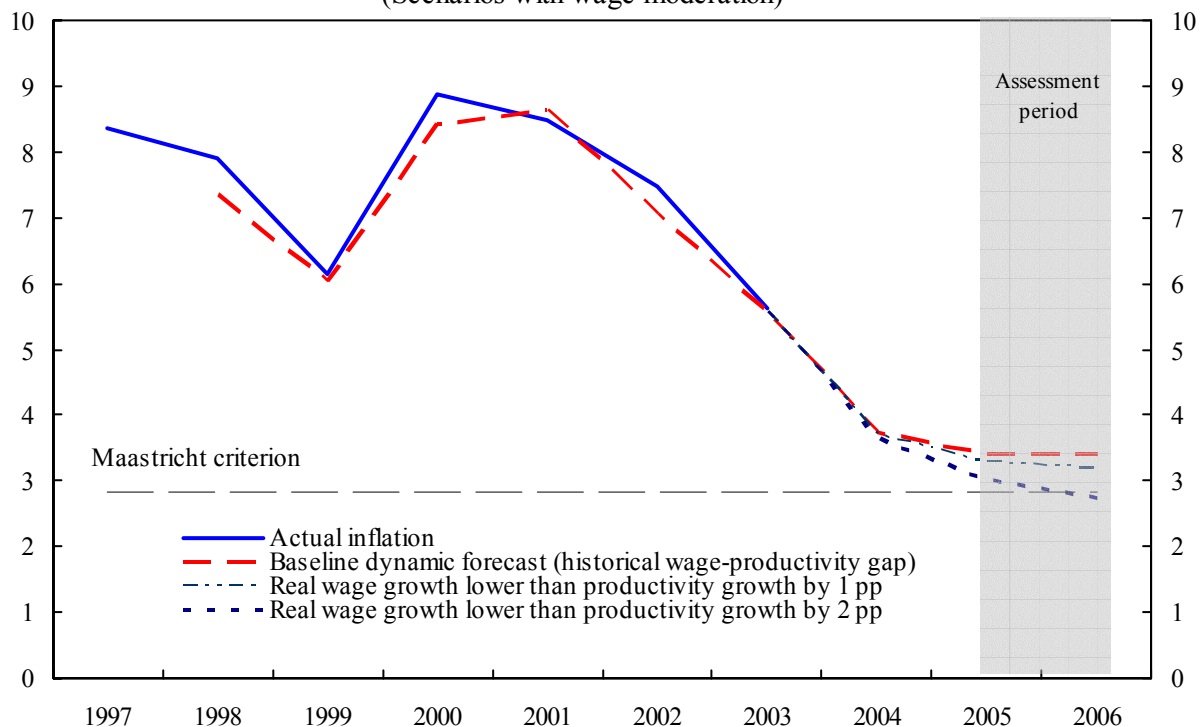
13. **There was consensus that the contribution of net foreign demand to growth would likely remain negative in the foreseeable future.** Exports should pick up in line with the anticipated recovery in the EU, though imports, driven by strong domestic demand, are expected to increase at a faster pace. Accordingly, the staff projects real GDP growth rebounding to 3½ percent in 2004 and rising above the potential rate subsequently to 4½ percent in 2006. The external current account is expected to swing into a deficit in 2004 that would widen progressively to a peak of about 2 percent of GDP in 2007 (Tables 5 and 6). Under this scenario, which assumes that credit-financed domestic demand pressures will be self-correcting and that foreign direct investment inflows will recover upon euro adoption, the external debt-to-GDP ratio is projected to increase by about 10 percentage points over the medium term and stabilize at about 63 percent in 2008–09. Sustainability is not an imminent concern, but developments merit monitoring (Appendix III).

14. **Notwithstanding the notable decline in inflation during the past year, staff saw a need for additional policy measures to achieve the Maastricht inflation criterion.** The BoS projects that inflation would remain around 3½ percent during Q2–Q3, 2004 and fall to below 3 percent by the start of the assessment period (i.e., mid-2005), predicated on the assumption that GDP growth would remain below the growth rate of potential output. However, BoS officials acknowledged that lowering inflation below 3½ percent in a sustainable manner would be difficult, and generally agreed with the findings of the staff's inflation model (Box 2). A principal conclusion of the staff's analysis is that real GDP

⁴ See *Adopting the Euro in Central Europe—Challenges of the Next Step in European Integration* (forthcoming IMF Occasional Paper), Figures V.14–V.16. Projections based on this methodology suffer from upward bias. Thus, the credit paths—with growth rates possibly reaching 20–40 percent during 2004–05 and returning quickly to fairly low levels thereafter—coming from the simulations should be seen as extreme scenarios.

Box 2. Inflation in Slovenia (continued)

Slovenia: Annual Inflation, 1997-2006
(Scenarios with wage moderation)



Growth Assumptions and Inflation Projections
(In percent)

	2002	2003	2004	2005	Q3/2005 - Q2/2006	2006
Baseline-growth scenario						
GDP growth	2.9	2.3	3.5	4.1	...	4.5
Potential GDP growth	3.8	3.6	3.5	3.5	...	3.5
Output gap	-0.3	-1.6	-1.6	-1.1	...	-0.1
CPI inflation, avg	7.5	5.6	3.7	3.4	3.25	3.4
No demand boom scenario						
GDP growth	2.9	2.3	3.2	3.6	...	4.0
Output gap	-0.3	-1.6	-1.9	-1.8	...	-1.3
CPI inflation, avg	7.5	5.6	3.6	2.9	2.4	2.1
High-growth scenario						
GDP growth	2.9	2.3	3.7	4.5	...	5.0
Output gap	-0.3	-1.6	-1.4	-0.4	...	1.0
CPI inflation, avg	7.5	5.6	3.8	3.8	3.9	4.4

Source: IMF staff estimates.

growth above the potential growth rate and a consequent narrowing of the output gap will impede the disinflation process. The baseline scenario indicates that the BoS's inflation goal for 2004 may be feasible, but that average inflation during the assessment period would likely exceed the BoS projection.

B. Monetary and Exchange Rate Policy

15. The monetary and exchange rate policy orientation envisaged by the authorities is as follows:

- In the run-up to ERM2 entry, the BoS's operations would focus on progressively reducing the rate of depreciation of the tolar vis-à-vis the euro to zero by the fourth quarter of 2004, and on gradually lowering nominal interest rates. These measures would be undertaken in a manner that was consistent with the reduction in inflation and inflationary expectations and that did not open up the interest parity with abroad.
- In line with the staff's assessment, BoS officials considered the current level of the real exchange rate to be close to the equilibrium exchange rate, and thought it highly probable that the central parity under ERM2 would be set at the then prevailing market exchange rate.
- Under ERM2, the BoS was inclined toward adopting a narrow band around the central parity. In this set up, the BoS would let domestic interest rates be determined by interest rates in the euro area and the risk premium, and put the burden of absorbing shocks on wage and fiscal policies.
- To have the maximum scope for limiting exchange rate volatility through sterilized intervention, the BoS would continue with the current contractual cooperation with commercial banks on exchange rate policy operations (Box 3).
- Mindful that ERM2 will place a high premium on consistency of policies, the authorities intend to give priority to close policy coordination between the BoS and the government, and build on the progress achieved in 2003.

16. The staff called for a more pro-active role for monetary policy in lowering inflation in the coming months. In particular, the staff recommended that the BoS restrain monetary conditions in the run-up to ERM2 entry by reducing nominal interest rates cautiously and slowing the pace of depreciation deliberately. Early monetary restraint was advisable also to avoid a possible worst-case scenario of intense demand pressures under ERM2, when monetary tightening within a narrow exchange rate band could create a one-way bet, with the authorities facing either large sterilization costs or the need to let the exchange rate appreciate. If more than one round of appreciation proved necessary, competitiveness could take an appreciable hit.

Box 3. Foreign Exchange Rate Policy Operations

There are three main features in the BoS's exchange rate policy operations:

- A formal agreement between the BoS and individual banks under which the BoS sets the exchange rate and banks have access to central bank financing through a standing facility.
- Temporary (seven-day) swaps rather than outright purchases of foreign currency by the BoS. The banks pay a swap fee to the BoS, which is set in relation to the desired pace of depreciation, the refinancing rate of the ECB, and the interest rate on BoS bills.
- Sterilization of excess tolar liquidity through the issuance of central bank bills. Prudential considerations regarding maturity transformation constrain banks from extending long-term credits on the basis of short-term liquidity acquired by currency swaps, even though a large fraction of swaps is regularly renewed.

Under normal conditions, the BoS seeks to ensure the following relationship:

$$\text{Rate on BoS bills} + \text{Risk premium} = \text{ECB refinancing rate} + \text{Depreciation rate} + \text{Swap rate.}$$

In February 2004, the BoS and the commercial banks agreed to maintain the modalities of the current framework for foreign exchange market operations under ERM2. The BoS intends to purchase outright one-half of outstanding stock of swaps by the time of ERM2 entry to increase the attractiveness of the contractual agreement. By reducing the stocks of swaps while retaining the swap fee, the BoS would lower the cost imposed on banks.

17. **While acknowledging the importance of not forcing down real interest rates prematurely, BoS officials were concerned that restraining monetary conditions would open up the interest parity with abroad and trigger capital inflows.** They noted that key policy rates remained sufficiently positive in real terms. Nonetheless, they agreed that the BoS should lag rather than lead the market in lowering nominal interest rates during the convergence process. In the event of a credit boom, the BoS was in favor of tightening prudential requirements rather than relying on monetary policy instruments or controls on credit and capital inflows. BoS officials also argued that there was scope for lowering inflation through further flexibility in wage-setting procedures, with which the staff agreed. In response to staff's questions, they felt there would not be a need for, nor were they contemplating, a nominal step appreciation of the tolar on the eve of ERM2 entry to bring down inflation.

18. **The staff supported the BoS's plan to adopt a narrow exchange rate band under ERM2, and expressed understanding for the continuation of a contractual agreement with banks on exchange rate policy operations.** Ensuring unequivocal compliance with ERM2 requirements called for primacy being given to limiting exchange rate variability. BoS officials explained that the current managed foreign exchange intervention arrangement had

proved effective in avoiding exchange rate volatility. Shifting operating procedures would likely entail teething problems that could lengthen the euro adoption process. BoS officials recognized that euro system monetary instruments would need to be developed prior to euro adoption, and indicated that this task would be undertaken in a gradual manner.

19. **Several factors may mitigate exchange rate volatility under ERM2—though risks remain.** The staff agreed that a managed foreign exchange intervention arrangement, complete subordination of domestic interest rate decisions to those in the euro area, the small size of the projected fiscal deficit, a relatively thin government securities market, and enhanced policy coordination between the BoS and the government should reduce the scope for speculative capital flows and appreciation pressures. BoS officials further noted that it should be possible to accommodate Balassa-Samuelson effects (estimated at around 1–1½ percent per year) without creating tensions between meeting the inflation criterion and staying within a narrow exchange rate band. They did not expect a widening of the external current account deficit under ERM2 to cause market sentiment to swing toward depreciation, unless the deterioration was extremely large and persisted for a prolonged period.

C. Price and Wage Policies

20. **The authorities’ disinflation strategy will continue to entail limiting increases in administrative and regulated prices to no more than the projected inflation rate.** In line with the Fund’s recommendation during the last Article IV consultation, the authorities have prepared plans for adjustments of administered prices in a two-year framework for 2004–05. Consistent with these efforts, the government intends to avoid cost pressures arising from indirect tax increases.⁵ Also, the policy of adjusting the excise tax on gasoline to cushion fluctuations in international oil prices will remain. The authorities believed that many of the past increases in administered prices reflected monopoly pricing and ineffective functioning of the regulatory bodies, and that capping price increases would not result in losses for service providers and would induce efficiency gains. They indicated that government representatives on the regulatory bodies and supervisory boards of public enterprises would push for greater cost efficiency and savings.

	2002	2003	Proj.	
			2004	2005
Administered prices, all	9.2	5.5	3.4	2.3
Gasoline	7.7	3.3	-	-
Electricity tariffs	2.8	3.9	4.0	3.5
Telephone services	23.7	-	-	-
Municipal services charges	17.8	5.8	4.0	4.0
Social housing rents	9.4	29.8	30.0	5.1
<i>Memorandum item:</i>				
CPI inflation	7.2	4.6	3.7 1/	3.3 1/

Source: Institute of Microeconomic Analysis and Development (IMAD).
1/ Staff projection.

⁵ Only excise duty on cigarettes will be increased to gradually align it with the EU level.

21. **In the public sector, significant progress has been made in weakening wage indexation and slowing wage drift, but risks remain from the negotiations on a new wage structure.** Average real wages in the general government are projected to decline in 2004–05. Agreement has been reached to shift to a wage indexation formula that takes into account inflation in the EU, expected domestic inflation, and changes in the dollar/euro exchange rate. However, only one-half of the budgetary funds earmarked for wage bill indexation would be used for individual-level wage indexation, and the other half would be applied toward implementation of a new wage structure aimed at reducing wage dispersion.⁶ The Ministry of Finance officials expected negotiations on job grading under a new wage structure to be concluded around mid-2004, and acknowledged that there was a risk of cost overrun. However, they emphasized that, if the demand for additional resources seemed excessive, the Ministry would press the government to give primacy to remaining within the budgeted wage bill envelope.

22. **Wage negotiations in the private sector for 2004–05 also have focused on promoting the interest of lower-paid workers and reducing wage dispersion.** In early March, the social partners agreed under government mediation on a uniform lump-sum nominal wage increase for all workers, and to negotiate additional increases in the various industry branches. During the mission, the staff had expressed concern about this then pending proposal, as it would likely impair the viability of enterprises that have a large proportion of employees in the lower-wage brackets. However, the concern is mitigated by the government's decision to offset the negative effect through a corresponding cut in the payroll tax.

23. **In the short term, a special wage policy effort may be required, if achievement of the Maastricht inflation criterion were to come under threat.** Analysis carried out by the staff suggests that wage policy could contribute importantly to disinflation through a reduction of real wage increases relative to productivity growth. Given the claim of trade union representatives that the gap between real wage and productivity growth was influenced mainly by developments at the enterprise level, the staff expressed the view that national considerations for meeting the Maastricht criterion might warrant a temporary wage pact at the national and enterprise levels between social partners under the guidance of the government. This view was well received by the Finance Minister, and not rejected by trade union representatives. Beyond that, the staff noted that, in preparation for euro adoption, Finland, Greece, Ireland, Italy, and Spain had changed their wage-setting procedures—including the elimination of indexation in some cases—and achieved moderation of wage increases. The staff encouraged social partners to eliminate wage indexation completely, and

⁶ The aim is to lower dispersion gradually from 1:12.3 in 2004 to 1:10 in 2008. Over the past several years, in both the public and private sectors, the current wage-setting mechanisms had yielded larger wage increases for the higher-paid workers and increased wage dispersion.

to craft a new collective bargaining system that enhanced wage flexibility and was cognizant of competitiveness considerations.

D. Fiscal Policy

24. **The authorities remain committed to maintaining tight fiscal discipline, despite having to cope with fiscal pressures connected with EU accession.** While Slovenia will be a net recipient of EU funds during 2004–06, the authorities estimate that EU entry would worsen the overall fiscal position by $\frac{3}{4}$ percent of GDP in 2004 and by over 1 percent of GDP in 2005–06. The additional pressures arise mainly because of cofinancing obligations, Schengen border-related expenses, loss of customs revenues from imports originating in the EU, and decrease in VAT receipts tied to the elimination of border customs controls upon EU accession. Nevertheless, the authorities have formulated a rolling two-year budget that targets general government deficits of around 1.6–1.7 percent of GDP in 2004–05, only marginally higher than the outturn in the past four years. The authorities' goal is to achieve structural fiscal balance over the medium term.

	2004	2005	2006
Net transfers	34.1	21.7	13.9
Receipts from EU budget 1/	79.1	98.0	93.6
Contributions to EU budget	-45.0	-76.3	-79.7
Other factors	-80.8	-93.5	-100.0
Use of earmarked revenues	-54.6	-75.8	-79.0
Co-financing 2/	-17.1	-11.7	-6.2
Indirect negative impact on budget 3/	-21.8	-25.5	-27.4
Expenditure savings through substitution	12.7	19.5	12.7
Net impact on budget	-46.7	-71.8	-86.1
In percent of GDP	-0.8	-1.1	-1.2

Source: Ministry of Finance.

1/ Includes only transfers channeled through the budget. Includes budgetary compensation and lump-sum transfers.

2/ Includes expenditure on establishment of Schengen border.

3/ Includes decreases in VAT collections and customs duties.

25. **The budget for 2004–05 incorporates significant expenditure saving measures and revenue-neutral changes in some areas of direct taxes.** The main expenditure saving initiatives include slower increases in public sector wages and employment; limiting spending on goods and services; moving to forward-looking indexation for certain categories of social transfers and strengthening the administration of transfer payments; and a considerable reallocation of expenditures that is not very transparent from the budget figures. The authorities noted that there was a risk of employment exceeding the budgeted level in 2005, as adaptation to EU rules and requirements was likely to create additional staffing needs. The changes to direct taxes entail lowering the tax burden on the lower-income groups, raising the minimum threshold for payment of payroll tax, broadening the coverage of taxable income, and better targeting tax incentives for enterprises.

	2004	2005
Wages and personnel expenditures	8.2	9.3
Goods and services	7.8	9.1
Social transfers	3.8	8.9
Reallocation of expenditures	8.3	14.2
Alteration of criteria for entitlement to funds	8.0	12.0
Total saving	36.1	53.5
In percent of GDP	0.6	0.8

Source: Ministry of Finance.

26. **The authorities agreed that further expenditure saving measures would be crucial to enhance the flexibility of fiscal policy and achieve the medium-term goal of structural balance.** A recent technical assistance mission from the Fund's Fiscal Affairs Department (FAD) determined that there was scope for rationalizing spending in health and education and aligning social benefits to prevailing international standards. However, the authorities felt that, owing to political constraints, the scope for savings was likely smaller than that estimated by the FAD mission and that implementation might take time. There was an ongoing debate within the government on the realignment and de-indexation of social transfers and modalities of health care reform. The staff supported the Finance Ministry's position that social transfers that were not targeted to the most vulnerable groups should be de-indexed in order to reduce expenditure rigidities, and that health care reform should first address the existing inefficiencies in the system. In this context, the staff encouraged the authorities to reconsider a proposal to merge private health care premiums with the public sector in 2005. Such a move would weaken the role of the private sector and put upward pressure on labor costs with potential spillover risks for inflation.

27. **The staff encouraged the authorities to give consideration to the appropriate fiscal policy response in the event of a demand boom.** The staff emphasized that, at a minimum, the government should save any revenue overperformance and ensure an improved fiscal outturn. The authorities recognized that fiscal policy was the main remaining tool for mitigating a private sector demand boom under ERM2 and monetary union. However, they wondered whether revenue overperformance should be applied toward further lowering of payroll taxes in order to strengthen the competitiveness of Slovene enterprises, as had been proposed in the Social Agreement. The staff advised against it, on the ground that it would negate the operation of automatic fiscal stabilizers and translate a cyclical factor into a structural change in the fiscal balance. Furthermore, under the current wage-setting mechanisms there was a high likelihood of enterprises using the extra resources to grant wage increases.

28. **The government's debt management strategy is oriented toward reducing the debt ratio and facilitating the development of the domestic market for government securities.** Since 2002, the government has increasingly issued securities at nominal interest rates and shifted to borrowing in the domestic market. The authorities noted that recent issues of long-term nominal fixed-rate instruments were oversubscribed, and that currently borrowing costs of the government were lower in the domestic market than abroad. The government planned to extend the maturity structure of public debt; one-half of new long-term borrowing would entail 10-year bonds. The authorities' central scenario projects a decline in the general government debt-to-GDP ratio from 27 percent in 2003 to about

25 percent in 2008. The staff's assessment of Slovenia's debt sustainability remains materially unchanged from that in the last Article IV consultation report.⁷

E. Banking Sector Issues

29. **Financial soundness indicators show that the banking system is currently healthy, but stresses are in prospect during the transition to euro adoption.** Banks remain adequately capitalized and profitable, and asset quality remains high. However, the domestically owned banks experienced a decline in profits in 2003 as the net interest margin narrowed with increased competition. As a result, many of these banks have begun to shift their focus to higher risk business clients and retail banking. The staff expect these tendencies to intensify as profit margins are squeezed further. BoS officials noted that current Slovene banking regulations with

Banking Sector Soundness and Profitability (End of period)				
	2000	2001	2002	2003 Sept.
Net interest margin (percent of average interest bearing assets)	4.7	3.6	3.7	3.3
Return on average assets (before tax, in percent)	1.1	0.5	1.1	1.2
Return on average equity (before tax, in percent)	11.4	4.8	13.3	15.7
Nonperforming assets (percent of total assets)	6.5	7.0	7.0	6.7
Loan-loss provisions (percent of legal requirement)	101.0	100.5	102.0	101.5
Capital adequacy ratio (in percent)	13.5	11.9	11.9	11.4
Memorandum item:				
Ownership of banking sector (percent of equity capital)				
Nonresidents	12.0	16.0	32.5	33.5
Central government	36.8	37.0	20.3	19.8
Other domestic entities	51.2	47.0	47.2	46.7

Source: Bank of Slovenia.

respect to risk classification of borrowers and provisioning (which is based on potential rather than realized loss) restrain banks from making high-risk loans. However, banks considered these regulations more stringent than the international standard and lately have been putting pressure on the BoS to ease them. Given the potential for a credit boom and related risks in the run-up to euro adoption, the staff cautioned the BoS against any loosening of the existing prudential regulations. In the new competitive environment, BoS officials expected consolidation of the banking system in the period ahead.

30. **The staff encouraged the BoS to speedily implement measures recommended by the Financial System Stability Assessment (FSSA) update to strengthen supervisory and prudential oversight** (Box 4). BoS officials indicated that, in parallel with adopting a risk-based supervisory approach, they were planning to introduce dynamic "general" provisioning as a means to counter banks' otherwise rather procyclical behavior. They were studying Spain's dynamic provisioning system with the aim of tailoring it to the Slovene situation. In this context, the staff noted that as dynamic provisioning was not a tool that could be introduced quickly, other tools (such as reserve requirements) might have to be considered to control surges in credit growth in the short term.

⁷ Hence the updated sustainability exercise is not reproduced here. See Slovenia: IMF Country Report No. 03/108.

Box 4. FSSA Update

The main findings and recommendations of the November 2003 FSSA Update are as follows:

- The Slovene financial system remains sound, but is likely to face stresses arising from increased competition and potential rapid credit growth during the transition to euro adoption. Stress tests show that the financial system is vulnerable to interest rate spread compression and a deterioration in asset quality.
- The current supervisory approach complies well with the Basel core principles. However, in view of the changing operating environment for the financial system, banking supervision needs to strengthen its risk focus and ensure that pricing of risk and loan-specific provisioning by banks are appropriate. Consideration could be also given to introducing dynamic provisioning as a prudential tool.
- The insurance sector lacks transparency, and needs to develop the capacity to set pricing, provisioning, and capital at appropriate levels.
- Supervision of connected lending and financial conglomerates has improved, consistent with the recommendations of the 2001 FSAP. However, consolidated supervision still needs strengthening. Before proceeding with their plan to create a unified supervisory agency, the authorities need to ensure that the necessary preconditions for successful implementation are in place.
- Reform of the liquidity management framework recommended in the 2001 FSAP has been limited, in part because its scope was reduced by the need to manage large capital inflows. The current managed foreign exchange intervention arrangement should promote exchange rate stability under ERM2, but it will reduce incentives for banks to develop market risk management and operations capacity. The BoS needs to develop euro system monetary instruments prior to euro adoption.

31. **BoS officials were not unduly concerned about the increase in foreign currency denominated loans, with a majority of these loans being to exporters who were hedging their balance sheets.** However, they acknowledged that several large public sector enterprises were not hedged against currency risk, and agreed that their supervisory boards should discourage unhedged foreign borrowing. There was consensus that foreign currency denominated lending to households was likely to increase in the period ahead. The staff encouraged the BoS to ensure that banks offered hedging instruments to their clients and strengthened individual-level credit risk analysis of households. The staff considered the transfer of credit risk on household loans from banks to insurance companies as a potential vulnerability for the financial sector, and recommended that supervision of insurance companies be enhanced.

F. Other Structural Issues

32. **Progress continued in liberalizing utilities and transport services.** The telecommunications sector has been largely liberalized, and competition has been established in all segments of the market with the exception of the fixed network for inland calls. In the electricity sector, production and distribution have been unbundled, and the largest customers have been permitted to purchase electricity from abroad. Liberalization has brought about lower prices in the mobile telephone services and for the larger consumers of electricity.⁸ The authorities are making preparations for the liberalization of the natural gas sector, road transport, and railways in line with EU directives.

33. **In the authorities' view, unemployment in Slovenia—around 6½–7 percent for the past several years—was mainly structural in nature.** Over one-half of the unemployed had low education and were jobless for more than one year. The inflows into the unemployment pool during the past year were mainly persons whose fixed-term contracts had expired. The government has adopted employment policy programs based on the EU's common employment policy guidelines. The authorities noted that they would increase incentives for employing the long-term unemployed and unemployed women. More generally, to facilitate employment creation, they planned to take steps to eliminate the administrative barriers to the establishment and operation of enterprises.

34. **Upon EU accession, Slovenia will fully adopt the EU's trade policy and agreements.** All existing preferential trade agreements of Slovenia will be terminated. The harmonization of the tariff structure with the EU will lead to a lower average tariff on nonagricultural imports and a slightly higher average tariff on agricultural imports. The termination of free-trade agreements with the former Yugoslav republics is expected to have a potential negative impact on Slovene exports to those countries. However, the authorities considered this cost to be small compared with the benefits of joining the EU.

III. STAFF APPRAISAL

35. **With EU membership secured, policy makers now have to focus on laying the ground for a smooth transition to ERM2 entry and euro adoption.** The authorities' strategy to move expeditiously toward these goals appears feasible, but it is not risk-free. Slovenia is well positioned to enter the euro area with regard to optimal currency area properties, real convergence, and levels of fiscal deficit and public debt that already meet the Maastricht criteria. Competitiveness also appears adequate and stable. Several factors may mitigate exchange rate volatility under ERM2, though risks remain. However, a main immediate challenge is to lower inflation to a level that, in addition to meeting the Maastricht

⁸ The impact on prices for other consumers of electricity has not yet been determined by the authorities because of data gaps.

criterion, will prevent any loss of competitiveness. Maintaining low inflation and competitiveness thereafter will be a continuing challenge. In addition, alternative adjustment mechanisms to monetary policy—specifically, fiscal policy and wage flexibility—will need to be enhanced to absorb shocks. An environment of a credit-financed demand boom and related potential banking sector stresses would complicate addressing these challenges.

36. Monetary policy will need to play a deliberate role in lowering inflation in the run-up to ERM2 entry by restraining monetary conditions. While the BoS's concern about monetary restraint triggering capital inflows is understandable, it will be important to avoid reducing real interest rates prematurely.

37. Fiscal policy should be oriented to mitigating budgetary pressures associated with EU accession and coping with the risks of a possible private sector demand boom. Expenditure saving measures in the rolling two-year budget for 2004–05, aimed at easing the fiscal pressures connected with EU accession, are commendable and should be carefully safeguarded in an election year. However, further expenditure rationalization—especially in the areas of health care, education, and social transfers as identified by the November 2003 FAD mission—is key to securing sustained flexibility in the public finances as well as achieving the authorities' medium-term goal of structural balance. De-indexation of social transfers that do not target the most vulnerable groups also will help reduce expenditure rigidities. Health care reform should avoid measures that have the potential for fueling inflation. In the event of a demand boom, at a minimum, it is essential that the government save any revenue overperformance and ensure an improved fiscal outturn. Applying revenue overperformance toward further lowering of payroll taxes should be avoided.

38. Wage policy needs to play a critical role in disinflation and safeguarding competitiveness. In the public sector, wage indexation has been weakened, and wage drift reduced. To consolidate these gains, it would be important to restrict the cost of the new wage structure, under negotiation, within the budgeted wage bill. Wage policy can support disinflation by reducing wage growth relative to productivity growth, especially in the nontradable sector. If achieving the Maastricht inflation criterion appears to be under threat, national considerations might warrant, for a temporary period, a wage pact at the national and enterprise levels between the social partners under the guidance of the government. Both the government and social partners are encouraged to eliminate wage indexation and move to a wage-setting system that ensures greater productivity-based wage differentiation.

39. A strengthening of supervisory and prudential oversight of financial institutions will be critical to guard against the risks of rapid credit growth and stresses on the financial sector. Incipient signs have emerged of domestically owned banks shifting to more risky borrowers, and this tendency is likely to intensify as profit margins are squeezed further. Pressures from banks to ease existing prudential practices should be resisted. The BoS is also encouraged to speedily move the supervisory framework to a more risk-based approach, as recommended by the FSSA Update. The BoS's intention to introduce dynamic provisioning, in parallel with the risk-based approach, is appropriate. However, other tools, such as reserve

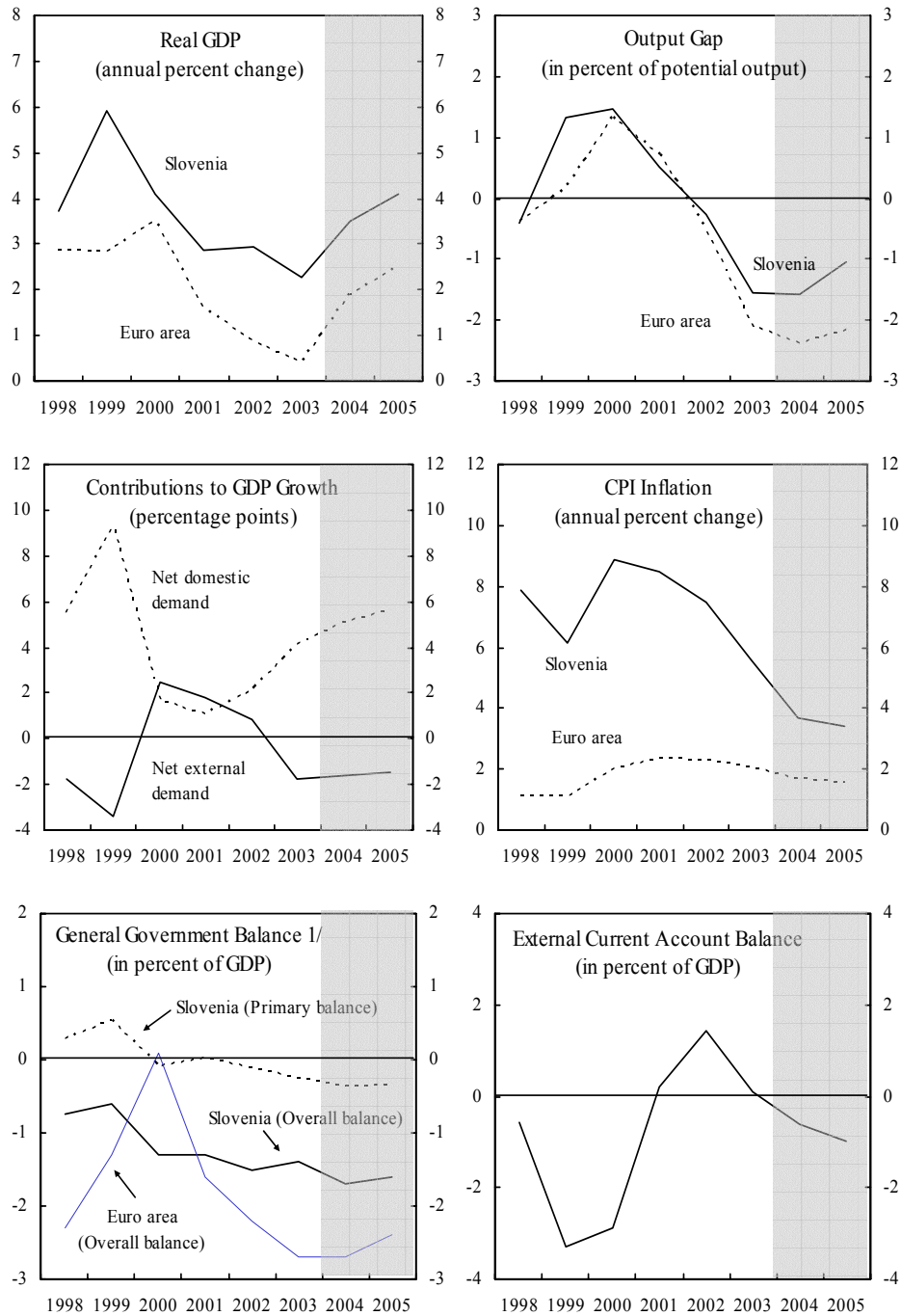
requirements, might have to be considered to control surges in credit growth in the short term.

40. **The momentum behind structural reforms in other areas should be maintained.**

The introduction of competition should result in lower prices, as experienced in the telecommunications sector. The authorities' decision to ask government representatives on the regulatory bodies and supervisory boards of public companies to push for efficiency gains, with a view to reducing the pressure on prices, is a step in the right direction.

41. It is recommended that the Article IV consultation with Slovenia remain on the standard 12-month cycle.

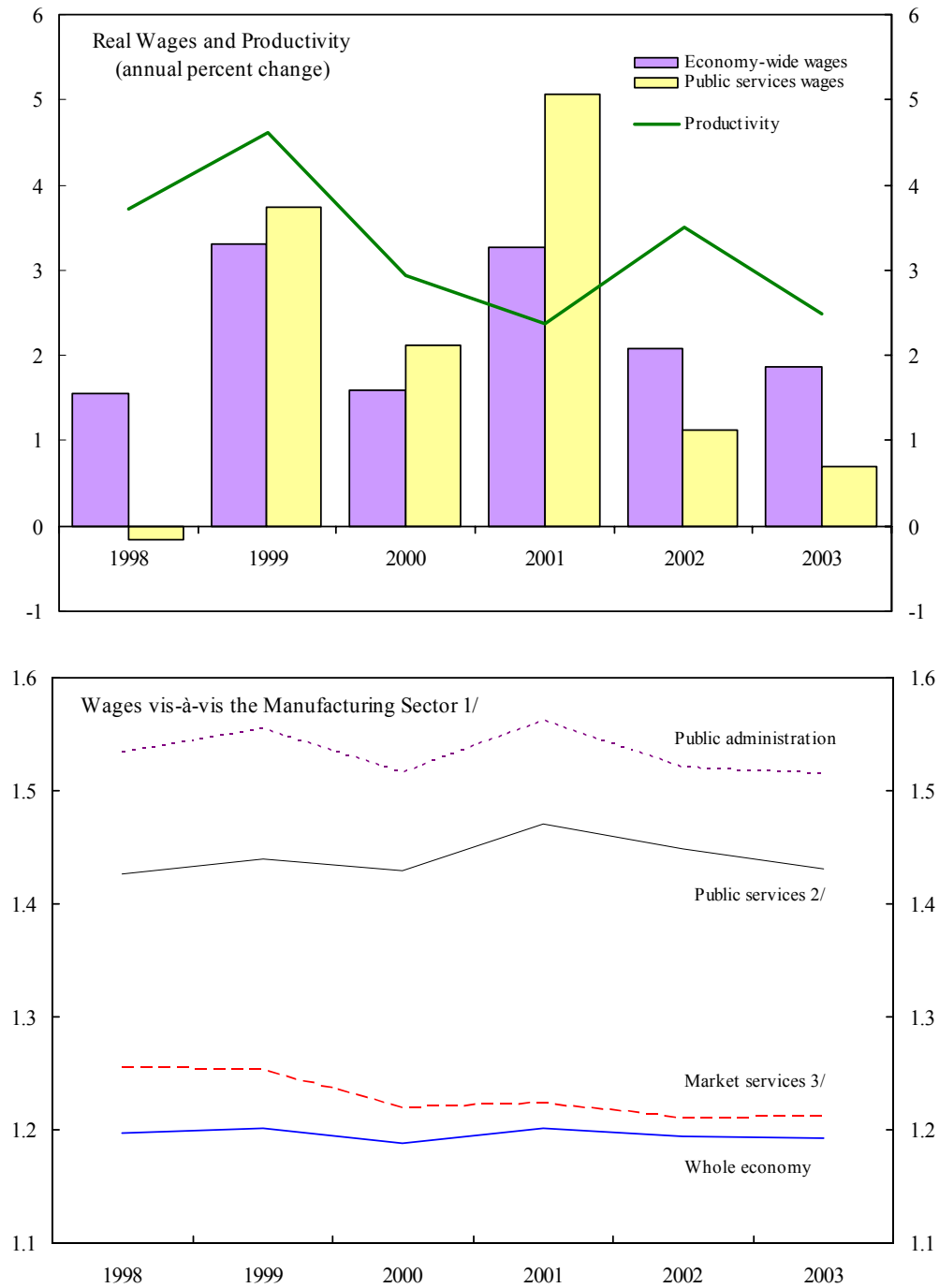
Figure 1. Slovenia: Economic Indicators, 1998–2005



Sources: Data provided by the Slovene authorities; and IMF staff projections.

1/ Figures for 2002 have been adjusted for the shift in the budget accounting to a pure cash basis. The general government balance for 2004-05 refers to the budget approved by the parliament.

Figure 2. Slovenia: Wages and Productivity, 1998-2003



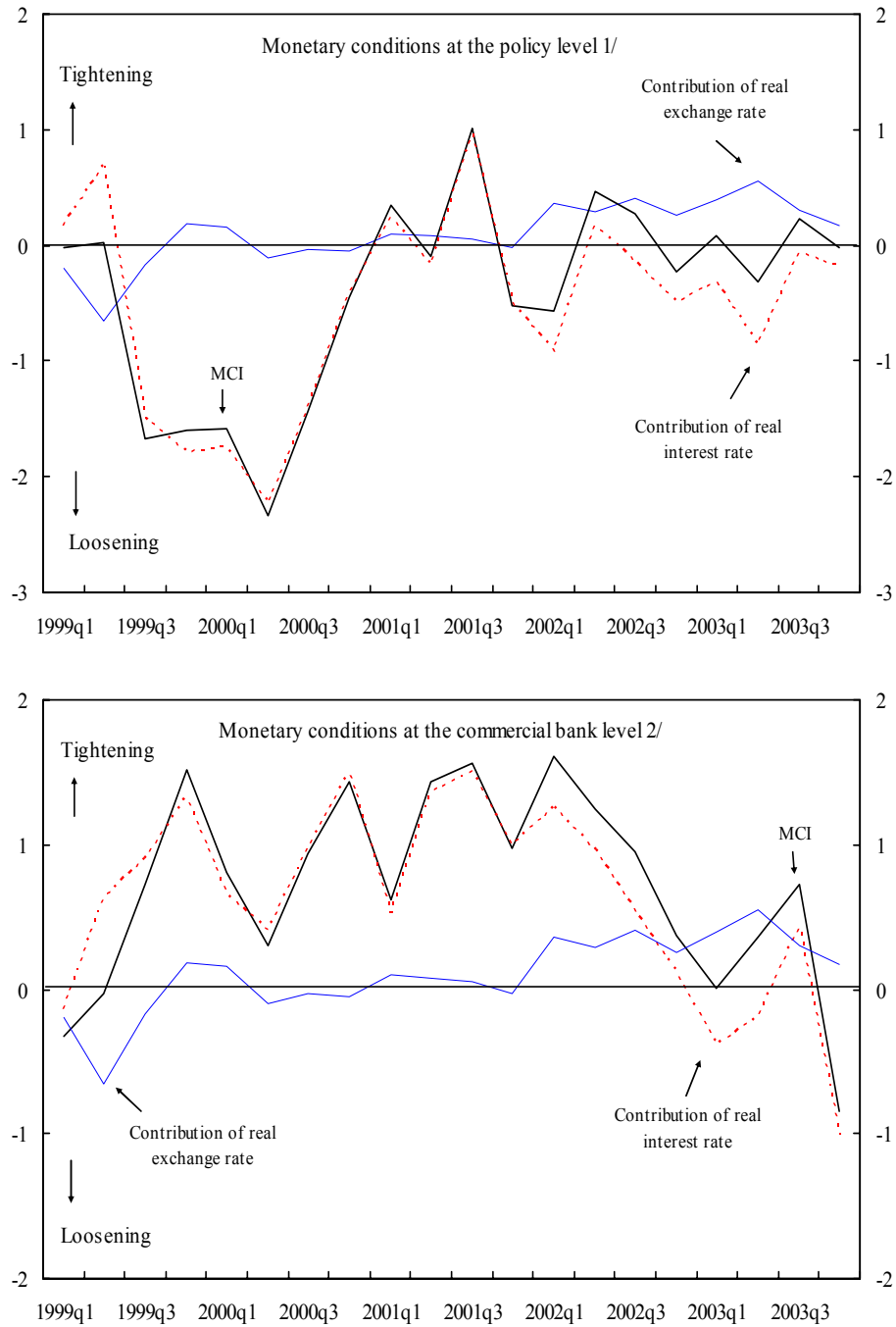
Source: Statistical Office of the Republic of Slovenia.

1/ Wages in respective sector divided by wages in the manufacturing sector.

2/ Includes public administration; education; health; and other social services.

3/ Includes distributive trade; hotels and restaurants; transport, storage, and communications; financial intermediation; and real estate.

Figure 3. Slovenia: Monetary Conditions Index, 1999-2003
(1999m1=0)

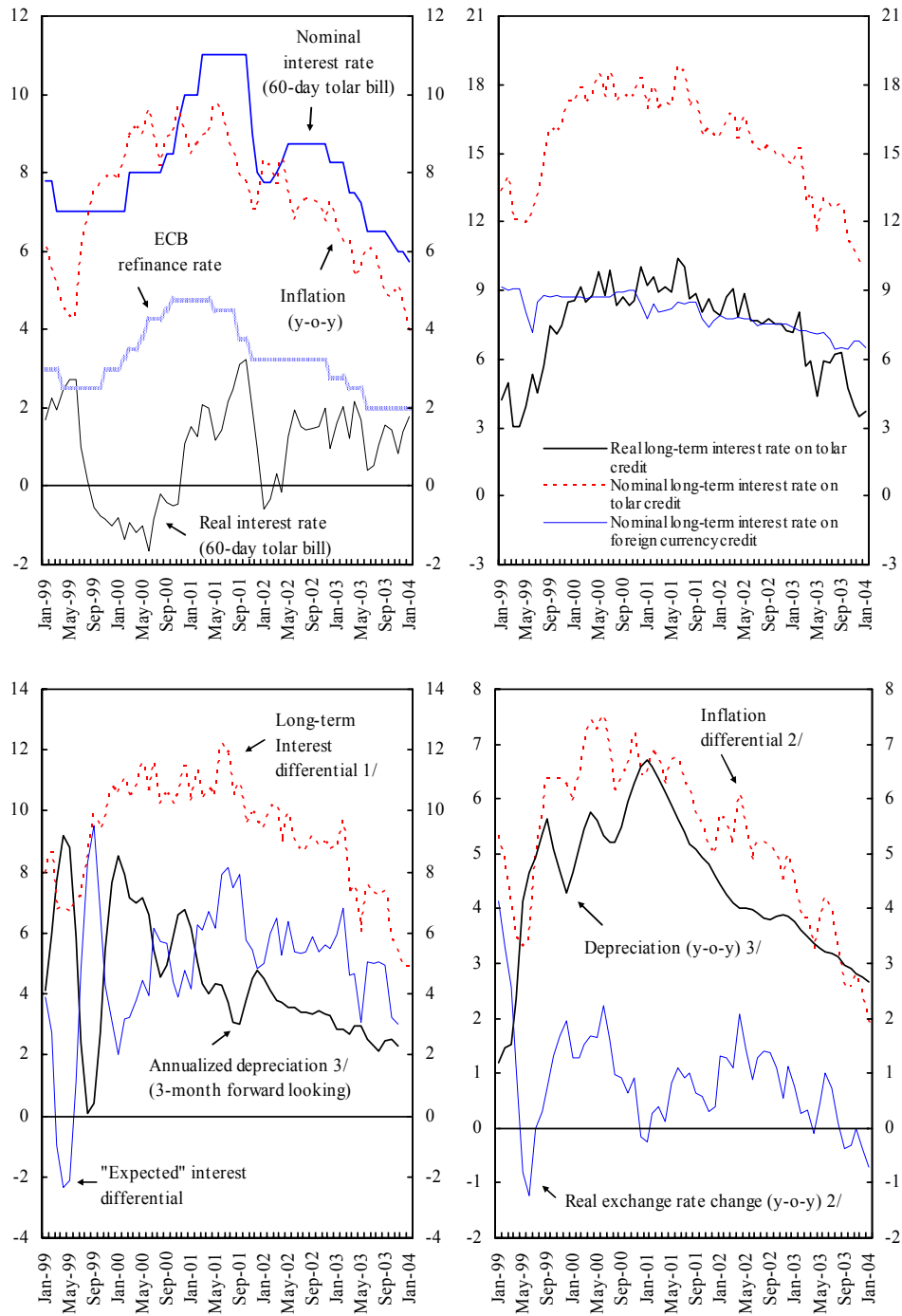


Source: IMF staff estimates.

1/ Interest rate measured with the BoS 60-day bill rate. End-of-quarter data.

2/ Interest rate measured with the long-term lending rate to enterprises. The monetary conditions index assigns 67 percent weight to changes in the real interest rate, and 33 percent weight to changes in the real exchange rate. The calculation does not assume any Samuelson-Balassa effect. End-of-quarter data.

Figure 4. Slovenia: Inflation, Interest Rates, and Depreciation, 1999-2004
(In percent)



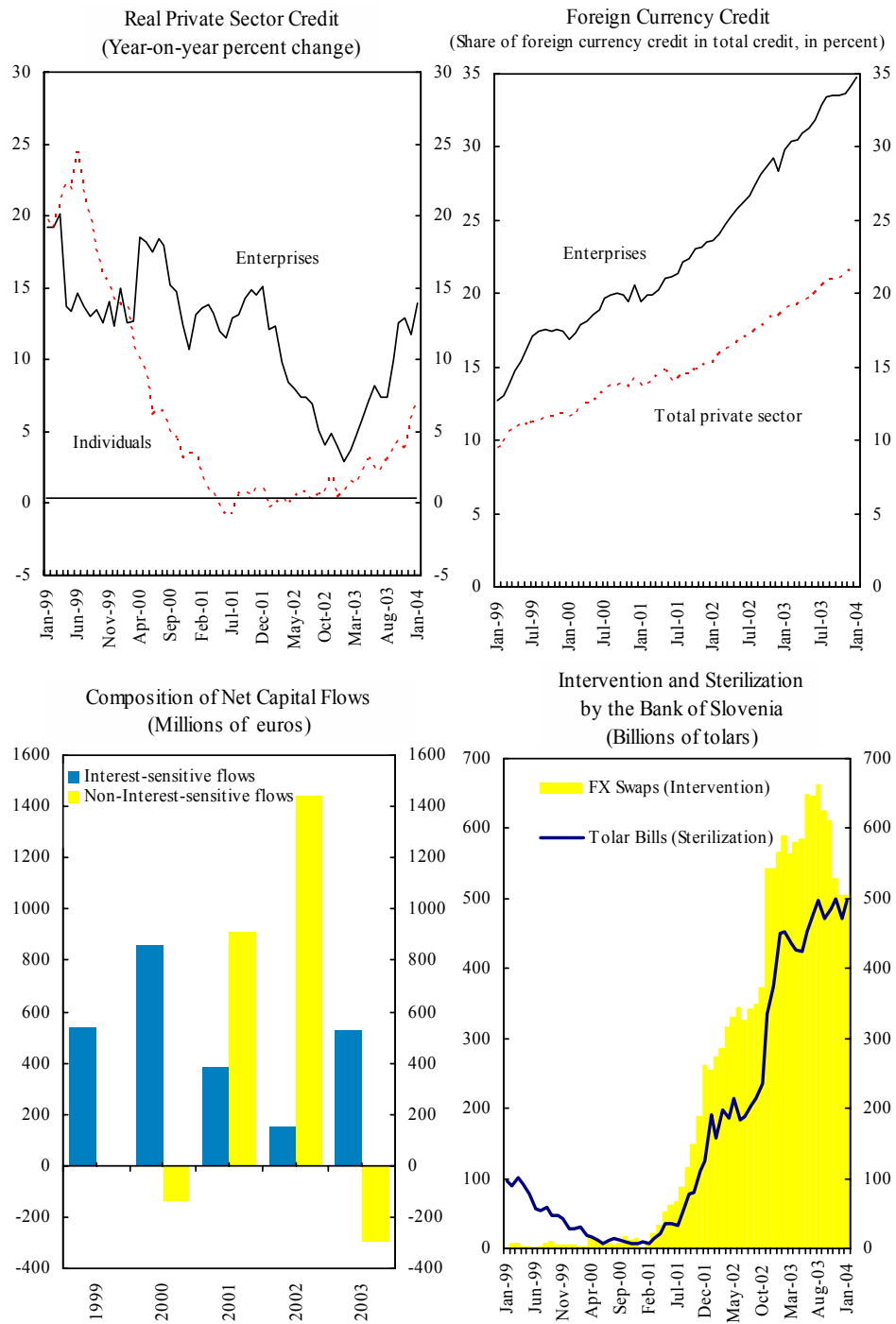
Sources: Bank of Slovenia; Eurostat; and Statistical Office of the Republic of Slovenia.

1/ Difference between long-term lending rates in Slovenia (tolar credit) and Germany.

2/ Vis-à-vis the euro area.

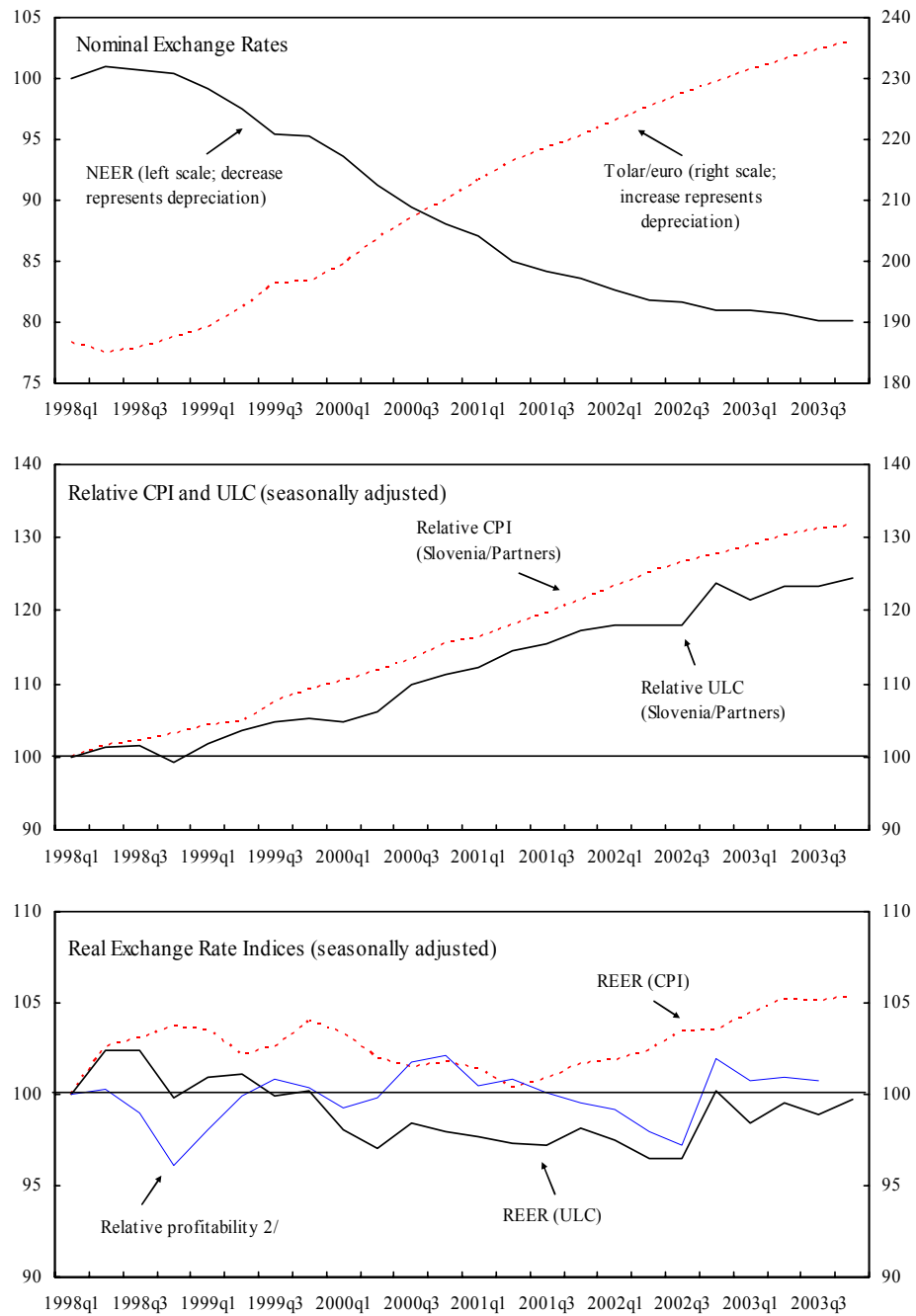
3/ Depreciation vis-à-vis the euro.

Figure 5. Slovenia: Selected Monetary Developments, 1999-2004



Source: Bank of Slovenia.

Figure 6. Slovenia: Exchange Rate Indicators, 1998-2003
(1998q1=100) 1/

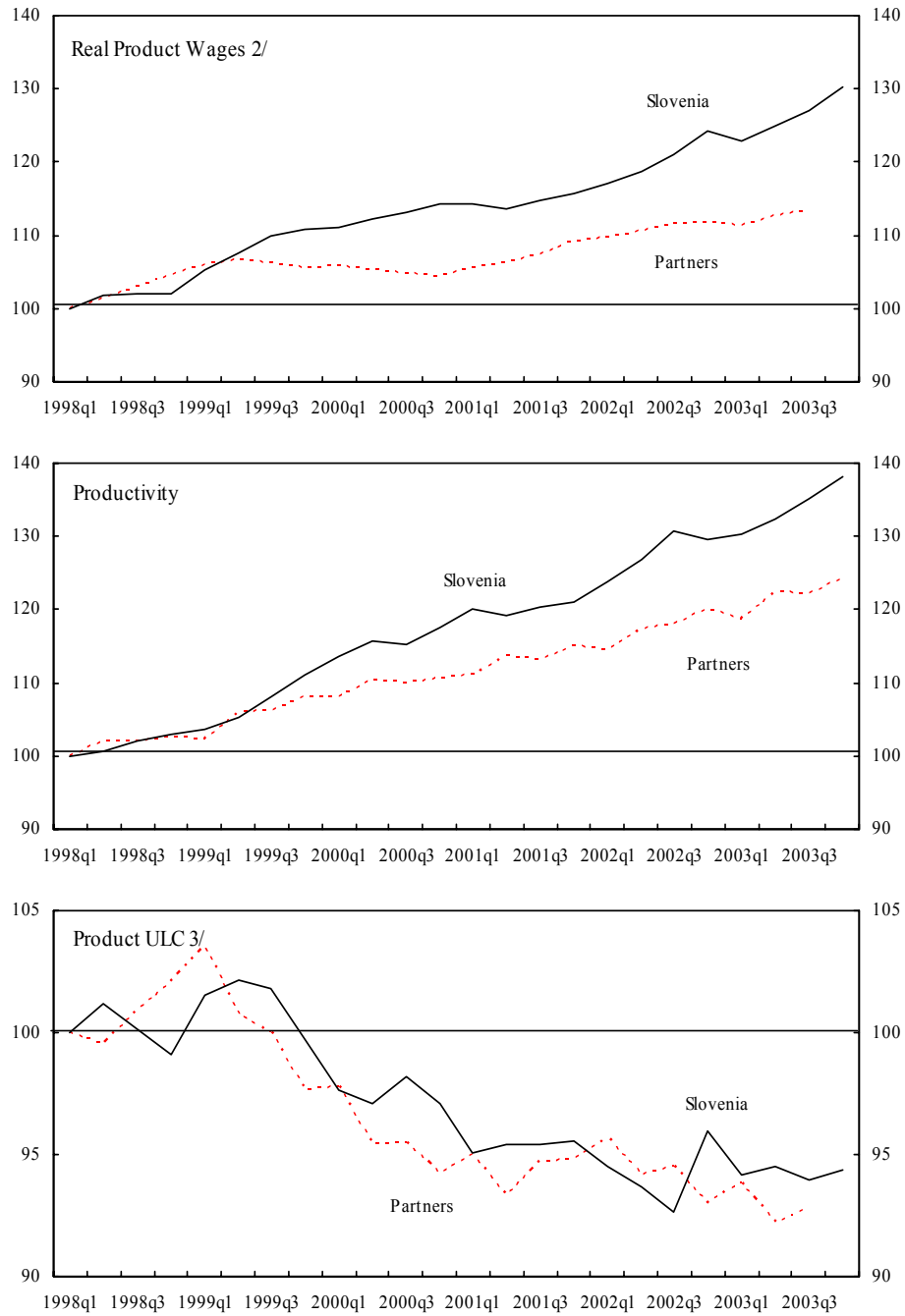


Sources: Bank of Slovenia Bulletin; Eurostat; *IFS*; and IMF staff calculations.

1/ Trade weights based on 1998-2000 data for exports of goods. Partner countries comprise: Austria, Croatia, France, Germany, Italy, Poland, United Kingdom, and United States.

2/ Unit labor costs in Slovenia relative to those in trading partner countries, adjusted for manufacturing producer price inflation—a rough indicator of developments in profitability.

Figure 7. Slovenia: Wages, Productivity, and Product ULC in Manufacturing, 1998-2003
(1998q1=100) 1/



Sources: Statistical Office of the Republic of Slovenia; and IMF staff calculations.

1/ Seasonally adjusted.

2/ Defined as the ratio of nominal wages to producer price index.

3/ Defined as the ratio of real product wages to productivity.

Table 1. Slovenia: Selected Economic Indicators, 1999-2005

	1999	2000	2001	2002	Prelim. 2003	Proj. 2004	2005
	(Annual percentage change)						
Real GDP	5.9	4.1	2.9	2.9	2.3	3.5	4.1
Domestic demand	9.5	1.5	1.0	2.1	4.0	5.0	5.4
Private consumption	5.9	0.3	2.4	1.1	3.1	4.5	5.5
Public consumption	2.9	2.3	4.0	2.5	2.8	2.3	1.3
Gross capital formation	22.4	3.3	-4.2	4.1	7.0	8.0	8.0
Industrial production	-0.5	6.2	2.9	2.4	1.4	...	...
Consumer prices							
Period average	6.1	8.9	8.4	7.5	5.6	3.7	3.4
End of period	8.0	8.9	7.0	7.2	4.6	3.7	3.3
Wages							
Nominal							
All sectors	9.6	10.6	11.9	9.7	7.5	7.0 1/	5.3 1/
Manufacturing	9.1	11.9	10.7	10.4	7.6	...	...
Public services	10.1	11.2	13.9	8.7	6.3	...	...
Real							
All sectors	3.3	1.6	3.3	2.1	1.9	2.0 1/	2.2 1/
Manufacturing	2.8	2.8	2.1	2.7	1.9	...	...
Public services	3.7	2.1	5.1	1.1	0.7	...	...
Employment							
Person basis	1.8	1.3	1.4	0.6	-0.8	...	...
Full-time-equivalent basis	1.2	1.1	0.5	-0.5	-0.2	0.5 1/	0.6 1/
Unemployment rate (in percent, ILO definition)	7.6	7.0	6.4	6.3	6.7	6.7 2/	6.4 2/
General government finances	(In percent of GDP)						
Revenue	41.4	40.9	41.5	40.9 3/	41.9	42.7 4/	42.8 4/
Expenditure	42.0	42.2	42.8	42.5	43.3	44.4 4/	44.3 4/
General government balance	-0.6	-1.3	-1.3	-1.5 3/	-1.4	-1.7 4/	-1.6 4/
State budget balance	-0.5	-0.9	-1.0	-1.2 3/	-1.2	-1.5 4/	-1.7 4/
General government debt	23.6	24.7		26.6	27.8	27.3 4/	27.4 4/
Money and credit	(Percentage change, end-period)						
Broad money (including foreign exchange deposits)	12.2	15.3	28.3	18.4	4.9	...	...
Base money	21.2	1.9	37.7	-4.3	4.1	...	...
Credit to the private sector	29.3	18.6	18.4	11.3	15.7	...	...
Interest rates (in percent)							
BoS Lombard rate	9.0	11.0	12.0	10.5	7.3	...	...
Rate on 60-day BoS bills	7.0	10.0	8.0	8.3	6.0	...	...
Lending rates	13.1-17.2	14.6-18.4	12.3-15.8	11.6-14.7	9.6-10.3	...	...
Deposit rates 5/	9.6-11.4	10.9-13.2	8.5-11.0	7.6-8.6	4.8-4.9	...	...
Balance of payments	(In millions of euros, unless noted otherwise)						
Merchandise exports	8,103	9,574	10,454	11,081	11,427	12,147	13,141
Exports volume (percent change)	2.7	12.9	6.9	6.5	4.5	5.9	6.9
Merchandise imports	-9,267	-10,801	-11,139	-11,347	-11,971	-12,836	-13,938
Imports volume (percent change)	8.6	7.7	3.2	4.4	6.8	8.0	8.4
Current account balance	-664	-583	38	330	17	-149	-288
(in percent of GDP)	-3.3	-2.8	0.2	1.4	0.1	-0.6	-1.0
Gross official reserves	3,159	3,436	4,984	6,781	6,879	7,426	8,220
(in months of imports of goods and nonfactor services)	3.5	3.3	4.7	6.2	5.9	6.0	6.1
External debt (percent of GDP, end-period) 6/	40.4	46.1	47.7	49.2	53.6	57.3	60.1
External debt service	843	1,103	1,877	1,778	2,144	2,424	2,724
(in percent of exports of goods and nonfactor services)	8.5	9.5	14.9	13.1	15.4	16.5	17.2
Exchange rate							
Tolars per U.S. dollar (end-period)	196.8	227.4	251.0	221.1	189.4	...	...
Tolars per euro (end-period)	197.3	211.5	221.4	230.3	236.7	...	...
Nominal effective exchange rate (1998Q1=100, period average)	96.8	90.6	85.0	81.8	80.5	...	...
Real effective exchange rate							
(CPI based, 1998Q1=100, period average)	103.1	102.1	101.1	102.8	105.0	...	...
(ULC based, 1998Q1=100, period average)	100.5	97.9	97.6	97.7	99.1	...	...

Sources: Data provided by the Slovene authorities; and IMF staff calculations and projections.

1/ Budget projections by the Ministry of Finance for 2004-05.

2/ Projections by the Institute for Macroeconomic Analysis and Development (IMAD).

3/ Revenues and deficit figures have been adjusted for the shift of budget accounting to a pure cash basis. Without the adjustment, the general government deficit would have reached SIT 156 bn, or 3.0 percent of GDP, as the unadjusted figures contained only 11 months of VAT and excise tax.

4/ Budget figures for 2004-05.

5/ For deposits with maturity between 31 days and 1 year.

6/ Data have been revised according to the External Debt Guide 2003.

Table 2. Slovenia: Summary of General Government Operations, 2000-05

	2000	2001	2002	2003			2004	2005
				Budget Dec. 2002	Suppl. Bdg. June 2003	Prelim. Outturn	Budget	Budget
(In billions of tolar)								
Total revenues	1,727	1,968	2,159 1/	2,375	2,347	2,375	2,614	2,817
Tax revenues	1,600	1,798	1,910	2,178	2,164	2,191	2,351	2,546
Personal income tax	260	289	320	358	346	353	380	388
Corporate income tax	52	69	75	86	99	107	117	129
Social security contributions	553	621	682	745	739	738	797	928
Taxes on payroll and workforce	68	83	94	108	104	107	118	123
Domestic taxes on goods and services	603	673	673	814	808	816	872	911
VAT	410	441	424	533	524	526	563	589
Excise taxes	134	166	171	194	194	198	213	219
Other	58	66	78	86	90	92	97	103
Other taxes	65	63	66	68	68	70	66	66
Nontax revenues	95	139	134	156	144	148	155	140
Capital revenues and grants	17	21	29	33	32	29	20	20
Transfers from extrabudgetary funds	15	9	11	7	7	8	8	8
Receipts from the EU budget 2/	...	...	...	...	...	...	80	103
Adjustment for methodological change 1/	...	...	76	...	...	...	...	...
Total expenditures	1,781	2,031	2,240	2,440	2,437	2,457	2,721	2,921
Wages and personnel expenditures	388	456	515	560	563	561	585	606
Direct budget users	132	155	175	192	196	196	203	208
Other government institutions	256	301	341	368	367	367	383	398
Premium for supplementary pension insurance	...	...	...	...	...	...	13	10
Expenditure on goods and services	336	386	418	442	447	453	479	566
Interest payments	61	73	84	87	86	93	94	92
Reserves	13	9	10	9	6	18	11	14
Transfers to individuals and households	731	821	910	979	985	986	1,056	1,107
Of which: Pensions	491	545	601	635	640	640	687	723
Subsidies	59	63	60	76	71	69	81	88
Other current transfers	23	24	36	37	30	42	68	66
Capital expenditures and transfers	171	199	207	249	248	235	288	297
Transfers to the EU budget	...	...	...	...	...	...	45	75
General government balance (GFS)	-55	-63	-80 1/	-65	-90	-82	-107	-104
Primary balance (GFS)	-4	1	-5 1/	-10	-13	-4	-23	-21
(In percent of GDP)								
Total revenues	40.9	41.5	40.9 1/	41.9	41.4	41.9	42.7	42.8
Tax revenues	37.9	37.9	36.2	38.4	38.2	38.6	38.4	38.6
Of which: Personal income tax	6.1	6.1	6.1	6.3	6.1	6.2	6.2	5.9
Corporate income tax	1.2	1.5	1.4	1.5	1.7	1.9	1.9	2.0
Social security contributions	13.1	13.1	12.9	13.1	13.0	13.0	13.0	14.1
Domestic taxes on goods and services	14.3	14.2	12.8	14.3	14.2	14.4	14.2	13.8
Receipts from the EU budget	...	...	...	...	...	...	1.3	1.6
Total expenditures	42.2	42.8	42.5	43.0	43.0	43.3	44.4	44.3
Current expenditures and transfers	38.1	38.6	38.5	38.6	38.6	39.2	39.0	38.7
Wages and personnel expenditures	9.2	9.6	9.8	9.9	9.9	9.9	9.5	9.2
Expenditure on goods and services	8.0	8.1	7.9	7.8	7.9	8.0	7.8	8.6
Transfers to individuals and households	17.3	17.3	17.3	17.3	17.4	17.4	17.2	16.8
Of which: Pensions	11.6	11.5	11.4	11.2	11.3	11.3	11.2	11.0
Capital expenditures and transfers	4.0	4.2	3.9	4.4	4.4	4.1	4.7	4.5
Transfers to the EU budget	...	...	...	...	...	...	0.7	1.1
General government balance (GFS)	-1.3	-1.3	-1.5 1/	-1.1	-1.6	-1.4	-1.7	-1.6
Primary balance (GFS)	-0.1	0.0	-0.1 1/	-0.2	-0.2	-0.1	-0.4	-0.3
Memorandum items:								
General government balance (ESA-95)	-3.1	-2.7	-2.4	...	...	-1.8	-1.6	-1.6
Structural budget balance (GFS)	-1.9	-1.6	-1.4	...	...	-0.8	-1.1	-1.1
Structural primary balance (GFS)	-0.7	-0.2	0.0	...	...	0.5	0.3	0.1
General government debt	24.7	26.6	27.8	...	...	27.0	27.3	27.4
Domestic	12.6	14.1	16.7	...	...	16.7	18.6	21.0
Foreign	12.0	12.5	11.2	...	...	10.3	8.8	6.4

Sources: Ministry of Finance; and IMF staff calculations and estimates.

1/ Revenues and deficit figures have been adjusted for the shift of budget accounting to a pure cash basis. Without the adjustment, the general government deficit would have reached SIT 156 bn, or 3.0 percent of GDP, as the unadjusted figures contained only 11 months of VAT and excise tax.

2/ Pre-accession aid of the EU was until 2003 classified as grants.

Table 3. Slovenia: Monetary Survey, 1999-2003

	1999	2000	2001	2002	2003
	(In billions of tolar; end-of-period)				
Net foreign assets	667.5	774.2	1,187.3	1,429.7	1,247.6
Assets	951.0	1,150.1	1,649.7	2,047.6	2,089.3
Bank of Slovenia	629.8	739.9	1,122.5	1,580.3	1,644.7
Deposit money banks	355.7	447.2	565.5	499.3	477.5
Less claims on National Bank of Yugoslavia	-34.5	-37.0	-38.3	-31.9	-33.0
Liabilities	-283.5	-375.9	-462.4	-617.9	-841.6
Bank of Slovenia	-0.1	-0.1	-0.3	0.0	0.0
Deposit money banks	-283.4	-375.8	-462.1	-617.9	-841.6
Net domestic assets	1,388.3	1,596.4	1,853.2	2,171.0	2,530.2
Claims on government (net)	325.9	361.5	423.3	443.1	528.2
Credit	399.6	441.1	491.8	614.3	679.4
Bank of Slovenia on central government	16.6	17.8	9.8	9.2	27.0
Banks on general government	383.0	423.3	482.0	605.1	652.4
Deposits	-73.7	-79.5	-68.6	-171.2	-151.2
Claims on enterprises	893.5	1,078.0	1,328.0	1,481.3	1,731.6
Claims on individuals	438.9	495.0	535.8	577.4	639.9
Claims on nonbanking financial institutions	37.8	51.6	59.1	81.1	105.2
Claims on National Bank of Yugoslavia	34.5	37.0	38.3	31.9	33.0
Securities	-63.9	-79.2	-113.6	-184.2	-221.4
Restricted deposits	-7.5	-9.0	-9.9	-7.6	-12.6
Other items (net)	-271.0	-338.4	-407.6	-252.1	-273.6
Broad money (M3)	2,055.7	2,370.6	3,040.6	3,600.7	3,777.8
Currency	125.0	119.8	142.1	143.1	156.0
Demand deposits	382.8	430.0	505.9	577.0	640.6
Bank of Slovenia	6.2	8.4	15.6	12.6	14.1
Deposit money banks	376.6	421.6	490.3	564.5	626.5
Quasi money	1,548.0	1,820.9	2,392.5	2,880.6	2,981.2
Tolar deposits	914.9	1,002.0	1,316.3	1,675.6	1,697.5
Foreign currency deposits	569.1	739.7	962.6	1,020.8	1,062.3
Tolar securities	52.3	65.9	96.1	181.1	217.7
Foreign currency securities	11.6	13.3	17.5	3.1	3.7
Memorandum items:					
Base Money	208.2	212.2	292.3	279.7	291.2
	(Percent change; end-of-period)				
Base money	21.2	1.9	37.7	-4.3	4.1
M1 (currency + demand deposits)	18.6	8.3	17.9	11.1	10.6
M2 (M1 + tolar deposits)	11.8	9.7	27.4	25.1	5.2
M3 (M2 + foreign currency deposits)	12.2	15.3	28.3	18.4	4.9
	(Percentage points)				
Contributions to M3 growth					
Net foreign assets	-0.1	5.2	17.4	8.0	-5.1
Net domestic assets	12.2	10.1	10.8	10.5	10.0
	(Percent)				
Share of foreign currency-denominated credit					
Private sector	11.8	14.3	15.3	18.5	21.6
Enterprises and nonprofit institutions	17.4	20.6	23.5	28.4	34.1
Individuals	0.7	0.6	0.7	0.7	1.0

Source: Bank of Slovenia, *Monthly Bulletin*.

Table 4. Slovenia: Vulnerability Indicators, 1999-2003
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003
Financial indicators					
General government debt	23.6	24.7	26.6	27.8	27.0
Domestic credit	46.1	48.9	50.9	52.2	55.7
Private sector credit (percent change, end-period)	29.3	18.6	18.4	11.3	15.7
Broad money (percent change, end-period)	12.2	15.3	28.3	18.4	4.9
Foreign exchange deposits (percent of broad money)	27.7	31.2	31.7	28.4	28.1
Financial market indicators (end of period)					
Stock market index	1,806	1,808	2,152	3,340	3,932
Stock market capitalization (in percent of GDP)	24.0	27.0	29.1	41.2	43.1
Foreign currency debt rating (S&P, long term)	A	A	A	A	A+
External indicators					
Exports of goods and NFS 1/ (percent change, value in euros)	-0.3	17.8	8.7	7.1	2.7
Imports of goods and NFS (percent change, value in euros)	5.4	15.5	3.4	3.0	5.5
Current account balance	-3.3	-2.8	0.2	1.4	0.1
Capital and financial account balance, excl. reserve assets	2.7	3.5	5.9	6.8	1.0
<i>Of which:</i> Inward portfolio investment	1.7	1.2	0.9	0.1	-0.1
Inward foreign direct investment	0.5	0.7	1.9	7.3	0.7
Other investment, net	0.8	2.2	4.4	0.2	2.3
Net foreign assets of commercial banks (in billions of euros)	0.4	0.3	0.5	-0.5	-1.5
Short-term foreign assets of commercial banks (in billions of euros)	1.3	1.6	1.9	1.5	1.4
Short-term foreign liabilities of commercial banks (in billions of euros)	0.4	0.4	0.6	0.7	1.1
Foreign currency exposure of commercial banks (in billions of euros)	-1.3	-1.5	-1.8	-2.3	-2.3
Net international reserves (in billions of euros)	2.5	2.6	4.0	4.1	6.4
Gross official reserves (in billions of euros)	3.2	3.4	5.0	6.8	6.9
Gross official reserves (in months of imports of goods and NFS)	3.5	3.3	4.7	6.2	5.9
Base money to gross official reserves (in percent)	33.4	29.2	26.5	17.9	17.9
Broad money to gross official reserves (in percent)	330	326	276	231	232
Short-term external debt to gross official reserves (in percent) 2/	106.8	127.5	91.7	65.6	66.2
Total external debt	40.4	46.1	47.7	49.2	53.6
<i>Of which:</i> Public and publicly guaranteed	12.4	14.0	14.3	13.7	13.9
Total external debt (in percent of exports of goods and NFS)	81.2	81.6	82.4	84.9	93.5
Total external debt service payments (in percent of exports of goods and NFS)	8.5	9.5	14.9	13.1	15.4
External interest payment (in percent of exports of goods and NFS)	2.4	2.8	3.2	2.8	2.6
External amortization payments (in percent of exports of goods and NFS)	6.1	6.7	11.7	10.3	12.8
Exchange rate (tolar per euro, period average)	193.6	205.0	217.2	226.2	233.7
REER (CPI-based, period-average basis, an increase indicates appreciation)	0.7	-1.0	-1.0	1.7	2.1

Sources: Data provided by the Slovene authorities; Bloomberg; and IMF staff calculations.

1/ NFS denotes nonfactor services.

2/ Remaining maturity basis.

Table 5. Slovenia: Macroeconomic Framework, 2000-08

	2000	2001	2002	Prelim. 2003	2004	2005	Proj. 2006	2007	2008
(Percent of nominal GDP)									
Foreign saving	2.8	-0.2	-1.4	-0.1	0.6	1.0	1.7	1.9	1.8
National saving	24.1	24.4	24.9	24.3	24.3	24.3	24.0	23.9	23.8
Government	2.8	2.9	2.4	2.7	3.0	2.9	3.2	3.8	3.8
Nongovernment	21.4	21.5	22.5	21.6	21.4	21.4	20.8	20.1	20.1
Domestic saving	23.4	23.5	25.0	24.2	24.3	24.4	24.2	24.1	24.1
Government	2.7	2.8	2.2	2.6	2.5	2.6	3.1	3.8	3.8
Nongovernment	20.7	20.7	22.8	21.6	21.9	21.8	21.1	20.3	20.3
Gross capital formation	27.0	24.2	23.5	24.2	24.9	25.4	25.7	25.8	25.6
Government	4.0	4.2	3.9	4.1	4.7	4.5	4.5	4.5	4.5
Nongovernment	22.9	20.0	19.5	20.1	20.2	20.9	21.2	21.3	21.1
Fixed investment	25.7	24.0	22.6	23.0	23.9	24.4	24.8	24.8	24.6
Change in inventories	1.2	0.2	0.8	1.2	1.0	1.0	1.0	0.9	1.0
General government balance	-1.3	-1.3	-1.5	-1.4	-1.7	-1.6	-1.3	-0.7	-0.7
(Percentage change in real terms)									
Real GDP	4.1	2.9	2.9	2.3	3.5	4.1	4.5	4.2	3.8
Domestic demand	1.5	1.0	2.1	4.0	5.0	5.4	5.6	4.8	3.9
<i>Of which:</i>									
Private consumption	0.3	2.4	1.1	3.1	4.5	5.5	5.0	4.0	3.5
Fixed investment	2.6	-0.4	1.3	5.5	9.1	8.2	8.1	6.9	5.1
Exports of goods and services	13.0	6.4	6.5	3.4	5.1	5.9	6.0	5.8	5.6
Imports of goods and services	7.6	3.0	4.9	6.3	7.5	7.9	7.6	6.5	5.6
(Contributions to growth, in percentage points)									
Domestic demand	1.6	1.0	2.1	4.0	5.1	5.6	5.9	5.1	4.2
<i>Of which:</i>									
Private consumption	0.2	1.4	0.6	1.7	2.5	3.1	2.9	2.3	2.0
Gross capital formation	0.9	-1.1	1.0	1.8	2.1	2.2	2.3	2.0	1.6
Net foreign demand	2.5	1.8	0.8	-1.8	-1.6	-1.5	-1.4	-0.9	-0.4
Memorandum items:									
General government debt (percent of GDP)	24.7	26.6	27.8	27.0	27.3	27.4	27.2	25.8	25.0
External debt (percent of GDP)	46.1	47.7	49.2	53.6	57.3	60.1	61.6	62.7	63.3
Ratio of official reserves to external debt (in percent)	36.2	47.9	59.1	52.9	50.5	49.8	48.4	47.1	45.4

Sources: Data provided by the authorities; and IMF staff projections.

Table 6. Slovenia: Balance of Payments, 2000-05
(In millions of euros, unless noted otherwise)

	2000	2001	2002	Prelim. 2003	Proj. 2004	2005
Current account	-583	38	330	17	-149	-288
Trade Balance	-1,227	-684	-265	-544	-689	-797
Exports f.o.b.	9,574	10,454	11,081	11,427	12,147	13,141
Imports f.o.b.	-10,801	-11,139	-11,347	-11,971	-12,836	-13,938
Services	489	536	627	541	540	538
Exports	2,052	2,178	2,449	2,465	2,582	2,726
Imports	-1,562	-1,642	-1,822	-1,924	-2,041	-2,188
Income, net	29	43	-174	-73	-122	-121
Current transfers, net	126	144	142	93	121	92
Capital account	4	-4	2	4	4	4
Financial account	724	1,295	1,590	228	692	1,078
Direct investment, net	77	251	1,608	-109	-34	70
In Slovenia	149	412	1,707	160	256	412
Abroad	-72	-161	-99	-269	-290	-342
Portfolio investment, net	185	80	-69	-219	-46	3
Other investment, net	462	964	51	556	771	1,005
Government	86	-74	-93	-67	-50	-40
Bank of Slovenia	-6	-7	-7	0	-7	-7
Commercial banks	39	-38	721	1,086	1,159	1,241
Nonbank private sector	343	1,083	-570	-463	-330	-189
Loans	563	534	428	387	411	424
Household currency and deposits	-13	797	-578	-592	-484	-405
Trade credits	-195	-249	-413	-235	-258	-208
Other	-12	1	-8	-24	0	0
Net errors and omissions	41	110	-3	46	0	0
Overall balance	187	1,439	1,919	295	547	794
Change in official reserves (-: increase)	-187	-1,439	-1,919	-295	-547	-794
Memorandum items:						
Current account balance (percent of GDP)	-2.8	0.2	1.4	0.1	-0.6	-1.0
Exports of goods (percent change in value)	18.2	9.2	6.0	3.1	6.3	8.2
Exports to the European Union (percent change in value)	14.2	6.4	1.3	1.5	5.4	8.0
Exports to non-EU countries (percent change in value)	25.9	14.1	13.8	5.5	7.6	8.4
Imports of goods (percent change in value)	16.6	3.1	1.9	5.5	7.2	8.6
External debt (in millions of euros) 1/ (percent of GDP)	9,490 46.1	10,403 47.7	11,482 49.2	12,995 53.6	14,693 57.3	16,508 60.1
Debt service payments (in millions of euros) (percent of exports of goods and services)	1,103 9.5	1,877 14.9	1,778 13.1	2,144 15.4	2,424 16.5	2,724 17.2
Gross official reserves (in millions of euros) 2/ (in months of imports of goods and services)	3,436 3.3	4,984 4.7	6,781 6.2	6,879 5.9	7,426 6.0	8,220 6.1

Sources: Bank of Slovenia; and IMF staff projections.

1/ Revised data as per the External Debt Guide 2003.

2/ Stocks and flows may not reconcile due to valuation changes.

Table 7. Slovenia: Financial and Budgetary Impact of EU Accession, 2004-06.
(In millions of tolar)

	Estimated disbursements			Consolidated Budget Revenue			Consolidated Budget Expenditures (without cofinancing)			Consolidated Budget Cofinancing (where applicable)			Consolidated Budget Savings and Substitution in Expenditures			Consolidated Budget Net Impact on the Budget		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
I. Pre-accession aid	21,133	16,143	7,263	21,133	16,143	7,263	-21,133	-16,143	-7,263	-5,880	-4,039	-1,817				-5,880	-4,039	-1,817
PHARE	13,950	10,299	...	13,950	10,299	...	-13,950	-10,299	...	-4,004	-2,250	...				-4,004	-2,250	...
ISPA	5,949	5,594	...	5,949	5,594	...	-5,949	-5,594	...	-1,259	-1,664	...				-1,259	-1,664	...
SAPARD	1,234	250	...	1,234	250	...	-1,234	-250	...	-617	-125	...				-617	-125	...
II. EAGGF	9,506	26,545	42,577	9,506	26,545	42,577	-9,506	-26,545	-42,577	-15,159	-15,033	-20,100	21,259	25,733	26,300 1/	6,100	10,700	6,200 1/
Market regulation	2,340	5,980	10,443	2,340	5,980	10,443	-2,340	-5,980	-10,443	0	0	0						
Direct payments	0	5,553	8,828	0	5,553	8,828	0	-5,553	-8,828	-13,775	-11,900	-14,700 2/						
Rural development	7,166	15,012	23,307	7,166	15,012	23,307	-7,166	-15,012	-23,307	-1,384	-3,133	-5,400						
III. Structural and Cohesion Funds	14,741	23,755	19,612	14,741	23,755	19,612	-14,741	-23,755	-19,612	-2,746	-5,014	-4,412	6,600	8,800	6,451	3,854	3,786	2,039
Structural Funds	8,141	14,955	13,161	8,141	14,955	13,161	-8,141	-14,955	-13,161	-2,746	-5,014	-4,412				-2,746	-5,014	-4,412
Cohesion Fund	6,600	8,800	6,451	6,600	8,800	6,451	-6,600	-8,800	-6,451	0	0	0	6,600	8,800	6,451	6,600	8,800	6,451
IV. Internal policies	12,914	15,765	18,108	9,194	9,393	9,581	-9,194	-9,393	-9,581	-8,454	-2,669	0				-8,454	-2,669	0
Current EU	3,192	5,691	7,833	0	0	0	0	0	0	0	0	0				0	0	0
Institutional development	528	681	694	0	0	0	0	0	0	0	0	0				0	0	0
Schengen	9,194	9,393	9,581	9,194	9,393	9,581	-9,194	-9,393	-9,581	-8,454	-2,669	0				-8,454	-2,669	0
V. Special cash transfer	24,533	22,164	14,533	24,533	22,164	14,533	0	0	0	0	0	0				24,533	22,164	14,533
Cash-flow lump-sum	16,786	4,750	4,845	16,786	4,750	4,845	0	0	0	0	0	0				16,786	4,750	4,845
Budget compensation	7,747	17,415	9,689	7,747	17,415	9,689	0	0	0	0	0	0				7,747	17,415	9,689
Subtotal	82,827	104,373	102,094	79,107	98,001	93,567	-54,574	-75,836	-79,033									
As percent of GDP	1.4	1.6	1.4	1.3	1.5	1.3	-0.9	-1.2	-1.1									
Slovene contribution to EU budget	-45,049	-76,265	-79,662				-45,049	-76,265	-79,662							-45,049	-76,265	-79,662
Traditional own resources	-3,604	-7,707	-7,802				-3,604	-7,707	-7,802							-3,604	-7,707	-7,802
VAT- based resource	-6,607	-9,208	-9,689				-6,607	-9,208	-9,689							-6,607	-9,208	-9,689
GNP- based resource	-31,334	-52,245	-54,635				-31,334	-52,245	-54,635							-31,334	-52,245	-54,635
UK rebate	-3,504	-7,106	-7,536				-3,504	-7,106	-7,536							-3,504	-7,106	-7,536
Other				-21,771	-25,454	-27,362										-21,771	-25,454	-27,362
Decrease in customs duties				-10,577	-7,591	-8,210										-10,577	-7,591	-8,210
Revenue loss from lower efficiency of VAT collection 3/				-13,000	-19,782	-21,191										-13,000	-19,782	-21,191
Gain in excises				1,806	1,919	2,039										1,806	1,919	2,039
Methodological adjustment 4/										15,159	15,033	20,100 4/	-15,159	-15,033	-20,100 4/	0	0	0
Net position with the EU	37,778	28,108	22,432															
As percent of GDP	0.6	0.4	0.3															
Net impact on the budget				57,336	72,547	66,205	-99,623	-152,102	-158,695	-17,080	-11,722	-6,230 4/	12,700	19,500	12,651 4/	-46,667	-71,777	-86,069
As percent of GDP				0.9	1.1	0.9	-1.6	-2.3	-2.2	-0.3	-0.2	-0.1	0.2	0.3	0.2	-0.8	-1.1	-1.2

Source: Ministry of Finance.

1/ Estimate of the Ministry of Finance.

2/ Top-up of direct payments from EU.

3/ Includes a one-time liquidity shortfall in collecting VAT on EU imports in 2004.

4/ The existing system of market regulation, direct payments, and rural development is being replaced by the EU system. Co-financing and savings in the agricultural spending are therefore treated on the net basis.

SLOVENIA: FUND RELATIONS

(As of February 29, 2004)

I. **Membership Status:** Joined: 12/14/1992; Article VIII status as from September 1, 1995.

II. General Resources Account	SDR Million	% Quota
Quota	231.70	100.00
Fund holdings of currency	140.10	60.46
Reserve position in Fund	91.61	39.54

III. **SDR Department**

Net cumulative allocation	25.43	100.00
Holdings	6.43	25.28

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to Fund**

(SDR million based on existing use of resources and present holdings of SDRs):

	2004	2005	2006	2007	2008
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.23	0.31	0.31	0.31	0.31
Total	0.23	0.31	0.31	0.31	0.31

VII. **Exchange Rate Arrangement**

The currency of Slovenia is the tolar (SIT). The external value of the tolar is determined in the interbank exchange market, in which the Bank of Slovenia (BoS) participates. On April 6, 2004, the middle rate for spot transactions in the interbank market was SIT 196.96 = US\$1.

The BoS influences the movements of the exchange rate through active intervention in the foreign exchange market without specifying, or precommitting to, a pre-announced path for the exchange rate. In this regard, the Slovene exchange arrangement is de jure managed floating with no pre-announced path for the exchange rate. However, as the value of the currency is maintained within a certain fluctuation margins around a depreciating path, the de facto exchange arrangement is an unannounced crawling band.

VIII. Last Article IV Consultation

The last Article IV consultation was concluded on April 16, 2003. It was agreed that Slovenia would remain on the standard 12-month cycle. The Acting Chairman's summing up of the discussion was circulated on April 22, 2003.

IX. FSAP Participation and ROSCs

A FSAP mission took place during November 6–20, 2000, and follow-up meetings were held with the authorities on February 8–9, 2001 in the context of the 2001 Article IV consultation mission. A FSSA report was prepared on April 24, 2001 and published on September 18, 2001 (IMF Country Report No. 01/161). The report includes assessments of the following standards: banking supervision, securities regulation, insurance regulation, and payments systems.

A FSAP Update mission visited Ljubljana during November 10–21, 2003. A FSSA report is scheduled to be published by mid-2004.

The fiscal transparency module of the fiscal ROSC was published in June 2002.

X. Technical Assistance

Date	Dept.	Subject/Identified Need
December 1991	STA	Balance of Payments
October 1992	FAD	Tax Reform Strategy
April–May 1993	FAD	Tax Administration
July 1993	FAD	Tax Policy
September 1993	STA	Money and Banking
July 1994	STA	Money and Banking
February 1995	LEG	Foreign Exchange Law
January–February 1995	FAD	Public Expenditure Management
March 1995	STA	Balance of Payments
April 1995	MFD	De-indexation of Financial Assets
May 1995	MFD	Seminar on Monetary Policy
June 1995	LEG	Income Tax Law
September–October 1995	FAD	Social Insurance System
November–December 1995	STA	National Accounts
December 1996	FAD	Tax Policy
December 1996	FAD	Public Expenditure Management
February–March 1997	FAD	Treasury Single Account and Ledger Accounting System
May 1997	STA	National Accounts
September 1997	STA	Money and Banking

November 1997	STA	Government Finance
January 1998	FAD	GFS Based Budget and Accounting Classification
April 1998	FAD	GFS Based Budget and Accounting Classification
July 1998	FAD	Public Expenditure Management and Treasury Single Account
September 1998	FAD	Public Expenditure Management
November 1998	FAD	Public Expenditure Management
December 1998	STA	Flow-of-Fund and Financial Programming
March 1999–Nov. 2002	FAD	Public Expenditure Management
March 1999	FAD	Fiscal Management
April 1999	FAD	Tax Administration/VAT
October 1999	STA	Government Finance Statistics
November 2000	MFD	FSAP
August 2001	FAD	VAT
November 2001	FAD	Direct Tax Reform
November 2003	FAD	Public Expenditure Management
November 2003	MFD	FSAP Update

SLOVENIA: STATISTICAL ISSUES

Special Data Dissemination Standard: Slovenia has subscribed to the Special Data Dissemination Standard (SDDS), meets the SDDS specifications, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board on the Internet.

Real Sector Statistics: The Statistical Office of the Republic of Slovenia (SORS) follows the *System of National Accounts 1993 (1993 SNA)* and the *European System of Accounts 1995 (ESA95)*. Quarterly GDP estimates by industry and expenditure categories are published within 80 days after the reference quarter.

In 2003, the SORS revised the expenditure side of its national accounts for 1995–2002. However, the SORS still considers data for 1995–99 preliminary and will publish final data based on the expenditure, value added and income approach during spring 2004.

The indices of consumer and producer prices are compiled in accordance with international standards. The SORS also compiles a retail price index (RPI), which differs from the consumer price index in weights only.

Government Finance Statistics: Slovenian fiscal statistics are timely and of a high quality. The ministry of finance publishes a comprehensive monthly *Bulletin of Government Finance*, which presents monthly data on the operations of the “state budget” (Budgetary Central Government), local governments, social security (Pension and Health funds), and the consolidated general government. The coverage of general government excludes the operations of extrabudgetary funds and own revenues of general government agencies (*zavods*), which are small. However, 2002 data reported for publication in the 2003 *GFS Yearbook* now include the operations of the twelve extrabudgetary funds. Monthly fiscal indicators are reported for publication in *IFS* on a timely basis.

Money and Banking Statistics: Monetary statistics are timely and of good quality.

Balance of Payments Statistics: Balance of payments data are comprehensive and of high quality. These data have been published in the *Balance of Payments Statistics Yearbook* since 1993 (with estimates of the international investment position published since 1994). In 2002, the Bank of Slovenia revised the balance of payments statistics going back to 1994; the most significant revisions were related to the income component of the current account and to the other investment component of the financial account. In 2003, the data on incoming foreign direct investment from 2001 onward were revised to include permanent debt from foreign banks to their affiliated financial leasing companies resident in Slovenia.

External Debt Statistics: External debt statistics were revised and brought in line with the IMF's external debt dissemination standards in August 2003. The main change comprised of inclusion of trade credits in debt data. However, debt service statistics that would be consistent with the new external debt data are not yet available.

Slovenia: Survey of Reporting of Main Statistical Indicators
(as of March 31, 2004)

	Exchange rates	International reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price Index	Exports/ imports	Current account balance	Central government balance	GDP/GNP	External debt
Date of latest observation	3/16/04	2/29/04	2/29/04	2/29/04	2/29/04	2/04	2/04	1/04	1/04	1/04	Q4/03	1/31/04
Date received	3/16/04	3/5/04	3/17/04	3/17/04	3/17/04	3/11/04	2/27/04	3/8/04	3/10/04	2/27/04	3/04	3/11/04
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of reporting/ Publication	Daily/ Daily	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Quarterly/ Quarterly	Monthly/ Monthly
Source of data	BoS	BoS	BoS	BoS	BoS	BoS	BoS/ SORS/ Reuters	BoS/ SORS/ Reuters	BoS/ Reuters	MoF	SORS	BoS
Mode of reporting	On-line	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public

Note: BoS, SORS, and MoF stand for Bank of Slovenia, Statistical Office of the Republic of Slovenia, and Ministry of Finance, respectively.

SLOVENIA: EXTERNAL SUSTAINABILITY ANALYSIS

1. **Slovenia's external outlook is less favorable than the assessment during the last Article IV consultation. While sustainability is not an imminent concern, developments merit monitoring.** Under the baseline scenario, the external debt-to-GDP ratio is projected to increase by about 10 percentage points in the next few years and stabilize at about 63 percent in 2008–09. External debt service, as ratio to exports of goods and services, is projected to reach 18 percent in 2007 and remain around that level thereafter. The underlying reasons for the increase in the debt-to-GDP ratio are as follows: (i) a widening of the current account deficit resulting from strong domestic demand fueled by the convergence related decline in interest rates in the run-up to euro adoption. As the experience of noncore euro area countries shows, domestic demand pressures are likely to be self-correcting, and the current account deficit should eventually narrow; (ii) increased reliance by all domestic entities on foreign financing as access becomes easier upon EU accession; and (iii) a temporary slowdown of the government's privatization program and the associated foreign inflows, reflecting the authorities' desire to minimize exchange rate pressures under ERM2. Foreign direct investment inflows are expected to recover upon euro adoption.

2. **The stress tests suggest that the baseline scenario is subject to some risk, in particular with regard to sizeable depreciation of the currency.** While Slovenia seems relatively resilient to shocks to nominal interest rates and GDP growth, a one-time depreciation of the currency would have a considerable impact on the external debt ratio. A 30-percent decline in the tolar exchange rate against the euro in 2004 would result in an immediate increase of the debt-to-GDP ratio to 78 percent, which would reach 81½ percent by 2008. However, given a possibility of sizeable capital inflows in a run-up to euro adoption, Slovenia is more likely to face an upward pressure on its currency, thus limiting the likelihood of this scenario. A combination of one-standard error shocks (scenario 6) would have a considerably smaller effect on external indebtedness, with the debt-to-GDP ratio reaching about 67½ percent in 2009. Finally, if GDP growth, nominal interest rate, euro deflator, noninterest current account, and nondebt inflows would remain at their historical averages in 2004–09, the projected increase in the external debt-to-GDP ratio would be less pronounced than in the baseline scenario. Substantial nondebt capital inflows and higher GDP deflator growth account for the more favorable outlook in this scenario. Neither of these factors are expected to contribute to external debt developments to a similar extent in the baseline scenario as the government is likely to proceed more gradually with its privatization plans and inflation is projected to slow down.

Table A1. Slovenia: External Debt Sustainability Framework, 2000-09
(In percent of GDP, unless otherwise indicated)

					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1 External debt	46.1	47.7	49.2	53.6	57.3	60.1	61.6	62.7	63.3	63.7
2 Change in external debt	5.7	1.6	1.6	4.3	3.8	2.8	1.5	1.1	0.6	0.3
3 Identified external debt-creating flows (4+8+11)	0.9	-3.8	-11.1	-1.2	-2.1	-3.1	-3.7	-4.0	-4.2	-4.7
4 Current account deficit, excluding interest payments	1.3	-2.0	-3.0	-1.3	-0.8	-0.9	-0.7	-0.7	-0.9	-1.1
5 Deficit in balance of goods and services	3.6	0.7	-1.5	0.0	0.6	0.9	1.5	1.7	1.5	1.4
6 Exports	56.5	57.9	58.0	57.2	57.4	57.8	57.7	57.5	57.5	57.7
7 Imports	60.0	58.6	56.5	57.3	58.0	58.7	59.2	59.2	59.1	59.1
8 Net non-debt creating capital inflows (negative)	-0.4	-1.0	-6.6	0.8	0.2	-0.4	-0.9	-1.3	-1.6	-2.1
9 Net foreign direct investment, equity	0.4	1.2	6.9	-0.4	-0.1	0.3	0.8	1.2	1.4	1.7
10 Net portfolio investment, equity	0.1	-0.1	-0.3	-0.3	0.0	0.1	0.1	0.1	0.2	0.4
11 Automatic debt dynamics 1/	0.1	-0.7	-1.5	-0.7	-1.5	-1.8	-2.1	-2.0	-1.7	-1.5
12 Contribution from nominal interest rate	1.6	1.9	1.5	1.2	1.4	2.0	2.4	2.6	2.7	2.7
13 Contribution from real GDP growth	-1.6	-1.2	-1.3	-1.1	-1.8	-2.2	-2.5	-2.4	-2.2	-2.0
14 Contribution from price and exchange rate changes 2/	0.1	-1.4	-1.7	-0.8	-1.1	-1.6	-2.0	-2.2	-2.2	-2.2
14 Residual, incl. change in gross foreign assets (2-3)	4.8	5.4	12.7	5.5	5.9	5.9	5.2	5.1	4.8	5.1
External debt-to-exports ratio (in percent)	81.6	82.4	84.9	93.5	99.8	104.0	106.8	109.1	110.1	110.3
Gross external financing need (in billions of euros) 3/	3.3	3.0	3.4	4.1	4.7	5.0	5.5	5.9	6.1	6.3
In percent of GDP	16.2	13.9	14.4	17.1	18.2	18.3	18.5	18.2	17.7	17.1
Key macroeconomic and external assumptions										
Real GDP growth (in percent)	4.1	2.9	2.9	2.3	3.5	4.1	4.5	4.2	3.8	3.4
Exchange rate appreciation (euro value of local currency, change in percent)	-5.6	-5.6	-4.0	-3.2	-2.2	-0.4	0.0	0.0	0.0	0.0
GDP deflator in euros (change in percent)	-0.2	3.0	3.8	1.8	2.1	2.9	3.5	3.7	3.6	3.6
Nominal external interest rate (in percent)	4.0	4.3	3.4	2.6	2.7	3.7	4.4	4.6	4.6	4.5
Growth of exports (goods and services in euro terms, in percent)	17.8	8.7	7.1	2.7	6.0	7.7	7.9	7.8	7.6	7.5
Growth of imports (goods and services in euro terms, in percent)	15.5	3.4	3.0	5.5	7.1	8.4	9.0	8.0	7.3	7.2
1. Real GDP growth, nominal interest rate, euro deflator, non-interest current account, and non-debt inflows are at historical average in 2004-09				53.6	55.0	56.4	57.0	57.6	57.8	58.3
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005				53.6	58.9	61.6	63.1	64.1	64.7	65.0
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				53.6	58.1	60.9	62.4	63.4	64.0	64.3
4. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005				53.6	61.3	64.0	65.3	66.3	66.8	67.1
5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005				53.6	61.1	63.8	65.2	66.2	66.7	66.9
6. Combination of 2-5 using one standard deviation shocks				53.6	61.9	64.5	65.9	66.9	67.3	67.6
7. One time 30 percent nominal depreciation in 2004				53.6	78.0	80.1	80.9	81.4	81.5	81.4
Historical statistics for key variables (past 10 years)										
		<u>Historical</u>	<u>Standard</u>		<u>Average</u>					
		<u>Average</u>	<u>Deviation</u>		<u>2004-09</u>					
Current account deficit, excluding interest payments		-1.1	2.1		-0.8					
Net non-debt creating capital inflows		1.3	2.0		1.0					
Nominal external interest rate (in percent)		3.9	0.9		4.1					
Real GDP growth (in percent)		3.9	1.0		3.9					
GDP deflator in euros (change in percent)		3.8	4.5		3.2					

1/ Derived as $[r - g - \rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in euro terms, g = real GDP growth rate, ϵ = nominal appreciation (increase in euro value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \epsilon\alpha(1+r)] / (1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\epsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table A2. Slovenia: External Sustainability Framework—Gross External Financing Need, 2000-09

					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross external financing need in billions of euros 1/	3.3	3.0	3.4	4.1	4.7	5.0	5.5	5.9	6.1	6.3
In percent of GDP	16.2	13.9	14.4	17.1	18.2	18.3	18.5	18.2	17.7	17.1
Gross external financing need in billions of euros 2/										
1. Real GDP growth, nominal interest rate, euro deflator, noninterest current account, and nondebt inflows are at historical average in 2004-09				4.1	4.7	4.9	5.0	5.3	5.5	5.8
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005				4.1	5.1	5.2	5.6	6.0	6.3	6.5
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				4.1	4.7	5.0	5.5	5.8	6.1	6.3
4. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005				4.1	4.7	5.0	5.4	5.8	6.0	6.2
5. Noninterest current account is at historical average minus two standard deviations in 2004 and 2005				4.1	5.8	5.4	5.8	6.2	6.5	6.7
6. Combination of 2-5 using one standard deviation shocks				4.1	5.5	5.3	5.7	6.1	6.3	6.5
7. One time 30 percent nominal depreciation in 2004				4.1	4.7	4.9	5.3	5.5	5.7	5.9
Gross external financing need in percent of GDP 2/										
1. Real GDP growth, nominal interest rate, euro deflator, noninterest current account, and nondebt inflows are at historical average in 2004-09				17.1	17.9	17.2	16.5	16.0	15.5	15.1
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005				17.1	20.0	18.8	19.0	18.7	18.1	17.5
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				17.1	18.5	18.6	18.7	18.5	17.9	17.3
4. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005				17.1	19.6	19.6	19.7	19.4	18.8	18.1
5. Noninterest current account is at historical average minus two standard deviations in 2004 and 2005				17.1	22.5	19.6	19.6	19.3	18.7	18.0
6. Combination of 2-5 using one standard deviation shocks				17.1	22.0	19.8	19.9	19.5	18.9	18.2
7. One time 30 percent nominal depreciation in 2004				17.1	25.4	25.1	24.7	24.1	23.2	22.3

1/ Defined as noninterest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

**Statement by Willy Kiekens, Executive Director for Republic of Slovenia
and Ksenija Maver, Advisor to Executive Director
May 7, 2004**

The authorities wish to thank the staff for constructive discussions and their balanced, well-structured report, and for their valuable insights that helped shape the Slovenia's policy strategy during its crucial preparations for entering the ERM-2 and adopting the euro.

I. Recent Economic Developments

In the first quarter of 2004, the economy's rebound continued, and inflation has declined faster than planned...

In April 2004, annual headline inflation was at 3.5 percent, down from 5.3 percent in April 2003 and 8.4 percent in April 2002. Core inflation was around 3.0 percent. This implies that the targets for the end of 2004 have already been met in April. The steep disinflation acquired momentum with the adoption of the program for ERM-2 entry and euro adoption launched last November by the Bank of Slovenia and the Slovenian Government. The program was paralleled by improved coordination of economic policies, a substantial de-indexation of interests and wages, firm fiscal policies, a determined wage policy, better control of administered prices, and lowered excise duties in response to sharp oil price increases. These actions were complemented by a monetary policy that prevented capital inflows from generating inflationary pressures. Weak economic activity, at a level below potential, gave additional support. In addition, a large share of increasing domestic demand was satisfied by imports, which eased the pressure on domestic prices.

It is most important that inflation is declining in a sustainable way, with the external and internal accounts kept in balance. Slovenia's economic policy actions were coordinated to avoid possible disruptions in the real economy.

Concerning the factors contributing to disinflation, the views of the authorities and the staff differ only in nuances. The staff concludes that the main force behind the disinflation was the widening of the output gap during the economic slowdown. The authorities believe that other factors, primarily policy coordination, wage de-indexation, fiscal prudence and wage restraint were also important and should be cited.

.... and the fiscal account remained close to balance.

The fiscal position during the first quarter of 2004 remained strong. Strong tax collection has kept revenues buoyant, exceeding the projections. Expenditures were strictly monitored and stayed below the budgeted limits. As a result the 2004 fiscal deficit target of 1.7 percent is within reach.

The monetary policy framework was kept unchanged.

Monetary policy remains focused on disinflation, keeping a close eye on parity with foreign interest rates to head off inflationary pressures caused by capital inflows. Backed by the strong deflationary trend and Slovenia's declining country risk premium, the Bank of Slovenia has continued lowering policy interest rates and moderating the pace of the nominal depreciation of the tolar against the euro. Operational activities concentrated on aligning Slovenia's monetary policy operations with the standards of the European Central Bank.

II. The Outlook for the Rest of 2004 and Beyond

Economic activity is picking up and the prospects over the next two years are positive.

Slovenian growth will be driven mostly by private consumption and investments. Private consumption will be encouraged by lower interest rates and the launching of a housing scheme, and will be restrained by the moderation of wage growth and uncertainties in the labor market stemming from competitive pressures within the EU. The prospects for both private and public investment are positive: conditions in the financial markets are favorable, and there are ambitious plans for infrastructure investments. The Bank of Slovenia foresees growth rebounding from the low of 2.3 percent recorded in 2003 to 3.1 percent in 2004, 3.6 percent in 2005, and 3.9 percent in 2006.

It is expected that the external current account position will weaken. Imports will be stimulated by domestic demand, but exports, while they will increase, will be restrained by the continuing uncertainty of the euro zone's recovery. The current account, which was virtually in balance in 2003, is expected to register a deficit of about 1.0 percent of GDP in 2004. This deficit could rise to 2.0 percent in the years 2005 and 2006.

The inflation outlook is better than expected.

Given the strong momentum of disinflation, and the balanced macroeconomic situation, the Bank of Slovenia has revised its inflation forecasts for the end of 2004 from 3.5 percent to 3.2 percent, and for the end of 2005 from 2.9 percent to 2.8 percent. Inflation is expected to remain at 2.8 percent in 2006. These outcomes would ensure compliance with the Maastricht inflation target.

The authorities and the staff broadly agree on the growth and inflation projections. The authorities consider that the low demand scenario is the more likely. Accordingly their growth and inflation projections are also more modest than those of the staff.

The Government aspires to an early entry into ERM-2 and euro adoption at the beginning of 2007.

The milestones marking the path to ERM-2 and euro adoption, set last November by the Government and the Bank of Slovenia, are considered feasible, the more so because the

general government deficit was 1.4 percent of GDP in 2003, the public debt is currently 27 percent of GDP, and the long-term interest rate was 4.99 percent in April 2004--all comfortably within the Maastricht limits. The exchange rate is stable, and the disinflation record is encouraging.

During the run up to ERM-2 entry, monetary policy will remain focused on disinflation and exchange rate stability. After ERM-2 entry, exchange rate stability will be the only remaining objective, with interest rate policy subordinated to the stability of the exchange rate. The central parity at the time of ERM-2 entry will be jointly established by the Slovenian Government, the Bank of Slovenia, the European Central Bank, the Euro group, and the European Commission. It is expected to be near the market rate prevailing at the time of Slovenia's ERM-2 entry. It is also expected that Slovenia will accept the ERM-2's standard fluctuation band. During the ERM-2 period, Slovenia's monetary policy instruments will remain unchanged, since they are well tailored to the local environment and can serve as a powerful tool for efficient market interventions that may be required under the ERM-2 arrangement.

The ERM-2 period will entail risks endangering the inflation target and exchange rate stability. Excessive private consumption and wage growth could undermine the inflation and exchange rate objectives. The macroeconomic environment should remain stable to avoid that the financial markets would be tempted to test the sustainability of the central parity. Preserving fiscal stability is the key to preserving the credibility of the central parity and avoiding a prolonged stay in the ERM-2. Wage discipline and fiscal prudence will be important tools for avoiding developments that could seriously damage the economy, and especially employment. A strong publicity campaign has made these tradeoffs well known to the public.

Fiscal policy will be key to maintaining macroeconomic stability.

Fiscal policy will have to ensure continued macroeconomic stability and keep inflation in check. Measures for safeguarding the strength of the public finances will include, first, imposing rational limits on public consumption to ensure the maintenance of sufficient reserves to allow automatic stabilizers to be used to their full extent; and second, restraining public sector wage growth.

It is beyond doubt that this will not be easy, especially during the approach of the elections scheduled for next October. The fiscal targets have been secured by two important safeguards. First, the budget for 2005 was already locked in last December with the framework of Slovenia's 2004-2005 budget, and will not be adjusted until the spring of 2005, after the macroeconomic outlook is assessed. Second, the rule for the strict monitoring of the budget execution has been put in place, and will be followed notwithstanding the overperformance of the first quarter revenues.

Slovenia's improved fiscal outlook makes some room for fiscal action. The authorities intend to increase the competitiveness of the corporate sector by advancing the planned reduction of

the payroll tax by six months, from next January to July 2004. This measure, which will reduce the 2004 budget by some five billion Slovenian tolar, equivalent to 0.08 percent of GDP, is aimed at reducing the cost of labor and helping companies that pay lower wages. To keep the tax holiday from spilling over into higher wages, the reduction of the payroll tax will not become effective until safeguards are put in place to ensure that private sector wages are kept within the pre set limits.

Wage policy is considered essential for securing a smooth ERM-2 entry.

Real wages are expected to rise by 2.0 percent annually, lagging behind productivity growth. The largest contribution to wage moderation will come from the public sector, where an agreement concluded last July among the social partners has locked in the growth of public sector wages. Real increases of no more than 0.5 percent for 2004 and 1.0 percent for 2005 are expected.

The wage setting arrangement for the public sector has defined the path for private sector wage adjustments. On April 28, 2004, the social partners reached a national agreement limiting private sector wage growth in 2004 and 2005 to one percentage point below productivity growth, which provides for making adjustments in 2005 if the 2004 targets are not met. At the individual level, the agreement secures a lump sum wage increase for all workers aimed at reducing wage disparities. Negotiations have now started at the level of individual industries, to make the agreed wage settlement operational and effective. This will clear the way for the payroll tax reduction.

The financial system remains robust but is coming under increasing competitive pressure from the EU.

The recent mission for updating Slovenia's FSAP has confirmed that Slovenia's financial system is sound. It has provided valuable advice on how to address problems arising from the increased competitive pressures resulting from EU entry. The mission's recommendations will provide the framework for an Action Plan to be coordinated by the Bank of Slovenia, which will monitor the practical implementation of the mission's advice just as it did after initial FSAP exercise in 2000.

The Bank of Slovenia is considering a reinforcement of banking supervision, especially in light of stronger pressures to lend to weaker clients. The Bank might also introduce at the beginning of 2005 dynamic provisioning to counteract cyclic upturns, if international accounting standards would not yet apply.

III. Conclusion

A few days ago, Slovenia became a member of the European Union community. The promise of EU accession was a major factor in securing public support for the structural and institutional reforms aimed at bringing sustained growth and macroeconomic stability. The Slovenian economy today has remarkable resilience. It has come very close to achieving

price stability; the current account deficit and the fiscal deficit are expected to remain modest; the financial system is robust; and safeguards against the risks have been put in place.

From the beginning of its independence to the present day, Slovenia has never needed financial assistance from the Fund. But its regular Article IV consultations and technical assistance missions have enabled it to constantly check its policy approach with the Fund's staff. The Fund's expertise, the frank exchange of views, and especially the readiness of Fund missions to examine everything from conceptual policy issues to the effectiveness of those policies, were highly valued features of these consultations. At this important moment of EU accession, the authorities wish to express their sincere gratitude for the Fund's good advice, and for the support for their stabilization policies embodied in the valuable reports resulting from these discussions.



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IMF Concludes 2004 Article IV Consultation with the Republic of Slovenia

On May 7, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.¹

Background

Domestic demand rebounded strongly in 2003 after three anemic years. All components of domestic demand strengthened appreciably, fueled by declines in interest rates and the associated pickup in bank credit to the private sector. However, there was a large negative swing in the contribution of net foreign demand to growth. Real GDP growth slowed to 2.3 percent, and the output gap widened. The external current account position receded from a sizeable surplus in 2002 to approximate balance in 2003. Competitiveness and other external vulnerability indicators remained satisfactory.

Progress with disinflation was better than expected. Year-on-year inflation declined from 7.2 percent at end-2002 to 3.5 percent in March 2004. Staff analysis suggests that the widening of the output gap associated with the economic slowdown was the dominant driving force behind disinflation in 2003. Other contributory factors, albeit to a lesser degree, were a moderation of the pace of tolar depreciation, smaller increases in regulated prices and indirect taxes, and excise tax adjustments to offset increases in international oil prices. While wage drift in the public sector slowed and economy-wide real wage growth in 2003 was broadly similar—about 2 percent—to that in 2002, the gap between wage and productivity growth narrowed.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The fiscal outturn in 2003 implied some withdrawal of stimulus. The general government deficit—1.4 percent of GDP—was slightly smaller than that envisaged in the mid-year supplementary budget and broadly similar to the outturn in the past three years.

Monetary conditions at the policy level remained broadly unchanged in 2003. Prompted by the deceleration in inflation, European Central Bank interest rate cuts, and a perception of falling country-risk premium, the Bank of Slovenia lowered its key policy rate steadily by a total of 3½ percentage points since December 2002 to 4.75 percent in April 2004. Meanwhile, the tolar continued to depreciate vis-à-vis the euro, though the pace of depreciation slowed from an annualized rate of 3.3 percent in December 2002 to 2 percent in March 2004. The indexation of financial contracts was eliminated in 2003. Bank lending rates fell in real terms, and private credit demand and interest-sensitive capital inflows picked up. A large part of the expansion of credit to enterprises was foreign currency-denominated, and was financed by rising bank borrowing from abroad.

GDP growth is expected to rebound in 2004 and rise above the potential rate subsequently. Growth is likely to be driven by strong domestic demand boosted by favorable business and consumer expectations triggered by European Union (EU) accession and prospective euro adoption, and a convergence-related decline in interest rates. In this environment, there is some risk of domestic demand boom. The contribution of net foreign demand to growth would likely remain negative in the foreseeable future, and the current account is expected to swing into a modest deficit. The prospective narrowing of the output gap is likely to slow down the disinflation process, complicating achievement of the Maastricht inflation criterion. Slovenia already meets the Maastricht criteria for long-term interest rates and the fiscal deficit and public debt ratios.

Following Slovenia's accession to the European Union on May 1, 2004, the authorities plan to enter ERM2 in the course of the second half of 2004 with the aim of adopting the euro in January 2007.

Executive Board Assessment

Executive Directors congratulated the authorities for their successful entry to the European Union (EU) on May 1, 2004 and their impressive macroeconomic policy achievements, and noted that the main challenge now is to ensure a smooth ERM2 entry and euro adoption, as well as to continue preparing the economy for successful performance within the union. Directors observed that Slovenia is in many respects well poised to join the euro area, particularly in light of the substantial real and nominal convergence in meeting most of the Maastricht criteria. They also considered that Slovenia's competitiveness appears adequate. Inflation, however, while falling, remains above the EU average.

Directors stressed that the intended early ERM2 entry and eventual euro adoption would depend critically on bringing inflation sustainably down to a level that, in addition to meeting the Maastricht criterion, would not hamper competitiveness once the exchange rate is fixed.

Other key tasks are to ensure that fiscal and wage policies are capable of absorbing shocks. Directors cautioned that a credit-financed demand boom could complicate achieving the Maastricht inflation criterion and create stresses on the banking sector.

Directors welcomed the recent sharp drop in inflation. They noted that while the increased slack in the economy in 2003 was probably the main driving force behind disinflation, policy measures—such as a slower pace of tolar depreciation—also contributed. Directors also welcomed the efforts to limit excessive increases in administrative and regulated prices by pressing for greater cost efficiency and savings in public companies. In this context, some Directors stressed the need to further liberalize those prices. Directors commended the decision to eliminate indexation of financial contracts.

Directors underscored that monetary policy needs to play a pro-active role in the run-up to ERM2 entry by restraining monetary conditions in order to contribute to disinflation and help contain possible intense demand pressures under ERM2. While acknowledging the Bank of Slovenia's (BoS) concern that monetary restraint could trigger capital inflows and potentially impact competitiveness, Directors stressed that monetary conditions should not be loosened prematurely.

Directors emphasized that fiscal policy should be oriented to alleviating budgetary pressures related to EU accession and coping with the risk of a possible private sector demand boom. They welcomed the significant expenditure saving measures incorporated in the budget for 2004–05, and noted that these measures should be carefully safeguarded in an election year. Nevertheless, they stressed that further expenditure rationalization—particularly in the areas of health care, education, and social transfers—is essential to ensure sustained flexibility in fiscal policy and to achieve the authorities' medium-term goal of structural balance. Directors urged that, in the event of a demand boom, any revenue overperformance should be saved and any further lowering of payroll taxes avoided.

Directors stressed that wage policy needs to play a central role in fostering disinflation and safeguarding competitiveness. They commended the authorities for weakening wage indexation and reducing wage drift in the public sector, and urged them to consolidate these gains by restricting the cost of the new wage structure. Directors noted that wage policy can usefully contribute to disinflation by reducing wage increases relative to productivity growth, particularly in the nontradable sector. They also considered that achieving the Maastricht inflation criterion might warrant a temporary wage pact at the national and enterprise levels under the guidance of the government. Directors encouraged the government and social partners to fully eliminate wage indexation and move to a wage-setting system that ensures wage differentiation based on productivity.

Directors noted that the banking system is generally sound. However, they emphasized that strengthening supervisory and prudential oversight—in line with the Financial System Stability Assessment update—is essential to guard against the risks of rapid credit growth and stresses on the financial system. They noted signs that banks were starting to shift to more risky borrowers as a result of increased competition, and cautioned that this tendency was likely to

intensify as profit margins were squeezed further. Given the potential for a credit boom and related risks in the run-up to euro adoption, Directors cautioned against any easing of the existing prudential regulations. They deemed appropriate the BoS's intention to complement the supervisory framework by introducing dynamic provisioning appropriate, while noting that other prudential tools may have to be considered to control surges in credit growth. Directors welcomed Slovenia's active AML/CFT efforts.

Directors urged the authorities to maintain the momentum behind structural reforms in other areas and to improve the environment for private sector development. They welcomed achievements in liberalizing utilities and transport services, and called for further progress in the natural gas, telephony, and transport sectors, as well as a broader privatization program. Directors also noted that stronger competition was likely to lead to lower prices, and hence usefully complement the authorities' disinflation efforts. The move toward the adoption of the euro would be helped by greater labor market flexibility and higher participation rates—especially among older workers.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2004 Article IV Consultation with Slovenia is also available.

Slovenia: Selected Economic Indicators, 1999-2005

	1999	2000	2001	2002	Prelim. 2003	Proj. 2004	2005
	(Annual percentage change)						
Real GDP	5.9	4.1	2.9	2.9	2.3	3.5	4.1
Domestic demand	9.5	1.5	1.0	2.1	4.0	5.0	5.4
Private consumption	5.9	0.3	2.4	1.1	3.1	4.5	5.5
Public consumption	2.9	2.3	4.0	2.5	2.8	2.3	1.3
Gross capital formation	22.4	3.3	-4.2	4.1	7.0	8.0	8.0
Industrial production	-0.5	6.2	2.9	2.4	1.4	...	...
Consumer prices							
Period average	6.1	8.9	8.4	7.5	5.6	3.7	3.4
End of period	8.0	8.9	7.0	7.2	4.6	3.7	3.3
Wages							
Nominal							
All sectors	9.6	10.6	11.9	9.7	7.5	7.0 1/	5.3 1/
Manufacturing	9.1	11.9	10.7	10.4	7.6	...	...
Public services	10.1	11.2	13.9	8.7	6.3	...	...
Real							
All sectors	3.3	1.6	3.3	2.1	1.9	2.0 1/	2.2 1/
Manufacturing	2.8	2.8	2.1	2.7	1.9	...	...
Public services	3.7	2.1	5.1	1.1	0.7	...	...
Employment							
Person basis	1.8	1.3	1.4	0.6	-0.8	...	...
Full-time-equivalent basis	1.2	1.1	0.5	-0.5	-0.2	0.5 1/	0.6 1/
Unemployment rate (in percent, ILO definition)	7.6	7.0	6.4	6.3	6.7	6.7 2/	6.4 2/
General government finances	(In percent of GDP)						
Revenue	41.4	40.9	41.5	40.9 3/	41.9	42.7 4/	42.8 4/
Expenditure	42.0	42.2	42.8	42.5	43.3	44.4 4/	44.3 4/
General government balance	-0.6	-1.3	-1.3	-1.5 3/	-1.4	-1.7 4/	-1.6 4/
State budget balance	-0.5	-0.9	-1.0	-1.2 3/	-1.2	-1.5 4/	-1.7 4/
General government debt	23.6	24.7	26.6	27.8	27.0	27.3 4/	27.4 4/
Money and credit	(Percentage change, end-period)						
Broad money (including foreign exchange deposits)	12.2	15.3	28.3	18.4	4.9	...	...
Base money	21.2	1.9	37.7	-4.3	4.1	...	...
Credit to the private sector	29.3	18.6	18.4	11.3	15.7	...	...
Interest rates (in percent)							
BoS Lombard rate	9.0	11.0	12.0	10.5	7.3	...	...
Rate on 60-day BoS bills	7.0	10.0	8.0	8.3	6.0	...	...
Lending rates	13.1-17.2	14.6-18.4	12.3-15.8	11.6-14.7	9.6-10.3	...	...
Deposit rates 5/	9.6-11.4	10.9-13.2	8.5-11.0	7.6-8.6	4.8-4.9	...	...
Balance of payments	(In millions of euros, unless noted otherwise)						
Merchandise exports	8,103	9,574	10,454	11,081	11,427	12,147	13,141
Exports volume (percent change)	2.7	12.9	6.9	6.5	4.5	5.9	6.9
Merchandise imports	-9,267	-10,801	-11,139	-11,347	-11,971	-12,836	-13,938
Imports volume (percent change)	8.6	7.7	3.2	4.4	6.8	8.0	8.4
Current account balance	-664	-583	38	330	17	-149	-288
(in percent of GDP)	-3.3	-2.8	0.2	1.4	0.1	-0.6	-1.0
Gross official reserves	3,159	3,436	4,984	6,781	6,879	7,426	8,220
(in months of imports of goods and nonfactor services)	3.5	3.3	4.7	6.2	5.9	6.0	6.1
External debt (percent of GDP, end-period) 6/	40.4	46.1	47.7	49.2	53.6	57.3	60.1
External debt service	843	1,103	1,877	1,778	2,144	2,424	2,724
(in percent of exports of goods and nonfactor services)	8.5	9.5	14.9	13.1	15.4	16.5	17.2
Exchange rate							
Tolars per U.S. dollar (end-period)	196.8	227.4	251.0	221.1	189.4	...	...
Tolars per euro (end-period)	197.3	211.5	221.4	230.3	236.7	...	...
Nominal effective exchange rate (1998Q1=100, period average)	96.8	90.6	85.0	81.8	80.5	...	...
Real effective exchange rate							
(CPI based, 1998Q1=100, period average)	103.1	102.1	101.1	102.8	105.0	...	...
(ULC based, 1998Q1=100, period average)	100.5	97.9	97.6	97.7	99.1	...	...

Sources: Data provided by the Slovene authorities; and IMF staff calculations and projections.

1/ Budget projections by the Ministry of Finance for 2004-05.

2/ Projections by the Institute for Macroeconomic Analysis and Development (IMAD).

3/ Revenues and deficit figures have been adjusted for the shift of budget accounting to a pure cash basis. Without the adjustment, the general government deficit would have reached SIT 156 bn, or 3.0 percent of GDP, as the unadjusted figures contained only 11 months of VAT and excise tax.

4/ Budget figures for 2004-05. Revenue projections include transfers from the EU budget, and expenditure projections include payments by Slovenia to the EU budget.

5/ For deposits with maturity between 31 days and 1 year.

6/ Data have been revised according to the External Debt Guide 2003.