 July 2005
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Republic of Slovenia: 2005 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 2005 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 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 21, 2005, with the officials of the Republic of Slovenia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2005. 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 July 20, 2005 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 has 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 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with the Republic of Slovenia

Approved by Poul Thomsen and G. Russell Kincaid

June 20, 2005

- The consultation discussions were held in Ljubljana during March 9–21 and in Washington during April 15–16. The mission met with Prime Minister Jansa, Finance Minister Bajuk, Bank of Slovenia (BoS) Governor Gaspari, other senior government and BoS officials, parliamentarians, and representatives of trade unions and the business, financial and academic communities.

- The mission comprised Messrs. Banerjee (head), Egoume-Bossogo, Ganelli (all EUR) and Ms. Oura (ICM). Mr. Rosenberg (Senior Regional Representative) and Ms. Maver (Advisor to the Executive Director for Slovenia) participated in the discussions. 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 March discussions. 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 No. 144 (52/51).

- Slovenia has subscribed to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance.

- The October 2004 parliamentary elections resulted in the formation of a center-right coalition government, replacing the center-left coalition that had governed Slovenia since 1992.

Contents Page

Text Tables

Appendices

EXECUTIVE SUMMARY

Background: Slovenia joined the EU on May 1, 2004. Real GDP growth last year accelerated to 4½ percent, driven by a positive swing in the contribution of net foreign demand while domestic demand growth maintained momentum. However, the external current account deficit widened to almost 1 percent of GDP, owing to a deterioration of the terms of trade. Inflation declined to 3.2 percent at end-2004 and fell further to 2.1 percent in May 2005. Following ERM2 entry on June 28, 2004, the exchange rate stabilized and monetary conditions tightened. The fiscal deficit, at 1.4 percent of GDP, was lower than envisaged in the budget.

Outlook: Economic growth is likely to moderate to 4 percent in 2005–06, owing to a continued slowdown in inventory accumulation. The current account deficit is projected to deteriorate further in 2005 but narrow in 2006, in line with anticipated terms of trade developments. The authorities expect average inflation of about 2½ percent in 2005–06. The revised 2005 budget envisages a broadly neutral fiscal stance.

Policy Discussions

Euro adoption: Slovenia is well poised to adopt the euro in early 2007, but risks remain. It meets all the Maastricht criteria except for the one on inflation. The authorities were more concerned about the upside risk to the inflation outlook from oil price rises than from faster-than-potential economic growth or increases in producer prices. If achievement of the Maastricht inflation criterion were at risk, the authorities would take appropriate corrective measures, including active use of incomes and exchange rate policies. The actual choice of policy instruments would depend on an assessment of their effectiveness, taking into account the stage in the assessment period in which an upturn in inflation materialized.

Monetary and exchange rate policy: Under ERM2, the Bank of Slovenia (BoS) will give primacy to exchange rate stability and keep policy interest rates unchanged until forced otherwise by market conditions. However, should there be signs before end-2005 of inflation exceeding the projected path, the BoS would tighten monetary conditions. The staff agreed that, given transmission lags, initiating monetary tightening after end-2005 might not have a discernible impact on inflation during the assessment period.

Wage policy: The prospects for continued wage moderation in 2005 are good but risks remain from wage negotiations for 2006 and beyond. The staff noted that greater wage flexibility was paramount for absorbing asymmetric shocks once in the monetary union, and encouraged the social partners to eliminate wage indexation and move to a wage-setting system that ensured productivity-based wage differentiation.

Fiscal policy. The staff recommended a more restrictive stance to reduce the risks to the disinflation objective and put public finances on the consolidation path toward the official medium-term goal of structural balance. The authorities highlighted EU-related expenditures and unanticipated spending needs as constraining factors. Medium-term fiscal consolidation efforts would be directed toward reforming social entitlements and health care and containing the public sector wage bill, but achieving political consensus on some of these measures was likely to be time consuming. For political reasons, the authorities intend to revert in 2006 from the existing system of indexing pensions to wages with a lag to the earlier practice of indexing them to current wage growth. They are also considering a further reduction of payroll taxes with the aim of enhancing competitiveness. To promote structural balance, the staff advised against both measures.

Banking sector and other structural issues. The banking system is healthy, but exposure of banks to credit and interest rate risks will need close monitoring. The staff supported the BoS's intention to classify outstanding provisions released on account of adopting the IFRS in January 2006 as a component of statutory reserves. The staff encouraged the authorities to enhance the supervision of insurance companies. Consideration is being given to further privatization and improving labor market flexibility.

I. BACKGROUND

1. **Slovenia reached two significant milestones in 2004: European Union (EU) accession on May 1 and ERM2 entry on June 28**. The authorities' goal is to adopt the euro in early 2007. There is broad consensus of all political parties and social partners on this objective.

2. **Slovenia is well poised to adopt the euro, but risks and challenges remain**. Real convergence in terms of per capita income and productivity is comparable to that of some non-core euro countries. Slovenia already meets the Maastricht criteria for long-term interest rates and the fiscal deficit and debt ratios. The exchange rate of the tolar vis-à-vis the euro has remained close to the central parity since ERM2 entry. However, while inflation has steadily moved closer to eurozone compatible levels, achievement of the Maastricht criterion could be at risk if faster-than-potential economic growth and higher producer price inflation were to feed through to consumer prices. Though recent developments in real wages relative to productivity growth have been favorable, wage-setting mechanisms are not sufficiently flexible. Also, current conditions call for a tighter fiscal policy stance and a lowering of expenditure rigidities.

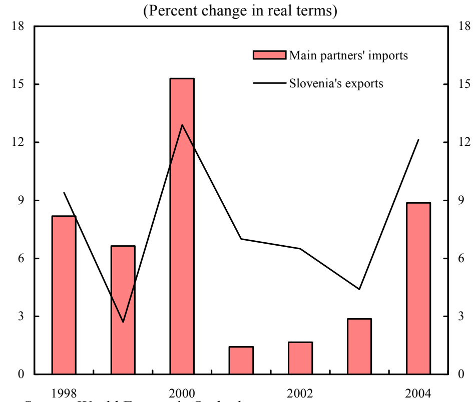
Slovenia: The Maastricht Criteria

	2004		2005	
	Criterion	Estimate	Criterion	Forecast
Average inflation (percent) 1/	2.2	3.6	2.8	2.6
Long-term interest rate (percent) 2/	5.7	4.9	5.8	4.0
General government deficit (In percent of GDP) 3/	3.0	1.9	3.0	1.8
General government debt (In percent of GDP)	60.0	29.5	60.0	30.1

1/ 1½ percentage points above the three lowest inflation rates in the EU. For 2005, criterion based on WEO projections.
2/ 2 percentage points above the rates in the three lowest inflation rate countries in the EU. For 2005, rate on 11-year government bond issued in January.
3/ ESA-95 basis

3. **Economic performance in 2004 was strong, and policy implementation was generally in line with the Fund's advice** (Box 1). Real GDP growth accelerated sharply to 4½ percent, driven by a positive swing in the contribution of net foreign demand. Exports to the main EU and non-EU destinations rose in response to stronger import demand in these countries. However, with the terms of trade deteriorating owing to higher oil and commodity prices, the external current account deficit widened to almost 1 percent of GDP (Figure 1 and Table 1).

Slovenia's Exports and Non-oil Imports of Partner Countries 1/
(Percent change in real terms)



Source: World Economic Outlook.
1/ Partners are: Austria, Bosnia Herzegovina, Croatia, Czech Republic, France, Germany, Hungary, Italy, Poland, Russia.

Box 1. Policy Recommendations and Implementation

In concluding the last Article IV consultation, Executive Directors focused on policies to ensure a smooth transition to ERM2 entry and euro adoption as well as strong performance in the monetary union (http://www.imf.org/external/pubs/cat/longres.cfm?sk=17421.0).

Over the years, the authorities have generally heeded the Fund's policy advice, except with regard to monetary policy. The BoS pursued a more gradual approach to tackling inflation than advocated by the staff. Nevertheless, recent progress in disinflation was better than expected.

In 2004, the implementation of monetary policy was cautious. In line with the Fund's advice, the BoS did not lead the market in lowering nominal interest rates prior to ERM2 entry. Under ERM2, it has given primacy to exchange rate stability.

On the fiscal front, despite the elections, the authorities implemented expenditure saving measures to contain the deficit within the budgeted level. However, there was little progress in laying the ground for expenditure rationalization that would ensure achievement of structural balance in the medium term.

The authorities took steps to strengthen banking supervision and implement the recommendations of the 2004 Financial System Stability Assessment (FSSA) update.

4. **Domestic demand growth did not take off as feared by the staff, but maintained momentum**. Consumption and investment contributed about equally to GDP growth. However, their growth rates exhibited contrasting trends. Private consumption strengthened appreciably, though to a lesser extent than expected owing to a marked restructuring of household financial assets and an apparent increase in the propensity to save. Households channeled increasing amounts to mutual funds, insurance companies, and voluntary supplementary pension insurance, which more than offset a sharp jump in bank borrowing. In contrast, investment growth slowed, owing to a smaller contribution from inventory accumulation. Moreover, outflows of investible resources from Slovenia increased in 2004: direct and portfolio investment outflows rose to nearly 4 percent of GDP from about 2½ percent of GDP in 2003.

Demand and Credit Growth, Financial Saving of Households, and Capital Flows

	2000	2001	2002	2003	2004
	(Percent change in real terms)				
Real GDP	3.9	2.7	3.3	2.5	4.6
Total domestic demand	1.5	0.9	2.3	4.7	4.7
Private consumption	0.3	2.3	0.3	2.7	3.5
Gross investment	3.3	-4.3	7.4	10.5	9.1
Real credit growth	8.5	11.0	1.9	10.7	17.1
Enterprises	11.2	15.9	2.5	12.4	17.0
Households	3.5	1.1	0.4	6.6	17.3
	(In percent of household disposable income)				
Annual net flow of resources from households					
Bank deposits in Slovenia	9.2	14.6	5.2	4.3	5.2
Currency & Bank deposits abroad	0.1	-5.6	3.9	3.7	4.4
Non-bank financial institutions	1.4	1.7	2.9	3.3	5.5
Flow of bank credit to households	2.0	1.3	1.3	1.8	3.5
Net financial saving of households	8.7	9.5	10.6	9.5	11.5
	(In percent of GDP)				
Net foreign direct investment	0.4	1.1	6.7	-0.5	0.1
Inward	0.7	1.9	7.5	1.2	1.6
Outward	-0.4	-0.7	-0.7	-1.7	-1.6
Net portfolio investment	0.9	0.4	-0.3	-0.9	-2.4
Inward	1.2	0.9	0.1	-0.1	-0.1
Outward	-0.3	-0.5	-0.4	-0.8	-2.3

Sources: Bank of Slovenia and Institute for Macroeconomic Analysis and Development (IMAD).

5. **Progress with disinflation continued, notwithstanding higher oil prices, a pick-up in producer prices, and a narrowing of the output gap**. Year-on-year headline inflation

declined from 4.6 percent in December 2003 to 3.2 percent in December 2004 and fell further to 2.1 percent in May 2005. Supply side and structural factors were important driving forces behind this trend: an improved harvest, the elimination of remaining duties on imports from the EU, and increased competition in the retail market resulted in falling food prices and moderate increases in the prices of non-food items (Figures 2 and 3). Wage developments also played a positive role, as the pace of real wage increases in both the tradable and non-tradable sectors lagged behind productivity growth by a wider margin than in 2003 (Figure 4). Disinflation was additionally reinforced by the stabilization of the exchange rate after ERM2 entry.

Productivity and Real Wages

	Whole economy		Tradables		Non-tradables	
	Productivity 1/	Real wage	Productivity 1/	Real wage	Productivity 1/	Real wage
	(Percent change)					
2001	2.6	3.2	2.9	2.2	2.1	3.6
2002	4.2	2.1	6.9	2.7	2.0	1.5
2003	2.8	1.9	4.6	2.0	1.2	1.6
2004	4.5	2.0	6.9	3.3	2.4	1.2

Sources: Statistical Office of the Republic of Slovenia; and IMF staff calculations.
1/ Measured on value added basis.

6. **The monetary framework changed following ERM2 entry, and monetary conditions became tighter**. Until June 2004, the BoS continued with its policy of lowering interest rates gradually in response to the deceleration in inflation, while depreciating the exchange rate at a steadily slowing pace to avoid widening the uncovered interest parity. Upon ERM2 entry, the BoS ended its depreciation policy, and set the central parity at SIT 239.64 per euro, close to the then-prevailing market rate. Since then, the market rate has not deviated from central parity by more than ±0.20 percent, and the BoS has kept its key policy interest rate (on 60-day bills) unchanged at 4 percent (Figure 5).

7. **However, with further convergence of tolar lending rates and increased competition in the banking sector, bank credit accelerated in 2004**. The pick-up in credit growth was particularly strong for individuals, but the bulk of the credit continued to be absorbed by enterprises. While most of the new loans to individuals were tolar denominated, about four-fifths of new lending to enterprises was euro denominated (Figure 6). With slow growth in deposits

Bank Financing (Annual Net Flows)

	2001	2002	2003	2004
	(In billions of tolars)			
Total Liabilities	771	569	495	601
Domestic Liabilities	685	414	245	282
Of which: Deposits from non-monetary sector	622	385	143	227
Tolar deposits	363	323	105	100
Foreign currency deposits	259	62	38	128
Foreign Liabilities	86	156	251	320
Of which: Borrowings from banks	48	123	141	287
Deposits from banks	13	42	103	29
Liabilities to non-monetary sector	25	-9	6	4
	(In percent of total liabilities)			
Domestic Liabilities	88.8	72.6	49.4	46.9
Of which: Deposits from non-monetary sector	80.7	67.6	29.0	37.8
Tolar deposits	47.1	56.8	21.2	16.6
Foreign currency deposits	33.6	10.8	7.8	21.2
Foreign Liabilities	11.2	27.4	50.6	55.2
Of which: Borrowings from banks	6.2	21.6	28.4	49.6
Deposits from banks	1.7	7.4	20.9	4.9
Liabilities to non-monetary sector	3.2	-1.6	1.3	0.6

Source: Bank of Slovenia

on account of lower interest rates and increased alternative saving opportunities, banks increasingly resorted to foreign financing from parent banks and through syndicated loans to fund their lending activities (Table 2). For both enterprises and individuals, interest rates on new tolar-denominated loans declined in nominal and real terms, while nominal rates on new euro-denominated loans were broadly stable. Aggressive pricing by foreign-owned banks to increase market share has resulted in lower interest rates on euro-denominated loans than abroad, while rates on tolar-denominated consumer loans are comparable to those in the euro area (Figure 7).

8. **The general government deficit was slightly lower than envisaged in the budget, but the expenditure structure became more rigid**. The temporary decrease in VAT receipts due to the elimination of border customs control upon EU accession was higher than anticipated. However, the shortfall was offset by higher collections of profits tax and non-tax revenues. Faced with uncertainties on VAT receipts, the authorities cut spending on goods and services in the fourth quarter. Capital expenditure from domestic resources was also lower than budgeted. However, the wage bill exceeded the budgeted level, owing to a higher-than-envisaged increase in employment and promotion-related wage creep toward the end of the year, which will have carryover effects into 2005. Receipts from the EU budget were only one half of the level envisaged, and expenditure associated with the undrawn funds was not executed (Table 3).

General Government Operations in 2004

	Budget	Outturn
	(In percent of GDP)	
Total revenue	42.2	41.6
Receipts from EU budget	1.3	0.7
Revenues excluding EU receipts	40.9	40.9
of which: VAT	9.2	8.7
Total expenditure	43.9	42.9
Payments to EU budget	0.7	0.7
EU-related expenditures	1.1	0.6
Use of earmarked revenues	0.9	0.4
Co-financing	0.2	0.2
Non-EU related expenditures	42.2	41.7
of which: wages and personnel expenditures	9.1	9.5
capital expenditures	4.0	3.6
Overall balance	-1.7	-1.4
EU-related items	-0.5	-0.5
Excluding EU-related items	-1.2	-0.8

Source: Ministry of Finance

9. **Competitiveness remains satisfactory**. The unit labor cost (ULC)-based real effective exchange rate (REER) and the relative profitability index have remained broadly unchanged since early 1998. The CPI-based REER has been relatively flat since mid-2003, consistent with the conclusion of recent IMF staff studies that the tolar appeared to be in line with its fundamentals[1] (Figures 8 and 9). In recent periods, Slovene exporters have increased their presence in both EU and non-EU countries, and many have promoted market penetration through establishing affiliates abroad. However, the increase in EU market share has been smaller for Slovenia than for the neighboring new EU-member states (NMS), although Slovenia’s bilateral real exchange rate vis-à-vis these countries has depreciated

[1] Susan Schadler et al., *Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration,* IMF Occasional Paper No. 234, 2005; and Aleš Bulíř and Kateřina Šmídková, “Exchange Rates in the New EU Accession Countries: What Have We Learned from the Forerunners?”, IMF Working Paper WP/05/27, February 2005.

(Figure 10).[2] The better export performance of the neighboring NMS is likely a reflection of higher inflows of foreign direct investment and the associated preferential market linkages.

10. **The build-up of external debt represents a potential vulnerability**. With the increased external financing by banks, total external debt rose rapidly in the past two years to about 60 percent of GDP at end-2004. However, the net debt position was small, at below 10 percent of GDP. Short-term debt (on residual maturity basis) remained less than gross official reserves, though the debt ratio increased. The external debt service ratio was broadly unchanged (Table 4).

II. Report on the Discussions

11. **The discussions centered on policy priorities for achieving smoothly the authorities' goal of early euro adoption and for strong performance in the monetary union.** The authorities were narrowly focused on the immediate main challenges: to implement policies that will lower average inflation to a rate that meets the Maastricht inflation criterion and to maintain exchange rate stability within the "normal fluctuation margins" of ERM2. They believed that continuation of current monetary conditions, restraint in administered price adjustments, wage moderation, and a neutral fiscal stance would enable achievement of the euro adoption goal. The staff thought that fiscal policy should adopt a more restrictive stance to reduce the risks to the disinflation objective. The authorities were less concerned than the staff about the risks, but would consider corrective policy measures as necessary. The staff noted that maintaining low inflation and competitiveness after euro adoption and addressing the budgetary implications of an ageing population would be continuing challenges, and advised faster progress in achieving the official medium-term goal of structural fiscal balance and in enhancing wage and fiscal policy flexibility.

A. Macroeconomic Outlook

12. **There was consensus that economic growth would likely moderate to around 4 percent in 2005-06—an expansion still above estimates of potential and implying a further narrowing of the output gap**. Domestic demand growth is expected to ease, owing to a further slowdown of inventory accumulation and the dampening effect of lower tax relief on investment that will come into force in 2006 (Table 5). While not ruling it out completely, the authorities perceived the risk of a pick-up in private consumption growth to be small. They pointed to various explanations why a domestic demand boom had not materialized in Slovenia and may be absent in the period ahead (Box 2). The staff agreed that the factors stimulating household saving in non-bank financial institutions and outflows of investible resources were likely to persist and that, with convergence of nominal lending rates virtually complete, bank credit growth should stabilize. However, in the event of a further acceleration

[2] Eurostat data shows that while Slovenia's ULC in euros is higher than that of most NMS, its relative ULC vis-à-vis this group has declined by about 18 percent since 1995.

Box 2. A Credit Boom Without Demand Boom

Slovenia experienced rapid private credit growth in 2004, fueled by interest rate convergence and heightened competition in the banking sector. This was not accompanied by a commensurate pick-up in domestic demand, though private consumption and credit growth to households seemingly rose hand in hand. While there is a strong positive correlation between private consumption and credit growth (0.74 during 2000–04), the importance of credit growth diminishes once developments in personal income are taken into account.

The authorities highlighted several features of the Slovene economy that may explain the weak relationship between credit and demand growth.

- Slovenia's per capita income is already about 70 percent of the EU-15 average and comparable to that of some non-core euro countries. Hence, the "catch-up" effect is small. Moreover, in recent years, income distribution has shifted in favor of higher-paid workers, who tend to have a higher saving propensity.
- House ownership is very high in Slovenia, implying limited potential demand for housing loans. Indeed, the share of housing loans in new loans to households has declined from about one half in 2002 to one third in 2004. In addition, home equity loans are not available.
- Structural changes in the financial sector have had a positive influence on household saving behavior. Participation in the voluntary pension insurance scheme has increased steadily since its introduction in 2000. Also, investment in mutual funds has grown progressively since 2002, coinciding with the harmonization of domestic legislation with that of the EU and supported by sustained high returns. In turn, insurance companies and mutual funds have invested an increasing proportion of their resources in foreign securities.
- To some extent, domestic credit growth to enterprises reflects substitution of direct foreign borrowing by the corporate sector. Also, it is likely that part of the bank credit has been to support investment abroad by Slovene firms.

Looking ahead, the authorities expect that, with interest rate convergence virtually complete, credit growth will stabilize. In their view, household saving in non-bank financial institutions and outflows of investible resources are likely to remain strong. With less than one third of the active working population currently covered by voluntary supplementary pension insurance, participation in the scheme should continue to increase. Entry by foreign mutual funds (that began in September 2004) ought to increase competition and broaden the domestic mutual funds market. Although mutual fund returns are expected to fall, they are likely to remain higher than bank deposit rates. Because of the low market capitalization of the Slovene securities market, mutual funds are likely to increase investment in foreign securities. To remain competitive in the global market, Slovene enterprises, especially those in the labor-intensive industries, are likely to place increasing emphasis on relocating some of their activities abroad through foreign investment.

in credit growth, the authorities would need to give consideration to appropriate offsetting policy response, particularly on the fiscal front.

13. **The stimulus to growth from net foreign demand is expected to be small in the foreseeable future**. Export growth is likely to ease in 2005 and remain over the medium term in line with the projected import demand in Slovenia's main trading partners. Gains in export market shares, especially in non-EU countries, are liable to diminish over time as it is anticipated that Slovene firms will increasingly invest abroad in production facilities for efficiency reasons rather than for trade promotion. The rising trend in import content of domestic demand is likely to continue. With higher oil prices contributing to a further deterioration in the terms of trade, the external current account deficit is projected to widen to 1½ percent of GDP in 2005. However, on the expectation that oil prices will drop subsequently to the present futures market levels, the current deficit is projected to fall in 2006 and stabilize at about ½ percent of GDP over the medium term (Tables 6 and 7).

14. **External debt sustainability is not an imminent concern**. On the assumption that external borrowing by banks will continue at a slower pace and that foreign direct investment inflows will pick up upon euro adoption, the external debt-to-GDP ratio is projected to increase gradually to around 67 percent of GDP in 2009. The baseline scenario is relatively resilient to nominal interest rate and real growth shocks, but would worsen significantly in the event of a sizable depreciation of the currency. However, the likelihood of this last scenario would seem small as Slovenia is more likely to face appreciation pressure in the run-up to euro adoption (Appendix III).

Stress Tests for External Debt-to-GDP Ratio

	2004	2005	2006	2007	2008	2009
			(In percent)			
Baseline scenario	59.4	62.1	64.8	66.2	67.1	67.1
1. Nominal interest rate is at historical average (3.6 percent) plus two standard deviations in 2005 and 2006	59.4	62.7	65.9	67.3	68.1	68.1
2. Real GDP growth is at historical average (4.1 percent) minus two standard deviations in 2005 and 2006	59.4	63.3	67.3	68.9	69.8	69.9
3. Change in euro GDP deflator is at historical average (3.7 percent) minus two standard deviations in 2005 and 2006	59.4	66.8	75.7	77.5	78.8	79.1
4. Non-interest current account is at historical average (1.1 percent of GDP) minus two standard deviations in 2005 and 2006	59.4	65.3	72.0	73.2	73.9	73.7
5. Combination of 1-4 using one standard deviation shocks	59.4	66.0	74.4	75.8	76.6	76.5
6. One time 30 percent nominal depreciation in 2005	59.4	88.7	93.0	95.7	97.6	98.3

Source: IMF Staff projections.

15. **Barring major shocks and with supportive policies, the authorities expected inflation to stabilize around 2½ percent during the assessment period (June 2005–May 2006) for the Maastricht criteria**. The projected inflation rate, which the staff considered feasible, is within the estimated reference rate based on the World Economic Outlook projections of inflation in the comparators (2.9 percent) but higher than the rate based on the current inflation outturn in these countries (2.2 percent). The authorities

highlighted the uncertainty about the reference rate for the Maastricht inflation criterion, and agreed on the need to remain vigilant about inflationary pressures. However, they were more concerned about the upside risk to the inflation outlook from oil price rises than from faster-than-potential economic growth or increases in producer prices. They noted that the effects of the narrowing output gap had been muted to date and took the view that any increase in domestic demand pressures would largely spill over into a higher external current account deficit. The authorities also argued that increased competition was suppressing the pass-through of higher producer prices to consumer prices. Further, the increase in producer prices in 2004 reflected mainly a catching-up with the price level in the EU and the pace had slowed in recent months.

16. **If the achievement of the Maastricht inflation criterion were at risk, the authorities would take appropriate corrective measures, including active use of incomes and exchange rate policies.** The actual choice of policy instruments would depend on an assessment of their effectiveness, taking into account the stage in the assessment period in which an upturn in inflation materialized.

B. Monetary and Exchange Rate Policy

17. **Under ERM2, the BoS intends to operate within a undisclosed narrow exchange rate band around the central parity and let domestic interest rates be determined by interest rates in the euro area and the country risk premium**. Despite a 2-percentage point differential between the BoS's policy rate and the European Central Bank (ECB) refinancing rate since ERM2 entry, there had been no pressure in the foreign exchange market from capital inflows and, therefore, no need for exchange rate intervention. BoS officials noted that, besides a clearly defined monetary policy framework, enhanced policy coordination between the BoS and the government, the small size of the fiscal deficit, and a relatively thin government securities market helped avoid exchange rate volatility.

18. **Given the need to guard against the upward risks to inflation, the staff welcomed the BoS's intention to keep the policy interest rate unchanged for as long as market conditions permit**. The BoS intends to equalize its policy rate with the ECB refinancing rate at the start of the euro pre-entry period [3] (provisionally autumn 2006, assuming euro adoption in January 2007) when the conversion rate of the tolar also would be irrevocably fixed. At that time, with the reduction of the exchange rate risk, the BoS also plans to discontinue the current contractual agreement with banks on exchange rate policy operations and the use of foreign exchange swaps.[4] The BoS has prepared a detailed blueprint for adjusting its policy instruments to those of the Eurosystem in the period leading up to the adoption of the euro.

[3] The period between the abrogation of the derogation and euro adoption.

[4] A description of the BoS's exchange rate policy operations appears in Box 3 of the Staff Report for the 2004 Article IV Consultation (IMF Country Report No. 04/150).

19. **BoS officials indicated that, should there be signs before end-2005 of inflation exceeding the projected path, they would consider tightening monetary conditions by using a combination of instruments and utilizing the flexibility provided under the ERM2 framework**. The staff agreed that initiating monetary tightening after end-2005 might not be practicable. Given the 3 to 4 quarters transmission lags, a sizable tightening would be needed to have a discernible impact on inflation during the assessment period and could adversely affect competitiveness and growth.

C. Price and Wage Policies

20. **The authorities' disinflation strategy will continue to entail limiting increases in administered and regulated prices to no more than the projected inflation rate**. The authorities consider this policy important to counteract monopoly pricing and ineffective functioning of regulatory bodies. They argued that capping price increases would not result in losses for service providers. The authorities indicated that oversight of policy implementation needed to be strengthened, as some administered prices had increased by more than planned in 2004. The government will continue to adjust excise taxes on liquid fuels counter-cyclically to cushion the fluctuations in international oil prices and their impact on inflationary expectations, but trend increases will be fully passed on to consumers, as in 2004.[5]

Adjustments in Administered Prices, 2002-05

(Percent change; end-of-period)

	2002	2003	2004		2005
			Proj.	Actual	Proj.
Administered prices	9.2	4.0	3.4	9.0	2.3
Gasoline	7.7	3.3	-	14.2	-
Electricity tariffs	2.8	3.9	4.0	4.0	1.8
Telephone services	23.7	-	-	-	-
Municipal services	17.8	5.8	4.0	11.4	5.0
Social housing rents	9.4	29.8	30.0	10.9	5.0
Memorandum item:					
CPI inflation	7.2	4.6	3.7	3.2	2.4

Source: Institute for Macroeconomic Analysis and Development.

21. **The prospects for continued wage moderation in 2005 are good**. The government recently concluded an agreement with trade unions that provides for a further decline in average real public sector wages. The Social Agreement for 2003–05 would remain the basis for wage settlements in the private sector. Thus, the authorities expected that the increase in real wages would lag behind productivity growth by at least 1 percentage point. Noting that a stable relative profitability index was associated with declining product unit labor costs in Slovenia as well as in partner countries (see Figures 8 and 9), the staff agreed that the policy of wage increases lagging productivity growth should continue for maintaining competitiveness.

[5] The domestic prices of oil derivatives, excluding excise taxes and dealer margin, are automatically adjusted every 14 days in line with world market price developments. The EU directive on minimum excise taxes puts a lower bound on the tax adjustment policy.

22. **However, risks remain from wage negotiations for 2006 and beyond**. Negotiations initiated in 2003 on a new public sector wage structure aimed at reducing wage dispersion have not yet been concluded.[6] The authorities intend to implement the new wage structure over a four-year period and finance it from funds set aside from the budgetary allocations for wage bill indexation. However, trade union representatives saw a need for additional resources. They cautioned that their position on wage bargaining would harden if concessions were sought on important non-wage issues during the negotiations on a new Social Agreement (see ¶33). The staff noted that greater wage and price flexibility was paramount for absorbing asymmetric shocks once in the monetary union, and encouraged social partners to eliminate wage indexation and use the scope for greater productivity-based differentiation of wages. For example, in contrast to the overall trend, the wage-productivity growth gap in the trade and hotel sectors had narrowed in 2004, as real wage increases in these two sectors had been allowed to lag sector-specific productivity growth by less than the one percentage point prescribed by the economy-wide guideline of the current Social Agreement. In this context, the staff noted that applying sector-specific productivity increases as the basis for wage increases in individual sectors would, *inter alia*, reduce supply-side inflation pressures.

23. **The authorities' agreed with the staff's view that the broadly shared objective of meeting the Maastricht inflation criterion might warrant a wage pact at the national and enterprise levels**. However, they noted that to have a dampening effect on inflation during the assessment period, the measure would need to be in place before end-2005, and indicated that its need would be assessed in the fourth quarter. Unlike during the 2004 consultation discussions, when a center-left government was in power, trade union representatives were hesitant to sign off unconditionally on this option. Senior government officials noted that efforts to strengthen relations with trade unions were ongoing.

D. Fiscal Policy

24. **The revised 2005 budget envisages a broadly neutral fiscal stance and involves a further tilt in resource allocation toward current expenditure.** The authorities agreed that a tighter fiscal stance was desirable in principle, to be supportive of disinflation and because the current economic conditions were propitious for initiating adjustment toward the official medium-term objective of structural balance. However, they highlighted several constraining factors: a large carryover from 2004 on the wage bill; underestimation of wages in the education sector in the original 2005 budget; additional staffing needs in judicial bodies and for border policing and defense (in line with EU and NATO requirements); and unanticipated needs such as higher maintenance expenditure on railway infrastructure and court-mandated

[6] The aim is to lower dispersion gradually from 1:12.3 to 1:10, which the staff does not consider a problem given the higher wages in public administration relative to the private sector. Over the past several years, the current wage-setting mechanism had increased wage dispersion by granting larger wage increases for the higher-paid workers.

refunds of tax overpayments. Although Slovenia would be a net recipient of EU funds in 2005, the authorities estimated that expenditure increases connected with EU accession would worsen the overall fiscal position by about ½ percentage point of GDP compared to 2004. Addressing staff's concern about the reduced allocation for investment, the authorities explained that the cuts were in non-priority areas. They acknowledged that the implementation of the policy on promotions in public administration was not sufficiently restrictive. They were skeptical about the scope for expenditure cuts during the year to counteract any pick-up in inflation. Nevertheless, they agreed that, if revenue performance was stronger than expected, they would save the additional revenue and ensure an improved fiscal outturn.

Fiscal Impact of EU Accession, 2004–05

	2004 Budget	2004 Outturn	2005 Original budget	2005 Revised budget
	(In billions of tolars)			
Total revenue of general government	2,614	2,575	2,739	2,800
Receipts from EU budget	80	44	103	114
Revenues excluding EU receipts	2,533	2,531	2,636	2,686
Total expenditure of general government	2,721	2,659	2,848	2,886
Payments to EU budget	45	41	75	75
Current expenditure and current transfers	2,388	2,374	2,476	2,533
EU-related expenditures	23	14	43	56
Use of earmarked revenues	19	11	36	48
Co-financing	4	3	7	8
Non-EU related expenditures	2,365	2,360	2,433	2,477
Capital expenditure and capital transfers	288	244	297	278
EU-related expenditures	42	22	41	47
Use of earmarked revenues	37	13	35	39
Co-financing	5	9	5	8
Non-EU related expenditures	246	223	256	231
Overall balance of general government	-107	-85	-109	-86
EU-related	-30	-32	-56	-64
Non-EU related	-77	-52	-53	-22
	(In percent of GDP)			
Overall balance of general government	-1.7	-1.4	-1.7	-1.3
EU-related	-0.5	-0.5	-0.8	-1.0
Non-EU related	-1.2	-0.8	-0.8	-0.3

Source: Ministry of Finance

25. **The authorities noted that fiscal consolidation toward structural balance would be challenging**. However, they considered it important to create a sufficient safety margin against breaching the Stability and Growth Pact's (SGP) 3 percent of GDP deficit threshold during a cyclical downturn. Given the high share of nondiscretionary expenditure commitments, the authorities were inclined to seek additional saving through slower employment increases in the public sector, rationalizing health care spending, verifying the eligibility for social benefits, and aligning social benefits—which are generous (see Table 8)—toward prevailing international standards. However, they emphasized that the task would require extensive legal changes. Achieving political consensus on

Fiscal Outlook

	2004 Outturn	2005 Rev. Budget	2006 Staff Proj.	2007 Staff Proj.
	(In percent of GDP)			
State Budget				
Total revenues	24.5	25.6	24.9	24.4
Tax revenues	22.1	22.1	21.8	21.5
Nontax revenues	1.7	1.8	1.6	1.5
Receipts from EU budget	0.7	1.8	1.5	1.4
Total expenditures	25.8	27.0	26.5	26.0
Wages and social security contributions	8.1	8.1	7.9	7.7
Expenditures on goods and services	3.1	3.3	3.2	3.0
Interest payments	1.4	1.3	1.3	1.2
Budgetary reserves	0.1	0.2	0.2	0.2
Current transfers	10.1	10.4	10.5	10.4
Capital expenditures	2.2	2.6	2.5	2.4
Payments to EU budget	0.7	1.1	1.1	1.3
Overall balance	-1.3	-1.4	-1.6	-1.6
Rest of General Government				
Overall balance	-0.1	0.1	0.0	0.0
Total General Government				
Overall balance	-1.4	-1.3	-1.6	-1.6
Structural balance	-1.0	-1.1	-1.6	-1.6

Sources: Ministry of Finance; and IMF staff projections.

some of the measures was likely to be time consuming. The specific measures would be elaborated during the preparation of the two-year budget for 2006–07. Even on the assumption of continued wage restraint in the public sector and no increase in real expenditure on goods and services and most social transfers, the staff estimate that the overall and structural fiscal deficits would worsen slightly in 2006–07. Accordingly, the staff encouraged the authorities to make an early decisive start in restraining nondiscretionary budgetary expenditure.

26. **In 2006, the authorities intend to revert from the existing system of indexing pensions to wages with a lag to the earlier practice of indexing them to current wage growth**. The staff expressed concern that the proposed change would have a serious negative effect on the long-term soundness of the pension system and public finances in general, as it would result in additional annual pension obligations of about 1 percent of GDP within seven years. Population ageing already poses significant budgetary challenges. Even with the pension reform undertaken in 2000, pension payments are projected to increase from 13 percent of GDP in 2005 to 18 percent of GDP in 2020. The staff recommended that the issue of pension indexation be handled within the framework of a comprehensive reform package that preserved the long-run sustainability of the pension system, and that consideration be given to linking pensions to inflation instead of wage growth. While senior policymakers saw merit in these arguments, they considered the widening gap between pensions and wages to be politically untenable.

27. **The authorities are considering a further reduction of payroll taxes to enhance competitiveness and intend to link the measure to the new Social Agreement for 2006 and beyond**. However, in light of the confirmation by representatives of the business community that past payroll tax reductions were used for wage increases, the staff advised against lowering payroll taxes unless a new wage setting mechanism was designed to prevent the extra resources from being used for wage increases.

28. **Public debt sustainability is not a major concern**. At end–2004, general government debt stood at 29½ percent of GDP—well below the Maastricht limit. Most debt is long-term and the repayment profile is spread evenly over time. Assuming that the structural fiscal deficit remains unchanged, the debt ratio is projected to decline to 27 percent in 2009 (Appendix IV). Vulnerability of government debt to changes in inflation, interest rates, and the exchange rate is low. Since 2002, the government has increasingly issued securities at fixed rates and shifted to borrowing in the domestic market. Currently, fixed-rate debt represents about 60 percent of general government debt, and the proportion of index-linked debt has decreased to about 14 percent of total debt.

E. Banking Sector Issues

29. **Financial soundness indicators show that the Slovene banking system is healthy, though some potential vulnerabilities merit monitoring**. Banks are adequately capitalized and profitable, and asset quality remains high. Competition and interest rate convergence have resulted in shrinking interest margins and lower net interest income (Table 9). Since interest margins in euro-denominated activities are lower than in tolar-denominated

activities, banks are vulnerable to further margin compression in the transition to euro adoption. Banks have redressed the reduction in interest income mainly by improving cost efficiency and increasing non-interest revenues. There is no evidence to date of deteriorating credit quality. BoS officials noted that banking regulations with respect to risk classification and provisioning (based on long-term expected loss) were stringent and restrained banks from making high-risk loans. Moreover, supervisory oversight had been strengthened, especially with regard to pricing of risk. However, they were concerned that banks may be exposed to interest rate risk owing to a higher proportion of assets being at fixed rates and for longer maturities compared to liabilities. The BoS was planning to prepare regulations on interest risk reporting and to perform additional on-site inspections on interest risk exposure. In meetings with the staff, banks downplayed the BoS's concern, noting that they typically covered interest rate exposure through swaps.

Open Foreign Exchange Position of Corporate Sector, 2000–03 1/

	2000	2001	2002	2003
Open foreign exchange position of corporate sector as percent of assets	-6.5	-7.4	-7.8	-9.4
Of which:				
Open foreign exchange position vis-à-vis domestic banks as percent of assets	-1.0	-1.3	-1.6	-2.7
Open foreign exchange position vis-à-vis rest of the world as percent of assets	-5.5	-6.1	-6.2	-6.7

Source: Bank of Slovenia
1/ A negative sign indicates that foreign currency-denominated liabilities are greater than foreign currency-denominated assets.

30. **The International Financial Reporting System (IFRS) will be applied to banks from January 2006**. The authorities indicated that this would require some reorganization of provisioning triggers and rates,[7] and would likely lower the provisioning requirements for outstanding and new claims. With a view to avoiding additional credit expansion, the authorities have decided, in consultation with the banks and auditors, to classify outstanding provisions released as a component of statutory reserves.

31. **Foreign currency exposure of the corporate sector represents a source of increasing, albeit still small, credit risk for banks**. The bulk of the short open foreign exchange position of the corporate sector, which has been rising since 2000, is with entities other than domestic banks. The rising trend in banks' own open foreign exchange position reversed slightly in 2004 (see Table 9). Banks emphasized that they strictly adhered to prudential guidelines on direct foreign exchange exposure and offered hedging instruments to their clients. They saw the increasing euroization of their balance sheets as a natural concomitant of integration with the EU financial system, and argued that the increase in euro-denominated loans reflected the high probability attached by borrowers to early euro adoption. The share of domestic euro-denominated deposits (about one third in 2004) was also rising, though at a slower pace owing to higher interest rates on tolar deposits and expectation of exchange rate stability.

[7] For example, unlike the IFRS, current Slovene regulations do not allow provisioning requirements to be lowered for loans secured by mortgages.

32. **The transfer of credit risk on household loans from banks to insurance companies is a potential vulnerability for the financial sector**. About one half of household loans are secured by insurance companies. In the past few years, insurers have recorded a very high ratio of claims paid out to collected premiums on credit insurance (averaging about 90 percent compared to 64 percent for all insurance classes combined). The staff encouraged the authorities to enhance supervision of insurance companies and, as recommended in the 2004 FSSA update, to ensure that insurers develop the capacity to set pricing, provisioning, and capital at appropriate levels.

F. Other Structural Issues

33. **Further privatization and attracting foreign direct investment are continuing challenges**. The authorities have initiated an audit of the government's ownership in enterprises and, in light of the improved market environment, are preparing strategies to privatize the dominant telecommunications provider and steel mills. They also plan to list the NKBM (the second largest bank) on the stock exchange, with a view to its privatization. According to representatives of the business community, although Slovenia had introduced laws aimed at improving the business climate and had harmonized its legislation with that of the EU, potential investors still found administrative procedures at the local government level cumbersome and were discouraged by the limited availability of developed industrial sites and high labor costs. However, the authorities believed that a highly educated and skilled labor force made Slovenia an attractive destination for investors interested in creating a niche in specialized markets. They noted that interest of potential investors in automotive, chemicals, and distribution sectors was steadily growing.

34. **Consideration is being given to improving labor market flexibility**. Slovenia's employment protection legislation is more restrictive than that of neighboring new EU-member states. The employment rigidity index is also above the regional and EU-15 average. Layoffs are not permitted in the public sector except on disciplinary grounds, while procedural and financial costs of layoffs for economic reasons in the private sector are large. The authorities are planning to make labor legislation for public sector employees the same as that for private sector workers, and many quasi-government officials are advocating easing employment protection in the private sector. Trade union representatives argued that liberal regulations on fixed-term employment gave sufficient flexibility to employers: the bulk of new hiring by enterprises was fixed-term and inflows into the unemployment pool were mainly persons whose fixed-term contract had expired. They cautioned that industrial relations would likely become tense and cooperation on wage policy suffer, if measures to increase labor market flexibility were not accompanied

Hiring and Firing Indicators in Selected Countries, 2004

Indicator	Czech Republic	Hungary	Poland	Slovak Republic	Slovenia	Regional Average	EU-15 Average
Difficulty of Hiring Index	44	11	11	0	28	31	35
Rigidity of Hours Index	20	80	60	20	80	51	62
Difficulty of Firing Index	20	30	30	10	50	42	34
Rigidity of Employment Index	28	40	34	10	53	42	44
Firing Costs (weeks of wages)	22	34	25	17	47	38	50

Source: World Bank, Doing Business in 2004.

Note: The first three indices measure how difficult it is to hire a new worker, how rigid the regulations are on working hours, and how difficult it is to dismiss a redundant worker. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The overall Rigidity of Employment Index is an average of the three indices.

by adequate resources for retraining laid-off workers and finding them jobs. The staff stressed the importance of staying within the overall budget envelope in implementing any program on this front.

35. **Upon EU accession, Slovenia has transferred the competence of trade policy to the EU authorities**. It has terminated all bilateral preferential trade agreements and adopted the EU's common customs tariff and preferential agreements.[8] The authorities considered the negative impact of the termination of the bilateral preferential agreements on exports to be small compared with the benefits of joining the EU. They indicated that the recent elimination of WTO quotas on textiles was likely to aggravate the already poor financial situation in this sector, which accounts for almost one tenth of exports and 5 percent of employment.

III. Staff Appraisal

36. **With EU accession and ERM2 entry accomplished, policy makers are now focused on securing a smooth transition to euro adoption in early 2007**. The authorities' goal appears feasible, though risks remain. The levels of fiscal deficit, public debt, and long-term interest rate already meet the Maastricht criteria. Exchange rate variability under ERM2 has been limited, and competitiveness appears adequate. However, the inflation rate, though falling, remains above the Maastricht criterion. Progress toward achieving this criterion could be undermined by potential upside risks to inflation—arising from higher oil prices, faster-than-potential economic growth, and large producer price increases—thereby putting added pressure on disinflation policies. Besides the short-term challenges to meeting the formal requirements of euro adoption, the authorities also face the task of ensuring strong performance in the monetary union. Thus far, the authorities' policy strategy has been driven mainly by the short-term goals of meeting the Maastricht criteria and a minimum stay in ERM2. More attention will need to be placed on enhancing the flexibility of fiscal and wage policies to absorb shocks in the absence of monetary policy and to maintain low inflation and competitiveness.

37. **The BoS should guard against upside risks to inflation**. Thus, the BoS's intention to keep policy interest rates unchanged until forced otherwise by market conditions is appropriate. At the first signs of inflation beginning to exceed the targeted path, a tightening of monetary conditions would be in order. It is understood, however, that because of transmission lags the scope for monetary tightening will become smaller with the approach of the end of the assessment period.

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[8] Upon EU accession, the simple average tariff for industrial goods has declined from 7.68 percent to 4.5 percent, while that for agricultural products has increased from 12.6 percent to 17.3 percent.

38. **Fiscal policy should support disinflation and aim at increasing flexibility in the public finances**. A tighter stance than that envisaged by the revised 2005 budget would help reduce the risks to the disinflation objective and put public finances on the consolidation path toward the official medium-term goal of structural balance. Further fiscal consolidation would create a safety margin against breaching the SGP's deficit threshold in case of adverse cyclical conditions. In the event of revenue overperformance, it will therefore be important to save the additional revenue and ensure an improved fiscal outturn. Determined efforts are needed to contain nondiscretionary budget expenditure and reduce its rigidities. The efforts should be initiated at an early stage and focus on slower increases in public sector employment, restrictions on non-selective promotions, and reform of social entitlements and health care. Given the budgetary challenges of an ageing population, any change in the pension indexation mechanism that results in higher pension payments should be avoided. Linking pensions with inflation instead of wage growth would improve the long-term soundness of the pension system. Also, further lowering of payroll taxes should not be considered unless mechanisms are in place to safeguard the extra resources from being used for wage increases.

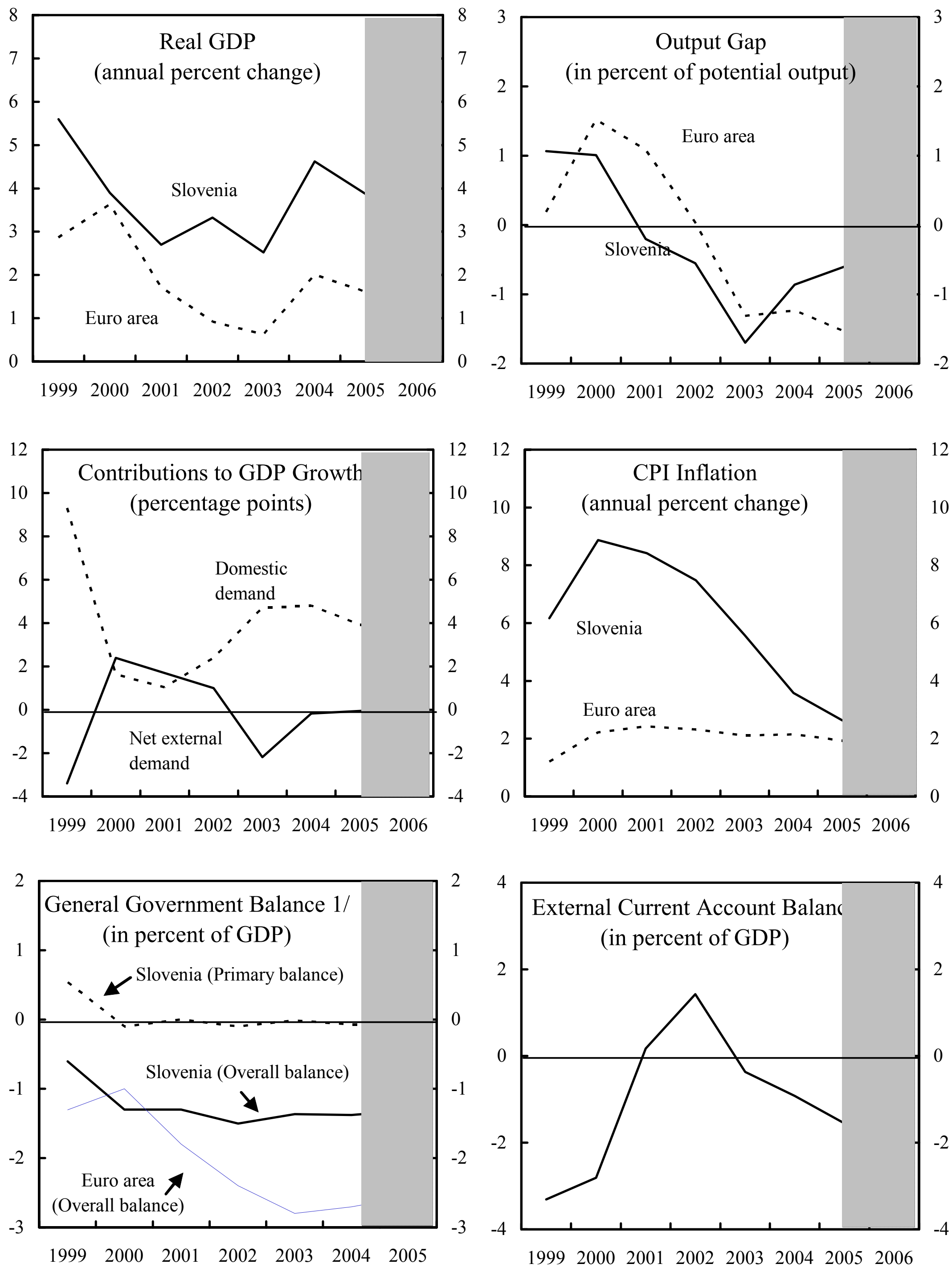
39. **Greater wage flexibility is most critical for adjusting to asymmetric shocks once in the euro area, securing sustained low inflation, and safeguarding competitiveness**. The recent favorable developments in real wages relative to productivity growth should be sustained. In the Social Agreement for 2006 and beyond, 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. In the public sector, it will be important to restrict the cost of the new wage structure within the overall budget constraint consistent with the government's medium-term fiscal goals. If achievement of the Maastricht inflation criterion appears to be under threat, a wage pact at the national and enterprise levels should be considered on an emergency basis.

40. **Maintaining strong supervisory oversight of financial institutions will be critical to guard against risk of stresses on the financial sector**. The BoS's intention to classify outstanding provisions released on account of adopting the IFRS as a component of statutory reserves is appropriate. The exposure of banks to credit and interest rate risks will require close monitoring and active management. Banks are particularly vulnerable to further compression of interest margins in the transition to euro adoption. The authorities are encouraged to enhance the supervision of insurance companies and implement the recommendations of the FSSA update for this sector.

41. **Progress in structural reforms in other areas should be maintained**. The staff welcomes the consideration being given to further privatization, attracting foreign direct investment, and improving labor market flexibility.

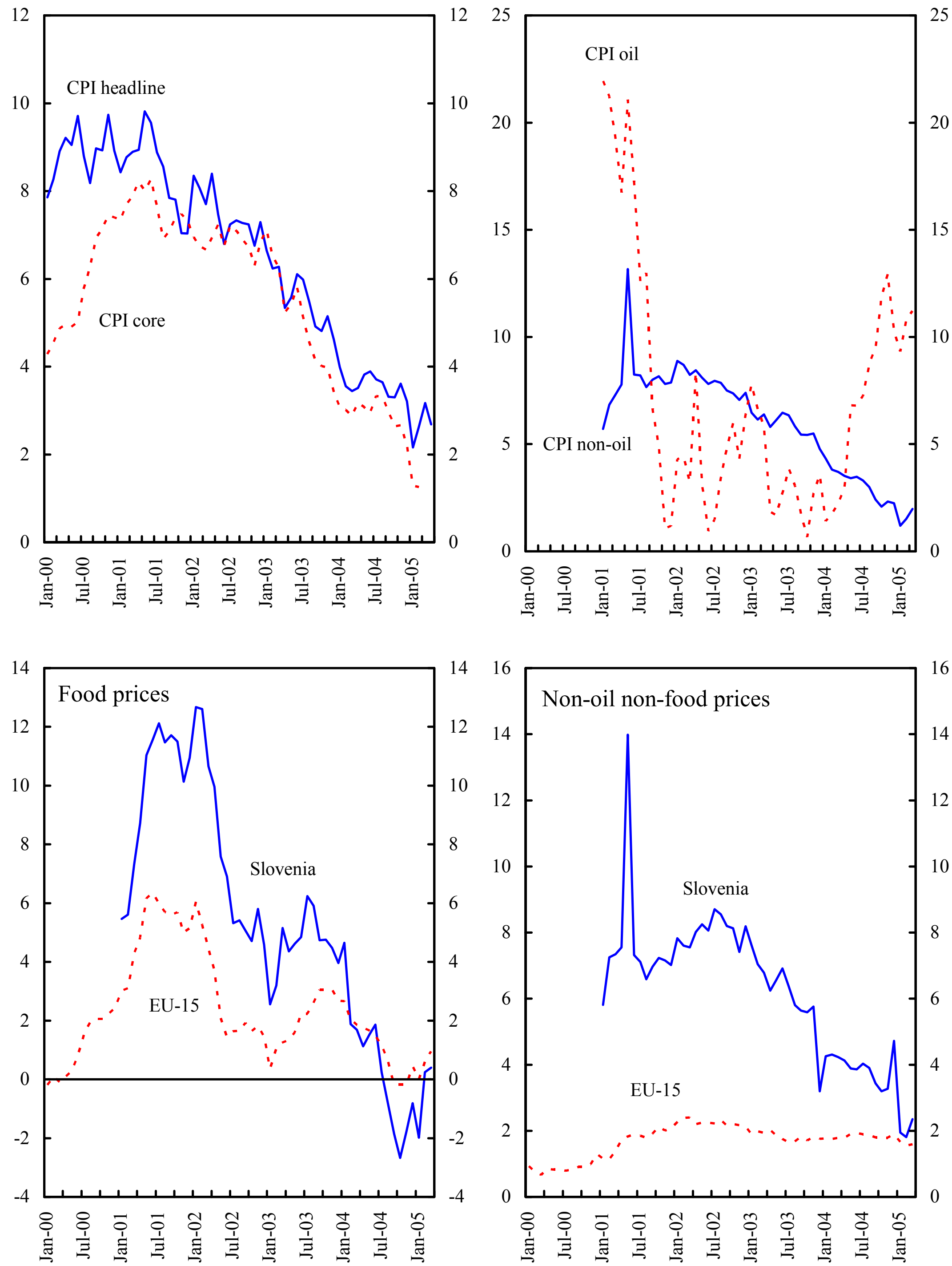
42. It is recommended that the Article IV consultation with Slovenia remain on the standard 12-month cycle.

Figure 1. Slovenia: Economic Indicators, 1999–2006



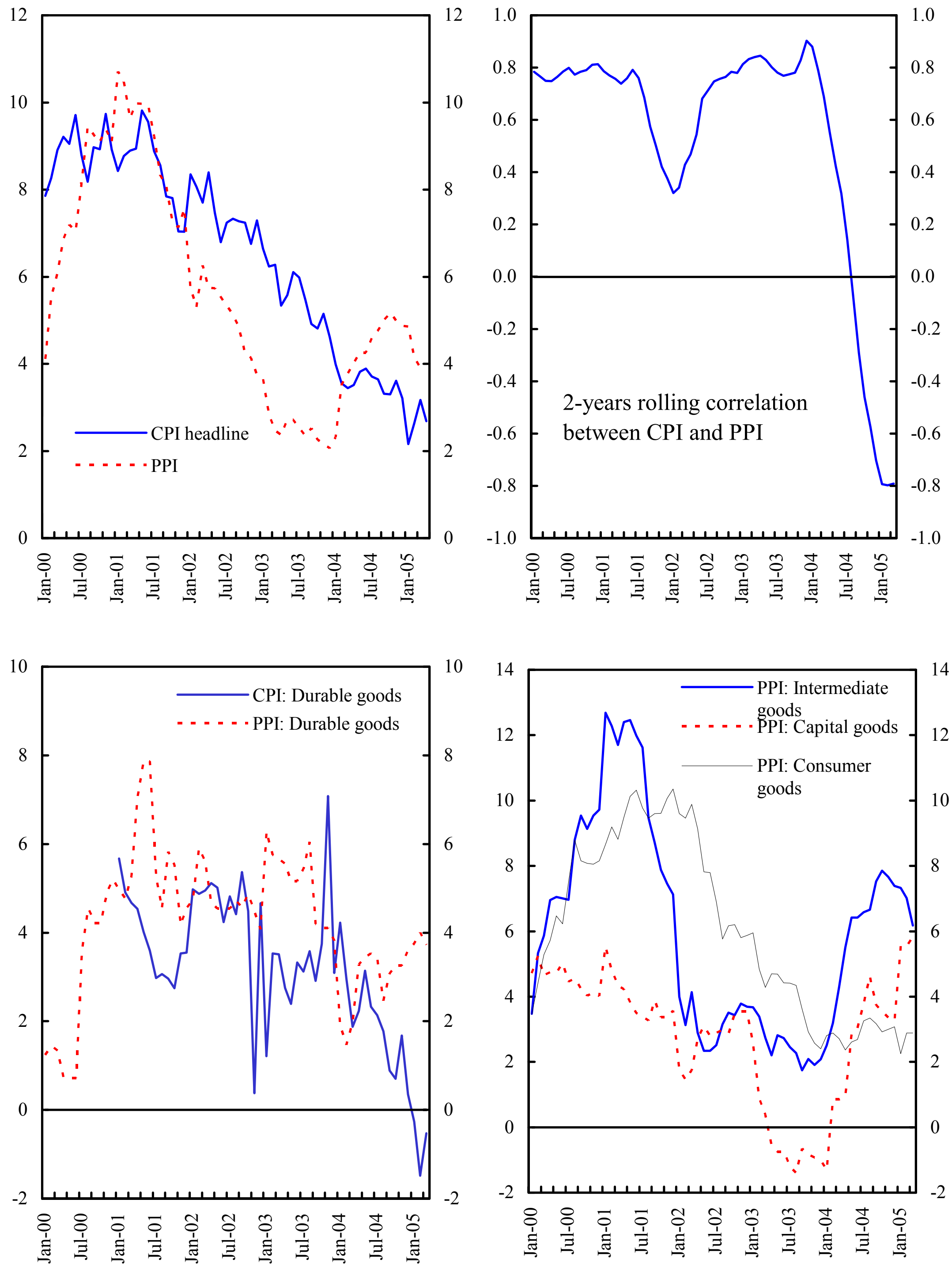
Sources: Bank of Slovenia; Ministry of Finance; Statistical Office; and IMF staff projections.
1/ Figures for 2002 have been adjusted for the shift in the budget accounting to a pure cash basis.

Figure 2. Slovenia: CPI Inflation and Components, 2000-2005
(Year-on-year change, in percent)



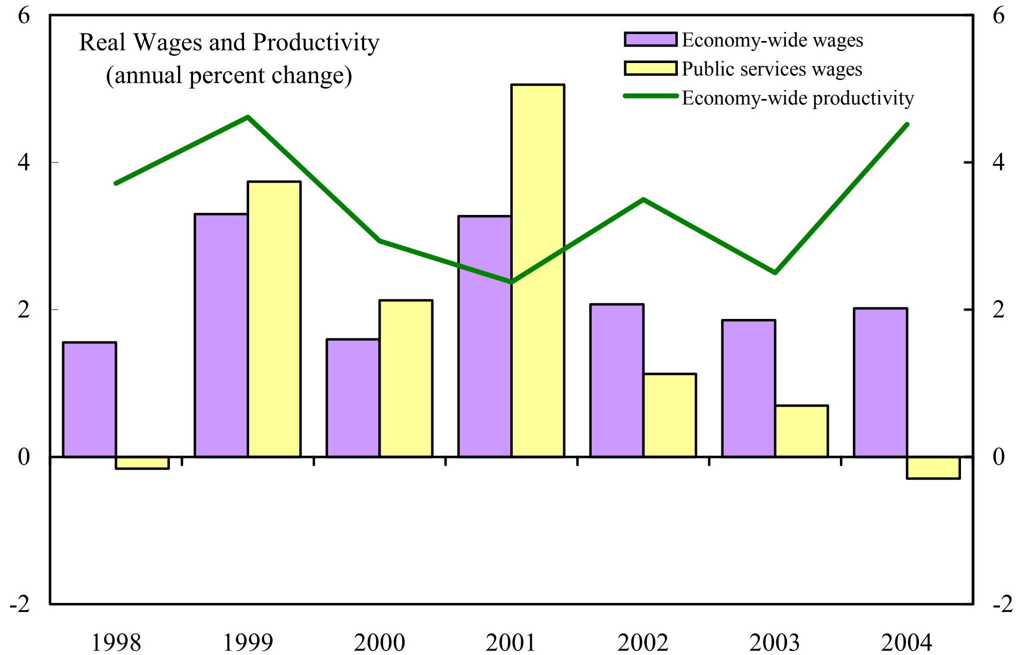
Sources: Statistical Office of the Republic of Slovenia; Eurostat; and IMF staff calculations.

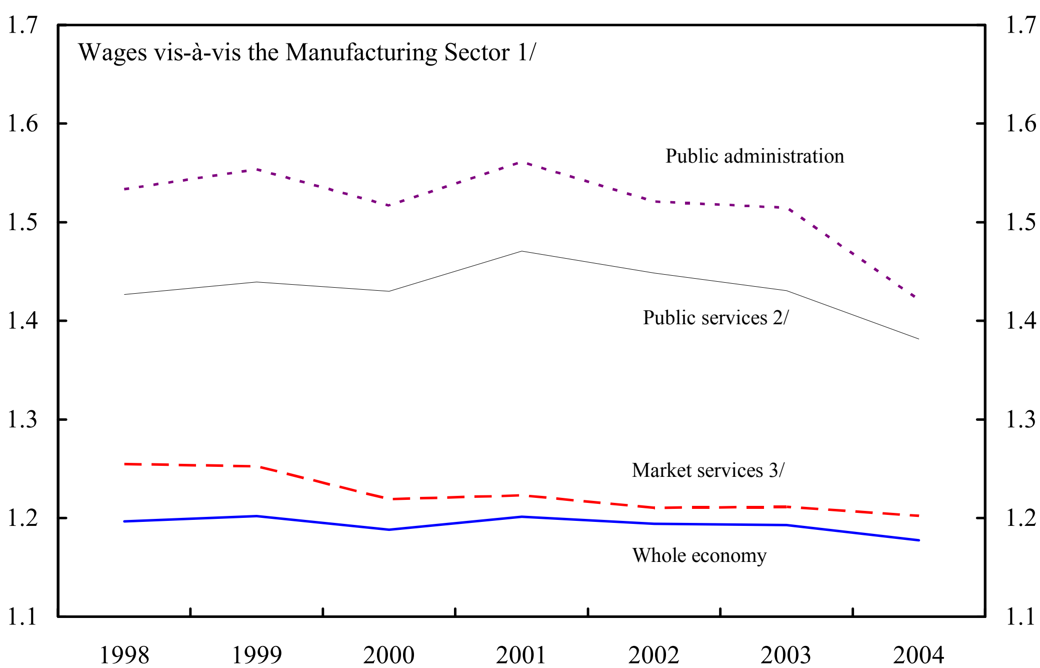
Figure 3. Slovenia: PPI and CPI Inflation, 2000-2005
(Year-on-year change, in percent)



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

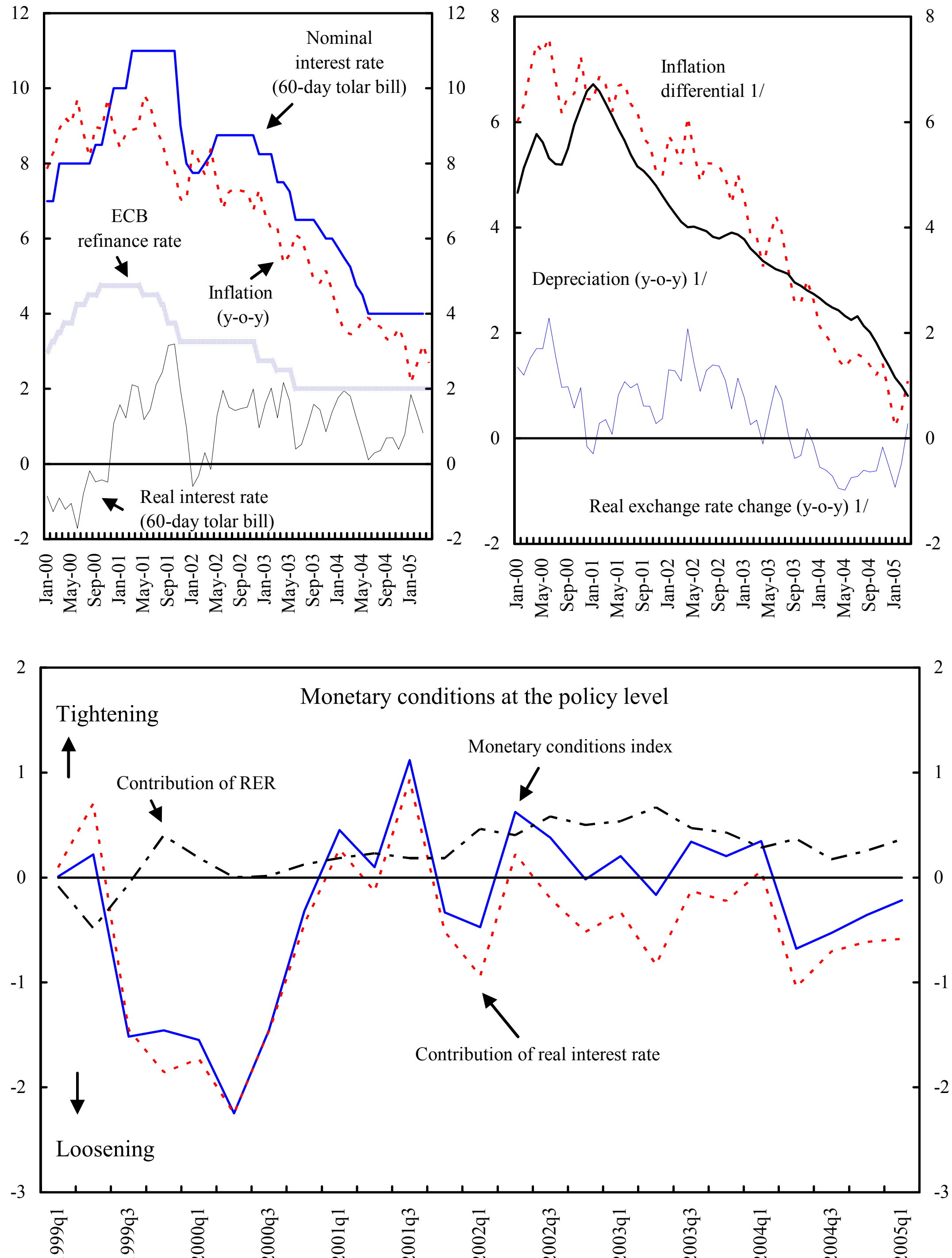
Figure 4. Slovenia: Wages and Productivity, 1998-2004





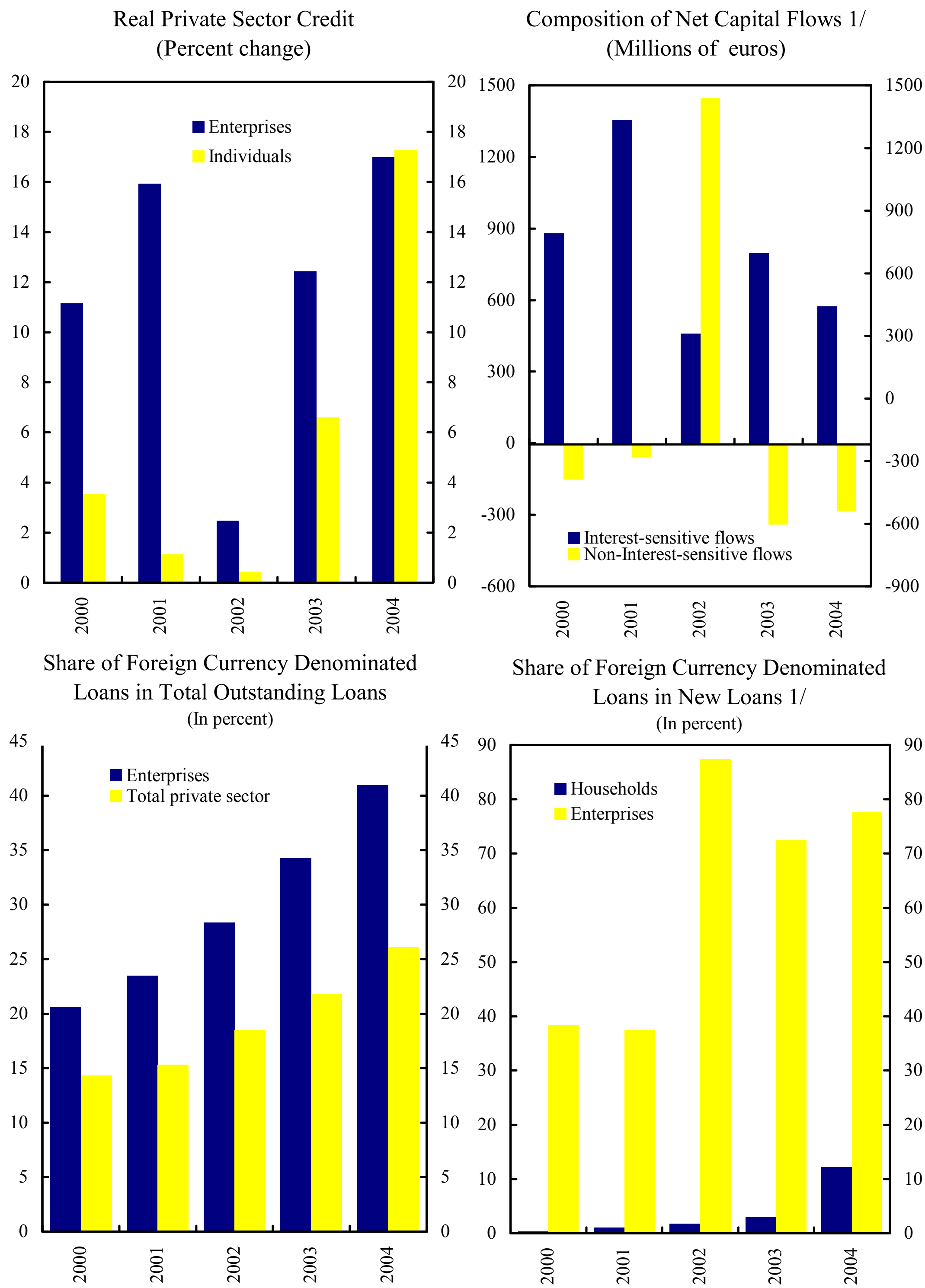
Source: Statistical Office of the Republic of Slovenia.
1/ Wages in respective sector divided by wages in the manufacturing sector.
2/ Includes public administration; education; health; and other social services.
3/ Includes distributive trade; hotels and restaurants; transport, storage, and communications; financial intermediation; and real estate.

Figure 5. Slovenia: Monetary Conditions, 2000-2005
(In percent)



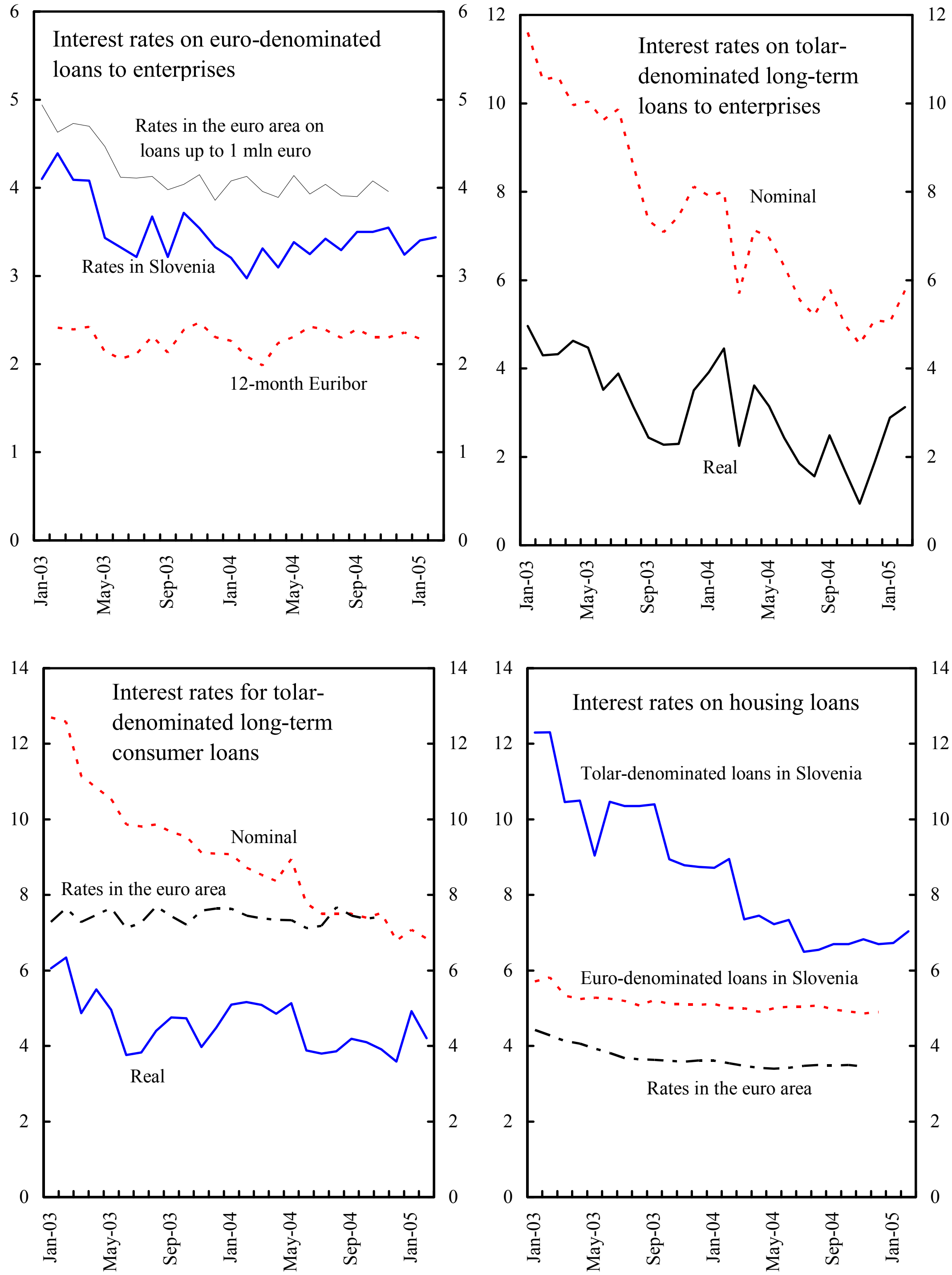
Sources: Bank of Slovenia; Eurostat; and Statistical Office of the Republic of Slovenia.
1/ Vis-à-vis the euro.

Figure 6. Slovenia: Credit Developments and Capital Inflows, 2000-2004



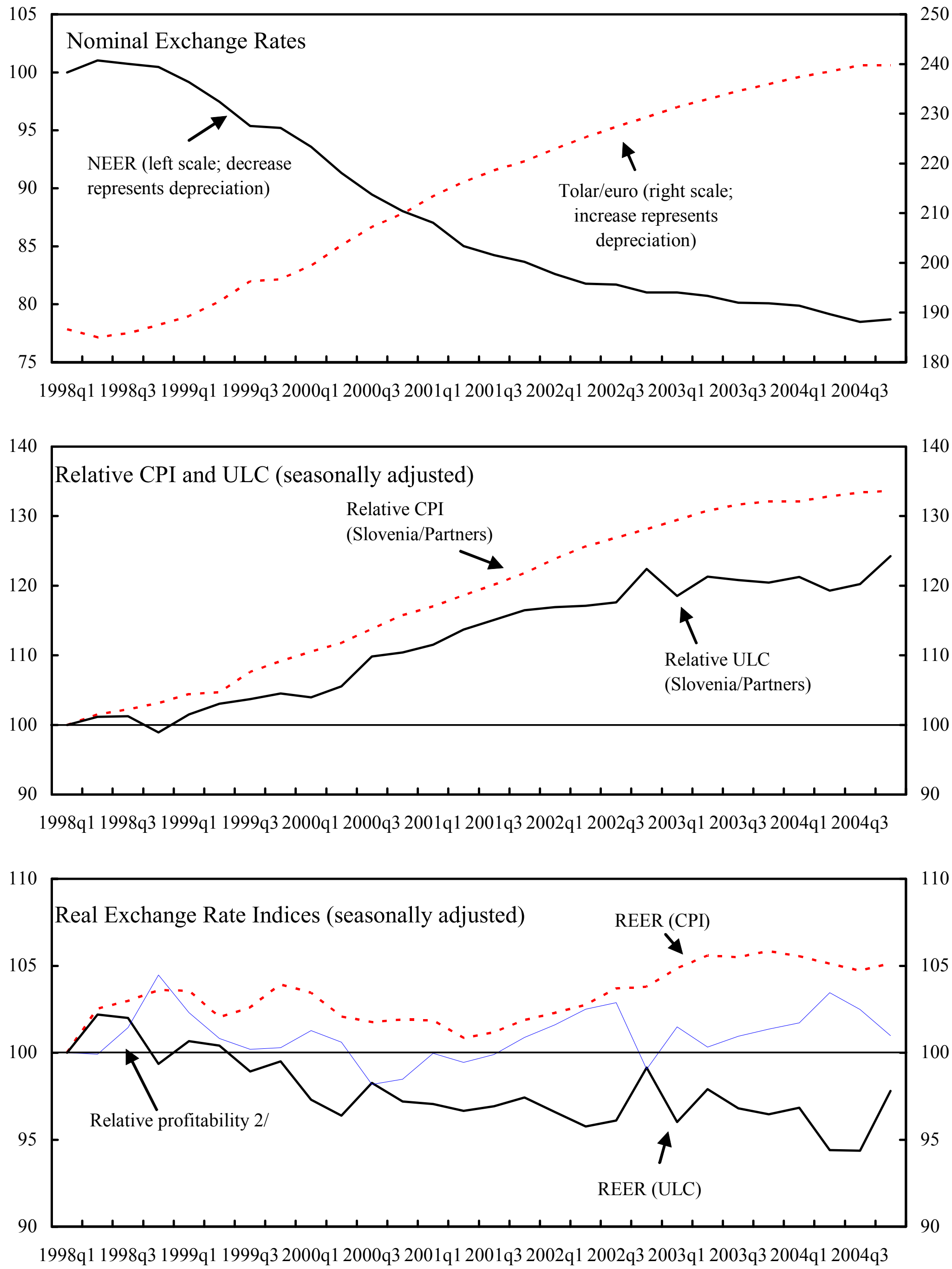
Source: Bank of Slovenia.

Figure 7. Slovenia: Bank Lending Rates on New Loans, 2003-2005
(In percent)



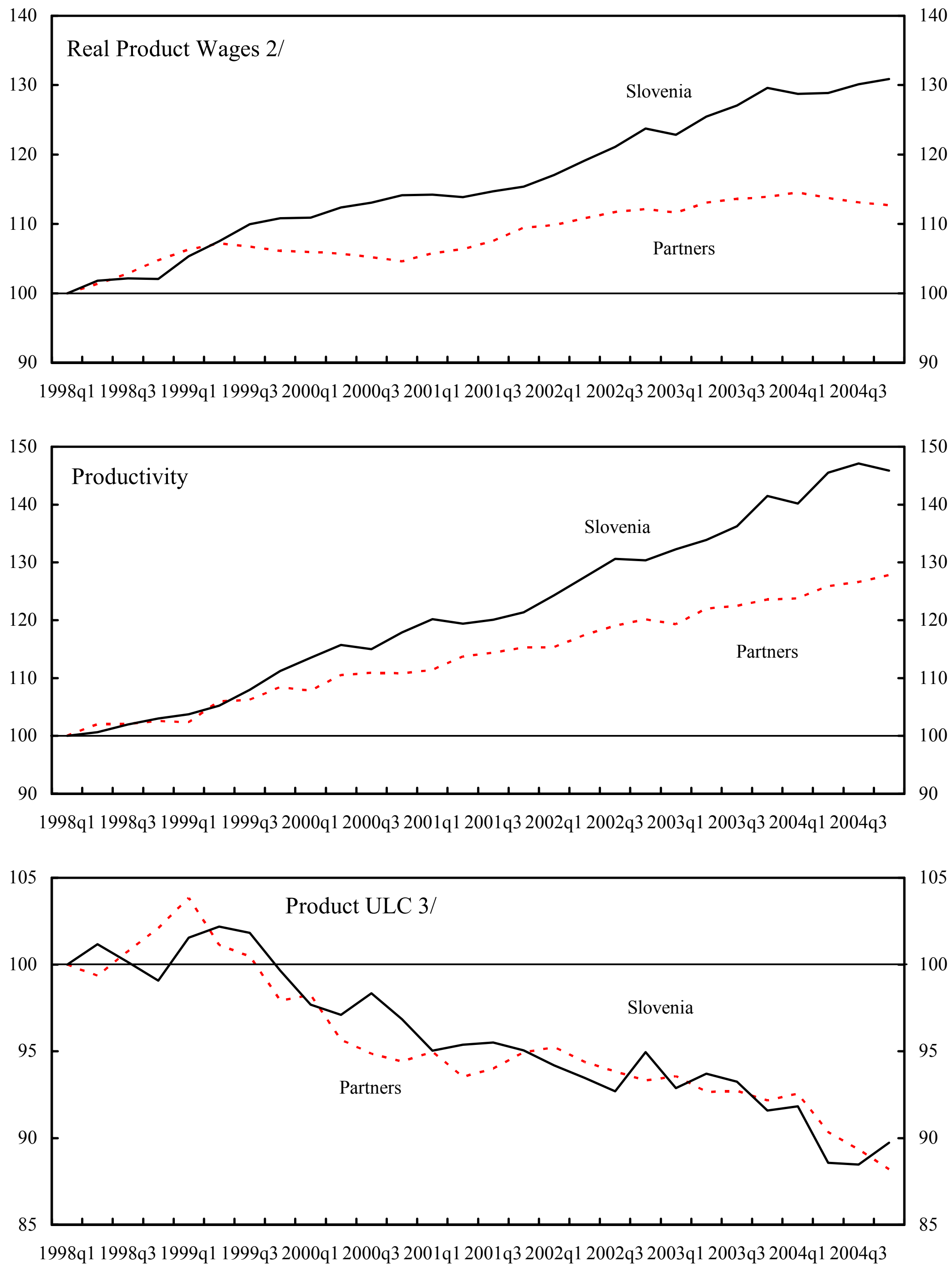
Sources: Bank of Slovenia; Eurostat.

Figure 8. Slovenia: Exchange Rate Indicators, 1998-2004
(1998q1=100) 1/



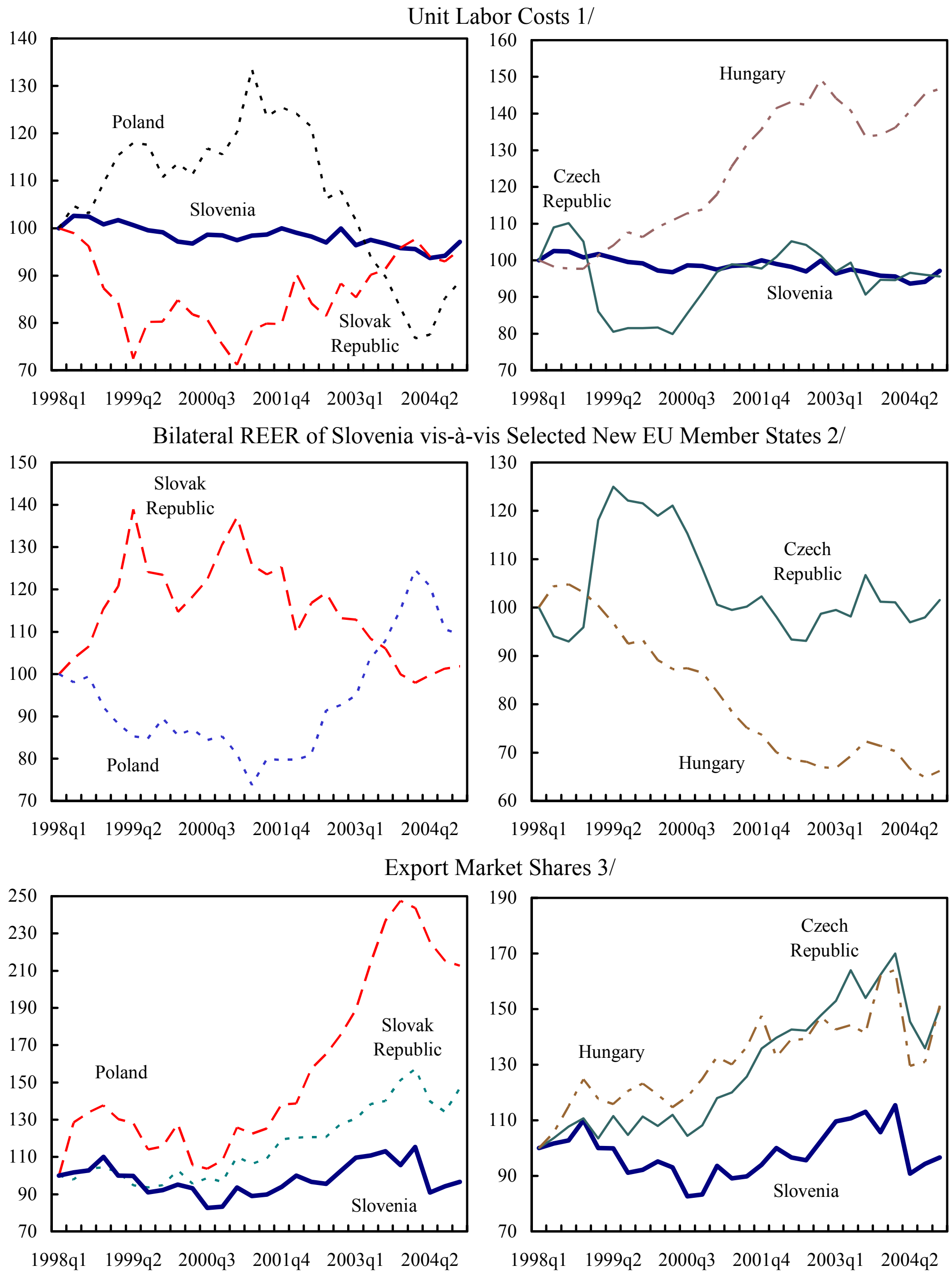
Sources: Bank of Slovenia Bulletin; Eurostat; *IFS* ; and IMF staff calculations.
1/ Trade weights based on 1998-2000 data for exports of goods. Partner countries comprise: Austria, Croatia, France, Germany, Italy, Poland, United Kingdom, and United States.
2/ Unit labor costs in Slovenia relative to those in trading partner countries, adjusted for manufacturing producer price inflation — a rough indicator of developments in profitability.

Figure 9. Slovenia: Wages, Productivity, and Product ULC in Manufacturing, 1998-2004
(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.

Figure 10. Slovenia: Competitiveness Indicators and Export Market Shares of Slovenia and Selected New EU Member States (1998q1=100), 1998-2005



Sources: IMF Direction of Trade Statistics; and IMF staff calculations based on data from national authorities.

1/ ULC in manufacturing in euros.

2/ Ratio of Euro ULC between Slovenia and EU accession candidates. An increase indicates appreciatio

3/ Calculated as the share of nominal exports of each individual country in the combined nominal import of the following countries: Austria, France, Germany, Italy, United Kingdom, and United States. The market share declines for all countries in 2004 because of higher prices of oil and commodity imports.

Table 1. Slovenia: Selected Economic Indicators, 2000-06

	2000	2001	2002	2003	2004	Projection 2005	2006
			(Annual percentage change)				
Real GDP	3.9	2.7	3.3	2.5	4.6	3.9	4.0
Domestic demand	1.5	0.9	2.3	4.7	4.7	3.8	3.8
Private consumption	0.3	2.3	0.3	2.7	3.5	3.5	3.5
Public consumption	2.3	3.9	1.7	2.6	1.7	3.1	2.5
Gross capital formation	3.3	-4.3	7.4	10.5	9.1	4.9	5.3
Output gap (in percent of potential GDP)	1.0	-0.2	-0.6	-1.7	-0.8	-0.6	-0.1
Industrial production	6.2	2.9	2.4	1.4	4.8	...	...
Consumer prices							
Period average	8.9	8.4	7.5	5.6	3.6	2.6	2.5
End of period	8.9	7.0	7.2	4.6	3.2	2.4	2.6
Wages							
Nominal							
All sectors	10.6	11.9	9.8	7.5	5.7	4.7 1/	5.0 1/
Manufacturing	11.9	10.8	10.4	7.7	7.0	...	...
Public services	11.2	13.9	8.7	6.4	3.3	...	...
Real							
All sectors	1.6	3.2	2.1	1.9	2.1	2.1 1/	2.6 1/
Manufacturing	2.8	2.2	2.7	2.0	3.3	...	...
Public services	2.1	5.1	1.1	0.8	-0.3	...	...
Employment							
Person basis	1.3	1.4	0.6	-0.8	0.5	...	...
National Accounts basis	1.1	0.5	-0.4	-0.3	0.1	0.4 1/	0.5 1/
Average unemployment rate (in percent, ILO definition)	7.0	6.4	6.3	6.7	6.4	6.2 1/	6.0 1/
General government finances 2/			(In percent of GDP)				
Revenue	40.6	41.3	39.2 3/	41.3	41.7	42.5	…
Expenditure	41.9	42.6	42.1	42.7	43.5	43.8	…
General government balance	-1.3	-1.3	-3.0 3/	-1.4	-1.4	-1.3	…
Structural general government budget balance	-1.7	-1.3	-1.3	-0.7	-1.0	-1.1	…
State budget balance	-0.9	-1.0	-2.6 3/	-1.2	-1.3	-1.4	…
General government debt	27.4	28.1	29.5	29.4	29.5	30.1	…
Money and credit			(Percentage change, end-period)				
Broad money	15.3	28.3	18.4	5.0	6.8	...	...
Base money	1.9	37.7	-4.3	4.1	2.2	...	...
Credit to the private sector 4/	18.1	18.5	10.5	15.5	20.2	...	...
Interest rates (in percent)							
BoS Lombard rate	11.0	12.0	10.5	7.3	5.0	...	...
Rate on 60-day BoS bills	10.0	8.0	8.3	6.0	4.0	...	...
Lending rates	14.6-18.4	15.8-12.3	11.6-14.7	9.0-10.3	7.9-8.5	...	...
Deposit rates 5/	10.9-13.2	8.5-11.0	7.6-8.6	4.8-5.7	3.2-4.0	...	...
Balance of payments			(In millions of euros, unless noted otherwise)				
Merchandise exports	9,574	10,454	11,082	11,414	12,736	13,977	15,465
Exports volume (percent change, volume)	12.9	7.0	6.5	4.4	13.2	8.6	9.0
Merchandise imports	-10,801	-11,139	-11,351	-11,960	-13,576	-15,041	-16,392
Imports volume (percent change, volume)	7.7	3.2	4.4	7.3	13.2	8.3	8.4
Terms of trade (percent change)	-3.3	2.1	2.0	0.5	-1.7	-1.3	1.0
Current account balance	-583	38	335	-91	-238	-427	-246
(in percent of GDP)	-2.8	0.2	1.4	-0.4	-0.9	-1.6	-0.8
Gross official reserves	3,436	4,984	6,781	6,879	6,542	5,937	6,130
(in months of imports of goods and nonfactor services)	3.3	4.7	6.2	5.9	5.0	4.1	3.9
External debt (percent of GDP, end-period)	46.4	47.4	48.9	54.1	59.4	62.1	64.8
External debt service	1,119	1,849	1,937	2,144	2,424	3,066	3,026
(in percent of exports of goods and nonfactor services)	9.5	14.9	13.1	15.4	15.6	17.9	16.0
Exchange rate							
Tolars per U.S. dollar (end-period)	227.4	251.0	221.1	189.4	176.2	...	…
Tolars per euro (end-period)	211.5	221.4	230.3	236.7	239.7	...	…
Nominal effective exchange rate (1998Q1=100, period average)	90.6	85.0	81.8	80.6	79.1	...	…
Real effective exchange rate							
(CPI based, 1998Q1=100, period average)	102.3	101.4	103.1	105.4	105.1	...	…
(ULC based, 1998Q1=100, period average)	97.3	97.0	96.9	96.8	95.9	...	…

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

1/ Projections by the Institute for Macroeconomic Analysis and Development (IMAD).
2/ Revised budget for 2005. Figures include higher transfers from EU and EU-related expenditures.
3/ Figures reflect a shift in the budget accounting to a pure cash basis entailing only 11 months of VAT and excise tax revenues. Adjusted for the methodological change, the general government deficit would be 1.5 percent of GDP.
4/ Including loans and other claims.
5/ For deposits with maturity between 31 days and 1 year.

Table 2. Slovenia: Monetary Survey, 2000-2004

	2000	2001	2002	2003	2004
	(In billions of tolars; end-of-period)				
Net foreign assets	774.2	1,187.3	1,429.7	1,240.0	920.8
Assets	1,150.1	1,649.7	2,047.6	2,108.5	2,110.3
Bank of Slovenia	739.9	1,122.5	1,580.3	1,644.7	1,584.5
Deposit money banks	447.2	565.5	499.3	488.4	550.8
Less claims on National Bank of Yugoslavia	-37.0	-38.3	-31.9	-24.6	-25.0
Liabilities	-375.9	-462.4	-617.9	-868.5	-1,189.5
Bank of Slovenia	-0.1	-0.3	0.0	0.0	-1.7
Deposit money banks	-375.8	-462.1	-617.9	-868.5	-1,187.8
Net domestic assets	1,596.4	1,853.2	2,171.0	2,539.9	3,115.2
Claims on government (net)	361.5	423.3	443.1	513.7	597.7
Credit	441.1	491.8	614.3	664.9	789.5
Bank of Slovenia on central government	17.8	9.8	9.2	27.0	29.8
Banks on general government	423.3	482.0	605.1	638.0	759.7
Deposits	-79.5	-68.6	-171.2	-151.2	-191.8
Claims on enterprises	1,078.0	1,328.0	1,481.3	1,734.8	2,080.9
Claims on individuals	495.0	535.8	577.4	643.8	779.2
Claims on nonbanking financial institutions	51.6	59.1	81.1	106.7	126.8
Claims on National Bank of Yugoslavia	37.0	38.3	31.9	24.6	25.0
Securities	-79.2	-113.6	-184.2	-221.4	-205.7
Restricted deposits	-9.0	-9.9	-7.6	-12.1	-7.7
Other items (net)	-338.4	-407.6	-252.1	-250.2	-281.2
Broad money (M3)	2,370.6	3,040.5	3,600.8	3,779.9	4,036.0
Currency	119.8	142.1	143.1	156.0	167.9
Demand deposits	430.0	505.9	577.1	641.1	851.0
Bank of Slovenia	8.4	15.6	12.6	14.1	12.8
Deposit money banks	421.6	490.3	564.5	627.0	838.1
Quasi money	1,820.9	2,392.5	2,880.7	2,982.8	3,017.1
Tolar deposits	1,002.0	1,316.3	1,675.6	1,697.0	1,596.8
Foreign currency deposits	739.7	962.6	1,020.8	1,064.4	1,214.7
Tolar securities	65.9	96.1	181.1	217.7	203.6
Foreign currency securities	13.3	17.5	3.1	3.7	2.1
Memorandum item:					
Base Money	212.2	292.3	279.7	291.2	297.5
	(Percent change; end-of-period)				
Base money	1.9	37.7	-4.3	4.1	2.2
M1 (currency + demand deposits)	8.3	17.9	11.1	10.7	27.8
M2 (M1 + tolar deposits)	9.7	27.4	25.1	5.2	4.0
M3 (M2 + foreign currency deposits)	15.3	28.3	18.4	5.0	6.8
	(Percentage points)				
Contributions to M3 growth					
Net foreign assets	5.2	17.4	8.0	-5.3	-8.4
Net domestic assets	10.1	10.8	10.5	10.2	15.2
	(Percent)				
Share of foreign currency-denominated outstanding credit					
Private sector	14.3	16.9	20.6	25.3	30.6
Enterprises and nonprofit institutions	20.6	23.5	28.4	34.3	41.0
Individuals	0.6	0.7	0.7	1.0	2.9
Share of housing loans in outstanding loans to individuals	17.5	19.0	21.4	24.0	26.1
Share of housing loans in new loans to individuals	30.8	37.6	51.5	45.4	35.7

Source: Bank of Slovenia, Monthly Bulletin.

Table 3. Slovenia: Summary of General Government Operations, 2000-05

	2000	2001	2002	2003	2004		2005	
					Budget Dec. 2003	Outturn	Original Budget Dec. 2003	Suppl. Budget May 2005
					(In billions of tolars)			
Total revenues	**1,727**	**1,968**	**2,159** 1/	**2,376**	**2,614**	**2,584**	**2,739**	**2,800**
Tax revenues	1,600	1,798	1,910	2,189	2,351	2,348	2,467	2,484
Personal income tax	260	289	320	353	380	383	388	388
Corporate income tax	52	69	75	107	117	124	129	146
Social security contributions	553	621	682	738	797	801	849	850
Taxes on payroll and workforce	68	83	94	107	118	118	123	123
Domestic taxes on goods and services	603	673	673	815	872	857	911	927
VAT	410	441	424 1/	524	563	539	589	589
Excise taxes	134	166	171 1/	198	213	218	219	238
Other	58	66	78	92	97	100	103	101
Other taxes	65	63	66	70	66	65	66	49
Nontax revenues	95	139	134	149	155	162	140	173
Capital revenues and grants	17	21	29	29	20	23	20	18
Transfers from extrabudgetary funds	15	9	11	8	8	8	8	8
Receipts from the EU budget	...	...	...	…	80	44	103	116
Total expenditures	**1,781**	**2,031**	**2,240**	**2,454**	**2,721**	**2,670**	**2,848**	**2,886**
Wages and personnel expenditures	388	456	515	542	566	589	606	625
Direct budget users	132	155	175	195	203	205	208	217
Other government institutions	256	301	341	347	383	384	398	408
Premium for supplementary pension insurance	...	...	...	...	13	13	10	10
Expenditure on goods and services	336	386	418	424	451	430	501	462
Interest payments	61	73	85	93	94	92	90	89
Reserves	13	9	10	19	10	12	14	15
Transfers to individuals and households	731	821	910	986	1,056	1,053	1,107	1,106
Of which: Pensions	491	545	601	640	687	678	723	716
Subsidies	59	63	60	69	81	78	88	85
Other current transfers	23	24	35	88	116	118	61	142
Capital expenditures and transfers	171	199	207	233	288	244	297	278
Acquisition of capital assets	111	128	129	142	184	151	188	168
Capital transfers	60	71	78	91	104	93	109	110
Transfers to the EU budget	...	...	...	...	45	41	75	73
General government balance	**-55**	**-63**	**-81** 1/	**-78**	**-107**	**-85**	**-110**	**-86**
Primary balance	**-4**	**1**	**-4**	**-1**	**-13**	**-4**	**-19**	**-2**
					(In percent of GDP)			
Total revenues	**40.6**	**41.3**	**40.6**	**41.3**	**42.2**	**41.7**	**41.3**	**42.5**
Tax revenues	37.6	37.8	35.9	38.1	38.0	37.9	37.2	37.7
Of which: Personal income tax	6.1	6.1	6.0	6.1	6.1	6.2	5.9	5.9
Corporate income tax	1.2	1.4	1.4	1.9	1.9	2.0	2.0	2.2
Social security contributions	13.0	13.0	12.8	12.8	12.9	12.9	12.8	12.9
Domestic taxes on goods and services	14.2	14.1	12.7	14.2	14.1	13.8	13.7	14.1
Receipts from the EU budget	...	...	...		1.3	0.7	1.6	1.8
Total expenditures	**41.9**	**42.6**	**42.1**	**42.7**	**43.9**	**43.1**	**43.0**	**43.8**
Current expenditures and transfers	37.9	38.5	38.3	38.7	38.6	38.5	37.4	38.5
Wages and personnel expenditures	9.1	9.6	9.7	9.4	9.1	9.5	9.1	9.5
Expenditure on goods and services	7.9	8.1	7.9	7.4	7.3	6.9	7.6	7.0
Transfers to individuals and households	17.2	17.2	17.1	17.2	17.1	17.0	16.7	16.8
Of which: Pensions	11.5	11.4	11.3	11.1	11.1	10.9	10.9	10.9
Capital expenditures and transfers	4.0	4.2	3.9	4.1	4.6	3.9	4.5	4.2
Transfers to the EU budget	...	...	...	...	0.7	0.7	1.1	1.1
General government balance	**-1.3**	**-1.3**	**-1.5**	**-1.4**	**-1.7**	**-1.4**	**-1.7**	**-1.3**
Primary balance	**-0.1**	**0.0**	**-0.1**	**0.0**	**-0.2**	**-0.1**	**-0.3**	**0.0**
Memorandum items:								
General government balance (ESA-95)	-3.5	-2.8	-1.0	-2.0	-2.3	-1.9	-2.1	-1.8
Structural budget balance (GFS)	-1.7	-1.3	-1.3	-0.7	-1.1 2/	-1.0	-1.1 2/	-1.1
Structural primary balance (GFS)	-0.5	0.1	0.1	0.7	0.3 2/	0.3	0.1 2/	0.1
General government debt 3/	27.4	28.1	29.5	29.4	...	29.5	...	30.1
Domestic	13.7	14.5	17.3	18.0	...	19.6	...	23.2
Foreign	13.8	13.6	12.2	11.4	...	9.8	...	6.9
Nominal GDP (in billions of tolars)	4,252	4,762	5,314	5,747	6,147	6,191	6,594	6,591

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 percent of GDP, as the unadjusted figures contained only 11 months of VAT and excise tax.
2/ On the basis of the macro framework presented by the authorities when the budget was adopted.
3/ In 2005, foreign debt falling due was replaced by domestic debt.

Table 4. Slovenia: Vulnerability Indicators, 2000-04
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004
Financial indicators (end of period)					
General government debt	27.4	28.1	29.5	29.4	29.5
Domestic credit	48.2	50.5	51.7	54.3	60.3
Private sector credit (percent change, end-period) 1/	18.1	18.5	10.5	15.5	20.2
Broad money (percent change, end-period)	15.3	28.3	18.4	5.0	6.8
Foreign exchange deposits (percent of broad money)	28.0	30.4	27.3	27.1	28.5
Financial market indicators (end of period)					
Stock market index	1,808	2,152	3,340	3,614	4,909
Stock market capitalization	26.8	29.0	40.9	42.5	49.3
Foreign currency debt rating (S&P, long-term)	A	A	A	A+	AA-
Spread of benchmark bond (basis points) 2/	88	55	45	29	17
External indicators					
Exports of goods and NFS (percent change, value in euros) 3/	17.8	8.7	7.0	2.7	11.9
Imports of goods and NFS (percent change, value in euros)	15.5	3.4	3.1	5.4	13.0
Current account balance (as percent of GDP)	-2.8	0.2	1.4	-0.4	-0.9
Capital and financial account balance, excl. reserve assets	3.5	5.9	7.4	1.2	0.4
Of which : Inward portfolio investment	1.2	0.9	0.1	-0.1	-0.1
Inward foreign direct investment	0.7	1.9	7.5	1.2	1.6
Other investment, net	2.2	4.4	1.7	3.2	3.4
Net foreign assets of commercial banks (in billions of euros)	0.3	0.5	-0.5	-1.6	-2.7
Short-term foreign assets of commercial banks (in billions of euros)	1.6	1.9	1.5	1.3	1.3
Short-term foreign liabilities of commercial banks (in billions of euros)	0.4	0.4	0.4	0.6	0.7
Foreign currency exposure of commercial banks (in billions of euros)	-1.6	-2.1	-2.6	-3.1	-3.3
Net international reserves (in billions of euros)	2.3	2.8	4.3	4.4	4.2
Gross official reserves (in billions of euros)	3.4	5.0	6.8	6.9	6.5
Gross official reserves (in months of imports of goods and NFS)	3.3	4.7	6.2	5.9	5.0
Base money to gross official reserves (in percent)	29.2	26.5	17.9	17.9	19.0
Broad money to gross official reserves (in percent)	326.2	275.6	230.6	232.0	257.3
Short-term external debt to gross official reserves (in percent) 4/	127.5	91.7	65.6	66.2	82.3
Total external debt	46.4	47.4	48.9	54.1	59.4
Of which: Public and publicly guaranteed	15.3	15.4	14.5	14.5	14.6
Total external debt (in percent of exports of goods and NFS)	82.2	82.4	84.9	95.8	99.2
Total external debt service payments (in percent of exports of goods and NFS)	9.5	14.9	13.1	15.4	15.6
External interest payment (in percent of exports of goods and NFS)	2.8	2.3	2.5	2.7	2.9
External amortization payments (in percent of exports of goods and NFS)	6.7	12.5	10.7	12.1	12.7
Exchange rate (tolar per euro, period average)	205.0	217.2	226.2	233.7	238.9
REER (CPI-based, period-average percent change, an increase indicates appreciation)	-1.9	-0.9	1.7	2.2	-0.3

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

1/ Credit including loans and other claims.

2/ Yield differential between 5.38 percent (coupon) Slovene eurobond maturing in 2010 and 5.38 percent (coupon) German government bond maturing in 2010.

3/ NFS denotes nonfactor services.

4/ Remaining maturity basis.

Table 5. Slovenia: Macroeconomic Framework, 2000-2009

	2000	2001	2002	2003	2004	Projections 2005	2006	2007	2008	2009
	(Percent of nominal GDP)									
Foreign saving	2.8	-0.2	-1.4	0.4	0.9	1.6	0.8	0.6	0.6	0.6
National saving	23.8	24.1	25.2	24.9	25.9	25.9	26.6	27.0	27.3	27.7
Government	2.7	2.9	2.4	2.7	2.6	2.8	3.1	3.3	3.5	3.7
Non-government	21.1	21.2	22.8	22.3	23.3	23.2	23.5	23.6	23.8	24.0
Domestic saving	23.1	23.2	25.2	25.3	26.2	26.5	27.2	27.7	28.0	28.4
Government 1/	3.1	3.2	2.7	3.0	2.9	3.0	3.1	3.6	3.8	4.0
Non-government	20.0	20.0	22.5	22.3	23.3	23.5	24.2	24.1	24.3	24.5
Gross capital formation	26.7	23.9	23.8	25.3	26.8	27.5	27.5	27.6	27.9	28.3
Government 1/	2.6	2.7	2.4	2.5	2.4	2.5	2.4	2.4	2.4	2.4
Non-government	24.0	21.2	21.3	22.8	24.4	25.0	25.0	25.2	25.5	25.9
Fixed investment	25.1	24.4	23.3	23.9	24.7	25.8	25.9	26.1	26.3	26.5
Change in stocks	1.6	-0.6	0.4	1.4	2.1	1.7	1.6	1.5	1.6	1.8
General government balance 1/	-1.3	-1.3	-1.5	-1.4	-1.4	-1.3	-1.0	-0.7	-0.5	-0.3
	(Percentage change in real terms)									
Real GDP	3.9	2.7	3.3	2.5	4.6	3.9	4.0	3.7	3.6	3.6
Domestic demand	1.5	0.9	2.3	4.7	4.7	3.8	3.8	3.9	4.2	4.3
Of which:										
Private consumption	0.3	2.3	0.3	2.7	3.5	3.5	3.5	3.6	3.7	3.7
Gross investment	3.3	-4.3	7.4	10.5	9.1	4.9	5.3	5.6	6.2	6.6
Exports of goods and services	13.0	6.3	6.7	3.2	12.7	8.3	8.6	8.0	7.8	7.7
Imports of goods and services	7.6	3.0	4.9	6.8	12.4	8.0	8.2	8.1	8.4	8.4
	(Contributions to growth, in percentage points)									
Domestic demand	1.6	1.0	2.4	4.7	4.8	3.9	3.9	4.0	4.3	4.5
Of which:										
Private consumption	0.2	1.2	0.0	1.5	1.9	1.9	1.9	1.9	2.0	2.0
Gross investment	0.9	-1.1	1.8	2.7	2.5	1.4	1.6	1.7	1.9	2.0
Net foreign demand	2.4	1.7	1.0	-2.2	-0.2	-0.1	0.1	-0.3	-0.7	-0.9
Memorandum items:										
General government debt (percent of GDP)	27.4	28.1	29.5	29.4	29.5	30.1	29.2	28.2	27.1	25.9
External debt (percent of GDP)	46.4	47.4	48.9	54.1	59.4	62.1	64.8	66.2	67.1	67.1
Ratio of official reserves to external debt (in percent)	36.2	47.9	59.2	51.7	42.5	34.7	32.1	31.7	32.1	33.1

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

1/ Government capital transfers are not included in government investment. From 2006, it is assumed that measures to achieve the government's goal of structural balance in the medium term are implemented.

Table 6. Slovenia: Balance of Payments, 2000-06
(In millions of euros, unless otherwise noted)

						Projections	
	2000	2001	2002	2003	2004	2005	2006
Current account	-583	38	335	-91	-238	-427	-246
Trade balance	-1,227	-684	-269	-546	-840	-1,063	-927
Exports f.o.b.	9,574	10,454	11,082	11,414	12,736	13,977	15,465
Imports f.o.b.	-10,801	-11,139	-11,351	-11,960	-13,576	-15,041	-16,392
Services	489	536	616	538	672	780	871
Exports	2,052	2,178	2,440	2,469	2,793	3,132	3,465
Imports	-1,562	-1,642	-1,824	-1,930	-2,121	-2,352	-2,595
Income, net	29	43	-154	-178	-101	-186	-231
Current transfers, net	126	144	142	94	31	42	41
Capital account	4	-4	-164	-166	-178	-179	-191
Financial account, excl. reserves	724	1,295	1,907	456	292	1	630
Direct investment, net	77	251	1,582	-115	21	50	350
In Slovenia	149	412	1,750	299	422	500	800
Abroad	-72	-161	-168	-414	-401	-450	-450
Portfolio investment, net	185	80	-69	-218	-619	-938	-506
Other investment, net	462	964	393	788	890	889	787
Government	86	-74	-85	-65	5	0	0
Bank of Slovenia	-6	-7	-6	0	-2	-2	-2
Commercial banks	39	-38	684	1,068	1,060	1,143	1,084
Nonbank private sector	343	1,083	-199	-214	-173	-253	-295
Loans	563	533	442	458	646	536	474
Household currency and deposits	-13	797	-592	-590	-710	-688	-662
Trade credits	-195	-249	-41	-57	-32	-34	-40
Other	-12	1	-8	-25	-77	-67	-67
Net errors and omissions	41	110	-193	65	-130	0	0
Overall balance	187	1,439	1,885	264	-256	-605	193
Change in official reserves (-: increase)	-187	-1,439	-1,885	-264	256	605	-193
Memorandum items:							
Current account balance (percent of GDP)	-2.8	0.2	1.4	-0.4	-0.9	-1.6	-0.8
Export of goods (percent change in value)	18.2	9.2	6.0	3.0	11.6	9.7	10.6
Exports to the European Union (percent change in value)	14.2	6.3	1.2	1.4	10.0	...	...
Exports to non-EU countries (percent change in value)	25.8	14.3	13.9	5.4	13.8	...	...
Import of goods (percent change in value)	16.6	3.1	1.9	5.4	13.5	10.8	9.0
Terms of trade (percent change)	-3.3	2.1	2.0	0.5	-1.7	-1.3	1.0
Gross external debt	9,490	10,403	11,455	13,305	15,397	17,092	19,073
(percent of GDP)	46.4	47.4	48.9	54.1	59.4	62.1	64.8
Net external debt (liabilities - assets) 1/	790	-422	-1,125	457	2,004	2,833	3,186
(percent of GDP)	3.8	-1.9	-4.8	1.9	7.7	10.3	11.0
Debt service payments	1,119	1,849	1,937	2,144	2,424	3,066	3,026
(percent of exports of goods and nonfactor services)	9.5	14.9	13.1	15.4	15.6	17.9	16.0
Gross official reserves 2/	3,436	4,984	6,781	6,879	6,542	5,937	6,130
(in months of imports of goods and nonfactor services)	3.3	4.7	6.2	5.9	5.0	4.1	3.9

Sources: Bank of Slovenia; and IMF staff projections.

1/ A negative number indicates net creditor position.

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

Table 7. Slovenia: Balance of Payments, 2004-09

(In millions of euros, unless otherwise noted)

		Projections				
	2004	2005	2006	2007	2008	2009
Current account	-238	-427	-246	-193	-204	-211
Trade balance	-840	-1,063	-927	-929	-998	-1,079
Exports f.o.b.	12,736	13,977	15,465	16,967	18,598	20,350
Imports f.o.b.	-13,576	-15,041	-16,392	-17,897	-19,596	-21,429
Services	672	780	871	956	1,030	1,113
Exports	2,793	3,132	3,465	3,816	4,182	4,582
Imports	-2,121	-2,352	-2,595	-2,859	-3,151	-3,469
Income, net	-101	-186	-231	-270	-298	-317
Current transfers, net	31	42	41	51	61	72
Capital account	-178	-179	-191	-203	-216	-230
Financial account, excl. reserves	292	1	630	609	633	265
Direct investment, net	21	50	350	395	427	466
In Slovenia	422	500	800	896	961	1,032
Abroad	-401	-450	-450	-501	-533	-566
Portfolio investment, net	-619	-938	-506	-456	-443	-898
Other investment, net	890	889	787	671	649	697
Government	5	0	0	0	0	0
Bank of Slovenia	-2	-2	-2	-2	-2	-2
Commercial banks	1,060	1,143	1,084	949	774	827
Nonbank private sector	-173	-253	-295	-276	-123	-129
Loans	646	536	474	463	497	528
Household currency and deposits	-710	-688	-662	-626	-500	-530
Trade credits	-32	-34	-40	-46	-53	-59
Other	-77	-67	-67	-67	-67	-67
Net errors and omissions	-130	0	0	0	0	0
Overall balance	-256	-605	193	213	212	-176
Change in official reserves (-: increase)	256	605	-193	-213	-212	176
Memorandum items:						
Current account balance (percent of GDP)	-0.9	-1.6	-0.8	-0.6	-0.6	-0.6
Export of goods (percent change in value)	11.6	9.7	10.6	9.7	9.6	9.4
Import of goods (percent change in value)	13.5	10.8	9.0	9.2	9.5	9.4
Terms of trade (percent change)	-1.7	-1.3	1.0	0.0	0.0	0.0
Gross external debt	15,397	17,092	19,073	20,741	22,363	23,820
(percent of GDP)	59.4	62.1	64.8	66.2	67.1	67.1
Net external debt (liabilities - assets) 1/	2,004	2,833	3,186	3,547	3,841	4,144
(percent of GDP)	7.7	10.3	11.0	11.3	11.5	11.7
Debt service costs (in millions of euros)	2,424	3,066	3,026	2,978	3,530	4,956
(percent of exports of goods and services)	15.6	17.9	16.0	14.3	15.5	19.9
Gross official reserves (in millions of euros) 2/	6,542	5,937	6,130	6,343	6,555	6,380
(in months of imports of goods and services)	5.0	4.1	3.9	3.7	3.5	3.1

Sources: Bank of Slovenia; and IMF staff prorections.

1/ A negative number indicates net creditor position.

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

Table 8. Maternity, Sickness, and Unemployment Benefits in Selected EU Countries

	Maternity benefits		Sickness benefits		Unemployment benefits	
	Benefits	Duration of benefits	Replacement ratio	Duration of benefits	Replacement ratio	Duration of benefits
Austria	100 percent of net earnings	16 weeks	Up to 75 percent of covered earnings.	26 to 52 weeks, depending on length of contribution, after benefit from employer.	55 percent of net earnings.	Up to 20 weeks; can be extended to up to 78 weeks, based on combined contribution and age-related criteria.
Germany	100 percent of net earnings	14 weeks	70 percent of gross earnings (up to a maximum of 90 percent of net earnings).	From first day of incapacity until recovery or until the award of a disability pension.	67 percent of net earnings for unemployed persons with children; 60 percent if without children.	Up to 12 months for unemployed workers aged less than 55 years and up to 18 months for older unemployed workers.
Netherlands	100 percent of net earnings up to the daily maximum of €167.70.	Up to 16 weeks around childbirth.	70 percent of earnings up to the daily maximum earnings of €167.70.	Up to 104 weeks; may be extended to 156 weeks.	Basic benefit: 70 percent of the minimum wage; Salary-related benefit: 70 percent of the last salary with daily maximum earnings of €167.70.	Basic benefit: 6 months; salary-related: from 6 months to 5 years, depending on employment record. 1/
Czech Republic	Up to 69 percent of daily assessment base	28 weeks; 37 weeks for single mother or multiple births.	First 3 days: 50 percent of daily assessment base (DAB); from 4th day, 69 percent of DAB.	Up to 1 year; could be extended up to 2 years if recovery is likely.	50 percent of earnings during the first 3 months; 40 percent for next 3 months; 60 percent in case of retraining.	6 months.
Hungary	70 percent of net earnings	24 weeks	60 percent of daily average net earnings or 70 percent with 2 years of continued employment.	Up to one year (or for the length of the continuous insurance period immediately prior to the onset of the illness, if less).	65 percent of the gross average salary.	Up to 270 calendar days.
Poland	100 percent of net earnings	16 weeks for first child, 18 weeks for subsequent births	Normally, up to 80 percent. But, 100 percent if incapacity continues beyond 90 days.	Up to 26 weeks. If recovery is not likely sickness benefit may be followed by rehabilitation benefit for up to 12 months at 75 percent of earnings.	A flat-rate base amount for those with between 5 and 20 years of employment; 80 percent of the base amount with less than 5 years; 120 percent of the base amount for more than 20 years employment.	From 6 to 18 months, depending on the unemployment rate in the region.
Slovak Republic	90 percent of net earnings	28 weeks and 36 weeks for single mothers	Up to 70 percent.	Up to 1 year. For the first 3 days, 25 percent of the daily assessment base; thereafter, 55 percent of the daily assessment base.	50 percent of gross labor income, subject to a ceiling of 60 percent of the average wage.	Up to 6 months, depending on the contribution history.
Slovenia	100 percent of net earnings	365 days	100 percent for the first 30 days and varies between 80 and 100 percent from day 31 onward. It cannot be lower than the minimum wage.	No limit.	70 percent for the first 3 months or the Minimum Subsistence Level, whichever is higher; 60 percent after three months; 80 percent of the MSL is paid to the unemployed who have exhausted their unemployment benefits.	Varies between 3 months and 24 months, depending on the number of years of contribution.

Sources: "Slovenia: Options for Short-Term Public Expenditure Rationalization", IMF, Fiscal Affairs Department, May 2004 and US Social Security Administration at: http://www.ssa.gov/policy/docs/progdesc/ssptw/2004-2005/europe/index.html.

1/ There are plans to reduce the duration to 3 years and 2 months.

Table 9. Slovenia: Banking Sector Soundness Indicators, 2000–04
(In percent; end of period)

	2000	2001	2002	2003	2004
Capital adequacy					
Regulatory capital to risk-weighted assets	13.5	11.9	11.9	11.5	11.0
Regulatory Tier 1 capital to risk-weighted assets	12.6	11.3	10.0	9.8	9.1
Capital (net worth) to assets	10.1	8.8	8.3	8.3	7.5
Nonperforming loans net of provisions to capital	32.1	35.5	36.3	34.3	29.1
Asset quality					
Nonperforming assets to total assets	6.5	7.0	7.0	6.5	5.7
Large exposures to capital	211.3	208.3	195.3	212.8	200.8
Earnings and profitability					
Net interest margin to average interest bearing assets	4.7	3.6	3.7	3.2	2.8
Operating expenses to average assets	3.5	3.3	3.2	3.0	2.8
Return on average assets (before tax)	1.1	0.5	1.1	1.0	1.1
Return on average equity (before tax)	11.4	4.8	13.3	12.5	14.2
Liquidity					
(Liquid assets to total assets) Average short-term assets to average short-term liabilities	85.6	89.3	90.6	93.2	88.4
Foreign exchange risk					
Foreign currency-denominated loans to total loans	29.4	29.8	32.4	34.9	38.0
Foreign currency-denominated liabilities to total liabilities	41.0	41.0	39.5	40.5	44.1
Net open position in foreign exchange to capital	21.5	33.9	51.6	58.6	55.1
Market risk					
Assets with maturity of more than 1 year (percent of total loans to non-bank sector)	42.2	42.8	45.9	47.2	50.1
Liabilities with maturity of less than 3 months (percent of total liabilities to non-bank sector)	62.7	62.1	52.9	56.0	64.5
Fixed rate contracts (share of new loans of largest 8 banks)	...	...	...	53.3	45.1
Memorandum item:					
Ownership of banking sector (percent of equity capital)					
Nonresidents	12.0	16.0	32.5	32.4	31.8
Central government	36.8	37.0	20.3	19.4	19.1
Other domestic entities	51.2	47.0	47.2	48.2	49.2

Source: Bank of Slovenia.

SLOVENIA: FUND RELATIONS

(As of April 30, 2005)

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	164.92	71.18
	Reserve position in Fund	66.78	28.82
III.	**SDR Department**		
	Net cumulative allocation	25.43	100.00
	Holdings	7.44	29.25

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):

	2005	**2006**	**2007**	**2008**	**2009**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.33	0.45	0.45	0.45	0.45
Total	0.33	0.45	0.45	0.45	0.45

VII. **Exchange Rate Arrangement**

The currency of Slovenia is the tolar (SIT). On June 28, 2004, Slovenia joined the ERM2 at the central parity of SIT239.64 per euro and the authorities stated that they would aim for stability of the exchange within a narrow, but unannounced band. Since ERM2 entry, the exchange rate has remained close to the central parity. Slovenia aims to adopt the euro in January 2007.

VIII. **Last Article IV Consultation**

The last Article IV consultation was concluded on May 7, 2004 (IMF Country Report No. 04/150). It was agreed that Slovenia would remain on the standard 12-month cycle. The Acting Chairman's summing up of the discussion was circulated as SUR/04/52.

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 (Country Report No. 01/161) was published on September 18, 2001. 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 (Country Report No. 04/137) was issued on May 24, 2004. The report includes assessments of the following standards: compliance with Basel Core Principles, insurance regulatory and supervisory system, corporate governance. and housing finance; and analyzes options for monetary operations in the transition to EMU.

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

X. Technical Assistance

Date	Dept.	Subject/Identified Need
October 1992	FAD	Tax Reform Strategy
December 1991	STA	Balance of Payments
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	MAE	De-indexation of Financial Assets
May 1995	MAE	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	MAE	FSAP
August 2001	FAD	VAT
November 2001	FAD	Direct Tax Reform
November 2003	FAD	Public Expenditure Management
November 2003	MFD	FSAP Update
April-May 2004	FAD	Performance Information to Support Better Budgeting
November 2004	STA	Recording Transactions in International Trade in Services

SLOVENIA: STATISTICAL ISSUES

43. **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. **http://dsbb.imf.org/Applications/web/sddscountrycategorylist/?strcode=SVN**

44. **Real Sector Statistics:** The Statistical Office of the Republic of Slovenia (SORS) follows the 1993 System of National Accounts (SNA 93) and the European System of Accounts 1995 (ESA95). Quarterly GDP estimates by industry and expenditure categories are compiled in both current and constant 2000 prices, and are published within 80 days after the reference quarter.

45. **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.

46. **Government Finance Statistics:** Slovenian fiscal data 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)*. However, these operations are small in size. Monthly and annual fiscal data are reported for publication in *International Financial Statistics (IFS)* and *the Government Finance Statistics Yearbook (GFSY),* respectively, on a timely basis.

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

48. **Balance of Payments Statistics:** Balance of payments data are comprehensive and of high quality. The 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.

7. **External Debt Statistics:** External debt statistics were revised and brought in line with the SDDS in August 2003. The main change comprised of inclusion of trade credits in the debt data.

SLOVENIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 3, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	5/23/05	5/23/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/30/05	5/16/05	M	M	M
Reserve/Base Money	4/30/05	5/16/05	M	M	M
Broad Money	3/31/05	4/20/05	M	M	M
Central Bank Balance Sheet	4/30/05	5/16/05	M	M	M
Consolidated Balance Sheet of the Banking System	3/31/05	4/20/05	M	M	M
Interest Rates[2]	4/05	5/13/05	M	M	M
Consumer Price Index	4/05	4/29/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	1/05	5/10/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	3/05	5/09/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/05	5/09/05	M	M	M
External Current Account Balance	3/05	5/12/05	M	M	M
Exports and Imports of Goods and Services	3/05	5/12/05	M	M	M
GDP/GNP	Q4/04	3/15/05	Q	Q	Q
Gross External Debt	2/28/05	4/23/05	M	M	M

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

SLOVENIA: EXTERNAL DEBT SUSTAINABILITY ANALYSIS

49. **Slovenia's external outlook does not raise major concerns regarding external sustainability.** Under the baseline scenario, the external debt-to-GDP ratio, which jumped by 5 percentage points in 2004 to 59 percent, will continue to grow at a slowing pace and stabilize at 67 percent of GDP from 2008. With the external current account deficit projected to average ½ percent of GDP during 2006-09, the increase in the external debt ratio mainly reflects a balance sheet restructuring by banks. With households increasingly saving in non-bank financial institutions, banks have resorted to foreign borrowing to fund their lending activities. It is expected that this tendency will slow down and stabilize over the medium term. Although the bulk of new borrowing is euro-denominated, the exchange risk is not a big concern given the experience so far under the ERM2, and would disappear with euro adoption planned for January 2007. Slovenia does not face any rollover risks on its external debt.

50. **Stress tests suggest that the baseline scenario is sensitive to shocks, particularly a sizable depreciation of the currency**. A hypothetical 30-percent decline in the tolar exchange rate against the euro in 2005 would result in a 29.3-percentage point jump in the debt-to-GDP ratio to 88.7 percent. The ratio would continue to grow at a declining rate, reaching 98.3 percent by 2009. However, in the run-up to euro adoption Slovenia is more likely to face an upward pressure on its currency, thus limiting the likelihood of this scenario. The baseline scenario would worsen significantly in the case of a two-standard deviation shock to the GDP deflator or a combination of one-standard deviation to the former and to real GDP, the nominal interest rate, and the non-interest current account. In both situations, the external debt-to-GDP ratio would jump in 2005-06 (by 7-9 percentage points of GDP in each year, more than three times higher than the increase in the baseline scenario). The growth in the ratio would taper off during subsequent years, reaching 79 percent in 2009 in the case of a GDP deflator shock and stabilizing around 76½ percent from 2008 in the case of a combination of shocks. Two-standard deviation shocks to real GDP, nominal interest rates, or the non-interest current account balance separately would lead to important, but less acute deviations from the baseline scenario. In any of these scenarios, Slovenia should be able to roll over its debt, thus sustainability problems appear limited.

Table A1. Slovenia: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	
									I. Baseline Projections					
External debt	37.8	46.4	47.4	48.9	54.1	59.4			**62.1**	**64.8**	**66.2**	**67.1**	**67.1**	
Change in external debt	3.9	8.6	1.1	1.4	5.2	5.3			2.7	2.7	1.4	0.9	0.0	
Identified external debt-creating flows (4+8+9)	0.4	0.9	-4.8	-12.1	-3.0	-3.4			-3.3	-4.7	-4.9	-5.0	-5.2	
Current account deficit, excluding interest payments	2.1	1.3	-2.0	-3.1	-0.8	-0.8			-0.4	-1.3	-1.6	-1.7	-1.8	
Deficit in balance of goods and services	4.1	3.6	0.7	-1.5	0.0	0.6			1.0	0.2	-0.1	-0.1	-0.1	
Exports	49.3	56.4	57.6	57.6	56.5	59.9			62.2	64.3	66.4	68.3	70.2	
Imports	53.4	60.0	58.3	56.1	56.5	60.6			63.2	64.5	66.3	68.2	70.1	
Net non-debt creating capital inflows (negative)	-0.5	-0.8	-1.9	-7.6	-1.2	-1.6			-1.5	-1.5	-1.6	-1.6	-1.7	
Automatic debt dynamics 1/	-1.3	0.5	-1.0	-1.5	-1.0	-1.0			-1.5	-1.9	-1.7	-1.6	-1.7	
Contribution from nominal interest rate	1.1	1.6	1.8	1.7	1.2	1.7			2.0	2.1	2.2	2.3	2.4	
Contribution from real GDP growth	-1.8	-1.4	-1.2	-2.0	-1.2	-2.4			-2.2	-2.3	-2.3	-2.2	-2.3	
Contribution from price and exchange rate changes 2/	-0.6	0.3	-1.6	-1.2	-1.0	-0.4			-1.3	-1.7	-1.7	-1.8	-1.9	
Residual, incl. change in gross foreign assets (2-3)	3.5	7.7	5.9	13.6	8.2	8.7			6.1	7.4	6.3	5.9	5.2	
External debt-to-exports ratio (in percent)	76.7	82.2	82.4	84.9	95.8	99.2			99.9	100.8	99.8	98.2	95.5	
Gross external financing need (in billions of euros) 3/	3.1	3.5	3.7	3.4	4.2	4.7			5.8	5.6	5.9	6.3	6.6	
in percent of GDP	15.3	17.0	16.8	14.6	16.9	18.0			21.0	19.2	18.9	18.8	18.7	
Key Macroeconomic Assumptions							10-Year Historical Average	10-Year Standard Deviation						Average, 2005-09
Real GDP growth (in percent)	5.6	3.9	2.7	4.5	2.5	4.6	4.1	1.0	3.9	4.0	3.7	3.6	3.6	3.9
Exchange rate appreciation (euro value of local currency, change in percent)	-3.8	-5.6	-5.6	-4.0	-3.2	-2.2	-5.5	3.6	-0.3	0.0	0.0	0.0	0.0	-0.4
GDP deflator in euros (change in percent)	1.9	-0.9	3.6	2.5	2.1	0.7	3.7	4.3	2.2	2.8	2.7	2.7	2.8	2.3
Nominal external interest rate (in percent)	3.6	4.3	4.2	3.8	2.6	3.4	3.6	0.5	3.5	3.6	3.7	3.8	3.8	3.6
Growth of exports (euro terms, in percent)	-0.8	18.1	8.7	7.1	2.6	11.9	8.2	5.5	10.2	10.6	9.8	9.6	9.4	10.3
Growth of imports (euro, in percent)	4.8	15.9	3.4	3.0	5.5	13.0	8.5	5.5	10.8	9.2	9.3	9.6	9.5	10.2
Current account balance, excluding interest payments	-2.1	-1.3	2.0	3.1	0.8	0.8	1.1	1.9	0.4	1.3	1.6	1.7	1.8	1.3
Net non-debt creating capital inflows	0.5	0.8	1.9	7.6	1.2	1.6	1.7	2.1	1.5	1.5	1.6	1.6	1.7	1.6
									II. Stress Tests for External Debt Ratio					
A. Alternative Scenario														
Key variables are at their historical averages in 2005-09 4/						59.4			**60.2**	**62.2**	**62.9**	**63.2**	**62.7**	
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						59.4			**62.7**	**65.9**	**67.3**	**68.1**	**68.1**	
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						59.4			**63.3**	**67.3**	**68.9**	**69.8**	**69.9**	
B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2005 and 2006						59.4			**66.8**	**75.7**	**77.5**	**78.8**	**79.1**	
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006						59.4			**65.3**	**72.0**	**73.2**	**73.9**	**73.7**	
B5. Combination of B1-B4 using one standard deviation shocks						59.4			**66.0**	**74.4**	**75.8**	**76.6**	**76.5**	
B6. One time 30 percent nominal depreciation in 2005						59.4			**88.7**	**93.0**	**95.7**	**97.6**	**98.3**	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) 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, e = nominal appreciation (increase in euro value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 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.

4/ The key variables include real GDP growth; nominal interest rate; euro deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

Table A2. Slovenia: External Sustainability Framework--Gross External Financing Need, 1999-2009

	1999	2000	2001	2002	2003	2004	Projections 2005	2006	2007	2008	2009
							I. Baseline Projections				
Gross external financing need, in billions of euros 1/	3.1	3.5	3.7	3.4	4.2	4.7	5.8	5.6	5.9	6.3	6.6
in percent of GDP	15.3	17.0	16.8	14.6	16.9	18.0	21.0	19.2	18.9	18.8	18.7
							II. Stress Tests				
Gross external financing need, in billions of euros 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						4.7	5.6	5.6	6.0	6.4	6.8
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						4.7	6.0	5.9	6.0	6.4	6.8
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						4.7	5.8	5.7	5.9	6.3	6.7
B3. Change in euros GDP deflator is at historical average minus two standard deviations in 2005 and 2006						4.7	5.8	5.7	6.0	6.4	6.8
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006						4.7	6.8	7.3	6.6	7.0	7.4
B5. Combination of 2-5 using one standard deviation shocks						4.7	6.3	6.6	6.3	6.7	7.0
B6. One time 30 percent nominal depreciation in 2005						4.7	5.8	5.8	6.1	6.6	7.0
Gross external financing need, in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						18.0	19.9	18.5	18.3	18.1	17.9
B. Bound Tests											
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006						18.0	21.7	19.9	19.2	19.2	19.0
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						18.0	21.4	19.9	19.7	19.7	19.5
B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2005 and 2006						18.0	22.6	22.5	22.3	22.4	22.3
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006						18.0	24.7	24.7	21.1	21.0	20.8
B5. Combination of 2-5 using one standard deviation shocks						18.0	23.6	24.1	21.7	21.6	21.4
B6. One time 30 percent nominal depreciation in 2005						18.0	30.1	27.9	27.9	28.1	28.1

1/ Defined as non-interest 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.
3/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

SLOVENIA: PUBLIC DEBT SUSTAINABILITY ANALYSIS

51. **Slovenia's general government debt was less than 30 percent of GDP at end-2004, which is low compared to other EU-member states and well below the Maastricht criterion threshold.** The debt-to-GDP ratio increased from 18½ percent at end-1994 to 29½ percent at end-2004 in spite of fiscal surpluses in the first part of the 1990s and of moderate deficits from 1997 onward. The increase was driven mainly by debt assumed as a result of bank and enterprise restructuring and by the inheritance of liabilities from the former Federal Republic of Yugoslavia.[9] In addition, until 2000 the central government borrowed mainly through inflation-linked (and to a lesser extent exchange-rate linked) instruments, which also contributed to a rising debt level in spite of a strong fiscal position.

52. **The baseline scenario shows a gradual decline in the general government debt-to-GDP ratio to around 27 percent in 2009.** In this scenario, it is assumed that the structural fiscal deficit remains unchanged at the 2005 level (i.e., 1.1 percent of GDP). The decline in the debt ratio would be larger if the government brought down the structural deficit progressively toward balance as envisaged in the Convergence Program. In 2000, the government started a gradual transition towards the use of long-term fixed-rate financing instruments. The first ten-year tolar-denominated Treasury bonds were issued in 2003. As a result of this debt management policy, the share of indexed debt is expected to steadily decline over the medium term. This explains why, unlike in the past, a prudent medium-term budgetary policy and the absence of debt assumption are expected to translate into a declining debt ratio.

53. **The baseline is relatively resilient to shocks and sustainability is not a problem.** The standard stress tests show that Slovenia's public debt position seems relatively resilient to real interest rate and exchange rate shocks. A two-standard deviations shock to the real interest rate in 2005 and 2006 implies a 29.6 percent debt-to-GDP ratio in 2009 (compared to 27.3 percent in the baseline scenario). Even in the case of a 30 percent real depreciation in 2005 (a scenario which could only materialize in the event of an unlikely speculative attack on the tolar prior to euro adoption), the debt-to-GDP ratio would still be contained at 31½ percent in 2009. The highest risk is posed by a 10 percent increase in other debt-creating flows in 2005. Even in this case, however, the debt-to-GDP ratio would be around 36½ percent in 2009.

[9] Debt assumption reached a peak in 1995, when it represented 45 percent of end-of-year outstanding debt.

Table A3. Country: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	10-Year Historical Average	10-Year Standard Deviation	Projections 2005	2006	2007	2008	2009	Average, 2005-09
									I. Baseline Projections					
Public sector debt 1/	23.4	27.4	28.1	29.5	29.4	29.5			**30.1**	**29.3**	**28.6**	**27.9**	**27.3**	
o/w foreign-currency denominated	12.5	13.8	13.6	12.2	11.4	9.8			6.9	6.7	6.6	6.4	6.3	
Change in public sector debt	0.9	4.0	0.7	1.4	-0.2	0.1			0.6	-0.8	-0.7	-0.7	-0.6	
Identified debt-creating flows (4+7+12)	0.2	2.0	0.4	-0.1	0.1	-0.2			0.0	-0.5	-0.6	-0.6	-0.7	
Primary deficit	-0.7	-0.1	-0.2	-0.1	-0.2	-0.1			0.0	-0.2	-0.1	0.0	0.0	
Revenue and grants	41.0	40.6	41.3	40.6	41.3	41.7			42.2	42.2	42.2	42.2	42.2	
Primary (noninterest) expenditure	40.3	40.5	41.1	40.5	41.1	41.6			42.2	42.0	42.1	42.1	42.3	
Automatic debt dynamics 2/	-0.7	0.2	-0.8	-0.8	-0.2	-0.6			-0.4	-0.7	-0.7	-0.7	-0.7	
Contribution from interest rate/growth differential 3/	-1.1	-0.5	-1.6	-1.3	-0.6	-0.6			-0.4	-0.7	-0.7	-0.7	-0.7	
Of which contribution from real interest rate	0.1	0.3	-0.9	-0.2	0.1	0.6			0.6	0.4	0.4	0.3	0.2	
Of which contribution from real GDP growth	-1.1	-0.8	-0.7	-1.1	-0.7	-1.3			-1.1	-1.1	-1.0	-1.0	-0.9	
Contribution from exchange rate depreciation 4/	0.4	0.7	0.8	0.5	0.4	...			...	...	...	...	...	
Other identified debt-creating flows	1.6	1.9	1.4	0.8	0.5	0.6			0.5	0.4	0.2	0.1	0.0	
Privatization receipts (negative)	-0.2	-0.1	-0.1	0.0	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.1	0.1	0.1	0.1	0.1	0.0			0.1	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	1.7	1.9	1.4	0.7	0.6	0.6			0.4	0.4	0.2	0.1	0.0	
Residual, including asset changes (2-3) 5/	0.7	2.0	0.3	1.5	-0.3	0.3			0.6	-0.3	-0.1	-0.1	0.0	
Public sector debt-to-revenue ratio 1/	57.1	67.6	68.1	72.7	71.0	70.6			71.2	69.4	67.7	66.2	64.7	
Gross financing need 6/	3.4	5.3	9.0	7.4	9.1	9.2			9.7	8.0	6.8	7.3	6.6	
in billions of euros	0.7	1.1	1.9	1.7	2.2	2.4			2.7	2.4	2.1	2.4	2.4	
Key Macroeconomic and Fiscal Assumptions							10-Year Historical Average	10-Year Standard Deviation						Average, 2005-09
Real GDP growth (in percent)	5.6	3.9	2.7	4.5	2.5	4.6	4.1	1.0	3.9	4.0	3.7	3.6	3.6	3.9
Average nominal interest rate on public debt (in percent) 7/	6.5	6.7	6.2	6.3	5.9	5.5	6.7	0.9	4.9	4.4	4.1	3.9	3.7	4.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	1.8	-3.5	-0.4	0.4	2.5	-3.1	4.7	2.4	1.5	1.4	1.2	1.0	1.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.8	-5.6	-5.6	-4.0	-3.2	...	-5.5	3.6	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.9	5.0	9.7	6.8	5.5	2.9	9.8	5.4	2.5	2.9	2.7	2.7	2.7	2.8
Growth of real primary spending (deflated by GDP deflator, in percent)	6.8	4.9	3.7	3.1	3.9	6.0	4.4	1.6	5.2	3.6	3.8	3.8	3.9	4.4
Primary deficit	-0.7	-0.1	-0.2	-0.1	-0.2	-0.1	-0.6	0.5	0.0	-0.2	-0.1	0.0	0.0	-0.1
									II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 8/						29.5			**28.0**	**25.6**	**23.4**	**21.2**	**19.3**	
A2. No policy change (constant primary balance) in 2005-09						29.5			**30.1**	**29.3**	**28.6**	**27.9**	**27.3**	
A3. Country-specific scenario 9/						29.5			**31.1**	**30.3**	**29.6**	**28.9**	**28.3**	
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006						29.5			**31.2**	**31.7**	**31.0**	**30.3**	**29.6**	
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						29.5			**31.4**	**32.8**	**33.6**	**34.4**	**35.2**	
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006						29.5			**30.6**	**30.5**	**29.8**	**29.1**	**28.5**	
B4. Combination of B1-B3 using one standard deviation shocks						29.5			**30.1**	**29.8**	**29.1**	**28.4**	**27.8**	
B5. One time 30 percent real depreciation in 2005 10/						29.5			**34.8**	**33.8**	**33.0**	**32.3**	**31.5**	
B6. 10 percent of GDP increase in other debt-creating flows in 2005						29.5			**40.1**	**39.0**	**38.1**	**37.2**	**36.4**	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of Euro).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Assumes that expenditures get out of control and increase by 1 percentage of GDP from 2005 onwards.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in Euro value of local currency) minus domestic inflation (based on GDP deflator).

Table A4. Country: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 1999-2009
(In percent of GDP, unless otherwise indicated)

							Projections				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
							I. Baseline Projections				
Gross financing need 1/	3.4	5.3	9.0	7.4	9.1	9.2	9.7	8.0	6.8	7.3	6.6
in billions of U.S. dollars	0.7	1.1	1.9	1.7	2.2	2.4	2.7	2.4	2.1	2.4	2.4
							II. Stress Tests				
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						9.2	7.3	5.7	4.3	4.3	3.5
A2. No policy change (constant primary balance) in 2005-09						9.2	9.6	8.0	6.8	7.3	6.6
A3. Country-specific scenario. 4/						9.2	10.8	9.3	8.1	8.5	7.9
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006						9.2	10.9	9.8	7.4	7.9	7.2
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						9.2	10.7	10.2	9.4	10.3	9.9
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006						9.2	10.3	8.9	7.1	7.6	6.9
B4. Combination of 2-4 using one standard deviation shocks						9.2	9.5	8.3	7.0	7.4	6.7
B5. One time 30 percent real depreciation in 2005 5/						9.2	10.2	9.3	7.9	8.4	7.7
B6. 10 percent of GDP increase in other debt-creating flows in 2005						9.2	10.9	10.7	9.1	9.7	8.8
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2005-09 3/						2.4	2.0	1.7	1.4	1.4	1.3
A2. No policy change (constant primary balance) in 2005-09						2.4	2.7	2.4	2.1	2.4	2.4
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 4/						2.4	3.0	2.7	2.5	2.8	2.8
B. Bound Tests											
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006						2.4	3.0	2.9	2.3	2.6	2.6
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						2.4	2.9	2.9	2.8	3.3	3.4
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006						2.4	2.8	2.6	2.2	2.5	2.5
B4. Combination of 2-4 using one standard deviation shocks						2.4	2.6	2.4	2.1	2.4	2.4
B5. One time 30 percent real depreciation in 2005 5/						2.4	1.9	1.8	1.7	1.9	1.8
B6. 10 percent of GDP increase in other debt-creating flows in 2005						2.4	3.0	3.2	2.9	3.2	3.1

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
2/ Gross 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.
3/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
4/ Assumes that expenditures get out of control and increase by 1 percentage of GDP from 2005 onwards.
5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

Statement by Johann Prader, Alternate Executive Director for Republic of Slovenia and Ksenjia Maver, Advisor to Executive Director
July 20, 2005

The Slovene authorities wish to thank the IMF mission for its constructive contribution to the economic policy discussion. The Article IV consultation resulted in a broad agreement between the authorities and the IMF team on the major policy issues and the challenges ahead.

This Buff provides an update of the developments since the March 2005 Article IV consultation, in particular of recent steps undertaken by the authorities to smoothen the transition to the euro.

Economic activity and balance of payments

Economic growth is projected to stay close to 4 percent in 2005 and 2006, down from 4.6 percent in 2004. The year-on-year rate of growth slowed from 4.3 percent in the fourth quarter of last year to 2.6 percent in the first quarter of this year, largely reflecting a sharp decline in gross capital formation. Other domestic demand components are in line with the projections. In the first quarter of 2005 seasonally adjusted GDP increased by 0.9 percent.

As a result of a better performance of the trade balance, the current account recorded a slight surplus in the first five months of 2005. Exports in this period were 12 percent higher than one year ago. Imports increased less than exports. The contribution of the foreign component to the first quarter economic growth was positive (1.3 percentage points). Nevertheless, the Bank of Slovenia expects a widening of the current account deficit from 0.9 percent of GDP in 2004 to 1.6 percent of GDP by the end of this year. The expected weakening of foreign demand, the deterioration in the terms of trade as well as the decline in net capital income are the most important causes of this worsening.

Inflation

In 2005, inflation has continued its downward path. Annual inflation was brought down from 3.2 percent in December 2004 to 1.9 percent in June 2005. The favorable disinflation reflects, in no small measure, sound and coordinated macroeconomic policies. Lower food prices, helped by the changes in the trade regime following the EU entry, also made an important contribution. The Bank of Slovenia's April 2005 Monetary Policy Report projects stabilization of inflation at 2.4 percent by the final quarter of this year, and at 2.6 percent by the final quarter of next year. The envisaged gradual increase in inflation should be seen against the backdrop of strong disinflation recorded in the second half of 2004 after the EU entry in May 2004. The risks to the inflation projection stem mainly from further increases in oil prices. The inflationary pressures from increased domestic demand are moderate. Still, support from fiscal policy and the social partners will be essential for continuing the downward trend in inflation.

Fiscal policy

In June 2005, the Parliament approved the revised budget for 2005 which envisages a deficit of 1.4 percent of GDP, compared with a deficit of 1.7 percent of GDP projected in the initial budget adopted in December 2003. There is a clear commitment to sustain the path of fiscal consolidation in line with the medium term fiscal objective, which will support the euro adoption process by contributing to a sustainable decline in inflation. Preparations for the two-year 2006/2007 budget have already started.

The Government is working on changes in two areas. In the health system, the changes are aimed at streamlining the basic benefit package and at increasing some benefits for the lower income population. In the pension system, the changes include an adjustment of the pension indexation formula in order to make the pension increases consistent with the wage growth.

The recent analysis prepared by the Institute of Macroeconomic Analysis and Development (IMAD) on the challenges ahead, especially those related to euro adoption, underlines the positive contribution of fiscal policy to macroeconomic stabilization, and calls for increased flexibility on the expenditure side, especially in the face of the high share of non-discretionary spending related to wages and social transfers. This would be important in order to release fiscal resources for investment and co-financing of EU funds.

Monetary policy and exchange rate

The Bank of Slovenia has kept its policy rates unchanged, except for the refinancing rate. On two occasions, in December 2004 and in April 2005, it raised its refinancing rate by a total of 0.5 percentage points. The refinancing rate, currently at 3.5 percent, exceeds the ECB's rate by 1.5 percentage points.

In the first six months of this year, the market rate moved in an even closer corridor around the central parity, compared with the first six months following Slovenia's ERM2 entry on June 28, 2004. The deviation of the market rate from the central parity did not exceed 0.06 percent. In this period, the Bank of Slovenia also did not intervene in the foreign exchange market. In the twelve months-period until May 2005, the real effective exchange rate of the tolar depreciated by only 0.1 percent.

Financial sector

The Financial Stability Report published by the Bank of Slovenia in June 2005 points out that Slovenia's banking system, capital market and insurance sector are sound and resilient to macroeconomic shocks, and compare favorably to those of other EU members. In the absence of major disruptions in the present trend of economic activity in Europe and in Slovenia, there are no serious reasons for concern. Nevertheless, the Report concludes that effective oversight of the financial system will be essential in the period leading to euro adoption.

The banking system strengthened but the demanding external environment does not allow for complacency. The Banks' capital ratio is solid at 11.8 percent. Also, profitability has increased owing mainly to strong non-interest income. The share of non-performing loans in bank portfolios amounts to a mere 3 percent, and the overall quality of the banks' portfolio is improving. The foreign exchange risks are manageable in light of the smooth process of transition to the euro that has already started in banks. Nevertheless, rapid growth of lending combined with easing loan standards in the face of intensifying competition, increased income variability and declining interest rate margins expose the banks to new risks. To sustain the current favorable position, the Bank of Slovenia is urging the banks to stay prudent and vigilant, and to enhance risk management, especially with regard to the interest rate risks. In parallel, the Bank of Slovenia will be further strengthening the banking supervision capacity and monitoring.

The insurance sector is performing relatively well. The coverage of technical provisions by assets recorded a level of 111 percent at the end of 2003. In 2004, insurance companies also improved their capital adequacy as measured by the surplus of the available capital above the required minimum capital.

The claims ratio for credit insurance, which accounts for only 2 percent of insurance companies' total collected premium, improved significantly from the previous years to 0.66 in 2004. In view of the low proportion of credit insurance and the trend of decreasing proportion of new banking loans insured by insurance companies (the proportion of new loans insured by insurance companies fell by 0.6 percentage points to 2.2 percent from the end of 2003 to the end of February 2005), there are no serious reasons for concern about the transfer of credit risk from the banking to the insurance sector.

Euro adoption

Slovenia comfortably complies with four of the five Maastricht criteria, and has stepped up efforts to meet the fifth, i.e. the inflation criterion. At the end of 2004, public debt amounted to 29.4 percent of GDP and the budget deficit was at 1.9 percent of GDP, well below the respective 60 percent and 3 percent targets. Moreover, at 4.3 percent, long term interest rates are well within the actual limit of slightly above six percent. Also, the exchange rate has been stable. In June 2005, the 12-month average price inflation as measured by the EMU convergence price index dropped to 3.0 percent and lowered the difference to the EMU convergence criterion from 1.8 percentage points in July 2004 to 0.7 percentage points.

Half way down the two-year ERM2 path, Slovenia has demonstrated the sustainability of its macroeconomic policy required for the euro adoption. It intends to introduce the euro as its legal tender on January 1, 2007, subject to positive convergence reports by the European Commission and the European Central Bank and the approval of the European Council, and following the irrevocable fixing of the tolar/euro exchange rate expected to be decided in June 2006. A one- year testing period that will inform the convergence reports has started in June 2005.

The January 2005 master plan for the euro changeover was endorsed by the Bank of Slovenia and the Slovenian Government and builds on the November 2003 joint program for euro adoption. The joint program defines the responsibilities for meeting the euro adoption targets. The master plan sets the stage for resolving technical aspects of this process. The technical preparations are coordinated by a special committee co-chaired by the Bank of Slovenia and the Ministry of Finance. The committee includes a number of institutions each entrusted to prepare their action plans and reports on implementation. Slovenia plans to adopt the euro under the Big Bang scenario which provides for one week of dual circulation of tolars and euros. To increase public awareness of the functioning of the economic and monetary union and to provide practical advice, communication with the households and the business community, especially the financial sector, has already been enhanced. The introduction of the dual display of prices is envisaged by March 1, 2006.

Structural issues

In June 2005, the Government endorsed Slovenia's new strategy for sustainable development that sets five priority areas and defines targets, actions and milestones for the period until 2013. On the economic front, improving competitiveness, deregulating the economy, adjusting the social model, enhancing innovation and investments into research and development, addressing the problem of ageing population, are its most important pillars.

Conclusion

Coordination of all economic policies will be key to meeting the conditions for adopting the euro. Monetary policy needs to preserve exchange rate stability. Fiscal policy has to continue the gradual fiscal consolidation process, enhance the quality of public finance and contribute to offsetting inflationary pressures. The social partners must make sure that the wage growth in all sectors lags behind the productivity growth by at least one percentage point. The government should allow only a moderate growth of administered prices. The financial supervision must ensure the stability of the financial sector. A favorable external environment would help, and a bit of luck would also be welcome.

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IMF Executive Board Concludes 2005 Article IV Consultation with the Republic of Slovenia

On July 20, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.[1]

Background

Real GDP growth accelerated to 4½ percent in 2004 driven by a large positive swing in the contribution of net foreign demand, while domestic demand growth maintained momentum. Private consumption strengthened, though to a lesser extent than expected owing to an apparent increase in the propensity to save. Investment growth slowed, owing to a smaller contribution from inventory accumulation. Exports rose markedly in response to stronger import demand in the main trading partners. However, because of a deterioration in the terms of trade on account of higher oil and commodity prices, the external current account deficit widened to almost 1 percent of GDP. Competitiveness remained adequate. However, owing to increased external financing by banks to fund their lending activities, total external debt rose sharply.

Progress with disinflation continued, notwithstanding higher oil prices, a pickup in producer prices, and a narrowing of the output gap. Year-on-year inflation declined from 4.6 percent in December 2003 to 3.2 percent in December 2004 and fell further to 2.1 percent in May 2005. An improved harvest, the elimination of remaining duties on imports from the European Union,

[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.

and increased competition in the retail market resulted in lower food prices and moderate increases in the prices of non-food items. Disinflation was additionally reinforced by the widening of the gap between real wage increases and productivity growth and by the stabilization of the exchange rate after ERM2 entry on June 28, 2004.

The monetary framework changed following ERM2 entry and monetary conditions became tighter. However, with further convergence of tolar lending interest rates and increased competition in the banking sector, bank credit accelerated. The pickup in credit growth was particularly strong for individuals. Upon ERM2 entry, the Bank of Slovenia ended its depreciation policy and set the central parity to at SIT 239.64 per euro, close to the then-prevailing market rate. Since then, the market rate has not deviated from the central parity by more than ±0.20 percent, and the Bank of Slovenia has kept its key policy interest rate (on 60-day bills) unchanged at 4 percent.

The general government deficit in 2004, at 1.4 percent of GDP, was lower than envisaged in the budget, but the expenditure structure became more rigid. Faced with uncertainties about VAT receipts, the authorities cut spending on goods and services in the fourth quarter. Capital expenditure from domestic resources was also lower than budgeted. However, the wage bill exceeded the budgeted level.

Economic growth is expected to moderate to 4 percent in 2005, but would still be above estimates of potential. Domestic demand is expected to ease, owing to a further slowdown of inventory accumulation. In addition, factors that led to higher household saving in 2004 are likely to persist. The stimulus to growth from net foreign demand would be small in the foreseeable future. Export growth would ease in line with projected import demand in Slovenia's main trading partners, and the rising trend in import content of domestic demand is likely to continue. With higher oil prices contributing to a further deterioration in the terms of trade, the external current account is projected to widen to 1½ percent of GDP in 2005. The authorities expect average inflation of about 2½ percent in 2005. The revised 2005 budget envisages a broadly neutral fiscal stance.

Following EU accession and ERM2 entry in 2004, the authorities are concentrating on securing a smooth transition to euro adoption in early 2007.

Executive Board Assessment

Executive Directors congratulated the authorities for Slovenia's entry into the European Union and ERM2 in 2004 and subsequent strong economic performance. Directors considered that, taking into account the degree of real convergence with other EU economies, its competitiveness, and the fact that it already meets the Maastricht criteria for long-term interest rates, the fiscal deficit, and public debt ratios, Slovenia is well positioned to adopt the euro in early 2007. However, risks remain: although disinflation has continued, meeting the Maastricht inflation criterion during the assessment period (June 2005-June 2006) will be challenging, as will sustaining low inflation after euro adoption. The authorities will also need to address the budgetary implications of an aging population in order to meet the medium-term balanced budget objective.

Directors agreed that, given the intended policy stance, inflation in 2005–06 is likely to be modest, but they cautioned that higher oil prices, continued faster-than-potential economic growth, and larger-than-expected producer price increases could create upside inflation risks. They welcomed the authorities' readiness to take corrective measures—including monetary tightening—if signs emerged that inflation would exceed the target or that the Maastricht inflation criterion would be jeopardized. They emphasized, however, that the scope for monetary tightening to have its intended effect on inflation within the assessment period would become smaller as the end of the period approached. Directors supported the Bank of Slovenia's intention to keep policy interest rates unchanged, unless forced otherwise by market conditions.

Directors commended the authorities for their track record of prudent fiscal policy. They stressed the importance of maintaining a fiscal stance consistent with the aim of lowering inflation, as envisaged in the revised 2005 budget, which will also contribute to putting the public finances on the path to meet the official medium-term goal of structural balance. At the same time, the need to safeguard investment expenditure to support future economic growth was recognized. Directors noted that further fiscal consolidation would create room for higher spending within the Stability and Growth Pact (SGP) deficit threshold in case of adverse cyclical conditions.

Directors called on the authorities to strengthen their efforts to increase budgetary flexibility, noting the relatively large proportion of nondiscretionary spending in the overall budget. These expenditures should be contained, including through the reform of social entitlements and health care; restrictions on non-selective promotions; and a slower increase in public sector employment. Changes in pension indexation that result in higher pension payments should be avoided. In that light, Directors encouraged the authorities to consider linking pensions to inflation—rather than to wage growth, as is currently being considered—and addressing the issue of pension indexation in the framework of a comprehensive reform to ensure the long-term soundness of the pension system. They cautioned against further lowering payroll taxes, unless mechanisms are in place to ensure that the resources thus released are not used for wage increases.

Directors welcomed the indications that productivity growth was continuing to outpace the growth of real wages, and noted that wage restraint and greater wage flexibility will be crucial for adjusting to asymmetric shocks in the euro area. Directors urged the authorities and social partners to eliminate wage indexation in the Social Agreement for 2006, and to adopt a wage setting system that allows greater productivity-based differentiation of wages. Directors recommended that a wage pact at the national and enterprise levels be considered if achievement of the Maastricht inflation criterion was threatened.

Directors noted that Slovenia's banking system remains sound, with the banks adequately capitalized and profitable and their asset quality high. At the same time, due to stiff competition and interest rate convergence, banks are vulnerable to further margin compression in the transition to euro adoption. In addition, the high share of assets held by banks with fixed interest rates and longer maturities may raise their interest rate risks, and increased corporate borrowing in euro may raise their credit risks. Directors therefore welcomed the Bank of Slovenia's intention to maintain tight oversight of financial institutions and to monitor closely banks' exposure to credit and interest rate risks. They encouraged the authorities to enhance the supervision of insurance companies and to ensure that these companies have the capacity to set pricing, provisioning and capital at appropriate levels.

Directors observed that the growth of the economy over the past decade could be attributed in large part to the authorities' sustained structural reform efforts, but that much remained to be done in this area. Labor market flexibility needs to be improved, including by reducing employment protections, and the problem of the long-term unemployed addressed. Directors welcomed the consideration being given to further privatization, and the increased competition in the electricity and gas markets, and urged that this be extended to other sectors, such as telecommunications. Directors encouraged the authorities to simplify administrative procedures and regulation and further strengthen the business environment, which would help to attract higher levels of foreign direct investment and make the economy even more dynamic in coming years.

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Slovenia: Selected Economic Indicators, 2000-06

	2000	2001	2002	2003	2004	Projections 2005	2006
			(Annual percentage change)				
Real GDP	3.9	2.7	3.3	2.5	4.6	3.9	4.0
Domestic demand	1.5	0.9	2.3	4.7	4.7	3.8	3.8
Private consumption	0.3	2.3	0.3	2.7	3.5	3.5	3.5
Public consumption	2.3	3.9	1.7	2.6	1.7	3.1	2.5
Gross capital formation	3.3	-4.3	7.4	10.5	9.1	4.9	5.3
Output gap (in percent of potential GDP)	1.0	-0.2	-0.6	-1.7	-0.8	-0.6	-0.1
Industrial production	6.2	2.9	2.4	1.4	4.8	...	...
Consumer prices							
Period average	8.9	8.4	7.5	5.6	3.6	2.6	2.5
End of period	8.9	7.0	7.2	4.6	3.2	2.4	2.6
Wages							
Nominal							
All sectors	10.6	11.9	9.8	7.5	5.7	4.7 1/	5.0 1/
Manufacturing	11.9	10.8	10.4	7.7	7.0	...	...
Public services	11.2	13.9	8.7	6.4	3.3	...	...
Real							
All sectors	1.6	3.2	2.1	1.9	2.1	2.1 1/	2.6 1/
Manufacturing	2.8	2.2	2.7	2.0	3.3	...	...
Public services	2.1	5.1	1.1	0.8	-0.3	...	...
Employment							
Person basis	1.3	1.4	0.6	-0.8	0.5	...	...
National Accounts basis	1.1	0.5	-0.4	-0.3	0.1	0.4 1/	0.5 1/
Average unemployment rate (in percent, ILO definition)	7.0	6.4	6.3	6.7	6.4	6.2 1/	6.0 1/
General government finances 2/			(In percent of GDP)				
Revenue	40.6	41.3	39.2 3/	41.3	41.7	42.5	…
Expenditure	41.9	42.6	42.1	42.7	43.5	43.8	…
General government balance	-1.3	-1.3	-3.0 3/	-1.4	-1.4	-1.3	…
Structural general government budget balance	-1.7	-1.3	-1.3	-0.7	-1.0	-1.1	…
State budget balance	-0.9	-1.0	-2.6 3/	-1.2	-1.3	-1.4	…
General government debt	27.4	28.1	29.5	29.4	29.5	30.1	…
Money and credit			(Percentage change, end-period)				
Broad money	15.3	28.3	18.4	5.0	6.8	...	...
Base money	1.9	37.7	-4.3	4.1	2.2	...	...
Credit to the private sector 4/	18.1	18.5	10.5	15.5	20.2	...	...
Interest rates (in percent)							
BoS Lombard rate	11.0	12.0	10.5	7.3	5.0	...	...
Rate on 60-day BoS bills	10.0	8.0	8.3	6.0	4.0	...	...
Lending rates	14.6-18.4	15.8-12.3	11.6-14.7	9.0-10.3	7.9-8.5	...	...
Deposit rates 5/	10.9-13.2	8.5-11.0	7.6-8.6	4.8-5.7	3.2-4.0	...	...
Balance of payments			(In millions of euros, unless noted otherwise)				
Merchandise exports	9,574	10,454	11,082	11,414	12,736	13,977	15,465
Exports volume (percent change, volume)	12.9	7.0	6.5	4.4	13.2	8.6	9.0
Merchandise imports	-10,801	-11,139	-11,351	-11,960	-13,576	-15,041	-16,392
Imports volume (percent change, volume)	7.7	3.2	4.4	7.3	13.2	8.3	8.4
Terms of trade (percent change)	-3.3	2.1	2.0	0.5	-1.7	-1.3	1.0
Current account balance	-583	38	335	-91	-238	-427	-246
(in percent of GDP)	-2.8	0.2	1.4	-0.4	-0.9	-1.6	-0.8
Gross official reserves	3,436	4,984	6,781	6,879	6,542	5,937	6,130
(in months of imports of goods and nonfactor services)	3.3	4.7	6.2	5.9	5.0	4.1	3.9
External debt (percent of GDP, end-period)	46.4	47.4	48.9	54.1	59.4	62.1	
Of which: Public and publicly guaranteed	15.3	15.4	14.5	14.5	14.1	...	…
External debt service	1,119	1,849	1,937	2,144	2,424	3,066	
(in percent of exports of goods and nonfactor services)	9.5	14.9	13.1	15.4	15.6	17.9	
Exchange rate							
Tolars per U.S. dollar (end-period)	227.4	251.0	221.1	189.4	176.2	...	…
Tolars per euro (end-period)	211.5	221.4	230.3	236.7	239.7	...	…
Nominal effective exchange rate (1998Q1=100, period	90.6	85.0	81.8	80.6	79.1	...	…
Real effective exchange rate							
(CPI based, 1998Q1=100, period average)	102.3	101.4	103.1	105.4	105.1	...	…
(ULC based, 1998Q1=100, period average)	97.3	97.0	96.9	96.8	95.9	...	…

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

1/ Projections by the Institute for Macroeconomic Analysis and Development (IMAD).
2/ Revised budget for 2005. Figures include higher transfers from EU and EU-related expenditures.
3/ Figures reflect a shift in the budget accounting to a pure cash basis entailing only 11 months of VAT and excise tax revenues. Adjusted for the change, the general government deficit would be 1.5 percent of GDP.
4/ Including loans and other claims.
5/ For deposits with maturity between 31 days and 1 year.