July 2006
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Republic of Slovenia: 2006 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 2006 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 28, 2006, 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 12, 2006. 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 June 30, 2006 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

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation
with the Republic of Slovenia

Approved by Juha Kähkönen and G. Russell Kincaid

June 12, 2006

- ***Discussions for the 2006 Article IV consultations took place in Ljubljana during March 14-28, 2006***. The mission met with Finance Minister Bajuk, Bank of Slovenia (BoS) Governor Gaspari, and other senior officials. The staff team comprised J. Fernández-Ansola (Head), P. Egoume-Bossogo, M. Mathibe, P. Sorsa, A. Tuladhar (all EUR). T. Mattina (FAD), C. Rosenberg and R. Sierhej (both Warsaw regional office) joined for a shorter period. Ms. Maver (OED) participated in key meetings. The report was prepared by Ms. Sorsa.

- ***The consultation focused on challenges to be faced for success in the euro zone.*** Therefore, the selected issues papers (SIPs) cover (i) budget flexibility and spending efficiency; (ii) the effects of population aging on fiscal sustainability; (iii) the effects of the tax and benefit systems, including retirement incentives, on labor participation; and (iv) a cross-country comparison of Slovenia's trade specialization and quality upgrading of exports.

- ***De facto exchange rate***. Slovenia entered ERM2 in 2004 and is expected to adopt the euro in January 2007.

- ***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).

- ***Outreach activities.*** The mission met with representatives of labor unions, industry, banks, universities, and parliament, and held a press briefing. The concluding statement was published.

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EXECUTIVE SUMMARY

Background

Slovenia is on the verge of joining the euro area. Favorable initial conditions and generally sound macroeconomic and incomes policies over the past decade have allowed Slovenia to sustain robust growth with gradually lower inflation. With the Maastricht criteria met at end-2005 and the tolar's two successful years in ERM2, the EU has ruled that Slovenia can adopt the euro on January 1, 2007.

Structural reform has trailed progress with macroeconomic policies, leaving the economy with many rigidities. Generous social benefits have led to low labor participation rates. Slow privatization, labor market rigidities, and regulatory constraints have been reflected in FDI flows and productivity growth lagging behind those of regional peers. An inflexible budget and one of the fastest aging populations in Europe also pose challenges to Slovenia's success in the euro zone.

Policy Discussions

With immediate prospects largely favorable, the discussions focused on the policy requirements for maintaining a balanced expansion, increasing the economy's flexibility, and supporting long-term growth:

- **Near-term policies.** In 2006–07, the economy is expected to stay close to capacity, with growth around 4 percent and inflation moderate. The authorities and staff agreed that a neutral fiscal stance is appropriate in 2006, and that policy rates should be kept unchanged until euro adoption, market conditions permitting. In the context of a generally sound banking system but rising pressures on profitability, bank supervision needs to guard against market and credit risks.

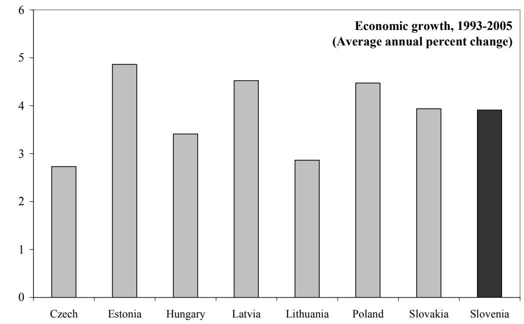
- **Fiscal policy in the medium term.** The authorities envisage major tax and expenditure reforms to achieve structural balance by 2010. The staff welcomed this goal while urging advancing the target date and front loading the consolidation, to support balanced growth and address aging-related sustainability concerns. The tax reform is aimed at improving incentives to work, whereas plans on spending reform have yet to be firmed. However, the authorities agreed on the need for expenditure flexibility in the euro zone, and shared the staff's concern about longer-term budgetary pressures from population aging. Better targeting of benefits and linking them to activation policies, parametric reform of the public pension system, and measures to boost private savings are key in this regard.

- **Reducing structural obstacles to growth.** The authorities are actively considering other ways to increase labor market participation and flexibility. They also agree on the need to improve the regulatory environment to attract FDI and raise productivity.

I. Introduction

1. **Slovenia is set to become the first among the new EU member states to adopt the euro.** Aided by broadly favorable initial conditions and generally sound macroeconomic and incomes policies, Slovenia has over the past decade sustained robust growth with small external imbalances, while gradually lowering inflation to euro-area levels. Long-term interest rates, the fiscal deficit, the public debt ratio, and inflation were all within the Maastricht Treaty limits at end-2005. This, combined with the tolar's two successful years within the ERM2, has set the stage for euro adoption in January 2007.

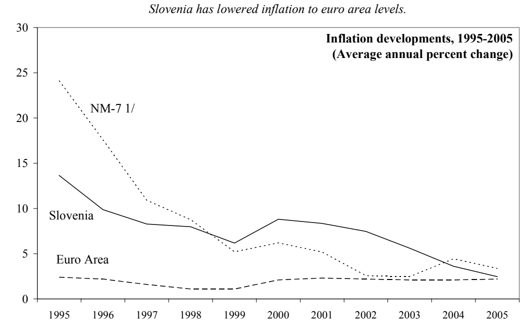
Growth has been strong over the past decade.



Source: World Economic Outlook.

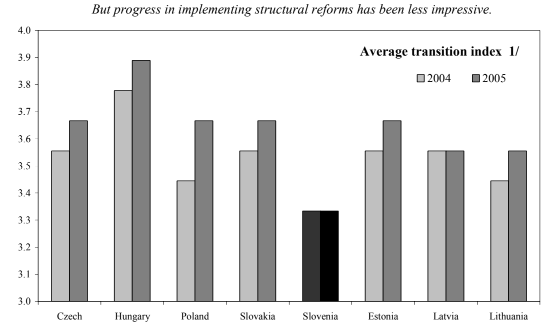
2. **The achievements notwithstanding, Slovenia faces structural challenges that need to be addressed to ensure success in the euro zone.** Although Slovenia's gradualist approach to reform has contributed to macroeconomic stability, it has left the country with many structural rigidities—notably an inflexible budget, a welfare system that discourages labor participation, and a restrictive business environment. The loss of the exchange rate instrument puts a premium on softening these rigidities. Over the longer horizon, Slovenia's population aging is expected to be among the most rapid in Europe, creating strong fiscal pressure through higher pension and health spending. Combined with a productivity growth lagging behind that of the other new Central European EU members (NM-8), this demographic trend could also weaken the growth potential. With the near-term outlook largely benign, the Article IV consultation focused on how to deal with these medium- and longer-term challenges.

Slovenia has lowered inflation to euro area levels.



Source: World Economic Outlook, IMF.
1/ Average for Czech, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia.

But progress in implementing structural reforms has been less impressive.



Source: EBRD Transition Report, 2005.
1/ Simple average across all categories surveyed. The closer the average is to 4 the closer the economy is to "the standards of an industrialized market economy."

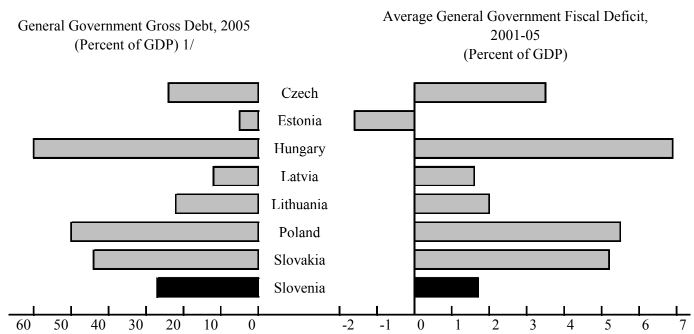
II. Background

3. **Strong growth continued in 2005, bringing output close to potential** (Table 1, Figures 1 and 2). In 2004, GDP growth reached a five-year peak of 4¼ percent, fueled by EU-accession-related investment, including inventory accumulation. Although the subsequent unwinding of inventories slowed domestic demand, growth in 2005 at 3.9 percent remained above the estimated potential of 3¾ percent, driven by strong exports. Consumption continued to contribute to growth, buoyed by real wage increases (of around

2 percent) and booming consumer loans. The strong activity boosted job creation, especially in services, and unemployment remained low at 6½ percent even as participation rates improved slightly. These trends, and the increase of the capacity utilization rate to the highest level in a decade, suggest that the output gap has been closed almost fully.

4. **In keeping with its record of fiscal prudence, Slovenia maintained a tight fiscal stance in 2005** (Table 2). In a performance setting it apart from its Central European peers, Slovenia has maintained low fiscal deficits, with public debt below 30 percent of GDP. In 2005, the general government deficit, at 1.1 percent of GDP, was below target, due to one-off municipal revenues and lags in spending EU transfers.[1] Tax revenues were buoyant, reflecting the recovery of indirect taxes from a temporary drop following EU accession. Adjusting for cyclical effects, the deficit implied a neutral fiscal stance for the year.

Slovenia has maintained a conservative fiscal policy with low deficits and debt.



Source: World Economic Outlook.
1/ Net debt for Hungary.

5. **With limited scope for independent central bank action, monetary conditions tightened only marginally in 2005** (Table 3 and Figure 3). Having set its key policy interest rate at 4 percent upon entering ERM2 in 2004, the BoS maintained the rate at that level through 2005. However, a surge in short-term capital inflows prompted reductions in February and March 2006 by 25 basis points each. Together with the recent increases in European Central Bank (ECB) rates, this narrowed the tolar–euro interest rate differential from 2 to 1 percent. Yet, the tolar-euro exchange rate has remained stable, aided by BoS swap operations.[2] With a broadly unchanged REER and lower inflation, the BoS stance implied a slight tightening of monetary conditions in 2005.

6. **In the context of broadly neutral macroeconomic policies, wage discipline has supported disinflation** (Figures 4 and 5). Despite the diminished slack in activity, core inflation more than halved—to less than 1 percent—during 2005, owing to lower tolar depreciation expectations, increased competition following EU accession, and prudent macroeconomic and incomes policies. In particular, guidelines setting wage growth below

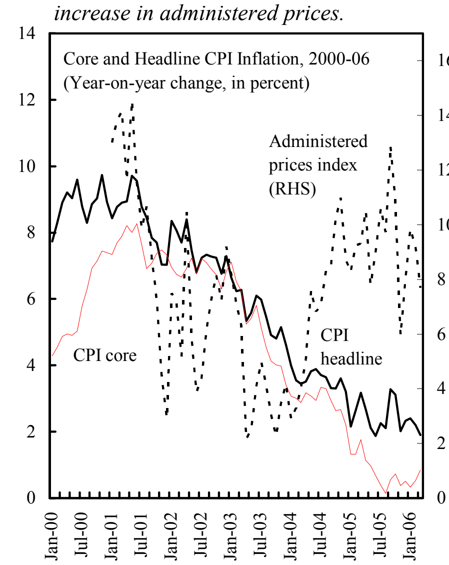
[1] Slovenia is set to receive from the EU annually on average 1.4 percent of GDP during 2004–06 and 2.4 percent of GDP during 2007–13.

[2] Since ERM-II entry in June 2004, the tolar has not deviated by more than ±0.2 percent from its central parity of SIT239.64 per euro.

that of productivity helped minimize second-round effects of energy price shocks. The benign core inflation led headline inflation to a historical low of 2½ percent during the year.

7. **The current account moved to near balance in 2005, with strong export performance more than offsetting the impact of a terms-of-trade deterioration** (Table 4 and Figure 6). The growing importance of Slovenia as a gateway to, and investor in, Southeastern Europe (SEE) boosted exports of services, especially tourism, transport, and construction. Despite the higher oil prices, moderation in domestic demand slowed nominal merchandise import growth to 11½ percent from over 16 percent in the previous year, while merchandise exports, led by cars, continued to grow by 12 percent. On balance, the current account deficit narrowed to about 1 percent of GDP from 2.1 percent in 2004.

Inflation declined in 2005 despite an increase in administered prices.



8. **Despite the favorable external performance, indicators of competitiveness show a mixed picture** (Figures 7–9). Measures of price competitiveness appear satisfactory, as evidenced by a stable real effective exchange rate and flat unit labor costs. Also, estimates of the equilibrium real exchange rate do not indicate a misalignment (see, for example, IMF Working Paper 05/27). However, in recent years Slovenia has underperformed regional competitors in gaining markets in EU-15 and world markets, and total factor productivity growth has lagged the NM-8, as has the pace of upgrading the quality and skill content of exports (Box 1 and SIP). Indeed, in 2005 manufacturing wages in Slovenia, adjusted for productivity, remained the highest among the NM-8.

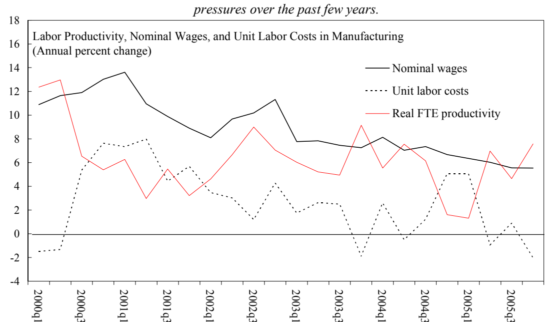
Strong net service exports were the main determinant of the narrowing of the current account.

Slovenia: Sources of Current Account Improvement, 2005
(Change in millions of euros over the same period of previous year)

Current Account	243
Exports of goods (f.o.b.)	1,584
Due to changes in volumes	1,113
Due to changes in prices	471
Imports of goods (f.o.b.)	-1,609
of which: Mineral fuels and lubricants	-492
Due to changes in volumes	-719
Due to changes in prices	-890
Services, income, and current transfers	268

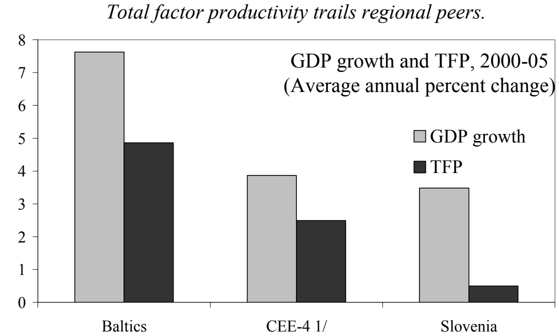
Sources: Bank of Slovenia; and staff estimates.

Wage growth has been moderating, ensuring lower unit labor cost pressures over the past few years.



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

Total factor productivity trails regional peers.

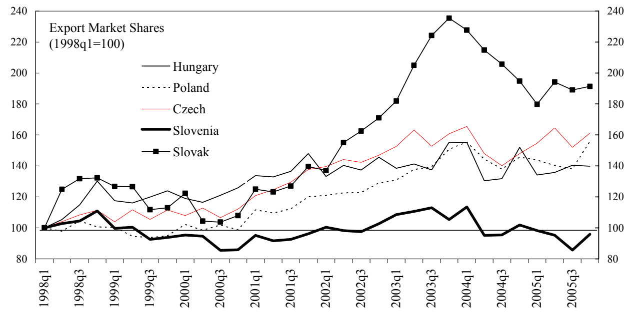


Source: World Economic Outlook, IMF.
1/ CEE-4 consists of Czech Republic, Hungary, Poland, and Slovak Republic.

Slovenia's manufacturing wages, adjusted for productivity, are relatively high.

Sources: Country authorities; and staff calcualtions.

Slovene exports have been unable to increase market penetration in the EU-15.



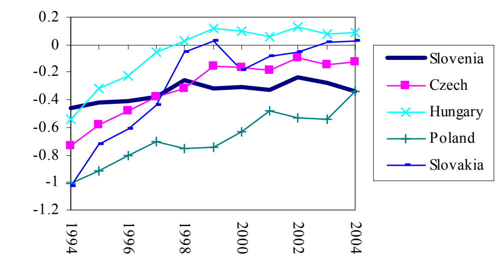
Source: Direction of Trade Statistics, IMF.
Note: Calculated as the share of nominal exports of each individual country in the combined nominal imports of EU 15 and the US.

Box 1. Trends in the Skill and Technology Content of Exports

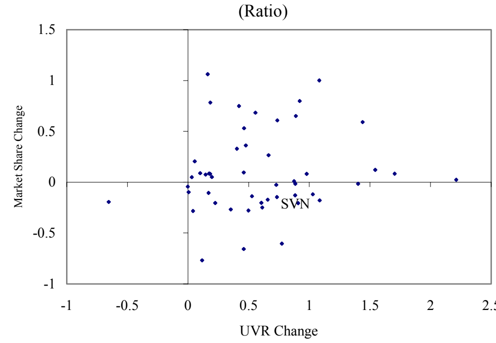
Slovenia's competitive position in the high-tech industries of the EU-15 is eroding as regional competitors gain markets at a faster pace. Revealed comparative advantage indicators—Slovenia's high-tech export share relative to that of the world—show that, although Slovenia had a strong initial competitive position, other NM-8s are catching up fast.

The pace of quality improvement has also been slower than in the other NM-8s. The change in unit value ratios (UVRs) of Slovene exports —a proxy for quality—has been lagging behind that of NM-8 exports. This is linked to Slovenia's small gains in market share in EU-15. A possible explanation is Slovenia's relatively favorable initial position, which reduces the scope for catch-up. But, given the low FDI, Slovenia may have missed opportunities to gain from technological spillovers and market linkages.

Revealed Comparative Advantage of High-Tech Sector, 1994-2004
(Ratio)



Change in Market Share versus Change in UVR, 1994-2004
(Ratio)



Source: COMTRADE; and staff calculations.

9. **Cross-border flows increased in 2005, signaling closer integration with global financial markets in the run-up to euro adoption** (Table 5). With domestic interest rates declining toward EU levels and the local stock market underperforming, investors sought to diversify their portfolios to higher yielding markets abroad. In particular, households' appetite for foreign-oriented mutual funds and firms' direct investment abroad increased. Also, as deposits were declining as a source of funding, banks resorted to longer-term foreign borrowing—mostly at variable rates and with higher liquidity risk—to meet the strong demand for credit. Although gross external debt increased rapidly as a result, net debt remains at 20 percent of GDP, which together with the imminent euro adoption and a one-to-

one reserve cover of short-term liabilities suggests resilience to sudden changes in market conditions.

Banking Sector Soundness Indicators, 2003–05
(In percent; end of period)

	2003	2004	2005
Regulatory capital to risk-weighted assets	11.5	11.8	10.5
Nonperforming assets to total assets 1/	6.5	5.5	4.9
Net interest margin to average interest bearing assets	3.2	2.8	2.5
Operating expenses to average assets	3.0	2.8	2.4
Return on average assets (before tax)	1.0	1.1	1.0
Average short-term assets to average short-term liabilities	93.1	88.6	84.8
Net open position in foreign exchange to capital	58.6	55.1	58.9
Fixed rate contracts (share of new loans of largest 8 banks) 1/	47.0	41.1	23.4
Ownership of banking sector by non residents (percent of equity capital)	32.4	32.3	35.7

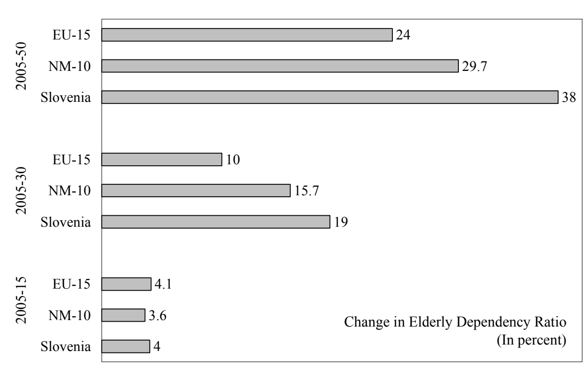
Source: Bank of Slovenia.

1/ For 2005, data as of September.

10. **The banking system remains sound and stable, but pressures on profitability and market risks are increasing** (Table 6, Figures 10 and 11). On the positive side, bank profitability improved slightly in 2005 despite a drop in interest income and increased competitive pressures. Also, the non-performing loan ratio declined, although this partly reflected a rapid expansion of new credit. But there were also indications of a relaxation of credit standards in the competition for market share, which combined with the increasing recourse to variable rate contracts has increased interest rate risks and the associated credit risks. This is increasingly straining bank profitability, which is already low by regional standards.

11. **Structural reform has lagged behind progress with macroeconomic policies, leaving the economy with many rigidities.** Generous welfare and retirement benefits have reduced incentives to work, leading to low labor participation rates, especially among low-income and older workers. Slow privatization, inflexible labor markets, and regulatory constraints that impede the business environment have been reflected in FDI flows and productivity performance that compare unfavorably with those in the other Central European countries. These factors, combined with a rigid budget and one of the fastest aging populations in Europe, pose challenges to Slovenia's long-run fiscal sustainability and growth prospects.

The projected rise in the elderly dependency ratio is among the fastest in Europe.



Sources: United Nations; and staff calculations.

III. Report on the Discussions

12. **With immediate prospects largely favorable but longer-term structural challenges looming, the discussions focused on the policy requirements for maintaining a balanced expansion, increasing the economy's flexibility, and supporting long-term growth in the face of population aging.** The mission also discussed the prospects for the financial sector after euro adoption. In line with previous consultations (Box 2), there was much agreement on the direction of policies, although the authorities stressed that substantive reforms are likely to take time in a consensus-driven society.

Box 2. Implementation of Past IMF Policy Recommendations

Fiscal policy. Slovenia has maintained an overall prudent fiscal policy, which the staff has supported. The fiscal stance has also been adjusted to cyclical conditions in line with staff recommendations. The authorities have been less successful in undertaking needed expenditure rationalization.

Monetary policy and financial sector issues. Over the years, the BoS followed a gradual approach to disinflation based on declining currency depreciation. While not disagreeing with the strategy, the staff argued for slower nominal depreciation of the currency and slower decline in tolar interest rates to achieve faster disinflation. After entering the ERM2 in June 2004, the BoS kept policy interest rates unchanged as long as possible in a cyclical upswing—as advocated by staff—until a surge in short-term capital inflows recently forced a reduction. Slovenia has also implemented most of the recommendations of the 2001 FSAP and of the 2004 FSSA update.

Structural reforms. Over the years, the authorities have generally resisted staff's recommendations to deepen and accelerate structural reforms. This reflects the slow decision-making process in a consensus-driven society. The government in power since December 2004 has expressed a strong commitment to reforms, which the staff supports. However, progress since last year has been slow.

A. Outlook

13. **The authorities and staff expected the economy to stay close to capacity, with growth around 4 percent in 2006 and 2007, and inflation to remain moderate.** Domestic demand would be the main driver, as investment is expected to recover, led by construction activity. Household consumption should remain moderate, provided real wage growth continues to lag behind productivity growth. Although export growth is likely to be sustained given strong external demand, net exports would be flat owing to a pick up in capital imports. This assessment is supported by indicators of consumer and business confidence, and is in line with private sector forecasts. Assuming oil prices of $70 per barrel in 2006 and wages trailing productivity growth, the staff projects average inflation at 2½ and 2¼ percent in 2006 and 2007, respectively, slightly above the authorities' projections. The government's Institute for Macroeconomic Analysis and Development (IMAD), in particular, projected inflation at 2.1 percent in both years, mainly because it assumes lower wage, oil price, and domestic demand pressures.

14. **The short-term risks to both growth and inflation were jointly seen as mainly on the upside.** The staff assumes nominal wage growth to accelerate to 5 percent in 2006–07 from an estimated 4¾ percent in 2005, still consistent with average wage growth lagging productivity growth by ½-1 percentage points. This baseline takes into account the recent reversal of the trend of declining unemployment owing to an increase in participation. But so far there has been no wage agreement for 2006–07, and larger wage settlements than those assumed would have knock-on effects on pensions and household demand. Furthermore, higher energy prices would result in second-round effects in the absence of countervailing policies that had helped offset the impact of oil prices in recent years. On the downside, a sharp appreciation of the euro, or a sluggish euro-area recovery could slow demand.

15. **Turning to the medium term, the authorities concurred that a loss of competitiveness following euro adoption was a key risk facing Slovenia.** In particular, strong wage growth could lead to real exchange rate appreciation and loss of export competitiveness. To mitigate this risk, the authorities saw the need to focus structural reforms on productivity-enhancing measures to reduce the rigidities that remained an obstacle to growth. Greater flexibility was also needed to deal with possible external shocks from changes in international interest rates and euro appreciation in the context of unwinding global imbalances. The DSA (Appendices 3 and 4) indicates that a combination of these factors would also affect external debt dynamics. Under a baseline that assumes continued strong appetite for foreign loans by banks, the gross external debt-to-GDP ratio would rise to over 90 percent by 2010. Despite this increase, risks are contained as net debt remains resilient to standard shocks to interest rates, growth, or exchange rate changes, owing to the large shares of long-term debt and gross foreign assets.

B. Near-Term Policies: How to Maintain a Balanced Expansion?

16. **While recognizing the limited scope for independent monetary policy, the staff agreed with the authorities that policy rates should be kept unchanged as long as market conditions permit.** With the economy in no need for additional stimulus, policy rates should ideally be equalized with the ECB just ahead of euro adoption in January 2007. But the authorities recognized that if Slovenia's risk premium falls rapidly and capital inflows surge, they may be forced to equalize rates earlier than that. Moreover, the remaining interest rate differential may narrow even faster if the ECB continues to raise interest rates. The authorities and staff therefore concurred that the onus of moderating domestic demand and inflationary pressures fell largely on fiscal policy.

17. **While agreeing that a neutral fiscal stance would be appropriate in 2006, the authorities saw this challenging to achieve, given existing commitments and overperformance in 2005.** Implementing the approved 2006 budget would imply a fiscal impulse of ½ percent of GDP (text table). Additional expenditure for highway construction

Measures of the Impact of Fiscal Policy, 2003-08
(Consolidated general government)

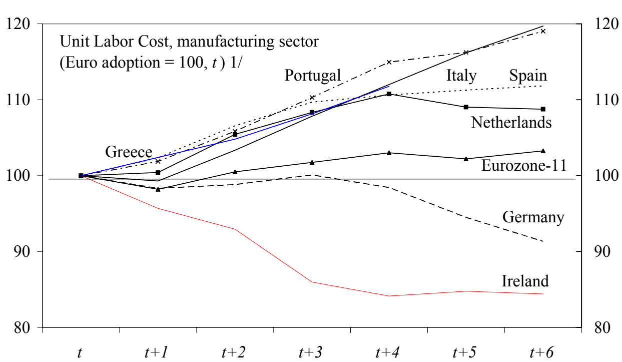
	2003	2004	2005	Projections 2006	2007	2008
			(In percent of GDP)			
Revenue	40.9	41.3	42.3	42.5	42.2	41.5
Expenditure	42.2	42.7	43.4	44.0	43.4	42.5
Headline fiscal balance	-1.3	-1.4	-1.1	-1.5	-1.2	-0.9
Structural balance	-0.9	-1.1	-0.9	-1.3	-1.1	-0.8
Fiscal impulse 1/	-1.6	0.2	-0.1	0.5	-0.2	-0.2
Memorandum items:						
Fiscal impulse, including motorway company	...	...	-0.5	0.8	0.0	-0.5
Output gap (in percent of potential GDP)	-0.6	-0.2	-0.1	0.0	0.1	0.1

Sources: Ministry of Finance; and IMF staff projections.
1/ A negative sign represents a fiscal withdrawal.

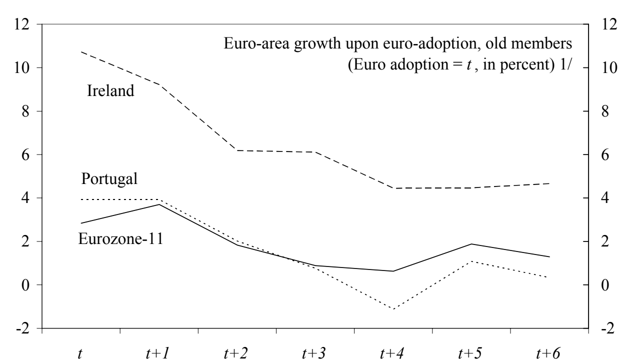
by a public enterprise could boost it further by ⅓ percent of GDP, while election-year spending by municipalities out of their surplus funds provided further risks. Against this background, the authorities agreed to take measures to maintain the deficit at about 1 percent of GDP, but highlighted the difficulties with securing short-term expenditure savings in a rigid budget.

18. **The staff noted that wage restraint and strong productivity growth were also essential to sustaining non-inflationary growth.** The consensus among social partners that has allowed wage growth to lag behind productivity growth has been critical for preventing

Ability to contain unit labor costs upon euro adoption has been associated with faster growth in the euro area



Source: World Economic Outlook, IMF.
1/ Eurozone-11 refers to the original 11 members.



Source: World Economic Outlook, IMF.
1/ Eurozone-11 refers to the original 11 members.

cost-push pressures. The staff pointed out that inability to contain unit labor costs has often been the distinguishing factor among countries that have underperformed in the Euro zone.[3] In this regard, current pent-up wage pressures posed a risk, especially following euro adoption. While acknowledging the risk, officials were confident that prudent wage settlements could be reached, given the social consensus about the need to maintain competitiveness in the euro zone.

C. Containing Financial Vulnerabilities

19. **The authorities concurred that, with rising pressures on bank profitability, bank supervision needed to be vigilant to prevent credit standards from weakening and balance sheet vulnerabilities from emerging.** Bank profitability is under increasing strain as yield convergence is compressing bank margins, euro adoption will eliminate most income from foreign exchange transactions, and increasing competition is pushing banks toward a riskier credit portfolio. Also, Slovenia's provisioning is relatively low and the application of the new International Financial Reporting Standards will effectively result in a decrease of required provisioning. The authorities´ transitory measure of classifying the released provisions as reserves will alleviate this impact, but in the longer run the combination of these factors could weaken balance sheets in some banks. The authorities concurred, and noted that they are stepping up risk-based supervision of banks' credit assessment standards to reduce credit risks. Nevertheless, these risks are contained—the authorities' stress tests indicate that a one percentage point decline in interest margins leads only to a 0.6 percentage point decline in capital adequacy ratios.

The banking system is sound but less profitable than in comparable countries.
(2005 or most recent data available, in percent)

	Capital Adequacy Ratio	Capital / Assets	Nonperforming Loans / Total Loans	Provisions / Nonperforming Loans	Return on Equity (ROE)	Return on Average Assets Before Tax (ROA)
Czech Rep.	11.9	5.8	4.3	62.6	25.3	1.4
Hungary	11.4	9.1	2.1	51.1	25.2	2.5
Poland	15.4	8.1	5.7	59.4	18.7	1.5
Slovakia	15.9	7.6	2.0	69.3	10.0	0.9
Slovenia	**10.5**	**7.4**	**4.9**	**28.2**	**13.8**	**1.0**
Ireland	12.6	4.7	0.8	87.4	19.3	0.8
Portugal	10.4	6.1	1.6	83.4	15.9	0.8

Sources: National authorities; Bankscope; ECB; Eurostat; Global Financial Stability Report, IMF; IFS; and IMF staff estimates.

20. **Both sides also agreed that while euro adoption will eliminate most exchange rate risks, the banking sector is becoming increasingly susceptible to market risks.** A substantial share of new loans carry variable interest rates, exposing borrowers and banks to increases in euro-area interest rates. Also, the increased interest-rate sensitivity of lending can rapidly translate into credit risks. With borrowers having seen interest rates only decline over the past decade, the staff recommended increasing public awareness of interest rate risks, and that supervisors collect more comprehensive data on household indebtedness, including indicators of debt concentration and debt-servicing capacity. The rapid growth of mortgages suggests that the housing market is a related risk, and a database of residential real

[3] A. Ahearne, and A. Pisani-Ferry, "The Euro: Only for the Agile," Bruegel Policy Brief, Issue 2006/01 Brussels: Bruegel, 2006.

estate transactions should be established to monitor developments in prices and turnover. BoS officials agreed, but noted that expanding the credit registry to cover households is hampered by the unwillingness of some large banks to share data to protect their market positions. They also noted that the increase in the foreign assets of Slovenian residents has reduced the vulnerability of Slovenian banks to foreign interest rate shocks.

21. **The authorities emphasized that, in an environment of strong cross-border financial linkages, they are increasingly cooperating with foreign supervisors to better detect regional vulnerabilities and limit contagion risks.** Slovenian banks—about one third of whose equity is foreign owned—rely heavily on borrowing from foreign institutions that have a high exposure to the region (most of the increase in liabilities in 2005 was to Austrian banks, which now account 40 percent of foreign liabilities of Slovenian banks). Moreover, a large share of bank-financed assets are invested in SEE as bank deposits, FDI or in mutual funds, exposing Slovenia to developments in that region. The authorities noted that information exchange and joint supervision of foreign subsidiaries of banks were being enhanced. They argued that foreign banks are discriminating in their country risk assessments, and that parent banks would, if needed, inject capital to Slovene subsidiaries to protect their reputations. Nevertheless, officials acknowledged an increased concentration of risks as foreign banks lent through subsidiaries specializing in the region. They also expressed concern that under the new EU directives national authorities would not have supervisory control over majority foreign owned-banks, but would remain responsible for guaranteeing their deposits. The staff noted that this concern would need to be weighed against the considerable potential for increased profitability and technological upgrading that divestment of the state's large remaining share in banks would bring.

Foreign ownership of banks is lower than in many comparable countries.
(2005 or most recent data available, in percent)

	Private Sector Credit / GDP	Foreign bank ownership (Percent of equity)	Share of Austrian banks in total equity	Foreign bank ownership (Percent of total assets)	Share of Austrian banks in total assets (Percent)	Deposit-Lending Rates Spread (Percentage point)
Czech Rep.	38	85	22	96	28	2.9
Hungary	52	52	10	...	...	2.1
Poland	28	75	...	49	2	4.2
Slovakia	37	89	43	97	48	3.6
Slovenia	**57**	**29**	**...**	**29**	**14**	**3.0**
Ireland	206	31	0	32	0	2.4
Portugal	147	34	0	33	0	3.4

Sources: National authorities; Bankscope; ECB; Eurostat; Global Financial Stability Report, IMF; IFS; and IMF staff estimates.

D. Fiscal Policy in the Medium Term: Enhancing Flexibility, Efficiency, and Sustainability

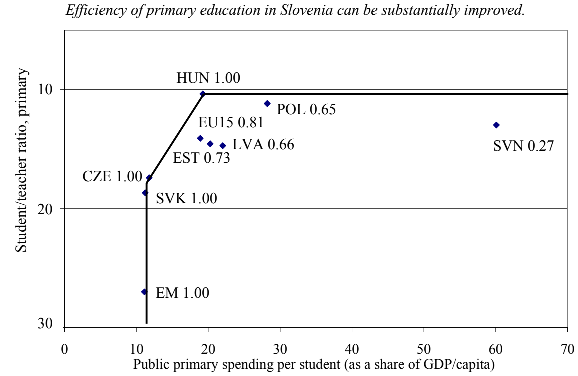
22. **The government envisages significant tax and expenditure reforms to achieve structural balance over the medium term**. Under the current budget forecast, the authorities aim for a 1 percent of GDP general government deficit in 2008 and structural balance in 2010. To lower the tax wedge and the high marginal tax rates, a gradual elimination of the payroll tax is planned through 2008. To further increase supply-side incentives, the authorities are also considering reducing the progressivity of personal and corporate income taxation, with an increase in indirect taxes as the offset. The most radical of these proposals, a flat tax, is facing opposition from unions and parts of the government, mainly on equity grounds. Expenditure reductions, mainly in the wage bill and discretionary and social outlays, have yet to be identified.

23. **While concurring on the need for fiscal consolidation, the staff noted that cyclical and long-term sustainability considerations call for frontloading the adjustment.** Under the authorities' plan, the structural deficit would decline only marginally over the next three years. To contain demand pressures with output close to potential, the staff argued for early achievement of at least structural balance. Specifically, the staff recommended that structural balance, or even a small surplus, should be reached in 2009, implying an annual adjustment of some ⅓-½ percent of GDP. While the public debt outlook remains favorable and resilient to shocks, longer-term aging considerations also support the case for faster consolidation. The staff pointed out that, under current policies, the long-run fiscal sustainability gap—the permanent adjustment needed to restore inter-temporal balance—is 10 percent of GDP in net present value terms (SIP). Moreover, each year of delay in reform increases the needed adjustment by ⅛ percent of GDP. Accordingly, the staff urged the authorities to move rapidly from plans to action with the envisaged tax and expenditure measures. The authorities agreed on the economic merits of faster adjustment, but noted that reaching political consensus on any change in social entitlements could be slow and difficult.

24. **While supporting the tax reform plans, the staff stressed the importance of focusing expenditure reform to reduce structural rigidities.** The planned tax reforms would reduce marginal effective tax rates, which are among the highest in Europe, and improve supply-side incentives to work, especially for high-skilled workers. But these needed to be supplemented by benefit reform, so as to improve incentives for labor participation, remove welfare traps that discourage the unemployed from re-entering the labor market, offset lower tax revenues, and make room for higher spending for an ageing population. The authorities noted that discussions on spending reform were ongoing. The staff welcomed the creation of a central registry of social benefits to prevent abuse and the draft law in parliament linking unemployment benefits to activation policies. Looking forward, the authorities were considering plans to unify various benefit indexation formulae, implement more flexible work arrangements in the public sector, trim public employment by one percent annually over the next three years, and adopt performance-based budgeting on a pilot basis.

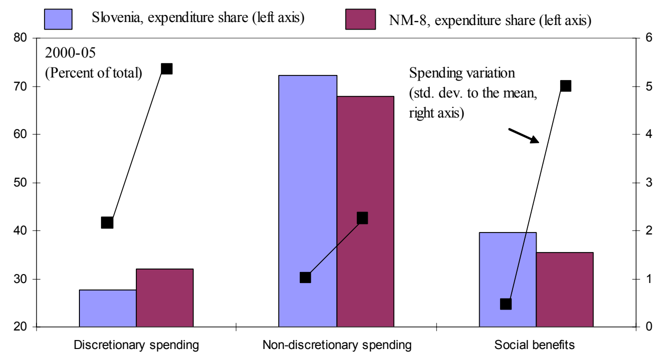
25. **The authorities agreed on the need for expenditure flexibility in the euro zone.** The imminent loss of the exchange rate instrument puts a premium on fiscal flexibility in dealing with shocks. In this regard, the staff noted that Slovenia has a rigid public spending structure, as evidenced by a high share of non-discretionary spending compared to its NM-8 peers. A cross-country comparison of key expenditures with performance outcomes shows room for improvement in many categories in Slovenia (SIP). For example, a decline in the primary school-age population has not been offset by a corresponding

Efficiency of primary education in Slovenia can be substantially improved.



reduction in the number of teachers and schools, leading to high costs per pupil (relative to per capita GDP) compared to regional peers. In this context, efficiency could be enhanced by reviewing rigid social sector funding and institutional arrangements, giving priority to reforms in areas where Slovenia's performance falls most short of comparator countries (text table). The authorities were well aware of the need for fiscal flexibility in adjusting to shocks, and welcomed the staff's analysis as a useful input into their expenditure policy discussions.

Non-discretionary spending in Slovenia is high and rigid compared to the NM-8.



Source: Staff estimates.

26. **The authorities shared staff concerns about longer-term budgetary pressures from population aging.** Slovenia's pension problem is particularly severe: the country has one of the most rapidly aging populations in Europe, one of the lowest average retirement ages in Europe, and one of the highest ratios of pensions to wages among the NM-8 (Box 3 and SIP). The substantial parametric reforms initiated in 2000, which among other things provided for a gradual increase in the retirement age, were subsequently set back by a shift to wage-based indexation. With the reforms therefore insufficient to restore sustainability, pension spending is projected to rise by over 7 percent of GDP by 2050. The authorities were well aware of these challenges and were looking for ways to enhance sustainability of the system, but noted that radical reform in the near term is unlikely. Measures are, however, envisaged to boost private saving for pensions, including the removal of the minimum return requirement on voluntary pensions and the establishment of employer-funded retirement accounts. The authorities are also reviewing the number and indexation methods of the numerous non-contribution based pension benefits. To deal more decisively with the aging pressures, the staff recommended strengthening the link between benefits and contributions; raising the statutory and effective retirement ages; revising the costly wage-based indexation formula; and improving incentives for private saving for retirement.

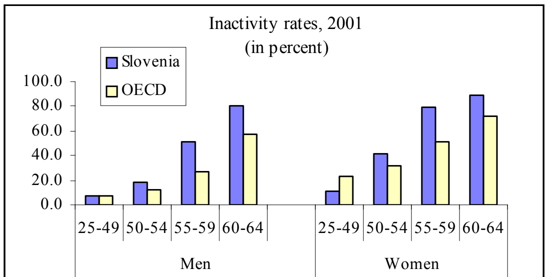
E. Reducing Structural Obstacles to Growth

27. **The staff stressed the need for reforms to improve labor market participation and flexibility.** Despite Slovenia's solid economic performance, productivity growth has not shown the dynamism seen among regional competitors, and labor force participation has fallen in relative terms (Box 4 and SIP). Trailing productivity performance compared with other Central European countries appears closely linked to weak investment, labor market rigidities, and regulatory constraints—factors that are slowing convergence to euro area income levels.

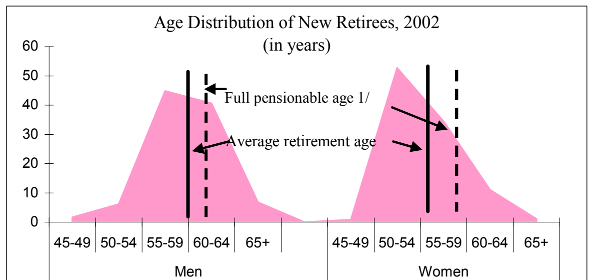
28. **The authorities were actively considering ways to improve the functioning of the labor market.** Discussions were underway within the government and social partners on

Box 3. The Pension System and Early Retirement

Slovenia has one of the lowest retirement ages in Europe. The statutory retirement age—currently at 61 years and 6 months for men, and 55 years and 4 months for women—will remain among the lowest in Europe even after a recently-approved increase over the next decade for employees with minimum pension-qualifying years. Combined with other generous features of the pension system, Slovenia also has one of the lowest effective retirement ages in Europe.

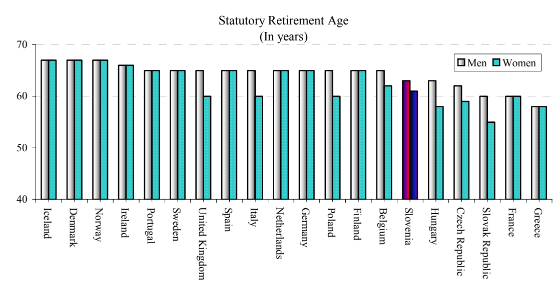


Source: OECD (2005), Statistical Yearbook of the Republic of Slovenia (2004).

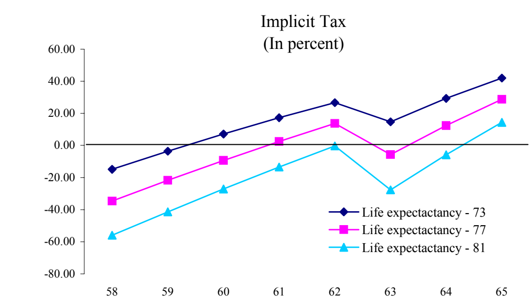


Source: World Bank (2004)
1/ Full pensionable age varies with mininum years of service.

The current system encourages early retirement, especially for low-income male workers. With the use of the accrual method, even under the newly approved higher compulsory retirement age, the system of penalties and bonuses is not strong enough to provide incentives to delay retirement. For example, a man earning the average wage who qualifies for a pension with 35 years of service at age 58 has an incentive to retire almost two years ahead of the full pensionable age of 63. These incentives are even stronger for low-income earners.



Source: OECD (2004); and Slovene authorities.

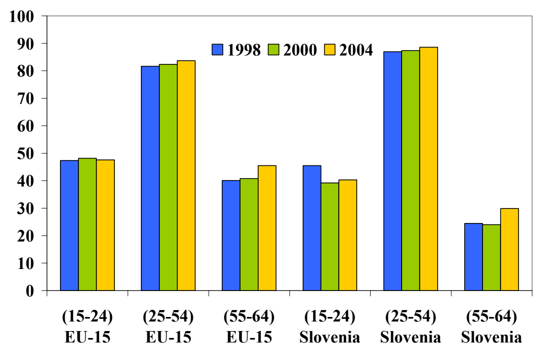


Source: Staff calculations.

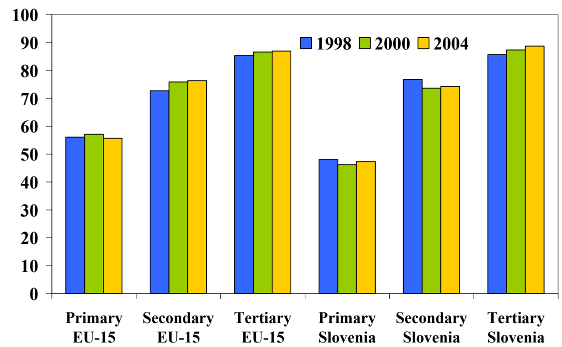
Box 4: Tax and Welfare Systems and Labor Participation

Staff analysis shows that participation rates among low-income workers (proxied by the level of education attainment) in Slovenia are low in the European context reflecting a combination of generous welfare entitlements and high tax rates:

Activity Rate by Age Groups (Labor Force Survey)

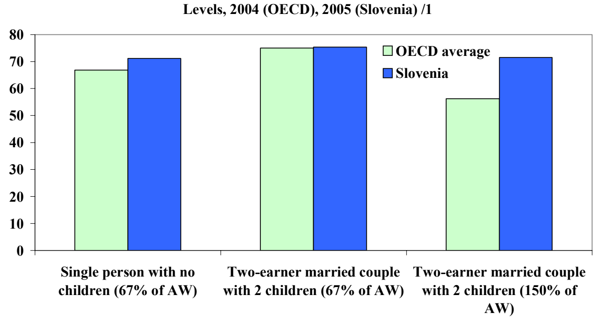


Activity Rates (age group: 15-64) by Level of Education Attained (Labor Force Survey)



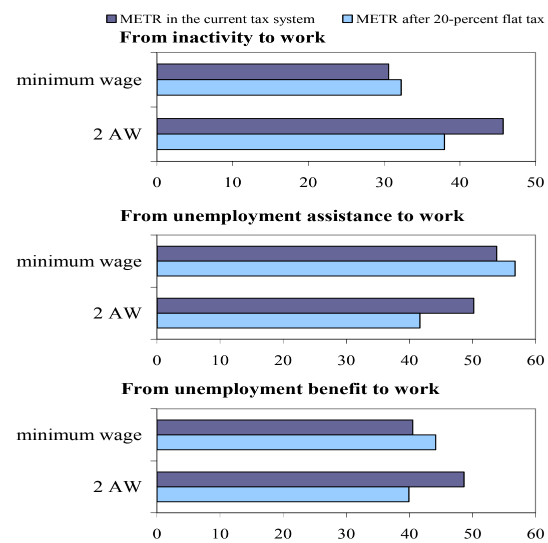
The personal income tax is highly progressive (rates ranging from 16 to 50 percent), and in addition wages are affected by a social security contribution of 22.1 percent and a progressive payroll tax (paid by the employer, with rates ranging from 6 to 14.8 percent). The welfare system is among the most generous in the EU (IMF Country Report No. 05/253, Table 8). In particular, net replacement rates exceed or equal OECD averages, leading to high marginal effective tax rates (METRs), particularly for individuals seeking to move from joblessness to work.

Net Replacement Rates: Initial Phase of Unemployment at Different Earnings Levels, 2004 (OECD), 2005 (Slovenia) /1



Sources: OECD, Tax-Benefit Models; and staff calculations.
1/ For married couples the percentage of average wage (AW) relates to one spouse only; the second spouse is assumed to have full-time earnings equal to 67% of AW.

METRs for a Couple with Two Children where the Principal Earns 67% of Average Wage (AW) and the Secondary Earns the Minimum Wage or 2 AW

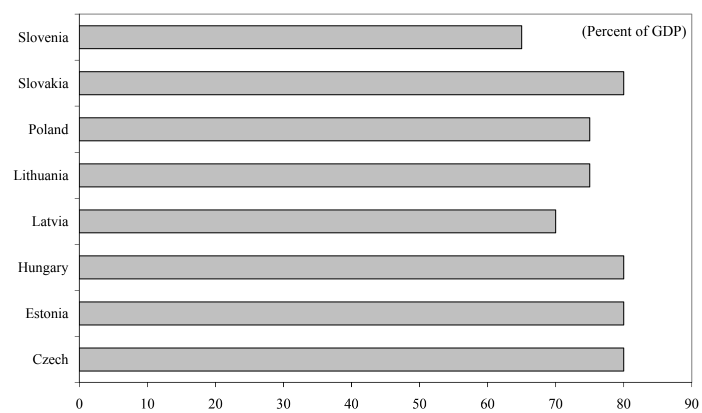


A simultaneous reform of the tax and welfare systems would boost labor participation. For example, less progressive taxes, such as a flat tax, while improving work incentives for high-income workers, would not on their own reduce METRs for low-income ones. Tax reform should therefore be accompanied by welfare reform to increase participation rates among the latter. In particular, a reform of the unemployment assistance that ensures a smooth transition in terms of lost benefits and increased taxation for lower-income workers would increase their incentives to work.

further measures to link payment of social benefits with activation policies, in line with the "flexicurity" and "work ability" models applied in the Nordic countries.[4] These measures, along with the reduction of marginal effective tax rates, would increase the incentives for labor participation. The source of some youth unemployment may also lie with the education system, which has weak links to private sector skill demands. Measures to ensure that graduates enter the labor market with sufficient and marketable skills, and to create adequate possibilities for life-long learning, would also help improve Slovenia's competitive edge. Concurrently, relaxing labor market regulations, including through lower costs of hiring and firing and a wage-setting mechanism that allows an opt-out for distressed companies, would be needed to increase labor demand. Labor market regulations have already become more decentralized and flexible, although in practice wages still followed centrally-set guidelines.

29. **Both sides saw room to improve the regulatory environment so as to reduce the cost of doing business and attract investment.** The Slovene economy is still heavily state dominated, as evidenced by the lowest private sector share in the economy among the NM-8. To strengthen entrepreneurship and corporate governance and improve efficiency, the authorities plan to accelerate divestment in strategic companies, including in the banking, telecom, and electricity sectors. Slovenia's business climate also ranks the worst among NM-8 countries owing to labor market rigidities, lengthy and cumbersome procedures for business registration, and difficulties in acquiring land for business and enforcing contracts. Measures to relax the regulatory environment are a high priority, and an all-in-one system for registration of individual entrepreneurs was already introduced in 2005. Other measures under consideration—such as extending the all-in-one system to corporations, and further reduction of regulatory barriers, particularly by strengthening judicial efficiency—could also help.

Slovenia has the lowest share of the private sector among NM-8, 2005



Source: EBRD Transition Report, 2005

Business Climate Indicators, 2005

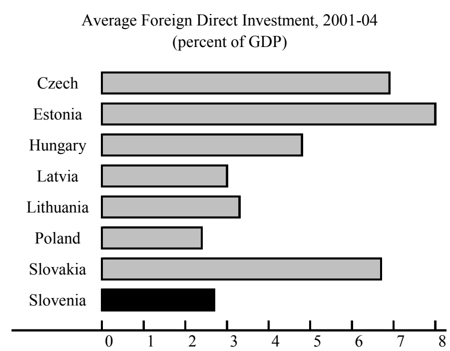
	Slovenia	Czech	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia
Starting a business								
Procedures (number)	13	3	6	6	7	8	10	9
Closing a business								
Recovery rate (cents on the dollar)	27.9	17.8	39.0	35.7	83.1	53.6	64.0	38.6
Enforcing contracts								
Procedures (number)	37	15	25	21	20	17	41	27
Time (days)	913	290	150	365	186	154	980	565
Registering property								
Time (days)	212	42	65	78	54	3	197	17

Source: World Bank.

[4] H. Jensen-J. Larsen (2005) The Nordic Labor Markets and the Concept of Flexicurity, Economic Policy Center Working Paper No. 20.

30. **The relatively slow growth in productivity suggests that Slovenia is not climbing up the technology ladder as fast as its regional peers.** While there is evidence of increasing specialization into high-tech sectors, export quality upgrading appears slower than in regional competitors. This could be a factor in Slovenia's difficulty in increasing export market shares. While noting that Slovenia's higher initial income level could partly explain its inability to grow at the pace of the other NM-8, the authorities acknowledged that the relatively low level of inward FDI may have limited the technological spillover effects. They also recognized that the efficiency of R&D spending is low when considering the number of patents and marketable research applications produced. It was therefore jointly seen that improving productivity growth would require more internal competition, further divestment of the state share in the economy, higher investment in research and development, innovation—including through a more fluid interaction between research centers and firms—and foreign direct investment to fully benefit from technological spillovers.

FDI flows to Slovenia have been low over the past few years compared to the region.



Source: World Economic Outlook, IMF.

IV. Staff Appraisal

31. **Slovenia's imminent entry into the euro area marks the culmination of a successful economic transformation since independence in 1991.** A skilled work force and open trade regime have encouraged the development of a manufacturing and service base that has generated solid economic growth. Inflation—after declining sharply in recent years—is low, public and net external debt have stayed at moderate levels, and interest rates are converging rapidly to euro area levels. The banking sector is sound. These achievements testify that years of prudent macroeconomic and incomes policies have paid off. A benign global economic environment should entrench these favorable developments in the near term.

32. **The task ahead is to translate these achievements into becoming a success within the euro area.** In recent years, the authorities' policies have been driven mainly by the goals of meeting the Maastricht criteria and a minimum stay in ERM2. To sustain income convergence in the future, more attention will now be needed on improving economic flexibility and long-term growth prospects. This will require policies that raise productivity, improve sustainability of public finances, and create an efficient business environment and a flexible labor market.

33. **Fiscal policy in the near term should be geared to containing the deficit to its 2005 level.** Interest rate convergence to the lower euro area interest rates provides monetary stimulus to an economy operating near capacity. Support to disinflation from incomes policy, which has been crucial is sustaining balanced growth in the past, is still uncertain as wage negotiations for 2006–07 have yet to be concluded. These factors and the loss of the exchange rate instrument put a premium on prudent fiscal policy. To contain the inflation

risks and counterbalance the monetary stimulus, a neutral fiscal stance is called for. This requires achieving expenditure savings to keep the fiscal deficit in 2006 to 1 percent of GDP, ½ percent of GDP below the budget.

34. **Over the medium term, fiscal policy will need to deal with the challenges of a rapidly aging population, while improving the flexibility and efficiency of public spending.** The authorities' commitment to achieving a structural balance over the medium term is commendable, but the target date of 2010 could be advanced and the consolidation made more front loaded than currently planned. This would both support balanced growth and help address long-term debt sustainability concerns, as the impending growth in age-related outlays provides a limited window of opportunity to create fiscal space. As regards tax reform, implementing the plans to reduce the steeply progressive income taxes should enhance incentives for more work and growth. These measures should be accompanied by expenditure reforms that address fiscal rigidities and deal with age-related spending pressures. Revision of the level and indexation mechanisms of the social benefits, parametric reform of the public pension system, and measures to boost private savings for old-age income are priorities in this regard. Together with better targeting and linking of social benefits to activation policies, these measures should help increase budgetary flexibility, incentives for work, and fiscal sustainability.

35. **While competitiveness appears adequate, challenges remain**. Market expectations are firmly anchored at the current level of the exchange rate for euro adoption, as was evident when short-term capital inflows surged earlier this year on account of the interest rate differential. Indicators of price competitiveness have been stable, studies on the equilibrium exchange rate do not point to misalignment, and export growth remains strong. Nevertheless, Slovenia trails other new EU member states in gaining export market shares, which could pose a challenge after Slovenia enters the euro zone.

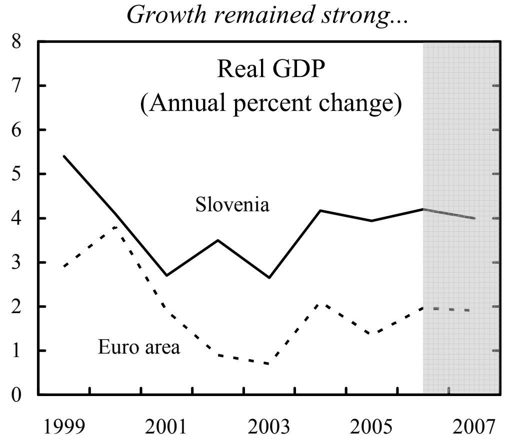
36. **To maintain competitiveness and ensure faster convergence, the authorities need to speed up the implementation of policies to boost productivity growth and increase labor flexibility and participation.** Slovenia's productivity growth and technological progress have lagged behind regional peers, and labor participation among older and younger workers is low. Slovenia also remains vulnerable to a persistent increase in unit labor costs. Together with one of the fastest aging population in Europe, these trends pose significant constraints on long-run growth. To address these challenges, Slovenia needs to redouble its efforts toward raising labor utilization and upgrading technology. To increase labor input, lower marginal tax rates, better targeting of social benefits and training, and reduced incentives to retire early are key. Reducing regulatory constraints that hinder the business environment and create labor market rigidities would help improve efficiency and promote FDI. Flexibility in labor markets would also be enhanced by lowering the costs of firing and hiring and establishing wage-setting mechanisms that allow distressed companies to opt out of minimum increases. Enhancing productivity growth will in addition require higher investment and a conducive environment for private-sector led growth, through privatization, simplified business regulations, and R&D promotion.

37. **Although the banking system remains sound, supervision should be enhanced to guard against market and credit risks.** Borrowers will face higher interest rates in the period ahead as euro-zone rates rise. This could translate into higher credit risk, particularly for those banks that have lent aggressively to riskier borrowers to gain market share. Although banks are expected to be resilient enough to withstand these shocks in the near term, their profitability is coming under increasing stress from competition, yield convergence, and loss of foreign exchange related income upon euro adoption. Supervisory scrutiny of credit assessment standards should be strengthened to ensure that the balance sheet transformation upon euro adoption does not lead to distress for some banks. The BoS has already taken steps to ensure adequate liquidity standards in the euro changeover process. These prudential measures should be complemented by strengthened coordination with foreign supervisors to limit contagion risks deriving from the regional concentration of funding. Surviving in this open, competitive, and rapidly changing international environment will require increasingly efficient and dynamic institutions, which calls for an increased role of the private sector in the banking system.

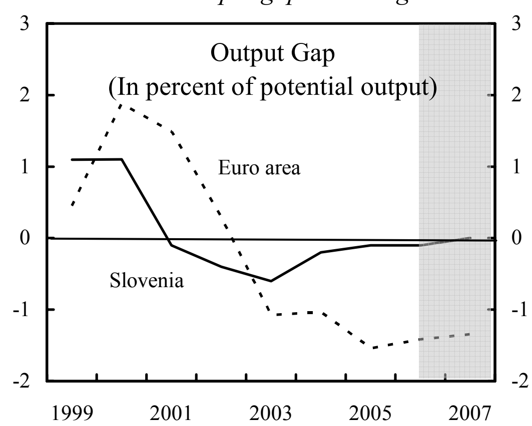
38. It is recommended that the Article IV consultation with Slovenia remain on the 12-month cycle.

Figure 1. Slovenia: Economic Indicators, 1999–2007

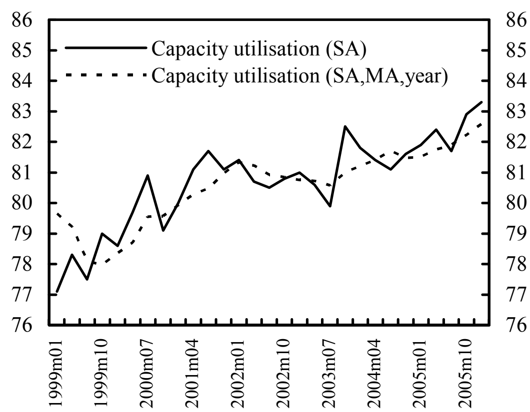
Growth remained strong...



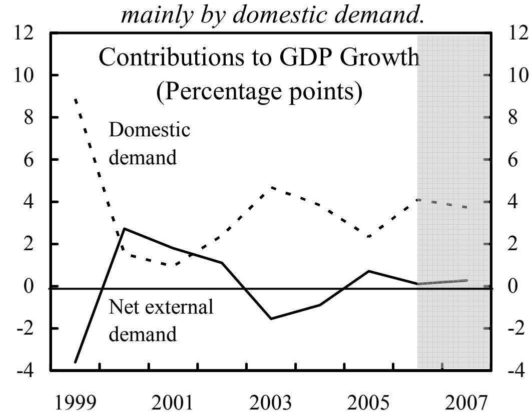
...but the output gap is closing...



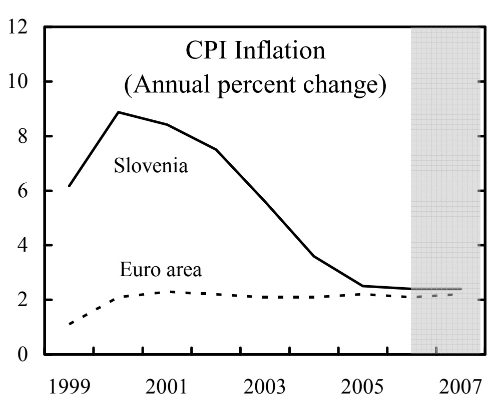
...and idle capacity has tightened.



Except in 2005, growth has been led mainly by domestic demand.

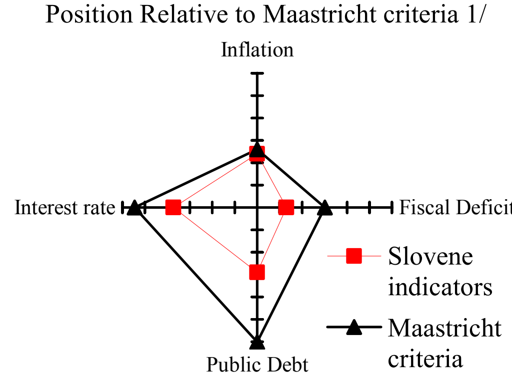


Inflation has declined to euro area levels...



...and the Maastricht criteria have been achieved.

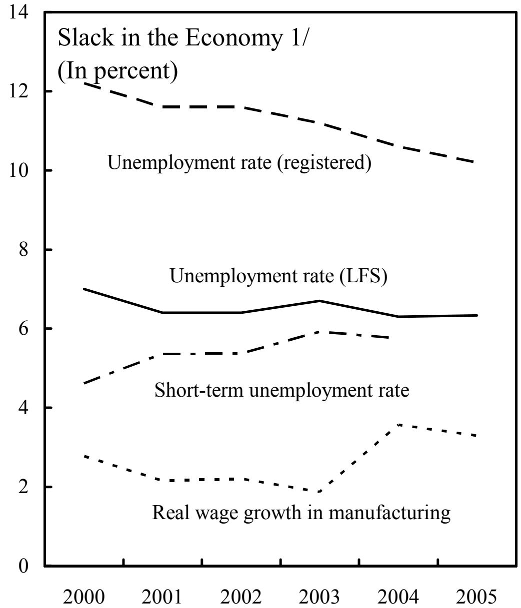
Position Relative to Maastricht criteria 1/



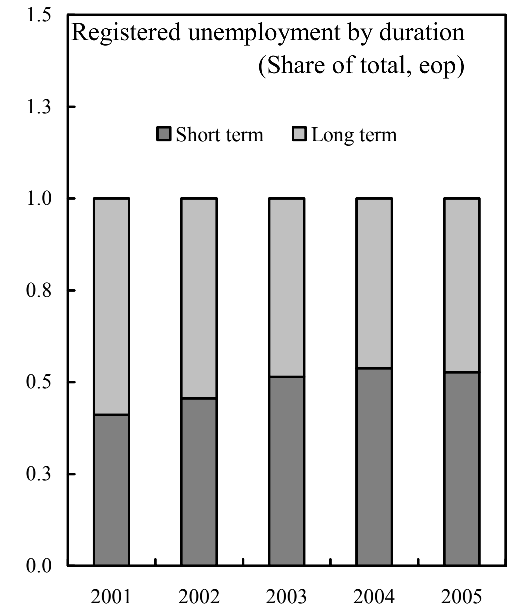
Sources: Bank of Slovenia; Ministry of Finance; Statistical Office; and IMF staff projections.
1/ Fiscal deficit and public debt as of end-2005; interest rate as of February 2006; inflation rate as of March 2006.

Figure 2. Slovenia: Labor Market Indicators, 2000-05
(y-o-y percent change, unless otherwise indicated)

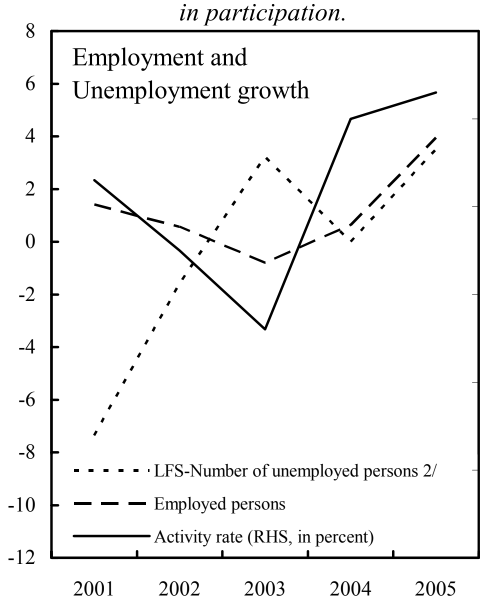
Unemployment has stabilized.



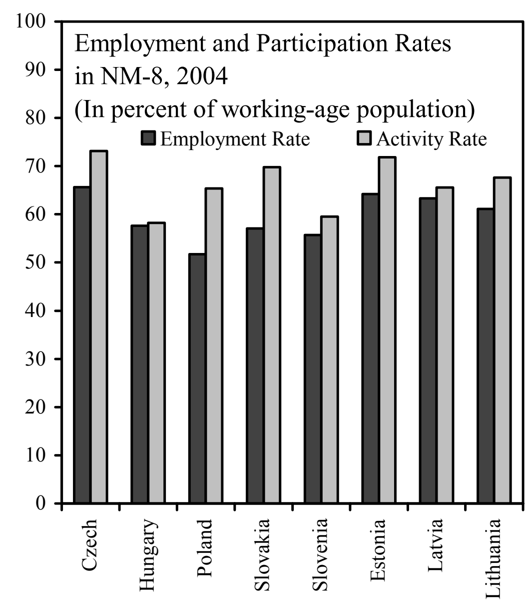
Long-term unemployment has declined.



Both employment and unemployment increased in 2005, reflecting a pick-up in participation.

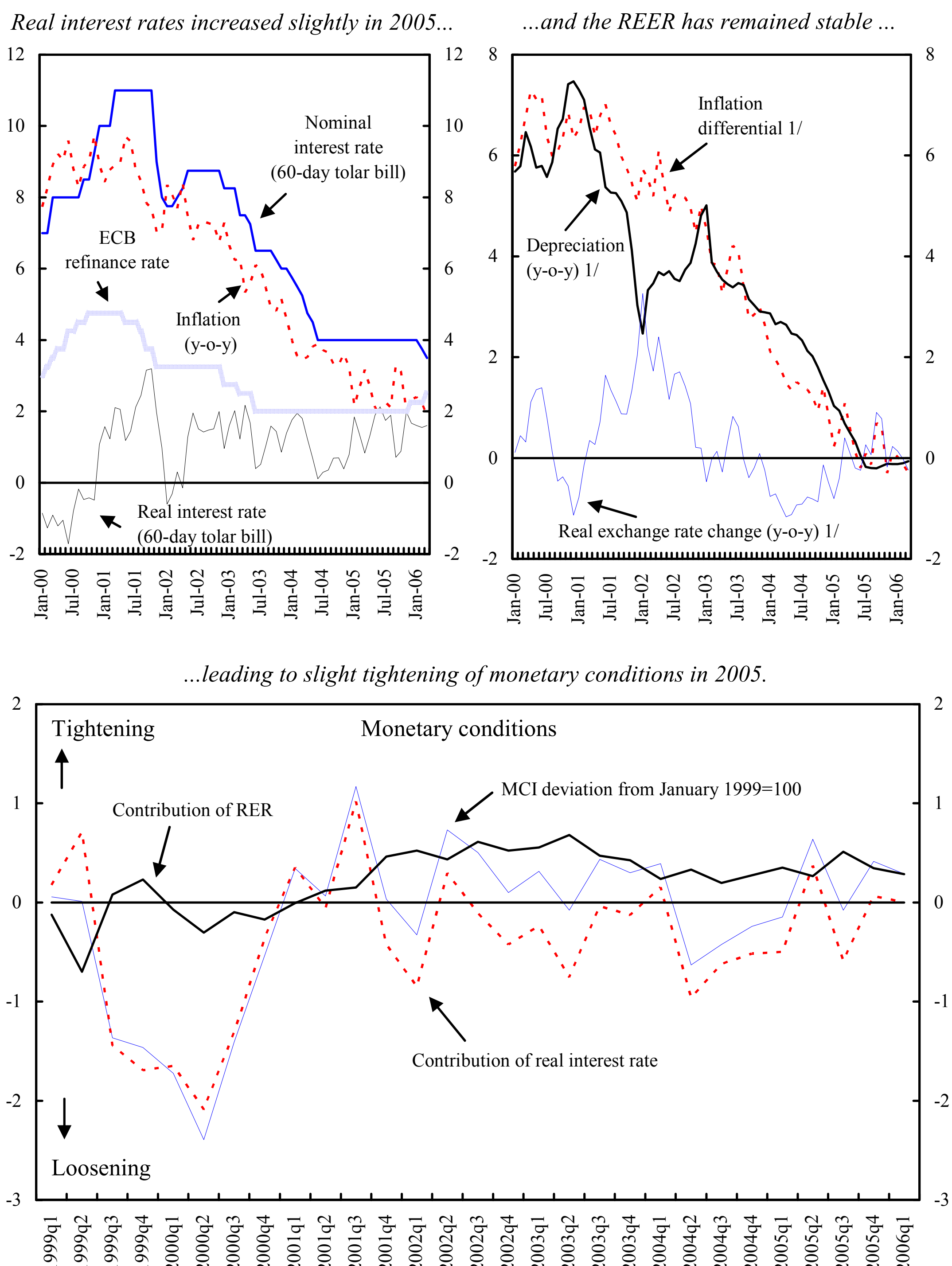


However, employment and participation rates remain among the lowest in NM-8.



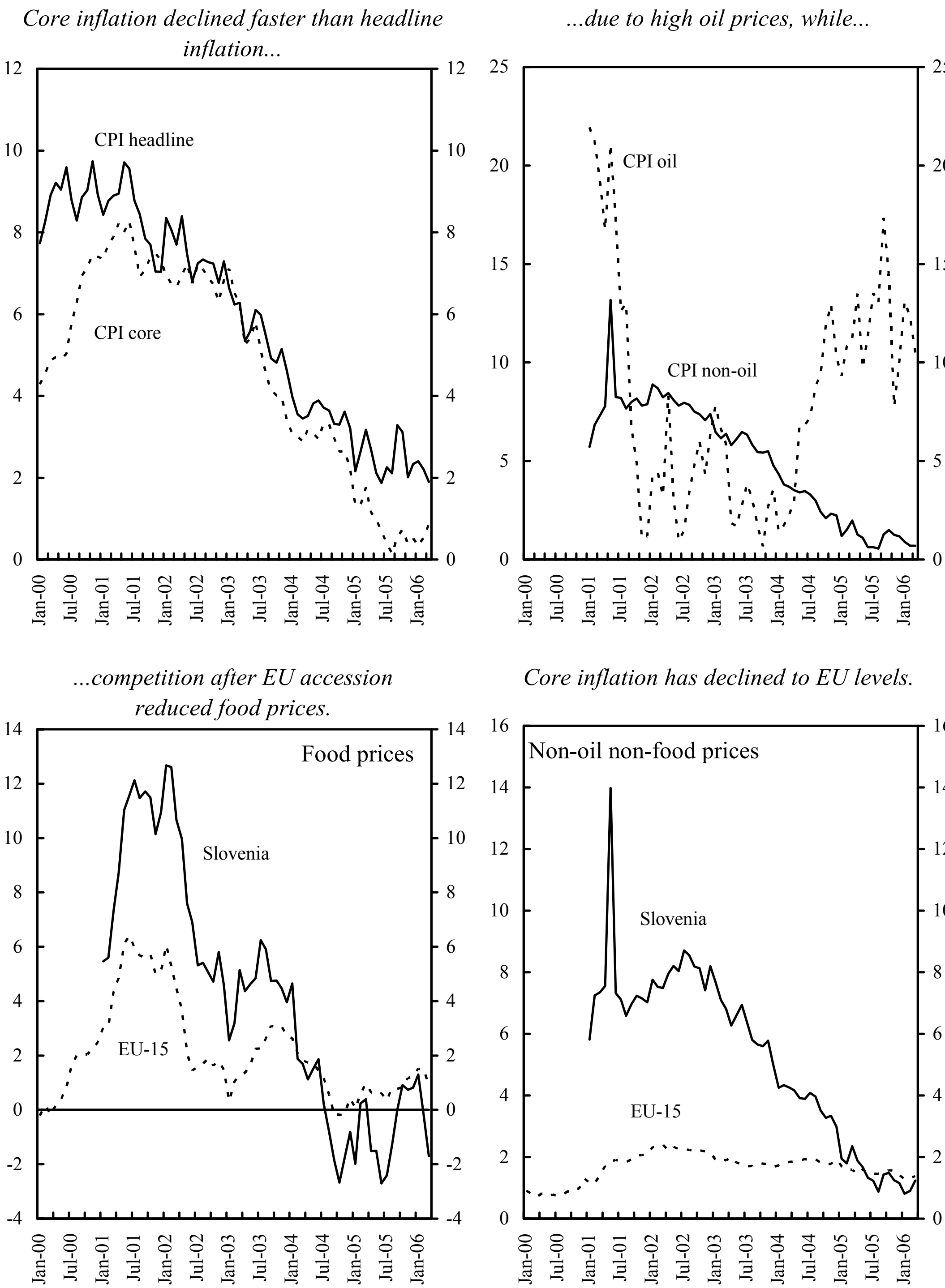
Sources: Employment Service of Slovenia; Monthly Bulletin, Bank of Slovenia; WEO; and IMF staff estimates.
1/ 2005 LFS data refers to third quarter.
2/ For 2005, data refer to the second quarter.

Figure 3. Slovenia: Monetary Conditions, 2000-06
(In percent)



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

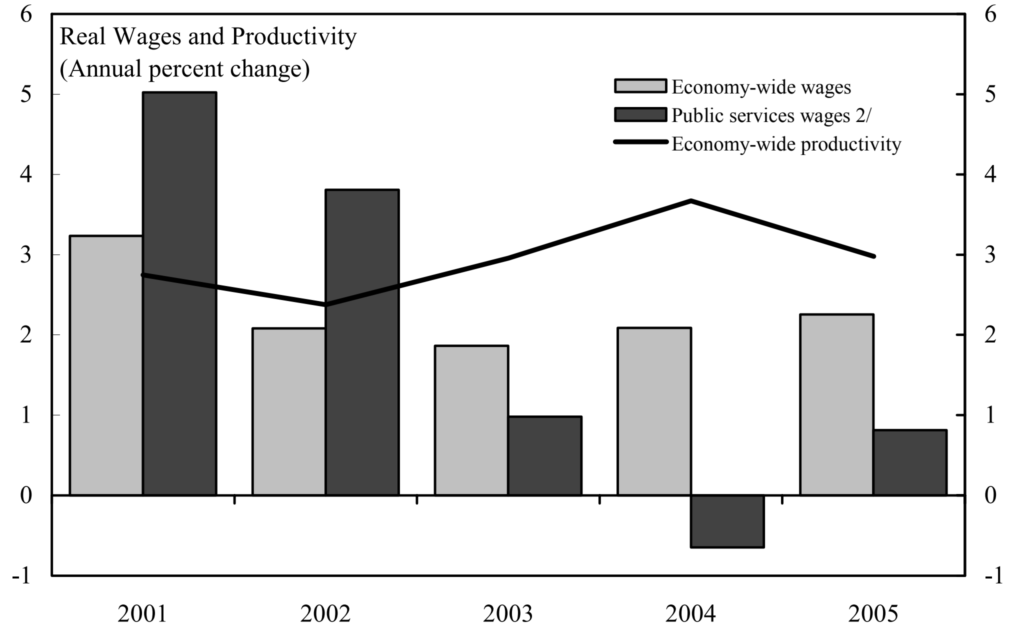
Figure 4. Slovenia: CPI Inflation and Components, 2000-06
(Year-on-year change, in percent)



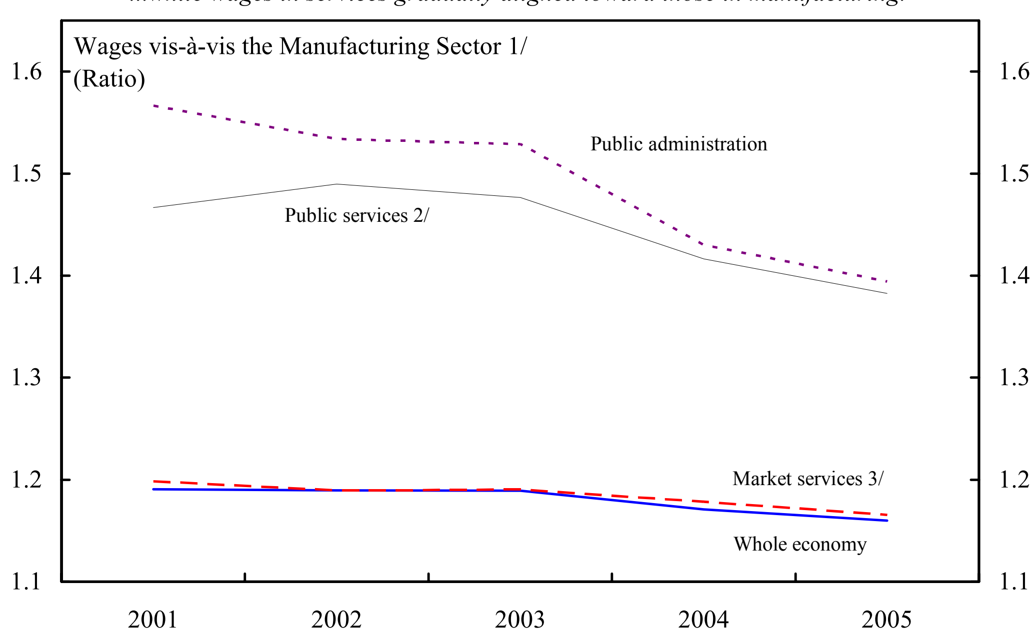
Sources: Statistical Office of the Republic of Slovenia; Eurostat; and IMF staff calculations.

Figure 5. Slovenia: Wages and Productivity, 1998-2005

Real wage increases have trailed productivity growth...



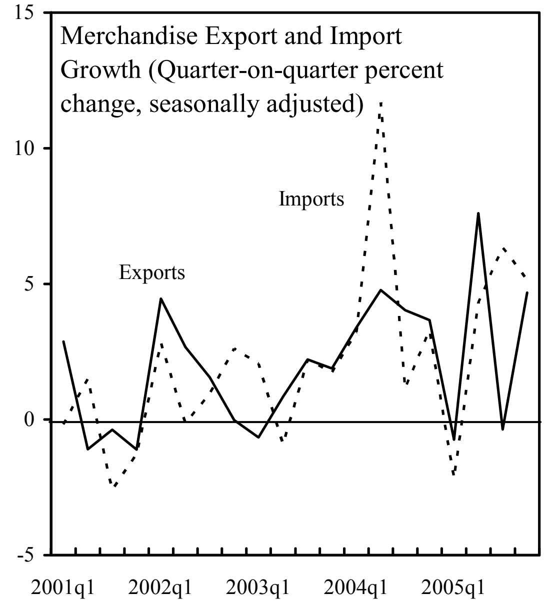
...while wages in services gradually aligned toward those in manufacturing.



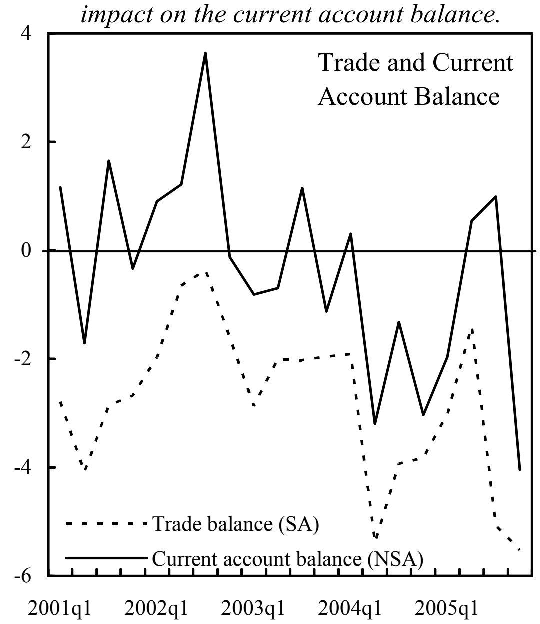
Source: Statistical Office of the Republic of Slovenia.
1/ Wages in respective sector divided by wages in the manufacturing sector.
2/ Includes public administration; education; health; and other social services.
3/ Includes distributive trade; hotels and restaurants; transport, storage, and communications;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

Figure 6. Slovenia: External Sector Developments, 2001-05
(In percent of GDP, unless otherwise indicated)

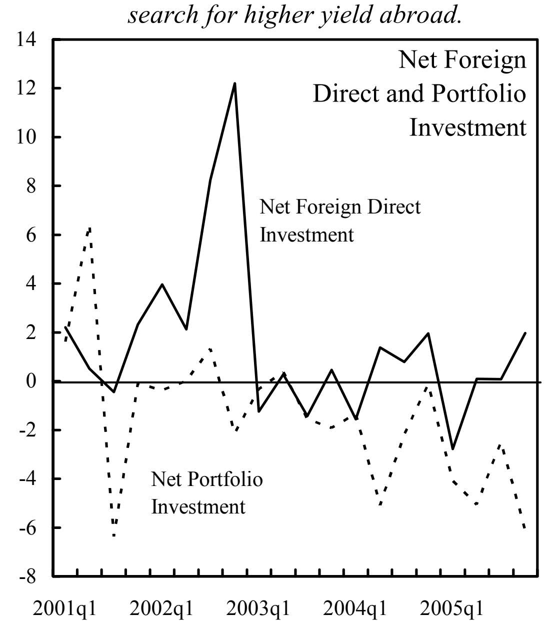
Both export and import growth picked-up,...



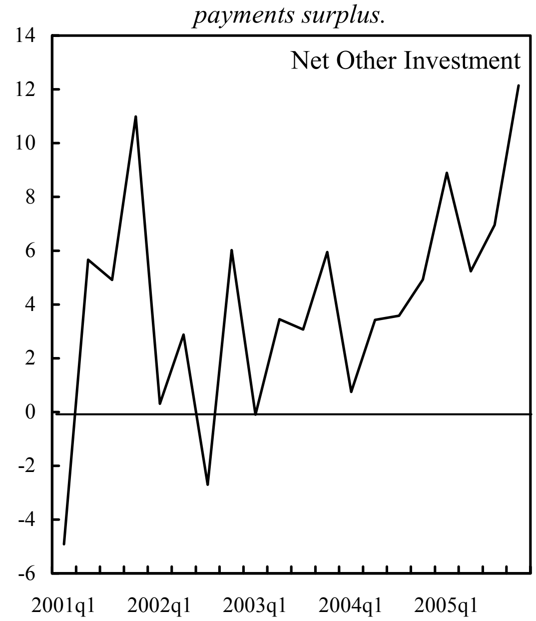
...worsening the trade balance, while increasing net services mitigated the impact on the current account balance.



Net FDI has remained low, while net outflows of portfolio investment reflect search for higher yield abroad.

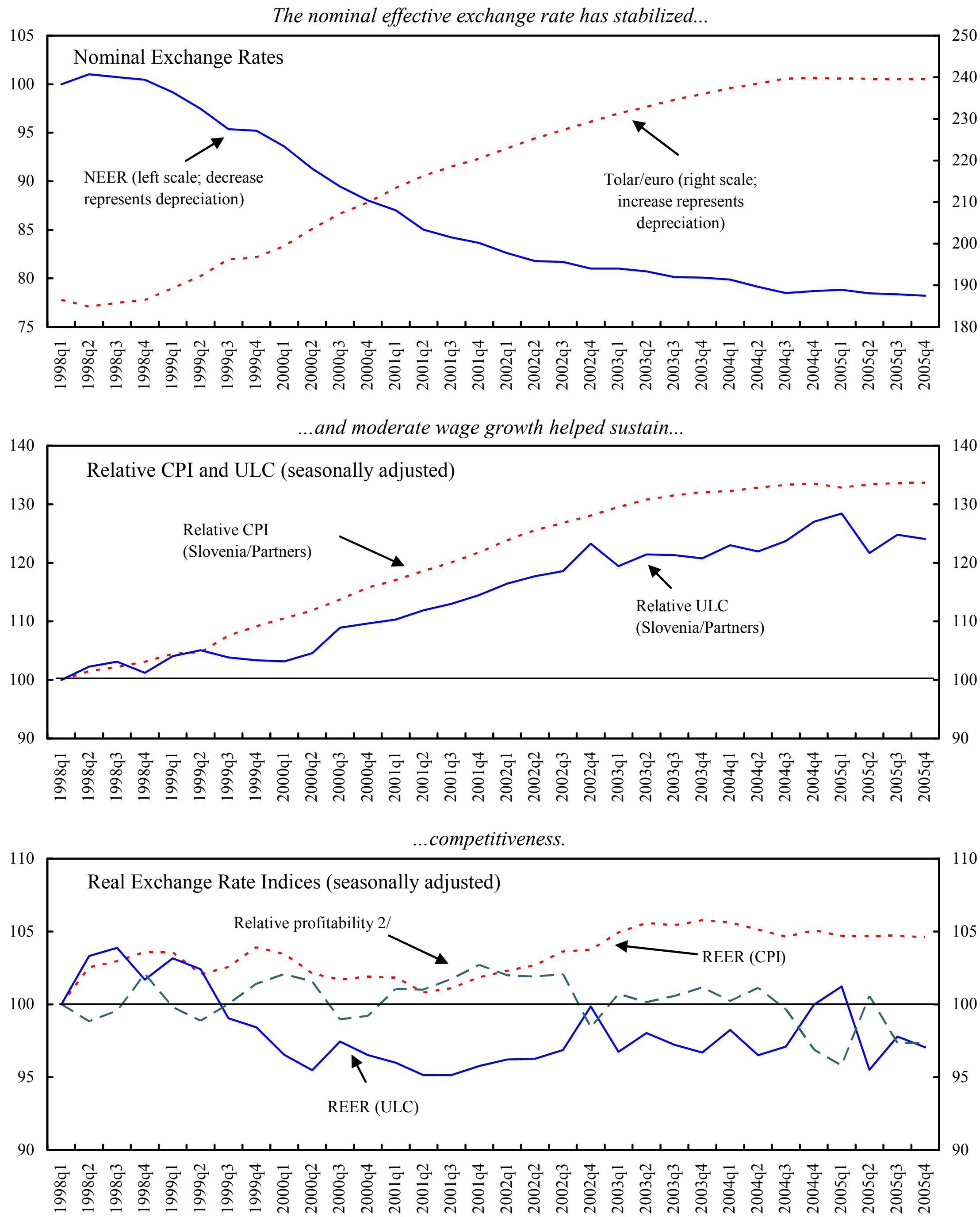


However rapid increase in foreign borrowing led to higher balance of payments surplus.



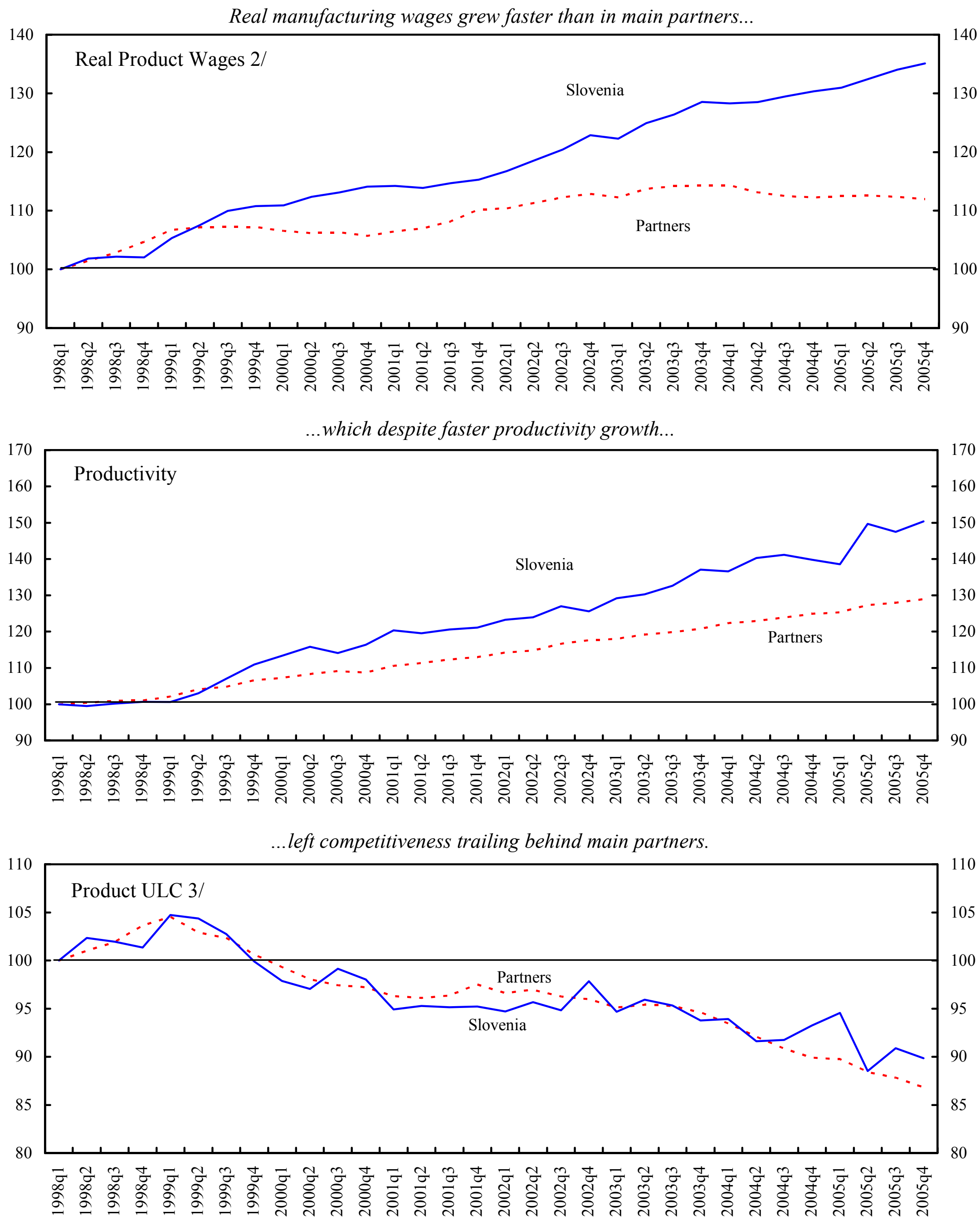
Sources: Monthly Bulletin, Bank of Slovenia; and IMF staff calculations.

Figure 7. Slovenia: Exchange Rate Indicators, 1998-2005
(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 trading partner countries relative to those in Slovenia, adjusted for manufacturing producer price inflation–a rough indicator of developments in profitability.

Figure 8. Slovenia: Wages, Productivity, and Product ULC in Manufacturing, 1998-2005
(1998q1=100) 1/

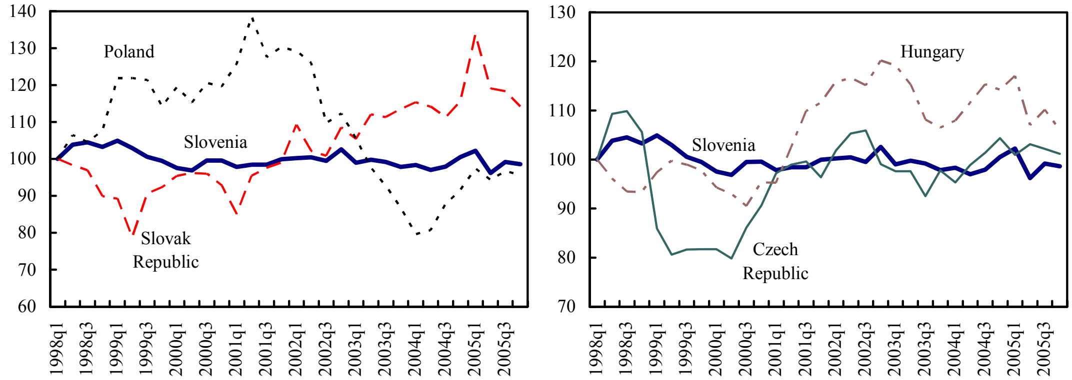


Sources: Statistical Office of the Republic of Slovenia; and IMF staff calculations.
1/ Seasonally adjusted. Trade weights based on 1998-2000 data for exports of goods. Partner countries comprise: Austria, Croatia, France, Germany, Italy, Poland, United Kingdom, and United States.
2/ Defined as the ratio of nominal wages to producer price index.
3/ Defined as the ratio of real product wages to productivity.

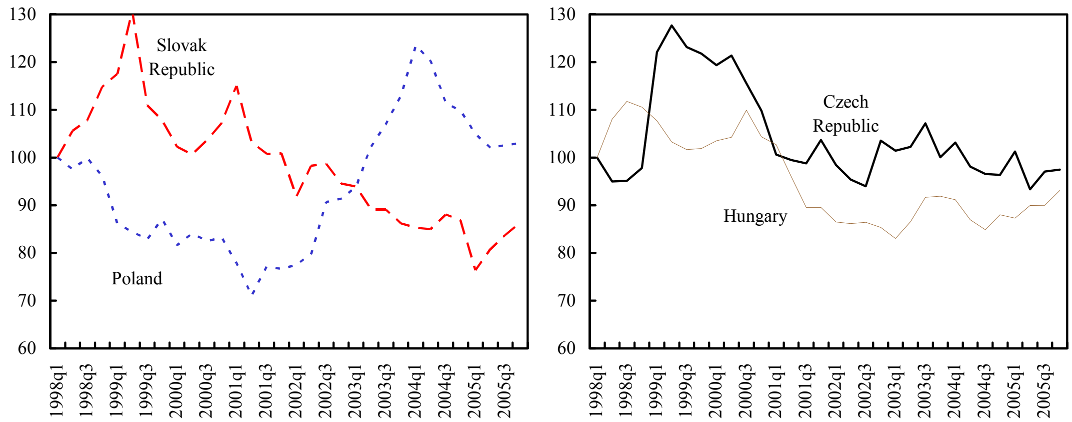
Figure 9. Slovenia: Competitiveness Indicators and Export Market Shares of Slovenia and New Member States (1998q1=100), 1998-2005

Unit labor costs in Slovenia have been stable compared to regional peers…

Unit Labor Costs 1/

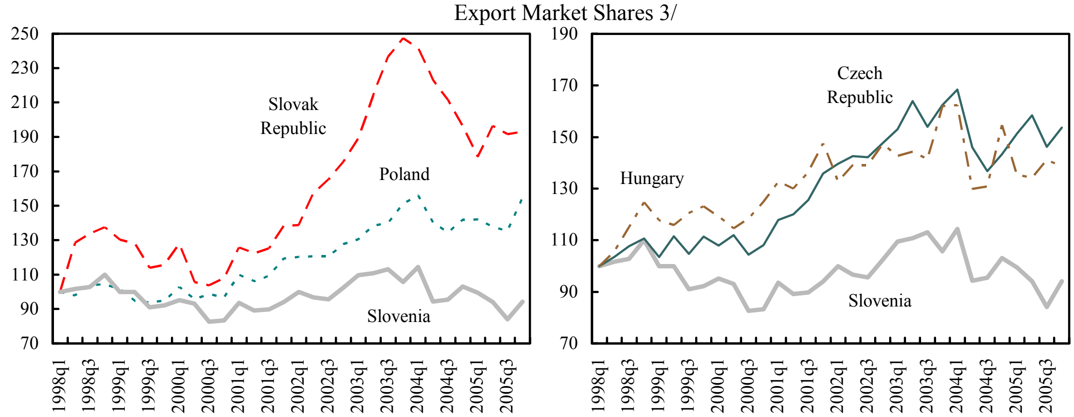


Bilateral REER of Slovenia vis-à-vis Selected New EU Member States 2/



…which however, are gaining market share faster in EU-15.

Export Market Shares 3/



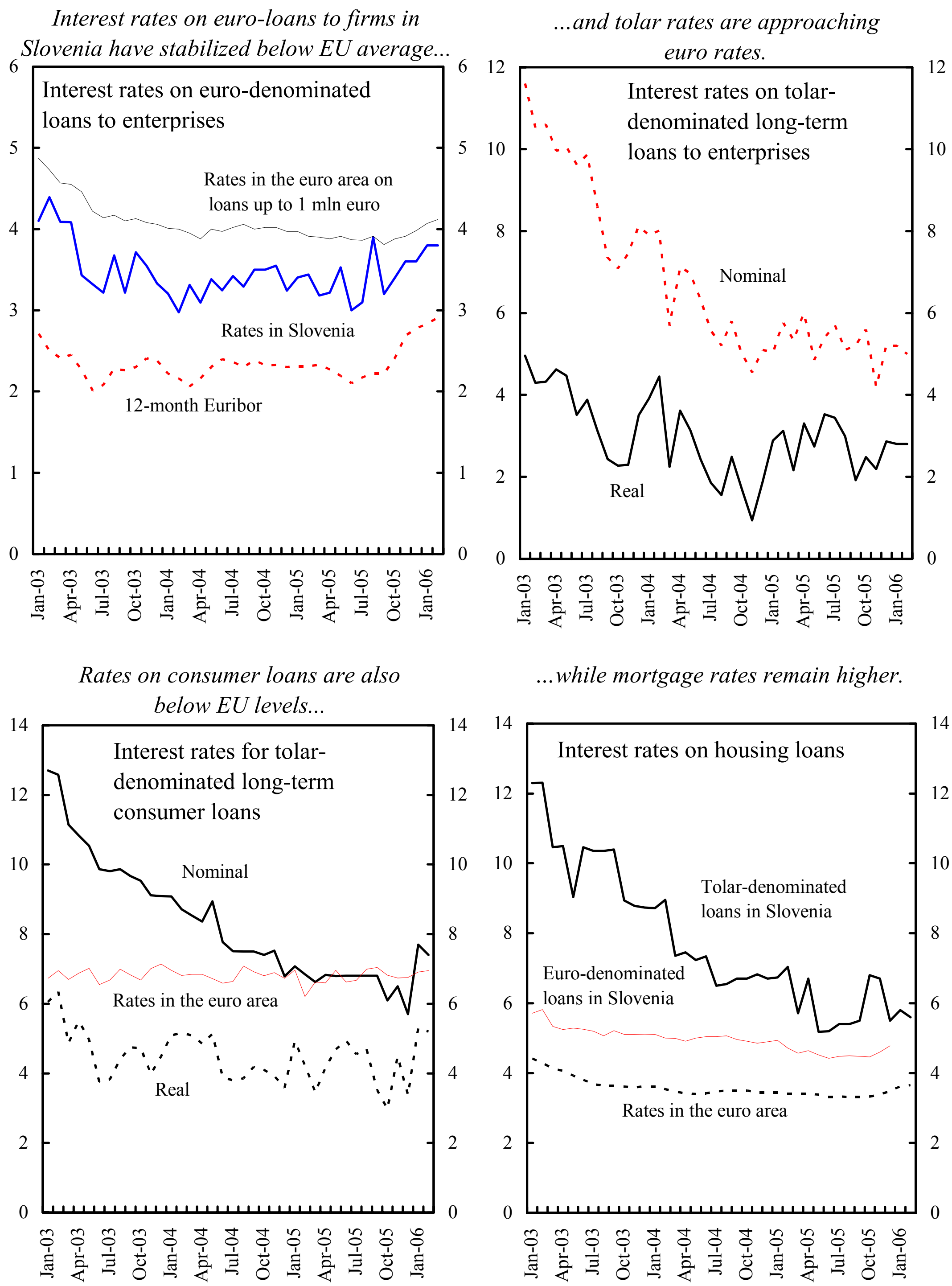
Sources: IMF Direction of Trade Statistics; and IMF staff calculations based on data from national authorities.

1/ ULC in manufacturing in euros.

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

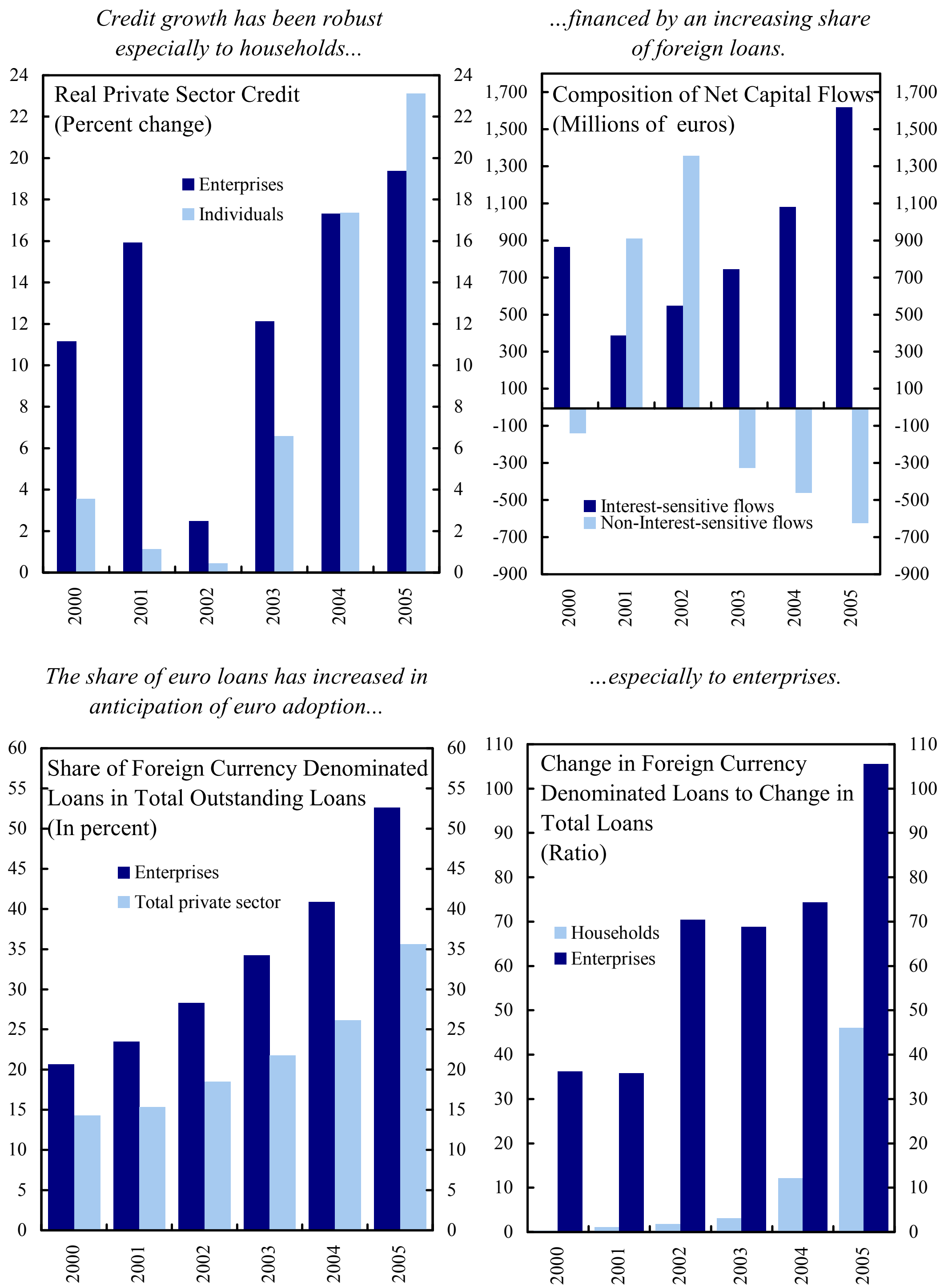
3/ Calculated as the share of nominal exports of each individual country in the combined nominal imports of the following countries: Austria, France, Germany, Italy, United Kingdom, and United States. The share declines for all countries in 2004 because of higher oil and commodity imports.

Figure 10. Slovenia: Bank Lending Rates on New Loans, 2003-06
(In percent)



Sources: Bank of Slovenia; Eurostat.

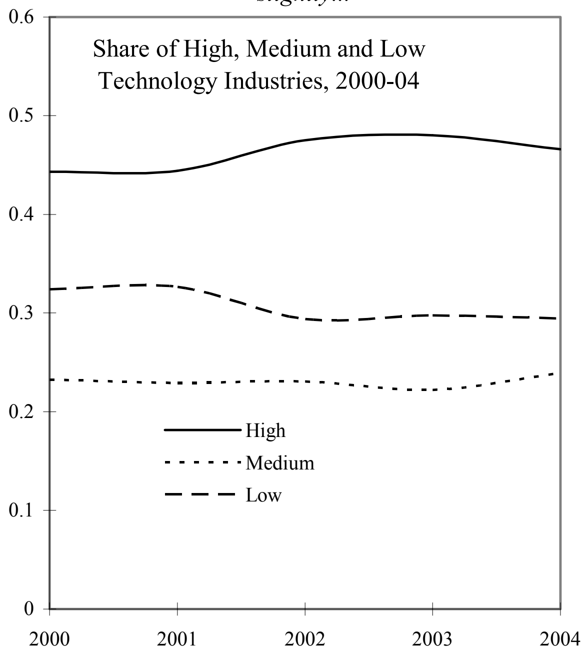
Figure 11. Slovenia: Credit Developments and Capital Inflows, 2000-05



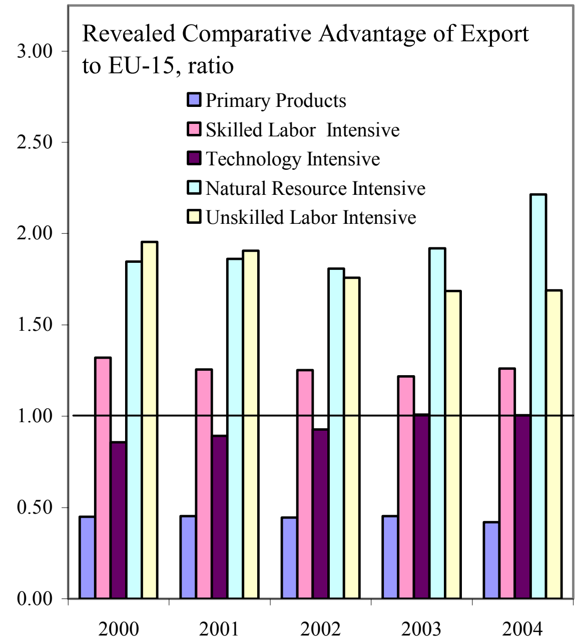
Source: Bank of Slovenia.

Figure 12. Slovenia: Trade Specialization and Quality Indicators, 2000-04
(In percent, unless otherwise noted) 1/

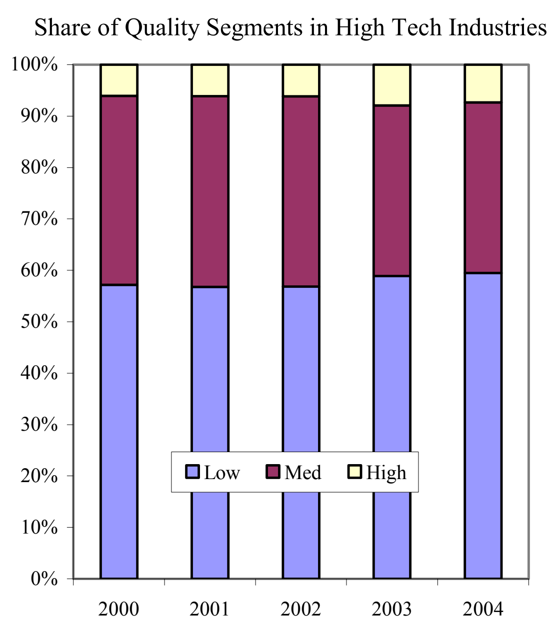
The technology content of exports has increased slightly...



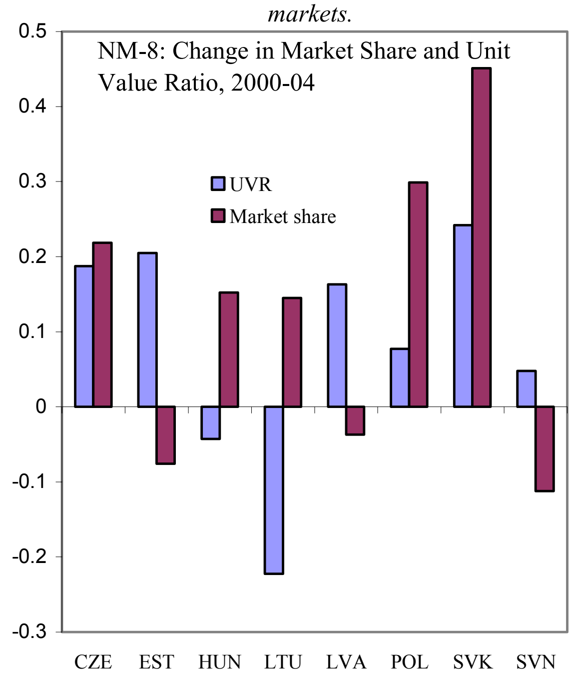
...and tech-intensive industries are gradually gaining market share.



But the quality content of high-tech exports has been stable...



...and Slovenia is lagging regional peers in EU markets.



Source: COMTRADE Database, Staff calculations.
1/ Underline data reflects exports to EU-15 market.

Table 1. Slovenia: Selected Economic Indicators, 2000-08

							Projections		
	2000	2001	2002	2003	2004	2005	2006	2007	2008
				(Annual percentage change)					
Real GDP	4.1	2.7	3.5	2.7	4.2	3.9	4.2	4.0	4.0
Domestic demand	1.4	0.9	2.4	4.7	3.8	2.3	4.2	3.7	3.7
Private consumption	0.7	2.3	1.3	3.4	3.1	3.2	3.6	3.8	3.8
Public consumption	2.6	3.9	3.2	1.6	2.9	3.0	2.8	2.9	2.1
Gross capital formation	2.2	-4.3	4.0	10.1	4.9	-0.5	6.2	4.1	4.3
Output gap (in percent of potential GDP)	1.1	-0.1	-0.4	-0.6	-0.2	-0.1	-0.1	0.0	0.1
Consumer prices									
Period average	8.9	8.4	7.5	5.6	3.6	2.5	2.5	2.3	2.3
End of period	8.9	7.0	7.2	4.6	3.2	2.3	2.6	2.3	2.2
Nominal wages									
All sectors	10.6	11.9	9.8	7.6	5.7	4.8	5.1	5.1	5.4
Manufacturing	11.9	10.8	10.4	7.6	7.3	6.1	...	...	...
Public services	11.2	13.9	8.7	6.6	2.9	3.5	...	...	...
Real wages									
All sectors	1.6	3.2	2.1	1.9	2.1	2.2	2.6	2.8	3.3
Manufacturing	2.8	2.2	2.7	1.9	3.6	3.4	...	...	...
Public services	2.1	5.5	1.1	1.0	-0.6	0.8	...	...	...
Employment									
Person basis (period average)	1.3	1.4	0.6	-0.8	0.6	0.6	...	…	…
National Accounts basis	0.8	0.5	1.5	-0.2	0.4	0.7	0.8 1/	0.6 1/	0.8 1/
Average unemployment rate (in percent, ILO definition)	7.0	6.4	6.4	6.7	6.3	6.6	6.6 1/	6.7 1/	6.7 1/
General government finances 2/				(In percent of GDP)					
Revenue	40.6	41.3	39.2 3/	40.9	41.3	42.3	42.5	42.2	41.5
Expenditure	41.9	42.7	42.1	42.2	42.7	43.4	44.0	43.4	42.5
General government balance	-1.3	-1.3	-3.0 3/	-1.3	-1.4	-1.1	-1.5	-1.2	-0.9
Structural general government budget balance	-1.7	-1.3	-2.6	-0.9	-1.1	-0.9	-1.3	-1.1	-0.8
State budget balance	-0.9	-1.0	-2.6 3/	-1.2	-1.3	-1.4	-1.4	-1.2	-0.9
General government debt	24.5	26.4	27.6	29.4	29.5	29.0	29.6	29.8	29.4
Money and credit				(Percentage change, end-period)					
Broad money	15.3	28.3	18.4	5.0	6.8	5.5	...	...	...
Base money	1.9	37.7	-4.3	4.1	2.2	6.5	...	...	...
Credit to the private sector	18.1	18.5	10.5	15.5	20.3	23.1	...	...	...
Interest rates (in percent)									
BoS Lombard rate	11.0	12.0	10.5	7.3	5.0	5.0	...	...	...
rate on 60-day BoS bills	10.0	8.0	8.3	6.0	4.0	4.0	...	...	...
Lending rates	14.6-18.4	15.8-12.3	11.6-14.7	9.0-10.3	7.9-8.5	6.2-7.8	...	...	...
Deposit rates 4/	10.9-13.2	8.5-11.0	7.6-8.6	4.8-4.9	3.2	3.1	...	...	...
Balance of payments				(In millions of euros, unless noted otherwise)					
Merchandise exports	9,574	10,454	11,082	11,414	12,933	14,517	16,155	17,789	19,425
Exports volume (percent change, volume)	13.2	7.0	6.4	4.4	12.8	8.5	9.1	8.1	7.8
Merchandise imports	-10,801	-11,139	-11,351	-11,960	-13,942	-15,551	-17,508	-19,241	-20,950
Imports volume (percent change, volume)	7.4	3.2	4.4	7.3	14.5	4.7	8.8	7.7	7.5
Terms of trade (percent change)	-3.0	2.1	2.0	0.5	-1.4	-2.7	-1.6	-0.1	0.0
Current account balance	-583	38	335	-91	-544	-301	-564	-647	-522
(in percent of GDP)	-2.8	0.2	1.4	-0.4	-2.1	-1.1	-2.0	-2.1	-1.6
Gross official reserves	3,436	4,984	6,781	6,879	6,542	6,895	7,627	8,578	9,277
(in months of imports of goods and nonfactor services)	3.3	4.7	6.2	5.9	4.9	4.6	4.5	4.6	4.6
External debt (percent of GDP, end-period)	46.1	47.7	48.5	53.3	58.4	71.4	76.8	82.5	86.9
External debt service	1,103	1,877	1,778	2,060	2,424	3,096	3,609	4,113	4,589
(in percent of exports of goods and nonfactor services)	9.5	14.9	13.1	14.8	15.4	17.4	18.4	19.2	19.7
Exchange rate									
Tolars per U.S. dollar (end-period)	227.4	251.0	221.1	206.7	192.1	192.5	…	…	…
Tolars per euro (end-period)	211.5	221.4	230.3	236.7	239.7	239.6	…	…	…
Nominal effective exchange rate (1998r1=100, period average)	90.6	85.0	81.8	80.5	79.1	78.5	…	…	…
Real effective exchange rate									
(CPI based, 1998r1=100, period average)	102.3	101.4	103.1	105.4	105.1	104.7	…	…	…
(ULC based, 1998r1=100, period average)	96.5	95.5	97.3	97.2	98.0	97.9	…	…	…

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

1/ For 2006-08, Spring 2006 forecasts of the Slovene Insitute of Macroeconomic Analysis and developments.
2/ Revenue and expenditure exclude social security contributions paid for government employees.
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/ For deposits with maturity between 31 days and 1 year.

Table 2. Slovenia: Summary of General Government Operations, 2003-08 1/

	2003	2004	2005 Suppl. Budget May 2005	2005 Preliminary	2006 Budget	2007 Budget	2008 Projection
			(In billions of tolars)				
Total revenues	**2,376**	**2,584**	**2,799**	**2,767**	**2,947**	**3,113**	**3,266**
Tax revenues	2,189	2,348	2,484	2,506	2,635	2,829	2,961
Personal income tax	353	383	388	395	411	448	479
Corporate income tax	107	124	146	142	165	190	211
Social security contributions	742	801	850	853	902	962	1,022
Taxes on payroll and workforce	107	118	123	126	106	87	48
Domestic taxes on goods and services	815	857	927	938	994	1,083	1,144
VAT	526	539	589	608	645	714	756
Excise taxes	198	218	238	230	243	262	276
Other	91	100	101	100	105	107	112
Other taxes	70	66	49	51	57	60	57
Nontax revenues	149	162	173	152	168	157	159
Of which, interest receipts	15	11	5	10	5	5	5
Capital revenues and grants	29	23	18	29	26	17	16
Transfers from extrabudgetary funds	8	8	8	8	11	11	11
Receipts from the EU budget	…	44	116	72	108	98	118
Total expenditures	**2,454**	**2,670**	**2,891**	**2,839**	**3,051**	**3,204**	**3,338**
Wages and personnel expenditures	542	589	627	614	651	675	707
Direct budget users	196	205	217	217	225	232	240
Other government institutions	347	384	410	397	427	443	466
Premium for supplementary pension insurance	...	13	10	10	11	11	12
Expenditure on goods and services	430	430	465	454	488	525	531
Interest payments	93	92	89	89	84	86	88
Reserves	19	12	15	13	18	25	29
Transfers to individuals and households	986	1,053	1,105	1,109	1,162	1,223	1,290
Of which: Pensions	640	678	716	714	759	806	858
Subsidies	69	78	85	91	100	105	110
Other current transfers	88	118	145	141	154	158	165
Capital expenditures and transfers	233	244	276	248	306	308	310
Acquisition of capital assets	142	151	168	156	204	192	194
Capital transfers	91	93	108	92	102	115	116
Transfers to the EU budget	...	41	73	68	75	87	97
General government balance	**-78**	**-85**	**-92**	**-72**	**-104**	**-91**	**-73**
Primary Balance	**-1**	**-4**	**-8**	**7**	**-26**	**-10**	**11**
			(In percent of GDP)				
Total revenues	**40.9**	**41.3**	**42.5**	**42.3**	**42.5**	**42.2**	**41.5**
Tax revenues	37.7	37.6	37.7	38.3	38.0	38.3	37.7
Of which:							
Personal income tax	6.1	6.1	5.9	6.0	5.9	6.1	6.1
Corporate income tax	1.8	2.0	2.2	2.2	2.4	2.6	2.7
Social security contributions	12.8	12.8	12.9	13.0	13.0	13.0	13.0
Taxes on payroll and workforce	1.8	1.9	1.9	1.9	1.5	1.2	0.6
Domestic taxes on goods and services	14.0	13.7	14.1	14.3	14.3	14.7	14.6
Receipts from the EU budget		0.7	1.8	1.1	1.6	1.3	1.5
Total expenditures	**42.2**	**42.7**	**43.9**	**43.4**	**44.0**	**43.4**	**42.5**
Current expenditures and transfers	38.2	38.1	38.6	38.5	38.5	38.1	37.3
Wages and personnel expenditures	9.3	9.4	9.5	9.4	9.4	9.2	9.0
Expenditure on goods and services	7.4	6.9	7.1	6.9	7.0	7.1	6.8
Transfers to individuals and households	17.0	16.9	16.8	16.9	16.8	16.6	16.4
Of which: Pensions	11.0	10.8	10.9	10.9	10.9	10.9	10.9
Capital expenditures and transfers	4.0	3.9	4.2	3.8	4.4	4.2	3.9
Transfers to the EU budget	...	0.7	1.1	1.0	1.1	1.2	1.2
General government balance	**-1.3**	**-1.4**	**-1.4**	**-1.1**	**-1.5**	**-1.2**	**-0.9**
Primary Balance	**0.0**	**-0.1**	**-0.1**	**0.1**	**-0.4**	**-0.1**	**0.1**
Memorandum items:							
General government balance (ESA 95)	-2.0	-2.0	-1.8	-1.7	-1.7	-1.4	-1.0
Structural budget balance	-0.9	-1.1	-0.9	-0.9	-1.3	-1.1	-0.8
Structural primary balance	0.4	0.2	0.3	0.3	-0.2	0.0	0.2
General government debt	29.4	29.5	30.7	29.0	29.6	29.8	29.4
Primary expenditures	40.6	41.2	42.5	42.0	42.8	42.3	41.3
Nominal GDP (in billions of tolars)	5,814	6,251	6,591	6,548	6,936	7,380	7,862

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

1/ Based on GSF 1986, unless otherwise indicated.

Table 3. Slovenia: Monetary Survey, 2000-05

	2000	2001	2002	2003	2004	2005
	(In billions of tolars; end-of-period)					
Net foreign assets	811.2	1,225.7	1,461.6	1,264.6	938.3	477.3
Assets	1,187.1	1,688.1	2,079.5	2,133.1	2,127.9	2,553.8
Bank of Slovenia	739.9	1,122.5	1,580.3	1,644.7	1,586.1	1,671.7
Deposit money banks	447.2	565.5	499.3	488.4	541.8	882.0
Liabilities	375.9	462.4	617.9	868.5	1189.7	2076.5
Bank of Slovenia	0.1	0.3	0.0	0.0	1.7	2.1
Deposit money banks	375.8	462.1	617.9	868.5	1,188.0	2,074.4
Net domestic assets	1,596.4	1,853.2	2,171.0	2,515.5	3,097.8	3,781.0
Claims on government (net)	361.5	423.3	443.1	513.7	582.8	751.2
Credit	441.1	491.8	614.3	664.9	774.5	834.8
Bank of Slovenia on central government	17.8	9.8	9.2	27.0	29.7	21.8
Banks on general government	423.3	482.0	605.1	638.0	744.8	813.1
Deposits	79.5	68.6	171.2	151.2	191.8	83.6
BoS on general government	39.1	60.0	164.8	146.7	188.7	81.4
Banks on general government	40.4	8.5	6.4	4.5	3.1	2.3
Claims on enterprises	1,078.0	1,328.0	1,481.3	1,734.8	2,080.7	2,540.4
Loans	1000.7	1241.6	1365.2	1605.7	1938.6	2369.5
Securities	77.3	86.3	116.1	129.1	142.1	170.9
Claims on individuals	495.0	535.8	577.4	643.8	779.8	979.8
Claims on nonbanking financial institutions	51.6	59.1	81.1	106.7	128.0	210.6
Loans	38.0	43.6	61.0	83.0	103.7	174.5
Securities	13.5	15.4	20.1	23.7	24.3	36.1
Claims on National Bank of Yugoslavia	37.0	38.3	31.9	24.6	16.7	16.7
Securities	79.2	113.6	184.2	221.4	205.7	197.8
Securities in Tolar	65.9	96.1	181.1	217.7	203.6	195.2
Securities in Fx	13.3	17.5	3.1	3.7	2.1	2.6
Restricted deposits	-9.0	-9.9	-7.6	-12.1	-7.7	8.6
Other items (net)	-496.8	-634.8	-620.5	-717.5	-688.2	-924.2
Broad money (M3)	2,370.6	3,040.6	3,600.7	3,780.1	4,036.0	4,258.3
Currency	119.8	142.1	143.1	156.0	167.9	187.2
Demand deposits	430.0	505.9	577.0	641.1	851.0	964.1
Bank of Slovenia	8.4	15.6	12.6	14.1	12.8	9.3
Deposit money banks	421.6	490.3	564.5	627.0	838.1	954.8
Quasi money	1,820.9	2,392.5	2,880.6	2,982.9	3,017.1	3,106.9
Tolar deposits	1,002.0	1,296.4	1,545.3	1,591.2	1,472.0	1,614.1
Foreign currency deposits	739.7	962.6	1,020.8	1,064.4	1,214.7	1,295.0
Tolar securities	65.9	96.1	181.1	217.7	203.6	195.2
Foreign currency securities	13.3	17.5	3.1	3.7	2.1	2.6
Government time deposits as BOS	0.0	19.9	130.3	105.8	124.7	0.0
Memorandum item:						
Base Money	212.2	292.3	279.7	291.2	297.5	316.9
	(Percent change; end-of-period)					
Base money	1.9	37.7	-4.3	4.1	2.2	6.5
M1 (currency + demand deposits)	8.3	17.9	11.1	10.7	27.8	13.0
M2 (M1 + tolar deposits)	9.7	27.4	25.1	5.2	4.0	5.0
M3 (M2 + foreign currency deposits)	15.3	28.3	18.4	5.0	6.8	5.5
	(Percentage points)					
Contributions to M3 growth						
Net foreign assets	7.0	17.5	7.8	-5.5	-8.6	-11.4
Net domestic assets	10.1	10.8	10.5	9.6	15.4	16.9
	(Percent)					
Share of foreign currency-denominated outstanding credit						
Private sector	77.0	85.6	83.6	88.3	89.5	89.7
Enterprises and nonprofit institutions	75.9	84.7	82.7	87.4	87.2	82.6
Individuals	1.1	1.0	0.9	0.9	2.3	7.1
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 4. Slovenia: Balance of Payments, 2000-10

(In millions of euros, unless otherwise noted)

						Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Current account	-583	38	335	-91	-544	-301	-564	-647	-522	-427	-314
Trade balance	-1,227	-684	-269	-546	-1,009	-1,034	-1,354	-1,452	-1,525	-1,588	-1,665
Exports f.o.b.	9,574	10,454	11,082	11,414	12,933	14,517	16,155	17,789	19,425	21,212	23,145
Imports f.o.b.	-10,801	-11,139	-11,351	-11,960	-13,942	-15,551	-17,508	-19,241	-20,950	-22,800	-24,810
Services	489	536	617	538	686	898	1,042	1,180	1,361	1,556	1,761
Exports	2,052	2,178	2,440	2,469	2,782	3,224	3,687	4,128	4,645	5,196	5,796
Imports	-1,562	-1,642	-1,824	-1,930	-2,096	-2,326	-2,645	-2,949	-3,284	-3,640	-4,035
Income, net	29	43	-154	-178	-250	-226	-314	-433	-463	-411	-421
Current transfers, net	126	144	142	94	29	61	62	58	105	17	11
Capital account	4	-4	-164	-166	-105	-128	-121	-123	-123	-123	-124
Financial account, excl. reserves	724	1,295	1,904	418	487	1,023	1,417	1,721	1,337	1,038	730
Direct investment, net	77	251	1,538	-118	221	-27	74	460	245	181	116
In Slovenia	149	412	1,700	300	662	427	550	960	770	732	695
Abroad	-72	-161	-162	-418	-442	-453	-476	-500	-525	-551	-579
Portfolio investment, net	185	80	-69	-223	-575	-1218	-470	-384	-405	-468	-513
Other investment, net	462	964	435	759	843	2268	1813	1645	1497	1325	1127
Government	86	-74	-95	-66	5	-27	-141	-42	-46	-424	-514
Bank of Slovenia	-6	-7	-6	0	-8	-2	-2	-2	-2	-2	-2
Commercial banks	39	-38	681	1,055	1,070	2,651	2,217	2,020	1,845	1,672	1,485
Nonbank private sector	343	1,083	-145	-230	-223	-354	-261	-332	-300	79	158
Loans	563	534	495	461	637	195	190	164	133	92	47
Household currency and deposits	-13	797	-593	-607	-756	-600	-510	-433	-368	-313	-266
Trade credits	-195	-249	-40	-57	-28	12	-94	-121	-133	-146	-159
Other	-12	1	-8	-29	-76	38	152	58	69	446	536
Net errors and omissions	41	110	-190	103	-94	-405	0	0	0	0	0
Overall balance	187	1,439	1,885	264	-256	189	732	952	692	488	292
Change in official reserves (-: increase)	-187	-1,439	-1,885	-264	256	-189	-732	-952	-692	-488	-292
Memorandum items:											
Current account balance (percent of GDP)	-2.8	0.2	1.4	-0.4	-2.1	-1.1	-2.0	-2.1	-1.6	-1.2	-0.8
Export of goods (percent change in value)	18.2	9.2	6.0	3.0	13.3	11.9	11.6	10.1	9.2	9.2	9.1
Import of goods (percent change in value)	16.6	3.1	1.9	5.5	16.6	11.0	13.2	9.9	8.9	8.8	8.8
Terms of trade (percent change)	-3.0	2.1	2.0	0.5	-1.4	-2.7	-1.6	-0.1	0.0	0.1	0.1
Gross external debt	9,491	10,403	11,484	13,259	15,278	19,511	22,747	25,922	28,927	31,259	33,502
(percent of GDP)	46.1	47.7	48.5	53.3	58.4	71.4	78.2	83.8	88.0	89.4	90.1
Net external debt (liabilities - assets) 1/	1613.9	468.2	1770.1	2408.8	3,659	5,565	5,019	4,893	4,745	4,318	4227.2
(percent of GDP)	7.8	2.1	7.5	9.7	14.0	20.4	17.3	15.8	14.4	12.3	11.4
Debt service costs (in millions of euros)	1,103	1,877	1,778	2,060	2,424	3,096	3,609	4,113	4,589	4,960	5,315
(percent of exports of goods and services)	9.5	14.9	13.1	14.8	15.4	17.4	18.4	19.2	19.7	19.5	19.2
Gross official reserves (in millions of euros) 2/	3,436	4,984	6,781	6,879	6,542	6,895	7,627	8,578	9,277	9,765	9,569
(in months of imports of goods and services)	3.3	4.7	6.2	5.9	4.9	4.6	4.5	4.6	4.6	4.4	4.0

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 5. Slovenia: Vulnerability Indicators, 2000-06
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	Date
Financial Indicators (end of period)								
General government debt	27.4	28.1	29.5	29.4	29.5	29.0	29.6	*December-05*
Domestic credit	48.2	50.5	51.3	53.7	59.7	69.4	67.5	*February-06*
Private sector credit (percent change) 1/	18.1	18.5	10.5	15.5	20.3	23.2	23.9	*February-06*
Broad money (percent change)	15.3	28.3	18.4	5.0	6.8	5.5	5.9	*February-06*
Foreign exchange deposits (percent of broad money)	29.7	30.6	27.5	27.2	28.6	28.6	28.9	*February-06*
Financial Market Indicators (end of period)								
Stock market index	1,808	2,152	3,340	3,614	4,909	4,630	4,439	*March-06*
Stock market capitalization	16.6	17.9	23.0	23.0	27.3	24.5	23.3	*March-06*
Foreign currency debt rating (S&P, long-term)	A	A	A	A+	AA-	AA-	AA-	*December-05*
Spread of benchmark bond (basis points) 2/	88	55	45	29	17	16	14	*March-06*
External Indicators								
Exports of goods and NFS 3/ (percent change, value in euros)	17.8	8.7	7.0	2.7	13.2	12.9	11.8	*Projection-06*
Imports of goods and NFS (percent change, value in euros)	15.5	3.4	3.1	5.4	15.5	11.5	12.7	*Projection-06*
Terms of trade (percent change, 12-month basis)	-3.0	2.1	2.0	0.5	-1.4	-2.7	-1.6	*January-00*
Current account balance	-2.8	0.2	1.4	-0.4	-2.1	-1.1	-2.0	*Projection-06*
Capital and financial account balance, excl. reserve assets	3.5	5.9	7.4	1.0	1.5	3.3	4.5	*Projection-06*
Of which : Inward portfolio investment	1.2	0.9	0.1	-0.1	0.1	0.1	1.1	*Projection-06*
Inward foreign direct investment	0.7	1.9	7.2	1.2	2.5	1.6	1.9	*Projection-06*
Other investment, net	2.2	4.4	1.8	3.1	3.2	8.3	6.2	*Projection-06*
Net foreign assets of commercial banks (in billions of euros)	0.3	0.5	-0.5	-1.6	-2.7	-5.0	-5.6	*February-06*
Short-term foreign assets of commercial banks (in billions of euros)	1.6	1.9	1.5	1.3	1.3	1.8	1.7	*January-06*
Short-term foreign liabilities of commercial banks (in billions of euros)	0.4	0.4	0.4	0.6	0.6	1.3	1.4	*January-06*
Foreign currency exposure of commercial banks (in billions of euros)	-4.9	-6.3	-7.0	-8.0	-9.8	-13.7	-14.5	*February-06*
Gross official reserves (in billions of euros)	3.4	5.0	6.8	6.9	6.5	6.9	7.6	*March-06*
Gross official reserves (in months of imports of goods and NFS)	3.3	4.7	6.2	5.9	4.9	4.6	4.5	*Projection-06*
Net international reserves (in billions of euros)	1.6	2.8	4.3	4.4	4.2	5.2	5.4	*February-06*
Base money to gross official reserves (in percent)	29.2	26.5	17.9	17.9	19.0	19.2	18.9	*February-06*
Broad money to gross official reserves (in percent)	326.2	275.6	230.6	232.2	257.3	257.8	260.5	*February-06*
Short-term external debt to gross official reserves (in percent) 4/	127.5	91.7	66.1	66.7	81.9	95.3	97.8	*February-06*
Total external debt	46.1	47.7	48.5	53.3	58.4	71.6	76.8	*Projection-06*
Of which: Public and publicly guaranteed	14.0	14.3	13.6	14.1	14.2	13.9	12.8	*Projection-06*
Total external debt (in percent of exports of goods and NFS)	81.6	82.4	84.9	95.5	97.2	110.3	112.0	*Projection-06*
Total external debt service payments (in percent of exports of goods and NFS)	9.5	14.9	13.1	14.8	15.4	17.4	18.4	*December-05*
External interest payment (in percent of exports of goods and NFS)	2.7	3.5	3.0	2.9	2.6	2.9	0.4	*December-05*
External amortization payments (in percent of exports of goods and NFS)	6.8	11.3	10.1	12.0	12.8	14.0	17.3	*December-05*
Exchange rate (tolar per euro, period average)	205.0	217.2	226.2	233.7	238.9	239.6	239.6	*March-06*
REER (CPI-based, period-average basis, an increase indicates appreciation)	-0.7	-0.9	1.7	2.2	-0.3	-0.5	…	*December-05*

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 2010 and 5.38 percent (coupon) German government bond maturing 2010.
3/ NFS denotes nonfactor services.
4/ Remaining maturity basis.

Table 6. Slovenia: Banking Sector Soundness Indicators, 2000–05
(In percent; end of period)

	2000	2001	2002	2003	2004	2005
Capital adequacy						
Regulatory capital to risk-weighted assets	13.5	11.9	11.9	11.5	11.8	10.5
Regulatory Tier 1 capital to risk-weighted assets	12.6	11.3	10.0	9.8	9.0	8.9
Capital (net worth) to assets	10.1	8.8	8.3	8.3	8.1	7.4
Nonperforming loans net of provisions to capital	32.1	35.5	36.3	34.3	28.5	28.2 1/
Asset quality						
Nonperforming assets to total assets	6.5	7.0	7.0	6.5	5.5	4.9 1/
Large exposures to capital	185.1	203.0	195.0	214.3	196.2	227.0
Earnings and profitability						
Net interest margin to average interest bearing assets	4.7	3.6	3.7	3.2	2.8	2.5
Operating expenses to average assets	3.5	3.3	3.2	3.0	2.8	2.4
Return on average assets (before tax)	1.1	0.5	1.1	1.0	1.1	1.0
Return on average equity (before tax)	11.4	4.8	13.3	12.5	13.3	13.8
Liquidity						
(Liquid assets to total assets) Average short-term assets to average short-term liabilities	85.42	89.21	90.4	93.1	88.6	84.8
Foreign exchange risk						
Foreign currency-denominated loans to total loans	29.4	29.8	32.6	35.1	38.6	48.7
Foreign currency-denominated liabilities to total liabilities	41.0	41.0	39.8	40.9	44.6	49.1
Net open position in foreign exchange to capital	21.5	33.9	51.6	58.6	55.1	58.9
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	49.6	52.9
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	65.0 1/
Fixed rate contracts						
(share of new loans of largest 8 banks)	...	...	...	47.0	41.1	23.4 1/
(share of new loans of all banks)	...	...	...	...	...	26.2 1/
Memorandum item:						
Ownership of banking sector (percent of equity capital)						
Nonresidents	12.0	16.0	32.5	32.4	32.3	35.7 1/
Central government	36.8	37.0	20.3	19.4	19.1	18.2 1/
Other domestic entities	51.2	47.0	47.2	48.2	48.6	46.1 1/

Source: Bank of Slovenia.

1/ Data as of September 2005.

Table 7. Slovenia: Macroeconomic Framework, 2000-10

						Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(Percent of nominal GDP)										
Foreign saving	2.8	-0.2	-1.4	0.4	2.1	1.1	2.0	2.1	1.6	1.2	0.8
National saving	24.3	24.1	24.8	24.3	24.3	24.1	23.9	23.8	24.4	25.0	25.6
Government	2.7	2.9	2.4	2.7	2.5	2.7	2.9	2.9	3.0	3.5	3.9
Non-government	21.5	21.2	22.4	21.7	21.7	21.4	21.0	20.9	21.4	21.5	21.7
Domestic saving	23.5	23.2	24.8	24.7	25.1	24.7	24.8	25.0	25.5	26.1	26.7
Government 1/	3.1	3.2	2.7	2.9	2.8	2.9	3.1	3.2	3.1	3.8	4.2
Non-government	20.5	20.0	22.1	21.7	22.2	21.8	21.7	21.9	22.4	22.3	22.5
Gross capital formation	27.1	23.9	23.4	24.7	26.3	25.2	25.9	25.9	26.0	26.2	26.4
Government 1/	2.6	2.7	2.4	2.4	2.4	2.9	3.3	3.1	2.9	2.9	2.9
Non-government	24.5	21.2	21.0	22.3	23.9	22.3	22.5	22.8	23.0	23.3	23.6
Fixed investment	25.8	24.3	22.6	23.3	24.1	24.7	25.5	25.5	25.6	25.7	25.9
Change in stocks	1.3	0.0	0.7	1.4	2.2	0.5	0.4	0.4	0.4	0.5	0.5
General government balance 1/	-1.3	-1.3	-1.5	-1.3	-1.4	-1.1	-1.5	-1.2	-0.9	-0.4	0.0
	(Percentage change in real terms)										
Real GDP	4.1	2.7	3.5	2.7	4.2	3.9	4.2	4.0	4.0	4.0	4.0
Domestic demand	1.4	0.9	2.4	4.7	3.8	2.3	4.1	3.7	3.7	3.7	3.8
Consumption	1.2	2.7	1.8	3.0	3.1	3.2	3.4	3.6	3.4	3.2	3.3
Government	2.6	3.9	3.2	1.6	2.9	3.0	2.6	2.9	2.1	1.4	1.4
Non-government	0.7	2.3	1.3	3.4	3.1	3.2	3.6	3.8	3.8	3.8	3.8
Gross capital formation	2.2	-4.3	4.0	10.1	4.9	-0.5	6.2	4.1	4.3	4.9	5.0
Fixed investment	1.8	0.4	0.9	7.1	5.9	3.7	6.3	4.1	4.3	4.8	5.0
Change in stocks (contribution to GDP growth) 2/	0.1	-1.2	0.2	-1.5	-0.9	-0.4	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	13.2	6.3	6.7	3.1	12.8	9.0	9.2	8.1	7.9	7.8	7.7
Imports of goods and services	7.3	3.0	4.8	6.7	13.5	5.0	8.8	7.7	7.5	7.5	7.5
Memorandum items:											
General government debt (percent of GDP)	27.4	28.1	29.5	29.4	29.5	29.0	29.6	29.8	29.4	29.2	29.0
External debt (percent of GDP)	46.1	47.7	48.5	53.3	58.4	71.4	76.8	82.5	86.9	89.9	91.9
Productivity (percent change)	...	2.2	1.9	2.9	3.7	3.2	3.6	3.5	3.6	3.6	3.6
Real wages (percent change)	...	3.3	2.1	1.9	0.8	2.2	2.6	2.8	3.3	3.5	3.5
Nominal GDP (billions of tolars)	4,300	4,800	5,355	5,814	6,251	6,548	6,936	7,380	7,862	8,381	8,932

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

1/ Government capital transfers are not included in government investment. In 2002 correcting to move to cash accounting.
2/ Includes the statistical discrepancy.

SLOVENIA: FUND RELATIONS

(As of April 30, 2006)

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	205.38	88.64
	Reserve position in Fund	26.32	11.36
III.	**SDR Department**		
	Net cumulative allocation	25.43	100.00
	Holdings	8.26	32.48

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):

	2006	**2007**	**2008**	**2009**	**2010**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.45	0.60	0.61	0.60	0.60
Total	0.45	0.60	0.61	0.60	0.60

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 a 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 on January 1, 2007.

VIII. **Last Article IV Consultation**

The last Article IV consultation with Slovenia was concluded on July 20, 2005. 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/05/85.

IX. FSAP Participation and ROSCs

An 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. An FSSA report (Country Report No. 01/161) was prepared on April 24, 2001 and published on September 18, 2001. The report includes assessments of the following standards: banking supervision, securities regulation, insurance regulation, and payments systems.

An FSAP Update mission visited Ljubljana during November 10–21, 2003. An FSSA report (Country Report No. 04/137) was issued on April 26, 2004. The report includes assessments of the following standards: Compliance with Basel Core Principles; insurance regulatory and supervisory system; corporate governance; 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
August 2001	FAD	VAT
November 2001	FAD	Direct Tax Reform
November 2003	FAD	Public Expenditure Management
April-May 2004	FAD	Performance Information to Support Better Budgeting
November 2004	STA	Recording Transactions in International Trade in Services

SLOVENIA: STATISTICAL ISSUES

1. **Data provision** is adequate for surveillance purposes.

2. **Special Data Dissemination Standard:** Slovenia has subscribed to the Special Data Dissemination Standard (SDDS), meets 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**

3. **Real Sector Statistics:** The Statistical Office of the Republic of Slovenia (SORS) follows the European System of Accounts 1995 (ESA95). Quarterly GDP estimates by industry and expenditure categories are compiled in both current and constant prices, and are published within 80 days after the reference quarter. In September 2005, the SORS changed the base year for compiling constant prices GDP from 2000 to the previous year's prices and started using the chain-link index methodology.

4. The SORS compiles the Harmonized Index of Consumer Prices (HICP) for monitoring compliance with the Maastricht inflation criterion. However, price collection is restricted to four cities and their surrounding rural areas. The weights are based on the three-year average of expenditure data for consumer goods from continuous Household Budget Surveys for 2002, 2003, and 2004. It also compiles a retail price index (RPI), which differs from the consumer price index in weights only.

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

6. The data published in the *Bulletin of Government Finance* are on a cash basis and broadly use the analytical framework and classification system of the IMF's 1986 government finance statistics methodology. The data reported for publication in the *GFS Yearbook* are also on a cash basis but are recast in the analytical framework and classifications of the *Manual on Government Finance Statistics 2001*(*GFSM 2001*).

7. The Slovenian authorities wish to adopt the *GFSM 2001* methodology, which could then be used as a building block for the compilation of the ESA 95-based data jointly by the Ministry of Finance and the SORS for reporting to the European Commission. To assist the Ministry of Finance resolve several classification issues and develop a migration path, a STA technical assistance mission visited Ljubljana in April 2006. The introduction in 2008 of a

new chart of accounts for all public entities based on accrual principles will greatly facilitate the adoption of the new methodology.

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

9. **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.

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

SLOVENIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF APRIL 28, 2006

	Date of latest observation	Date received or posted	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	5/1/06	5/1/06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/30/06	5/2/06	M	M	M
Reserve/Base Money	4/30/06	5/2/06	M	M	M
Broad Money	4/30/06	5/2/06	M	M	M
Central Bank Balance Sheet	4/30/06	5/2/06	M	M	M
Consolidated Balance Sheet of the Banking System	4/30/06	5/2/06	M	M	M
Interest Rates[2]	4/06	5/05/06	M	M	M
Consumer Price Index	4/06	4/28/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	1/06	4/18/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2/06	4/18/06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2/06	4/18/06	M	M	M
External Current Account Balance	2/06	4/12/06	M	M	M
Exports and Imports of Goods and Services	2/06	4/12/06	M	M	M
GDP/GNP	Q4/05	3/15/06	Q	Q	Q
Gross External Debt	2/06	4/12/06	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: PUBLIC DEBT SUSTAINABILITY ANALYSIS

1. Slovenia's general government debt remained at 29 percent of GDP at end-2005, which is well below the Maastricht criterion threshold (60 percent). The debt-to-GDP ratio increased from 18.5 percent in 1994 in spite of fiscal surpluses or moderate deficits since then. The increase was driven mainly from debt assumed as a result of bank and enterprise restructuring and by the inheritance of liabilities from the former Federal Republic of Yugoslavia.[1] 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 profile despite a strong fiscal position.

2. **In the baseline, general government debt would peak at 29.8 percent of GDP in 2007 and decline steadily afterwards.** The slight increase over 2006-07 reflects government plans to finance the fiscal deficit more through borrowing and less through running down its reserves. The debt-to-GDP ratio is projected to gradually decline to 27.2 percent by 2010, reflecting fiscal consolidation. In 2000, the government started a gradual transition towards the use of long-term nominal 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 in the medium term. This explains why, unlike in the past, the prudent medium-term fiscal policy is expected to translate into a declining debt path.

3. **The baseline is relatively resilient to shocks and sustainability is not a problem.** The standard stress tests show that Slovenia's public debt position is relatively resilient to a wide range of shocks. Relative to the baseline, shocks to real interest rates, real GDP growth, the primary balance, or a combination of all three would make the debt-to-GDP ratio rise at most to around 30 percent. A scenario where, compared to the baseline, interest rates are higher by 2 standard deviations (SD), real GDP growth is lower by one SD, and there is an exchange rate appreciation that dissipates over time would lead to an increase in the debt-to-GDP ratio to 37 ½ percent by 2010, a level still lower than the Maastricht criterion level. However, such scenario would set Slovenia on a path of rapid public sector debt increase.

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

Table A1. Slovenia: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing primary balance 10/**
Baseline: Public sector debt 1/	27.1	27.9	29.3	29.0	29.2	**29.0**	**29.6**	**29.8**	**29.4**	**28.3**	**27.2**	**-1.6**
o/w foreign-currency denominated	13.6	13.5	12.1	11.3	9.7	6.9	7.1	7.1	7.0	6.8	6.5	
Change in public sector debt	4.0	0.8	1.4	-0.3	0.2	-0.2	0.6	0.2	-0.4	-1.1	-1.2	
Identified debt-creating flows (4+7+12)	1.8	0.7	1.3	0.0	0.1	0.3	-2.6	-3.1	-3.2	-3.4	-2.1	
Primary deficit	-0.1	-0.2	1.4	-0.2	-0.1	-0.1	0.2	0.0	-0.2	-0.3	-0.4	
Revenue and grants	41.7	42.7	40.6	42.6	42.9	42.4	42.0	41.7	41.2	41.2	41.2	
Primary (noninterest) expenditure	41.6	42.5	42.0	42.4	42.8	42.3	42.2	41.7	41.0	40.8	40.7	
Automatic debt dynamics 2/	0.1	-0.5	-0.8	-0.3	-0.3	-0.2	-0.5	-0.7	-0.6	-0.7	-0.7	
Contribution from interest rate/growth differential 3/	-0.6	-1.3	-1.3	-0.7	-0.6	-0.2	-0.5	-0.7	-0.6	-0.7	-0.7	
Of which contribution from real interest rate	0.2	-0.7	-0.5	0.0	0.6	0.9	0.6	0.4	0.4	0.3	0.3	
Of which contribution from real GDP growth	-0.9	-0.6	-0.9	-0.7	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.0	
Contribution from exchange rate depreciation 4/	0.7	0.8	0.5	0.4	0.2	...	...	...	...	...	...	
Other identified debt-creating flows	1.9	1.4	0.8	0.5	0.5	0.5	-2.2	-2.5	-2.4	-2.4	-0.9	
Privatization receipts (negative)	-0.1	-0.1	0.0	-0.1	0.0	0.0	-2.7	-2.7	-2.5	-2.4	-1.1	
Recognition of implicit or contingent liabilities	0.1	0.1	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	1.9	1.4	0.7	0.6	0.5	0.4	0.4	0.2	0.1	0.0	0.2	
Residual, including asset changes (2-3) 5/	2.1	0.1	0.1	-0.3	0.0	-0.4	3.2	3.3	2.8	2.4	0.9	
Public sector debt-to-revenue ratio 1/	65.1	65.4	72.1	68.1	68.0	68.3	70.5	71.5	71.4	68.8	66.0	
Gross financing need 6/	5.2	9.0	8.7	9.0	9.1	9.6	8.3	6.9	6.8	5.5	5.7	
in billions of euros	1.1	2.0	2.1	2.2	2.4	2.6	2.4	2.2	2.2	1.9	2.1	
Scenario with key variables at their historical averages 7/						**29.0**	**27.9**	**26.7**	**25.3**	**23.4**	**21.7**	**-2.2**
Scenario with no policy change (constant primary balance) in 2005-2010						**29.0**	**29.4**	**29.4**	**29.2**	**28.3**	**27.5**	**-1.6**
Slovenia-specific scenario 8/						**29.0**	**29.6**	**30.8**	**32.4**	**34.5**	**37.5**	**-0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	2.7	3.5	2.7	4.2	3.9	4.0	4.0	3.8	3.9	3.9	
Average nominal interest rate on public debt (in percent) 9/	6.7	6.2	6.2	5.9	5.4	5.0	4.4	4.1	3.9	3.7	3.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.3	-2.5	-1.6	0.2	2.2	3.4	2.1	1.7	1.6	1.3	1.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-5.6	-5.6	-4.0	-3.2	-2.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.4	8.7	7.9	5.8	3.2	1.5	2.3	2.4	2.3	2.4	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	4.6	4.9	2.3	3.6	5.3	2.8	3.5	2.8	2.0	3.6	3.5	
Primary deficit	-0.1	-0.2	1.4	-0.2	-0.1	-0.1	0.2	0.0	-0.2	-0.3	-0.4	
B. Bound Tests												
B1. Real interest rate is at historical average plus one standard deviation						**29.0**	**30.4**	**31.3**	**31.7**	**31.4**	**31.0**	**-0.9**
B2. Real GDP growth is at historical average minus one standard deviation						**29.0**	**29.9**	**30.6**	**30.8**	**30.5**	**30.3**	**-1.6**
B3. Primary balance is at historical average minus one standard deviation						**29.0**	**30.0**	**30.5**	**30.5**	**29.8**	**28.9**	**-1.7**
B4. Combination of B1-B3 using 1/2 standard deviation shocks						**29.0**	**30.2**	**31.1**	**31.3**	**30.8**	**30.2**	**-1.2**

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 euros).
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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Relative to the baseline, this scenario assumes an increase in interest rates by 2 standard deviation; a decline in real GDP by one STD, and gradual exchange rate appreciation (10, 8, 6, 4, 2 percent from 2006 to 2010).
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table A2. Slovenia: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross financing need 1/	5.2	9.0	8.7	9.0	9.1	9.6	8.3	6.9	6.8	5.5	5.7
in billions of euros	1.1	2.0	2.1	2.2	2.4	2.6	2.4	2.2	2.2	1.9	2.1
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						9.6	6.5	5.0	4.8	3.7	3.9
A2. No policy change (constant primary balance) in 2006-10						9.6	8.1	6.7	6.8	5.7	6.0
A3. Slovenia-specific scenario 4/						9.7	9.2	8.6	9.2	8.8	10.1
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						9.6	9.1	7.9	8.0	6.8	7.2
B2. Real GDP growth is at baseline minus one-half standard deviations						9.6	8.6	7.4	7.5	6.5	7.1
B3. Primary balance is at baseline minus one-half standard deviations						9.6	8.7	7.4	7.3	6.1	6.4
B4. Combination of B1-B3 using 1/4 standard deviation shocks						9.6	9.0	7.7	7.7	6.5	6.8
Gross financing need in billions of euros 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						2.6	1.9	1.6	1.6	1.3	1.4
A2. No policy change (constant primary balance) in 2006-10						2.6	2.4	2.1	2.3	2.0	2.3
A3. Slovenia-specific scenario 4/						2.6	2.6	2.6	2.9	3.0	3.6
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						2.6	2.7	2.5	2.7	2.4	2.7
B2. Real GDP growth is at baseline minus one-half standard deviations						2.6	2.5	2.3	2.5	2.3	2.6
B3. Primary balance is at baseline minus one-half standard deviations						2.6	2.6	2.3	2.4	2.1	2.4
B4. Combination of B1-B3 using 1/4 standard deviation shocks						2.6	2.6	2.4	2.5	2.3	2.5

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/ Relative to the baseline, this scenario assumes an increase in interest rates by 2 standard deviation; a decline in real GDP by one STD, and gradual exchange rate appreciation (10, 8, 6, 4, 2 percent from 2006 to 2010).

SLOVENIA: EXTERNAL SUSTAINABILITY ANALYSIS

4. **Although Slovenia's outlook does not raise major concerns regarding external sustainability, the recent deterioration in the external debt situation needs monitoring.** Under the baseline scenario, the external debt-to-GDP ratio which jumped by 13.3 percentage points in 2005 to 71.4 percent, will continue to grow, but at a slowing pace until it reaches 92 percent in 2010. With the current account deficit in 2005 at 1.1 percent of GDP, the increase in external debt could principally be attributed to the sharp rise in bank loans from abroad and foreign deposits in the banking system substituting for lower deposit growth. It is expected that the decline in mutual funds' returns in 2005 would lead to a return of deposits to banks. Although some of banks' foreign borrowing is from parent companies, as seen in other emerging economies, these loans could still be called back. As the bulk of new borrowing is euro-denominated, barring a major unforeseen shock, the exchange risk is low given the imminent euro adoption (January 2007). However, there are maturity and credit risks arising from banks clients' balance sheet imbalances. The external debt service, as a ratio to exports of goods and services, is projected to rise from 17.4 percent in 2005 to 19.7 percent in 2008 and stabilize at around 19.5 percent over 2009-2010.

5. **Stress tests suggest that the baseline scenario is sensitive to shocks, but Slovenia's economy appears resilient to such shocks over the medium term**. Standard bound tests show a significant jump in the external debt-to-GDP ratio in 2006 by an average of 6 percentage points and further gradual increases to at most 95 percent by 2010 (3 points more than the baseline). A Slovenia-specific scenario assuming, relative to the baseline, a combination of 2-standard deviation higher interest rates, 1-standard deviation lower real GDP growth, and exchange rate appreciation that dissipates over time, would worsen debt trends slightly. The debt-to-GDP ratio would jump by 7 percentage point jump to 79 percent in 2006, and further increase to 96 percent of GDP by 2010. This would further increase the already high external debt-to-export ratio from 105.5 percent in 2005 to 165 percent in 2010. However, with the upcoming euro adoption, generally solid fundamentals and sound macro policies, and the planned privatization of state assets, the medium-term external debt outlook does not raise sustainability concerns at this point.

Table A3. Slovenia: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	
						I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
1 **External debt**	46.1	47.7	48.5	53.3	58.4	**71.4**	**76.8**	**82.5**	**86.9**	**89.9**	**91.9**	**-1.5**
2 Change in external debt	5.7	1.6	0.8	4.8	5.1	13.0	5.4	5.7	4.4	3.0	2.1	
3 Identified external debt-creating flows (4+8+9)	1.5	-4.1	-24.6	-1.2	-0.5	0.8	-0.3	-1.5	-1.4	-1.4	-1.5	
4 Current account deficit, excluding interest payments	1.2	-1.8	-3.4	-1.6	-0.2	-0.9	-1.1	-1.2	-1.7	-1.8	-2.0	
5 Deficit in balance of goods and services	3.6	0.7	-1.5	0.0	1.2	0.5	0.6	0.4	0.0	-0.2	-0.4	
6 Exports	56.5	57.9	57.1	55.8	60.0	64.9	68.6	70.9	73.2	75.5	77.8	
7 Imports	60.0	58.6	55.7	55.8	61.3	65.4	69.2	71.2	73.2	75.2	77.4	
8 Net non-debt creating capital inflows (negative)	-0.1	-1.1	-6.2	0.8	0.1	1.9	1.5	0.2	1.0	1.2	1.4	
9 Automatic debt dynamics 1/	0.4	-1.1	-14.9	-0.3	-0.3	-0.2	-0.7	-0.6	-0.7	-0.8	-0.9	
10 Contribution from nominal interest rate	1.7	1.6	1.4	2.0	2.3	2.0	2.1	2.3	2.4	2.5	2.5	
11 Contribution from real GDP growth	-1.6	-1.2	-1.1	-1.2	-2.1	-2.2	-2.8	-2.9	-3.1	-3.3	-3.4	
12 Contribution from price and exchange rate changes 2/	0.4	-1.6	-15.3	-1.1	-0.5	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3)/3	4.2	5.6	25.4	6.0	5.5	12.3	5.7	7.2	5.8	4.4	3.5	
External debt-to-exports ratio (in percent)	81.6	82.4	84.9	95.5	97.2	106.6	114.6	119.9	122.7	123.7	123.5	
Gross external financing need (in billions of Euros) 4/	3.5	3.8	3.3	4.1	5.0	5.4	6.0	6.6	7.0	7.5	8.0	
in percent of GDP	17.1	17.5	14.1	16.4	19.0	19.9	20.7	21.4	21.4	21.6	21.6	
Scenario with key variables at their historical averages 5/						**71.4**	**70.9**	**72.0**	**71.4**	**69.5**	**66.8**	**-6.2**
Slovenia-specific scenario 6/						**71.4**	**78.7**	**84.7**	**89.6**	**93.2**	**96.1**	**-1.9**
Net debt, baseline						**19.1**	**18.9**	**19.0**	**18.9**	**18.8**	**18.9**	
Net debt, Slovenia-specific scenario						**19.1**	**21.6**	**22.2**	**22.3**	**21.8**	**21.1**	
Key Macroeconomic Assumptions												
Real GDP growth (in percent)	4.1	2.7	3.5	2.7	4.2	3.9	4.2	4.0	4.0	4.0	4.0	
GDP deflator in Euros (change in percent)	-0.9	3.6	47.2	2.4	1.0	0.8	1.8	2.4	2.2	2.3	2.2	
Nominal external interest rate (in percent)	4.3	3.8	4.5	4.4	4.6	0.5	1.8	2.4	2.2	2.3	2.2	
Growth of exports (Euro terms, in percent)	17.8	8.7	7.0	2.7	13.2	3.5	3.2	3.2	3.1	3.0	3.0	
Growth of imports (Euro terms, in percent)	15.5	3.4	3.1	5.4	15.5	12.9	12.0	10.0	9.8	9.7	9.6	
Current account balance, excluding interest payments	-1.2	1.8	3.4	1.6	0.2	11.5	12.2	9.6	9.3	9.3	9.3	
Net non-debt creating capital inflows	0.1	1.1	6.2	-0.8	-0.1	0.9	1.1	1.2	1.7	1.8	2.0	
B. Bound Tests												
B1. Nominal interest rate is at baseline plus one-half standard deviation						**71.4**	**76.9**	**82.7**	**87.2**	**90.3**	**92.5**	**-1.4**
B2. Real GDP growth is at baseline minus one-half standard deviations						**71.4**	**77.1**	**83.2**	**88.0**	**91.5**	**94.0**	**-1.2**
B3. Non-interest current account is at baseline minus one-half standard deviations						**71.4**	**77.6**	**84.0**	**89.0**	**92.7**	**95.4**	**-1.6**
B4. Combination of B1-B3 using 1/4 standard deviation shocks						**71.4**	**77.4**	**83.7**	**88.7**	**92.3**	**95.0**	**-1.3**

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/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ 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.
6/ Relative to the baseline, this scenario assumes an increase in interest rates by 2 standard deviation; a decline in real GDP by one STD, and gradual exchange rate appreciation (10, 8, 6, 4, 2,percent from 2006 to 2010).
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, Euro deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table A4. Slovenia: External Sustainability Framework--Gross External Financing Need, 2000-2010

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross external financing need in billions of euros 1/	3.5	3.8	3.3	4.1	5.0	5.4	6.0	6.6	7.0	7.5	8.0
in percent of GDP	17.1	17.5	14.1	16.4	19.0	19.9	20.7	21.4	21.4	21.6	21.6
II. Stress Tests											
Gross external financing need in billions of euros 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						5.4	6.1	6.6	7.2	7.7	8.1
A2. Slovenia-specific scenario 4/						5.1	5.9	7.0	7.9	8.9	9.8
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						5.4	6.0	6.6	7.1	7.6	8.1
B2. Real GDP growth is at baseline minus one-half standard deviations						5.4	6.0	6.6	7.0	7.5	8.0
B3. Non-interest current account is at baseline minus one-half standard deviations						5.4	6.2	6.9	7.4	8.0	8.6
B4. Combination of B1-B3 using 1/4 standard deviation shocks						5.4	6.1	6.8	7.3	7.8	8.3
B5. One time 30 percent nominal depreciation in 2006						5.4	6.1	6.7	7.3	7.9	8.4
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						19.9	20.1	19.4	18.8	17.9	17.0
A2. Slovenia-specific scenario 4/						18.9	20.9	23.5	25.4	27.0	28.1
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						19.9	20.8	21.5	21.6	21.8	21.8
B2. Real GDP growth is at baseline minus one-half standard deviations						19.9	20.8	21.6	21.7	22.0	22.1
B3. Non-interest current account is at baseline minus one-half standard deviations						19.9	21.6	22.4	22.6	23.0	23.1
B4. Combination of B1-B4 using 1/4 standard deviation shocks						19.9	21.2	22.1	22.2	22.6	22.7
B5. One time 30 percent nominal depreciation in 2006						19.9	30.9	32.0	32.4	33.0	33.2

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; Euro deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
4/ Relative to the baseline, this scenario assumes an increase in interest rates by 2 standard deviation; a decline in real GDP by one STD, and gradual exchange rate appreciation (10, 8, 6, 4, 2 percent from 2006 to 2010).

INTERNATIONAL MONETARY FUND
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IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of Slovenia

On June 30, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.[1]

Background

Slovenia is set to become the first among the new European Union member states to adopt the euro. Aided by broadly favorable initial conditions and generally sound macroeconomic and incomes policies, Slovenia has over the past decade sustained robust growth with small external imbalances, while gradually lowering inflation to euro-area levels. Long-term interest rates, the fiscal deficit, the public debt ratio, and inflation were all within the Maastricht Treaty limits at end-2005. This, combined with the tolar's two successful years within the ERM2, has set the stage for euro adoption in January 2007.

The Slovene economy continued to grow strongly in 2005 amid a stable macroeconomic environment. Real GDP growth reached 4 percent supported by strong exports, while the unwinding of inventories accumulated in 2004 ahead of EU accession slowed domestic demand and imports. In spite of the oil price-driven deterioration of the terms of trade, the external current account deficit in percent of GDP declined by half to about 1. As growth remained above potential and idle capacity tightened, the output gap likely closed. Competitiveness remained adequate, supported in part by the continued positive gap of 1 percent between productivity and

[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. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

real wage growth. External debt jumped by 13 percentage points to 71½ percent of GDP reflecting strong foreign borrowing by banks.

Average inflation in 2005 declined to 2½ from 3 ½ percent in 2004. Despite the reduced available slack, core inflation more than halved to less than 1 percent during the year, owing to lower tolar depreciation expectations, increased competition following EU accession, and conservative wage policy. In particular the implementation of the guideline requiring real wage to trail productivity helped minimize second-round effects of energy price shocks.

The fiscal deficit in 2005 remained low and public debt was kept at below 30 percent of GDP. At 1.1 percent of GDP, the general government deficit was better than projected, reflecting one-off municipal revenues and lags in spending EU transfers. Adjusting for cyclical effects, this deficit implied a neutral fiscal stance. Tax revenue was buoyant, as indirect taxes recovered from a temporary drop following EU accession in May 2004.

Monetary policy through 2005 was marginally tight, but credit growth remained strong. Upon entering the ERM2 in 2004 the central bank set its key policy rate at 4 percent and kept it unchanged until end-2005, 200 basis points (bps) above the European Central Bank (ECB) refinance rate. However, a surge in short-term capital inflows in early 2006 and Bank of Slovenia's desire to prompt banks to gradually switch away from its bonds ahead of euro adoption led to cumulative reductions in the policy rate of 75 bps, which together with increases in the ECB refinancing rate, narrowed the interest rate differential with the ECB to 50 bps. Buoyed by strong foreign borrowing by banks, credit growth accelerated by 3 percentage points to 23 percent. Bank profitability and asset quality remained adequate and non-performing loans declined—in part reflecting a rapid expansion of new credit. However, the relaxation of credit standards owing to intense competition for market share and the increased recourse to variable-rate contracts have increased interest and credit risks.

In 2006, growth is projected to remain around 4 percent, but would be more balanced. The contribution of domestic demand would rebound, reflecting a recovery in investment and steady growth of consumption. Investment would be supported by highway construction, and lower inventory de-cumulation. Exports would continue to grow in line with favorable conditions in the EU, while import growth would accelerate, reflecting stronger domestic demand. This, combined with a further deterioration of the terms of trade would lead to the widening of the external current account to 2 percent of GDP. Despite an expected up-tick in core inflation, the Maastricht inflation ceiling is not expected to be breached, aided by price competition in the euro zone and continued wage restraint. Fiscal policy would need to be at least neutral to support this benign outlook.

Structural reform is still lagging, leaving the economy with many rigidities that pose challenges to growth and fiscal sustainability in the long run. Slovenia is beset with a relatively unfriendly business environment with an inflexible labor market, stringent business regulations, and a high share of government ownership of enterprises. This has led to lackluster performance in attracting Foreign Direct Investment (FDI) relative to other Central European countries. Generous welfare and retirement benefits have reduced labor participation, while one of the fastest aging populations in Europe, highlights the challenge to long-run fiscal sustainability.

Executive Board Assessment

Executive Directors commended the Slovenian authorities for the successful economic transformation that has paved the way for the country's entry into the euro zone in January 2007. They pointed to solid economic growth, low inflation, moderate public and external debt levels, and a sound banking system as evidence that years of prudent macroeconomic and incomes policies have paid off.

At the same time, Directors stressed that while the near-term outlook remains benign, important challenges remain for the medium term. Sustaining income convergence in the euro zone requires more attention to improving economic flexibility and long-term growth prospects. Directors therefore emphasized the need to implement policies that increase productivity, create an efficient business environment and a flexible labor market, and improve sustainability of public finances in the face of population aging.

Directors noted that the imminent loss of the exchange rate instrument puts a premium on fiscal and incomes policies to sustain a balanced expansion in the near term. With the output gap virtually closed and interest rates converging toward euro area levels, Directors stressed the need for a neutral fiscal stance in 2006 to contain inflation risks. This would require achieving expenditure savings to keep this year's fiscal deficit below budgeted levels. Directors also emphasized the importance of continuing with prudent wage settlements to contain price pressures and achieve a balanced growth.

Directors emphasized that over the medium term fiscal policy needs to deal with the challenges of an aging population, while improving the flexibility and efficiency of public spending. They welcomed the authorities' commitment to achieve a structural fiscal balance over the medium term, but recommended a frontloaded adjustment. This would help achieve balanced growth and provide an early start to addressing long-term fiscal sustainability concerns related to population aging. Directors welcomed the authorities' plans to reduce the progressive income taxes to enhance incentives to work and boost growth, but emphasized the need to accompany tax reform with expenditure rationalization. They urged the authorities to focus expenditure reforms on reducing fiscal rigidities and age-related spending pressures. Priorities in this regard would be parametric reforms of the pension system, revisions of the level and indexation mechanisms of social benefits, and linking social benefits to work-reinsertion policies.

Directors acknowledged that the authorities' consensus-based approach to reforms had helped preserve social cohesion, but noted that the authorities need to speed up the implementation of policies that boost productivity growth and increase labor flexibility and participation to maintain competitiveness and ensure faster convergence. They noted that while price competitiveness appears adequate and export growth strong, Slovenia trails other new EU member states in gaining market shares. They also observed that Slovenia's productivity growth lags behind that of its regional competitors, reflecting Slovenia's high income level as well as weak FDI and technological spillovers. Labor participation is also relatively low among the older and younger working-age population. To deal with these challenges, Directors urged the authorities to speed up efforts to raise labor utilization by lowering marginal tax rates, improving the targeting of social benefits, and reducing incentives for early retirement. Simplifying business regulations and reducing constraints that create labor market rigidities would increase efficiency and attract

FDI. In this respect, they welcomed the creation of centralized registration for independent entrepreneurs and encouraged extending it to larger corporate entities. Directors also supported the authorities' plan to accelerate the divestment of public companies.

Directors observed that while the banking system is sound, bank supervision should be enhanced to guard against market and credit risks. The rapid increase in credit amid competition for market share has exposed banks to higher credit risks, especially as interest rates in the euro zone are set to rise. Directors noted that although banks are expected to be resilient to these shocks in the near term, euro adoption will pressure profitability through competition, yield convergence, and loss of foreign exchange related revenue. Directors welcomed the steps taken to ensure adequate liquidity standards upon euro adoption, but called on the authorities to strengthen supervision of banks' credit assessment standards to ensure continued strong balance sheets. They encouraged enhanced coordination with foreign supervisors to limit contagion risks arising from the regional concentration of funding. Directors also urged further progress in increasing the role of the private sector in the banking system to boost efficiency in an increasingly competitive international environment.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Slovenia: Selected Economic Indicators, 2000-08

	2000	2001	2002	2003	2004	2005	2006	2007	2008
							Projections		
				(Annual percentage change)					
Real GDP	4.1	2.7	3.5	2.7	4.2	3.9	4.2	4.0	4.0
Domestic demand	1.4	0.9	2.4	4.7	3.8	2.3	4.2	3.7	3.7
Private consumption	0.7	2.3	1.3	3.4	3.1	3.2	3.6	3.8	3.8
Public consumption	2.6	3.9	3.2	1.6	2.9	3.0	2.8	2.9	2.1
Gross capital formation	2.2	-4.3	4.0	10.1	4.9	-0.5	6.2	4.1	4.3
Output gap (in percent of potential GDP)	1.1	-0.1	-0.4	-0.6	-0.2	-0.1	-0.1	0.0	0.1
Consumer prices									
Period average	8.9	8.4	7.5	5.6	3.6	2.5	2.5	2.3	2.3
End of period	8.9	7.0	7.2	4.6	3.2	2.3	2.6	2.3	2.2
Nominal wages									
All sectors	10.6	11.9	9.8	7.6	5.7	4.8	5.1	5.1	5.4
Manufacturing	11.9	10.8	10.4	7.6	7.3	6.1	…	…	…
Public services	11.2	13.9	8.7	6.6	2.9	3.5	…	…	…
Real wages									
All sectors	1.6	3.2	2.1	1.9	2.1	2.2	2.6	2.8	3.3
Manufacturing	2.8	2.2	2.7	1.9	3.6	3.4	…	…	…
Public services	2.1	5.5	1.1	1.0	-0.6	0.8	…	…	…
Employment									
Person basis (period average)	1.3	1.4	0.6	-0.8	0.6	0.6	…	…	…
National Accounts basis	0.8	0.5	1.5	-0.2	0.4	0.7	0.8 1/	0.6 1/	0.8 1/
Average unemployment rate (in percent, ILO definition)	7.0	6.4	6.4	6.7	6.3	6.6	6.6 1/	6.7 1/	6.7 1/
General government finances 2/				(In percent of GDP)					
Revenue	40.6	41.3	39.2 3/	40.9	41.3	42.3	42.5	42.2	41.5
Expenditure	41.9	42.7	42.1	42.2	42.7	43.4	44.0	43.4	42.5
General government balance	-1.3	-1.3	-3.0 3/	-1.3	-1.4	-1.1	-1.5	-1.2	-0.9
Structural general government budget balance	-1.7	-1.3	-2.6	-0.9	-1.1	-0.9	-1.3	-1.1	-0.8
State budget balance	-0.9	-1.0	-2.6 3/	-1.2	-1.3	-1.4	-1.4	-1.2	-0.9
General government debt	24.5	26.4	27.6	29.4	29.5	29.0	29.6	29.8	29.4
Money and credit				(Percentage change, end-period)					
Broad money	15.3	28.3	18.4	5.0	6.8	5.5	…	…	…
Base money	1.9	37.7	-4.3	4.1	2.2	6.5	…	…	…
Credit to the private sector	18.1	18.5	10.5	15.5	20.3	23.1	…	…	…
Interest rates (in percent)									
BoS Lombard rate	11.0	12.0	10.5	7.3	5.0	5.0	…	…	…
Rate on 60-day BoS bills	10.0	8.0	8.3	6.0	4.0	4.0	…	…	…
Lending rates	14.6-18.4	15.8-12.3	11.6-14.7	9.0-10.3	7.9-8.5	6.2-7.8	…	…	…
Deposit rates 4/	10.9-13.2	8.5-11.0	7.6-8.6	4.8-4.9	3.2	3.1	…	…	…
Balance of payments				(In millions of euros, unless noted otherwise)					
Merchandise exports	9,574	10,454	11,082	11,414	12,933	14,517	16,155	17,789	19,425
Exports volume (percent change, volume)	13.2	7.0	6.4	4.4	12.8	8.5	9.1	8.1	7.8
Merchandise imports	-10,801	-11,139	-11,351	-11,960	-13,942	-15,551	-17,508	-19,241	-20,950
Imports volume (percent change, volume)	7.4	3.2	4.4	7.3	14.5	4.7	8.8	7.7	7.5
Terms of trade (percent change)	-3.0	2.1	2.0	0.5	-1.4	-2.7	-1.6	-0.1	0.0
Current account balance	-583	38	335	-91	-544	-301	-564	-647	-522
(in percent of GDP)	-2.8	0.2	1.4	-0.4	-2.1	-1.1	-2.0	-2.1	-1.6
Gross official reserves	3,436	4,984	6,781	6,879	6,542	6,895	7,627	8,578	9,277
(in months of imports of goods and nonfactor services)	3.3	4.7	6.2	5.9	4.9	4.6	4.5	4.6	4.6
External debt(percent of GDP, end-period)	46.1	47.7	48.5	53.3	58.4	71.4	76.8	82.5	86.9
External debt service	1,103	1,877	1,778	2,060	2,424	3,096	3,609	4,113	4,589
(in percent of exports of goods and nonfactor services)	9.5	14.9	13.1	14.8	15.4	17.4	18.4	19.2	19.7
Exchange rate									
Tolars per U.S. dollar (end-period)	227.4	251.0	221.1	206.7	192.1	192.5	…	…	…
Tolars per euro (end-period)	211.5	221.4	230.3	236.7	239.7	239.6	…	…	…
Nominal effective exchange rate (1998r1=100, period average)	90.6	85.0	81.8	80.5	79.1	78.5	…	…	…
real effective exchange rate									
(CPI based, 1998r1=100, period average)	102.3	101.4	103.1	105.4	105.1	104.7	…	…	…
(ULC based, 1998r1=100, period average)	96.5	95.5	97.3	97.2	98.0	97.9	…	…	…

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

1/ For 2006-08, Spring 2006 forecasts of the Slovene Institute of Macroeconomic Analysis and developments.
2/ Revenue and expenditure exclude social security contributions paid for government employees.
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/ For deposits with maturity between 31 days and 1 year.

Statement by Johann Prader, Alternate Executive Director for the Republic of Slovenia and Ksenija Maver, Advisor to Executive Director
June 30, 2006

Slovenia has fulfilled all Maastricht convergence criteria for the adoption of the euro. Following the recommendations by the EU Commission and the European Central Bank, on June 15 and 16, 2006 the European Council gave the political go-ahead for Slovenia's adoption of the euro on January 1, 2007. When the EU finance ministers will meet on July 11, 2006, they are expected to formally adopt the decision and to fix the parity between the Slovenian tolar and the euro. On June 2006, the European Commission proposed that with effect from January 1, 2007, the exchange rate be fixed at 239.640 Slovenian tolars for one euro, which is the central rate at which the Slovenian tolar entered ERMII two years ago. Slovenia will become the 13th EU member state to adopt the euro as of January 1, 2007. These milestones crown the substantial efforts invested by the Slovenian people into what has become a national project. However, as discussed during the staff discussions for the Article IV consultation held in March 2006, the agenda is not yet finished, either on the macroeconomic or on the structural front.

The staff discussions showed a broad agreement between the authorities and the staff team on the major policy issues.

Recent economic developments: economic activity, fiscal and monetary policies and inflation

Economic trends in Slovenia remain broadly favorable. In the first quarter of 2006, economic growth was 5.1 percent year on year. For 2006 as a whole, the authorities' growth estimate is the same as the staff's (4.2 percent) and – like the staff's forecast - slightly lower in the next two years.

The Government's Framework of Economic and Social Reforms adopted last November is designed to significantly improve the competitiveness of the economy and to impart a new momentum to growth for the period beyond 2008. The authorities are now considering several important reform measures.

On the fiscal front, tax reform aimed at lowering the burden on labor is high on the agenda. The plan is to specify all its elements by autumn – after taking into consideration the advice of the IMF's Fiscal Affairs Department mission which will visit Ljubljana in July – and to have the reform ready for implementation in 2007. On the expenditure side, the Employment and Insurance Against Unemployment Act, which is being currently discussed in the Parliament, aims at better linking unemployment benefits to active job search and at making the benefits system more transparent. A Social Protection Act, which would require greater work effort by the recipients of social benefits is also being discussed in the Parliament.

Finally, the Ministry of Finance, with the help of the IMF's Regional Public Financial Management Advisor, is planning to address more systematically the issue of expenditure efficiency and flexibility, as discussed with the staff, by improving budget procedures. It is intended that work in this area will start with pilot projects in the fields of primary education and family allowances.

As for wages, agreements were reached in June for adjustments in both private sector and public sector wages. An increase of 2 percent was agreed for private sector wages in 2006 and 2007. For public sector wages, an increase of 2.35 percent will apply for 2006. However, only about half of this increase will, in effect, be disbursed in 2006 and the rest being retained until 2007 and then used for the elimination of wage disparities in line with the new collective agreement. Thus, the general increase in wages is in line with expected inflation.

Earlier this year, the Bank of Slovenia started to align its interest rates with those of the ECB. On June 8, 2006, the Bank cut the interest rate on 60-day tolar bills by 0.25 percentage points to 3.25 percent. The objective of this move – which was made in parallel with the ECB's interest rate increase – was to make Slovenian tolar instruments less attractive for banks, and to encourage them to replace tolar bills with European money market instruments.

There has been no significant excess supply of or demand for foreign exchange in the markets since Slovenia joined ERM II, which indicates that the central rate is sustainable in the long run. Since Slovenia has joined ERM II and up until June 2006, the average differential between the exchange rate in the spot market and the central rate was 0.06 percent.

In May 2006, the EMU convergence price index in Slovenia was 2.4 percent, up from 2.3 percent in the previous month but by 0.3 percentage point below the convergence criterion. Inflation was one of the toughest challenges faced by Slovenia in meeting the Maastricht criteria. Helped by the Bank of Slovenia's moderately restrictive monetary policy, and coordination between the monetary, fiscal and other macroeconomic policies, the inflation criterion has been met since last November. The Bank of Slovenia forecasts the average inflation rate to be 2.2 percent for 2006 and 2007, and 2.6 percent for 2008.

Challenges going forward

Keeping the macroeconomic environment supportive of sustained growth will require vigilance on several fronts:

* **Maintaining long-term sustainability of the general government budget and its compliance with the Stability and Growth Pact (SGP), as well as providing an adequate safety reserve in the public finances.**

With regard to demographic changes and the ageing population, further reform measures will be necessary, especially in the pension and the health systems, as well as other policies. The Framework for Economic and Social Reforms provides for some preventive measures. These include in the public pension system, raising the participation of the elderly in the work force so as to increase the retirement age. In the private pension system, it is intended to provide incentives to enhance the coverage of voluntary funded pension schemes and to increase the contribution of individuals to these schemes. It will also be essential to increase public awareness of the implications of the demographic shift.

* **Containing the wage growth**. The social agreement for the period 2006 – 2009 is still being negotiated. Its overall objective is to prevent an increase in wages not justified by a corresponding rise in productivity in either the private or the public sector. The plan is to keep – for the time being – the average wage growth lagging behind productivity growth.

* **Keeping inflation in check.** Some inflationary pressures may continue in the short run, but in the long run there are no major risks to price stability, assuming the continuation of a moderate growth in labor costs and relatively balanced growth in aggregate supply and demand. The low level of core inflation and the expected absence of higher energy prices feeding through into other prices are the two most important arguments supporting this position.

The pressure, brought by rounding following the euro adoption, is expected to be limited and temporary as it would be forestalled by the mandatory informative dual pricing effective from March 1, 2006 until six months after the euro adoption. However, there is the risk associated with the possible Value Added Tax (VAT) increase, the rise in excise duties and the relaxation in administered price policy, in particular in the energy sector. There is also the risk associated with higher oil prices. At the same time, the key tools already tested in the disinflation process, such as the government-backed plan on regulated prices for the period 2006 – 2007, will continue to be in place also after the euro adoption.

* **Managing financial sector risks**. The process of financial integration with the European Union (EU) has increased both the dependence on financial conditions abroad and the competition among banks. In 2005, interest rate risk increased, and credit risk diminished. Euro adoption will significantly reduce the exchange rate risk. Managing risks, the interest risks in particular, will become very important in the increasingly uncertain international environment. The Bank of Slovenia is considering stepping up its banking supervision activities and engaging in a constructive dialogue with the banks in order to improve risk management further.

* **Supporting structural reform.** The government-backed reform package proposes measures aimed at increasing the flexibility of the economy. These will comprise deregulation of product markets and promotion of competition. Also, steps to secure greater

labor market flexibility are on the agenda. These include greater regional, professional and educational mobility, greater flexibility of employment protection, and more flexible forms of employment. All these measures could contribute to greater macroeconomic stability and higher economic growth.

Conclusion

The fulfillment of the Maastricht convergence criteria, the favorable forecasts and the positive expectations of European institutions indicate that Slovenia is ready to adopt the euro. This step will mark the de jure conclusion of the task of integration that started with the European Agreement in June 1996. The Slovenian authorities are aware that in de facto terms, this task is not yet over and depends on the successful implementation of the reform agenda.