

Republic of Slovenia: 2007 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 2007 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 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 16, 2007, 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 May 2, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 18, 2007 discussion of the staff report that concluded the Article IV consultation; and
- 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

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REPUBLIC OF SLOVENIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation
with the Republic of Slovenia

Approved by Juha Kähkönen and G. Russell Kincaid

May 2, 2007

Executive Summary

Background: Slovenia's sound macroeconomic policies were crowned with success in January when Slovenia entered the euro area. Nonetheless, challenges remain. Strong growth driven by domestic demand brought output to capacity limits in 2006, and inflation stabilized. Looking forward, credit growth and wage and fiscal pressures are risks to non-inflationary growth, while the slow pace of structural reform is a challenge for future competitiveness.

Staff views: The staff saw risks of overheating and, to ensure a balanced expansion, advocated a neutral fiscal stance in 2007–08 and continued prudent wage policies. Upfront expenditure reforms would also smooth the adjustment towards structural balance in 2011, improve fiscal flexibility, and help accommodate spending pressures from infrastructure and pensions. Closer monitoring of rising credit risks, privatization and improved corporate governance of banks, along with capital market development would help contain and diversify risks and boost growth. Using the good times to reduce financial vulnerabilities and advance structural reforms would also benefit growth and competitiveness.

The authorities' views: The authorities broadly shared the staff's assessment and agreed on the need to enhance efficiency of budgetary spending. However, the Ministry of Finance ruled out majority foreign ownership of large banks given EU's home-host supervisory rules that make the cost of bank failures the responsibility of the host country, while the home country is responsible for supervision. It was also not convinced of the need to tighten fiscal policy as it saw little risk of overheating, and wage pressures contained. Progress with further structural reforms, including on pensions, would be politically difficult.

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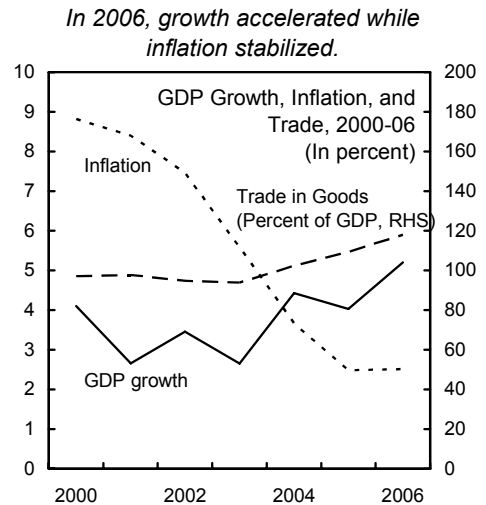
I. INTRODUCTION

1. **After 15 years of transition, Slovenia became the first new EU member to adopt the euro in January 2007.** Favorable initial conditions and sound macroeconomic policies over the past decade have allowed Slovenia to sustain robust growth with small external imbalances and public debt while gradually lowering inflation and interest rates to euro area levels. PPP-based per capita income reached about 80 percent of EU-average in 2006, putting Slovenia on par with Greece and above Portugal.

2. **Growth spillovers from the region intensified in 2004–06.** Since EU entry in 2004, trade integration has deepened and exports have been buoyed by euro area recovery. Declining real interest rates and risk premia have sustained strong credit growth, boosting domestic demand. These factors led growth to near record levels in 2006.

3. **Sustaining this performance in the euro area will require Slovenia to maintain policy discipline while addressing structural rigidities more vigorously.** The strong fiscal and wage policy discipline that preceded euro adoption needs to be sustained to ensure continued balanced expansion.

Fiscal flexibility is constrained by one of the most rigid public spending structures in Europe, limiting the scope of countercyclical policies, while rapid aging is exacerbating longer run fiscal pressures. Efficiency of the largely state-controlled financial sector is low, hampering financial intermediation and longer-term growth. To address these issues, the 2007 Article IV consultation focused on challenges in the financial sector and fiscal reforms, complementing last year's in-depth assessments of the structure of public spending, long-run fiscal sustainability and structural challenges in product and labor markets.¹



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

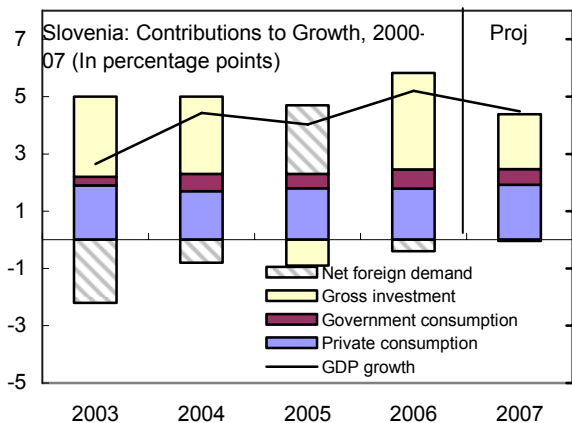
II. BACKGROUND

4. **Growth accelerated in 2006, led by investment demand (Table 1, Figures 1 and 2).** Growth rose from 4 percent in 2005 to 5¼ percent in 2006, the highest level in this decade as a recovery in investment, driven by robust credit growth and infrastructure spending, took over from exports as the main engine of activity. Private consumption

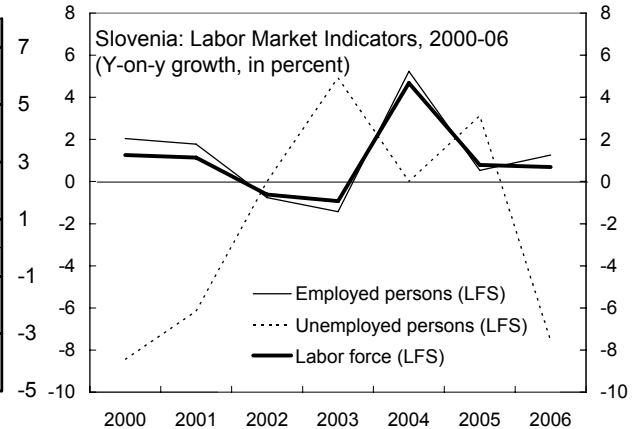
¹ This year's Selected Issues Papers cover: (i) bank efficiency in the EU context; (ii) risks with cross-border flows; (iii) capital market development; and (iv) fiscal frameworks.

remained stable, reflecting moderate wage increases. The strong economy boosted job creation mainly in services, and unemployment continued to decline. These trends, along with strong labor demand as indicated by employment rates and the continued rise in capacity utilization to record levels, suggest that the economy has reached capacity limits.

Investment-led domestic demand took over from net exports as main driver of growth in 2006.



The strong economy has boosted job creation and lowered unemployment.

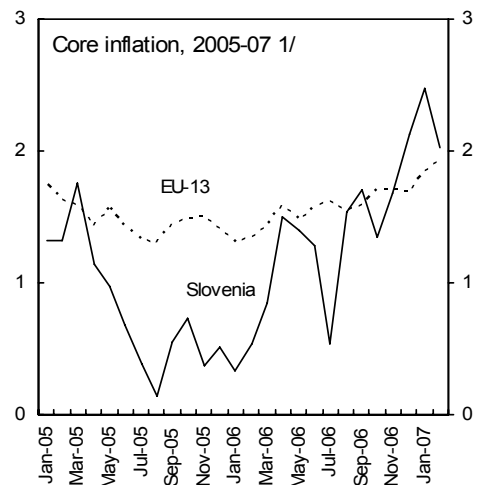


Sources: Eurostat; Haver; and Statistical Office of the Republic of Slovenia.

5. **The fiscal deficit continued to narrow in 2006, aided by the rapid growth (Table 2).** In keeping with its tradition of fiscal prudence, Slovenia further lowered the general government deficit to about $\frac{3}{4}$ percent of GDP in 2006 from about 1 percent in 2005. The budgetary overperformance, of around $\frac{1}{2}$ percent of GDP, primarily reflected stronger-than-planned tax revenues owing to both cyclical gains and one-off factors. In particular, windfall gains related to the adoption of International Accounting Standards helped boost corporate income tax collections, more than compensating for the reduction in payroll taxes. A lower-than-expected wage bill also contributed to maintaining stable expenditure levels. All in all, this implied a neutral fiscal impulse for the year.

6. **Monetary conditions in 2006 were broadly neutral as policy rates converged in the run up to euro adoption (Figure 3).** In the face of continued strong capital inflows, the Bank of Slovenia (BoS) lowered its key policy rate (60-day bills) to $3\frac{1}{4}$ percent in the first half of the year, after keeping them constant at 4 percent since ERM2 entry in 2004. With the increases in the European Central Bank (ECB) rate, the interest rate differential was closed by year-end. As the

Core inflation has reached EU levels.



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

1/ For EU-15, core inflation corresponds to total CPI excluding energy and seasonal food from the European Index of Consumer Prices.

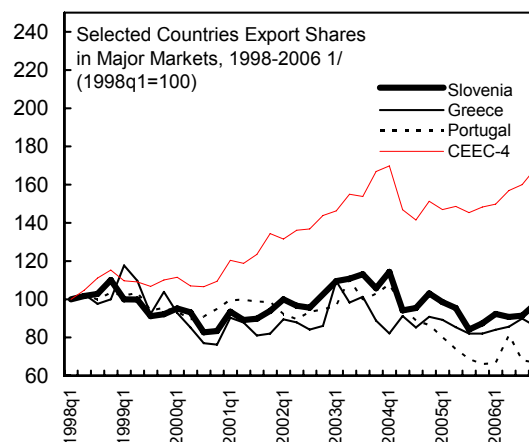
tolar-euro rate and average inflation remained stable, real interest rates declined slightly.

7. **Besides balanced macroeconomic policies, incomes policies helped to contain inflation (Figures 4 and 5).** Prudent wage policies, elimination of import duties, and increased competition following EU accession drove core inflation in 2005 below one percent. By mid-2006, it had reverted to the EU-15 average, picking up further towards end-year owing to capacity constraints and rapid credit growth. In this context, collective wage agreements that continued to set wage increases below productivity growth were key to price stability by containing second-round effects of energy price increases and demand pressures. Average headline inflation remained stable at 2½ percent, aided by receding oil prices.

8. **The current account deficit widened slightly, mainly reflecting increased factor payments (Table 3, Figure 6).** Strong demand in Europe helped sustain robust export growth at 10 percent in 2006 driven by chemicals and automotive industries. Imports accelerated to over 10 percent, owing to demand for investment goods. This, together with the higher, partly one-off, outflows of dividends to foreign investors, resulted in a widening of the current account deficit from 2 percent of GDP in 2005 to an estimated 2.6 percent in 2006.

9. **Competitiveness appears adequate, although Slovenia's ability to sustain its export markets remains a longer-run concern (Figures 7-9).** Low inflation has led to stable real effective exchange rates while moderate wage increases and a recent surge in productivity have contributed to lower unit labor costs. Export growth is solid and staff estimates using the CGER methodology suggest that the real exchange rate is aligned with fundamentals. However, gains in export market shares have been sluggish reflecting, in part, rapid catch-up by lower-cost regional competitors. Technological upgrading, which is crucial for a high-wage economy such as Slovenia's, has been lagging behind regional competitors, reflecting relatively low FDI.²

Slovenia's gains in export market share have been lacklustre.



1/ Value index, major Slovene trading partners include Austria, France, Germany, Italy, UK, and USA.

Source: IMF DOT; and IMF Staff calculations.

10. **Cross-border investment positions continued to expand in 2006, raising vulnerability to external conditions.** With declining domestic interest rates, households turned to foreign-oriented mutual funds, while banks and enterprises increased their holdings in high-return countries, especially in Southeastern Europe. To finance these investments and

² Country Report 06/250.

the rising credit demand, banks continue to resort to cheaper foreign borrowing, which made gross external debt to climb to 80 percent of GDP and reversed Slovenia's net creditor position.

11. Rapid credit growth is increasing credit risks, especially in the corporate sector (Box 1). Real credit to the private sector continued to grow by nearly

25 percent, driven by investment demand. Household credit, at 15 percent of GDP, is

still low compared to countries with similar incomes (Figure 10), but rising rapidly owing to

the greater demand for housing. In contrast, credit to enterprises is near euro area levels. Given low FDI and absence of a developed equity market, enterprises have relied primarily

on debt financing, which has led to relatively high leverage ratios compared to the region.

Banks have increased foreign borrowing to finance asset growth.

Slovenia: Sources of Growth of Bank Balance Sheets, 2001-05
(In percentage points of GDP, y-on-y change)

	2001	2002	2003	2004	2005
Private sector credit	2.3	0.5	2.4	4.7	7.6
Government credit	0.3	-0.1	-0.3	0.9	0.4
Other financial institutions	0.0	0.3	0.3	0.2	1.1
Foreign assets	6.5	-7.8	-0.9	0.2	4.7
Deposits	7.7	0.6	-1.2	-0.2	0.9
Bonds	0.1	0.3	0.2	0.7	0.3
Foreign liabilities	0.9	2.3	3.4	4.0	12.4
Money market instruments	0.5	0.6	0.3	-0.8	-0.3
Other financial institutions	0.2	0.2	0.4	0.2	0.0
Annual GDP (Billions of SIT)	4,800	5,355	5,814	6,272	6,620
Total bank assets (percent of GDP)	83	80	82	85	100

Source: Bank of Slovenia.

Box 1. Sectoral Balance Sheet Analysis

The corporate sector in Slovenia has important net total and non-equity financial liabilities, which coupled with the high debt-to-assets-ratio point to rising leverage of enterprises. The liabilities are mainly to domestic banks, increasing the banks' exposure to credit risks. Banks' rising net foreign liabilities, in turn, are increasing their vulnerability to changes in foreign market conditions.

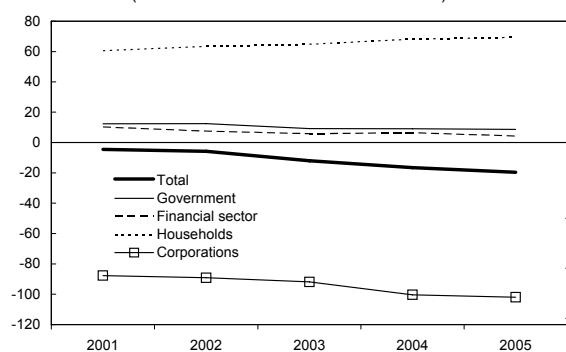
Indicators of underlying corporate vulnerabilities in selected markets, 2005

	Czech	EMU	Greece	Hungary	Portugal	Slovenia 1/
Debt-to-assets ratio, in percent (DA)	9.7	25.7	28.3	20.1	43.1	33.3
Interest coverage ratio (EE)	54.8	20.1	15.1	23.2	7.3	4.8
Return on assets (RA)	6.6	5.4	5.6	7.5	5.2	5.1
Price to earning ratio (PC)	11.2	13.9	13.4	10.7	13.0	18.5

Source: Corporate Vulnerability Database.

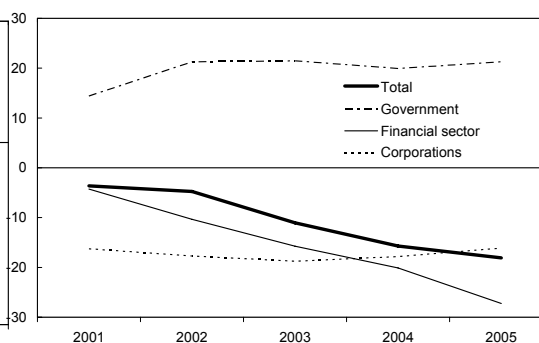
1/ Based on limited sample

Slovenia: Total Net Financial Position of Main Sectors, 2001-05
(All assets less liabilities as share of GDP)

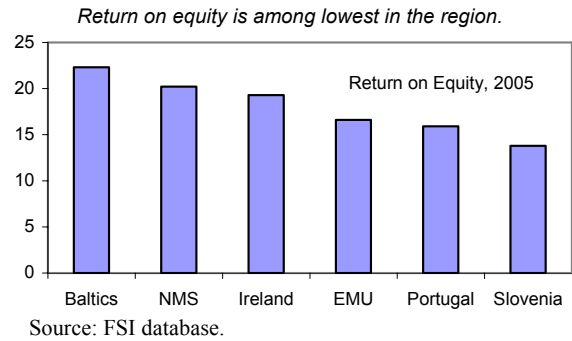


Source: Bank of Slovenia; and IMF staff estimates.

Slovenia: Net International Financial Position, 2001-05
(Percent of GDP)



12. **The financial sector remains sound to deal with these risks, but vulnerabilities are building up (Tables 4-5).** Banks' financial soundness indicators remain adequate. However, declining interest margins and loss of foreign exchange revenue are putting pressure on profitability, which is already regionally low. High levels of indirect ownership linkages could amplify transmission of shocks in the economy.



III. REPORT ON THE DISCUSSIONS

13. **Against this background, the discussions focused on the main current policy challenges for Slovenia—maintaining the strong commitment to policy discipline and advancing structural reforms—to ensure continued success in the euro zone.** The main themes were policy requirements for a balanced expansion, and using the favorable times to contain vulnerabilities and increase economic flexibility and productivity. In line with past consultations, there was broad agreement on the direction of policies.

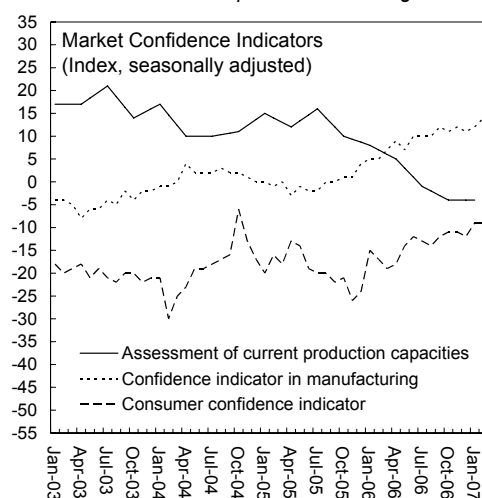
Slovenia: Effectiveness of Fund Surveillance

Past Policy Advice	Policy Outcomes
<ul style="list-style-type: none"> • Faster fiscal consolidation in good times to reduce overheating risks and deal with longer-term fiscal pressures • Increase budget flexibility by reforms in non-discretionary outlays • Improve expenditure efficiency with performance budgeting • Undertake up-front substantive pension reform to increase effective retirement age, reduce the generous benefits and develop private pensions 	<p style="text-align: center;"><i>Fiscal Policy</i></p> <ul style="list-style-type: none"> • The fiscal deficits in 2004-06 overperformed the budget and the impulse was broadly neutral, in line with Fund recommendations. • The medium-term target of structural balance has been shifted out to accommodate higher capital spending. • Social benefits, except for pensions, have been reindexed to inflation. • Political support for reducing mandatory expenditures further is limited. • The MOF has made initial progress towards performance budgeting, but broader government commitment is needed. • Pension benefits were re-indexed to wages, but transitional provisions still apply limiting its negative impact in the near term. • Discussions are ongoing to improve retirement incentives towards more active aging. The authorities regard more systemic reforms to be politically infeasible.
<ul style="list-style-type: none"> • Disinflation process anchored on interest rate policies and stronger reliance on incomes policies • Reinforce risk assessments with stress tests and cooperation with foreign supervisors • Increase efficiency by further bank privatization 	<p style="text-align: center;"><i>Monetary Policy and Financial Sector</i></p> <ul style="list-style-type: none"> • A gradual approach to disinflation based on a declining currency depreciation was undertaken. • A social agreement to set wage increases to lag productivity growth was implemented. Public sector wage bill is set to grow in line with inflation. • Stress testing and cooperation with foreign supervisors have been strengthened. • State control of the largest bank will be maintained until the home-host supervisory relationship in the EU is clarified. The second largest bank will be privatized.
<ul style="list-style-type: none"> • Encourage work incentives by better targeting of social benefits • Increase labor market flexibility by reducing high costs of hiring and firing • Improve the business climate by a one-stop-shop and continue to privatize state companies 	<p style="text-align: center;"><i>Labor and Product Markets</i></p> <ul style="list-style-type: none"> • Unemployment benefits have been tied to active labor market policies. • A centralized database on social benefits due in 2009 is expected to reduce system abuse. • Increased work incentives for high income earners by elimination of payroll tax. • Discussions are ongoing to facilitate use of temporary workers. • There is limited support for relaxing the strict employment protection in place. • Work on e-government has progressed significantly and “one stop shop” for company registration will be implemented in late 2007. • Household electricity prices will be liberalized. • The state-owned telecom company has been listed on the stock exchange.

A. Outlook

14. **The authorities and staff expect the near-term economic outlook to remain favorable (Table 6).** Growth in 2007 is projected to slow down, but remain robust at 4½ percent, assuming prudent fiscal and wage policies. With household consumption rising in line with higher disposable incomes, domestic demand is expected to continue driving growth. While the investment boom should decelerate owing to the reduced tax breaks and higher interest rates, business confidence surveys, manufacturing orders, and infrastructure investment plans suggest still strong trends. While the euro area slowdown will affect exports, a concurrent decline in imports will limit the impact on net exports and the current account is expected to be broadly unchanged at 2½ percent of GDP. Despite the pressures on capacity, there are no signs of overheating as yet, with private consumption flat and inflation expectations stable. Headline inflation is projected to remain at 2.6 percent, assuming prudent macroeconomic policies and moderate increases in administrative prices, and core inflation will gradually rise on account of services. This assessment is broadly in line with BoS and consensus forecasts.

Confidence indicators point to sustained growth.



Source: Statistical Office of the Republic of Slovenia.

Growth will slow down moderately in line with Euro-area trends.

Summary of Macroeconomic indicators

	2005	2006	2007	2008
			Projections	
Slovenia				
GDP	4.0	5.2	4.5	4.1
Inflation (period average)	2.5	2.5	2.6	2.6
Current Account	-2.0	-2.6	-2.6	-2.5
Euro Area				
GDP	1.4	2.6	2.3	2.3
Inflation (period average)	2.2	2.2	2.0	2.0
Current Account	-0.1	-0.2	-0.3	-0.4
Interest Rate (short-term)	2.3	3.1	3.8	3.7

Source: WEO.

15. **Views differed mainly on overheating risks to this outlook.** Staff and BoS noted that the tightening labor market, strong credit growth and climbing asset prices could raise demand pressures. With growing constraints on resources as suggested by record high capacity utilization rates and estimates of a positive output gap since 2006 (using both HP-filter and production function methodologies), overheating risks are on the rise. However, the Ministry of Finance considered overheating risks as contained, as it viewed the economy as growing at a higher potential rate following euro adoption, which is not captured by these empirical estimates based on short historical series. There was agreement that external risks can arise from higher world oil prices, and a potential disorderly unwinding of global imbalances that would lead to euro appreciation and lower growth.

16. **The authorities concurred that near-term external and financial vulnerabilities are contained.** The risks to financial stability in Slovenia are currently low. Although the rising reliance on cross-border capital flows exposes Slovenia to changes in investor

sentiment, market confidence remains high as indicated by declining spreads and solid credit ratings (Figure 11). Debt sustainability analysis also shows that, despite rising gross debt, the risks are contained by a large share of long-term liabilities. Net debt remains at a low 5 percent of GDP (Appendix I).

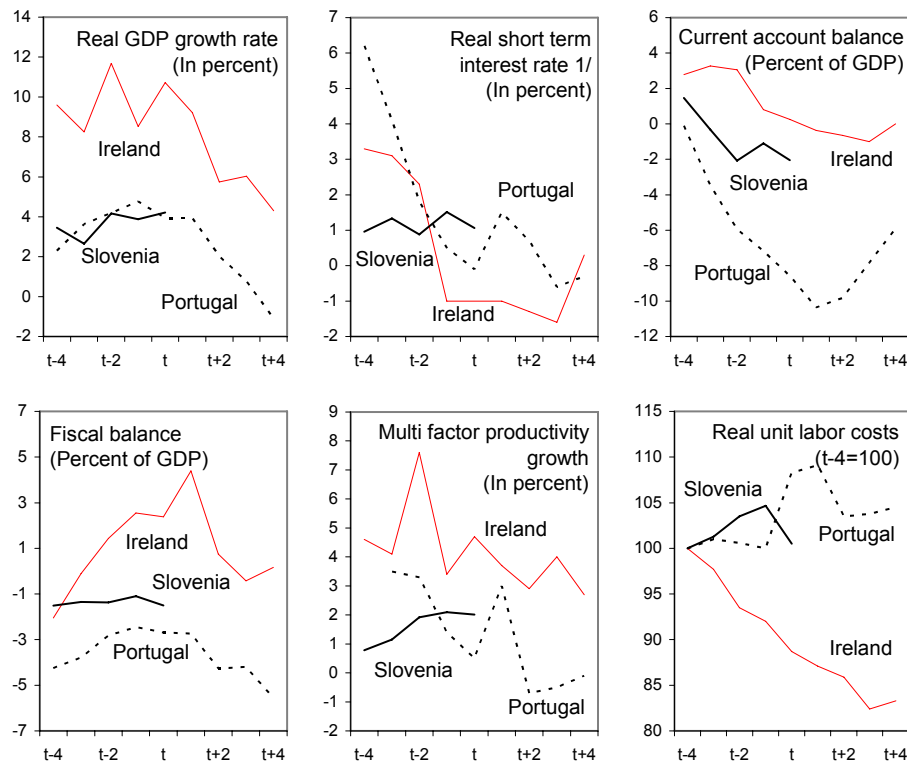
17. **There was agreement that the main risk to medium-term growth and faster convergence arises from a failure to maintain competitiveness.** Both sides noted the experience with sluggish growth of some of the current EMU members since they adopted the euro. In the absence of flexible fiscal and labor policies, a credit-induced boom mostly in the nontradable sector resulted in real appreciation and loss of competitiveness (Box 2). Reducing structural rigidities in the budget, and in the financial and labor markets was thus crucial for demand management and growth. The authorities agreed that increases in real wages to catch up to productivity, as currently discussed between social partners, would need to be implemented over a longer term horizon to safeguard competitiveness.

Box 2. Slovenia–Lessons from Portugal and Ireland from Euro Adoption

As in Slovenia, euro adoption in Ireland and Portugal was preceded by strong growth, aided by capital inflows. In Ireland, large FDI inflows raised productivity. Low taxes encouraged labor supply and investment, while wage growth below productivity and skilled labor offered high returns in export-oriented activities. Upon euro adoption, Ireland continued to grow. In Portugal, credit boosted consumption and housing while productivity growth slowed sharply as a cumbersome business environment and excessive wage growth discouraged investment in manufacturing. A pro-cyclical fiscal policy added to demand pressures, and led to a real appreciation. A boom-bust cycle ensued as a drop in consumption and a loss of competitiveness stalled growth. Adjustment has been slow given limited fiscal space, downward rigid wages and low productivity.

To avoid the low-growth trap, Slovenia should accelerate structural reforms and improve economic flexibility. It is entering the euro zone with strong growth sustained by a foreign financed investment boom. Although productivity growth has picked-up in recent years, low FDI and slow technological upgrading of production are a risk for its future sustainability. Therefore, it is important to improve allocation of investments to high productivity projects by reforms that encourage economic flexibility.

Selected Euro Area Countries: Macroeconomic Indicators at the Time of Euro Adoption



Source: Eurostat, OECD Productivity Database and AMECO.

B. Fiscal Policy

18. **Echoing the different assessments of the risks of overheating, views differed on the need for a tighter-than-planned fiscal stance in 2007–08.** The government's fiscal plans target an increase in the general government deficit from $\frac{3}{4}$ percent in 2006 to 1.3 percent and 1.7 percent of GDP in 2007-08 (including the railway company but without the budgeted VAT increase, which the government plans to forego).³ This implies a procyclical impulse—measured as a change in the primary structural balance—of about 1 percent of GDP over 2007-08. While acknowledging that potential growth estimates in a transition economy are highly uncertain, staff viewed growth as being above potential in light of the tightening resource constraints and recommended, at a minimum, a neutral fiscal stance—to be achieved through reforms in areas such as the inefficient current transfers and the wage bill. The Ministry of Finance argued that the current plans are appropriate given uncertainties about the cyclical position of the economy. Moreover, it saw limited scope for further expenditure rationalization in the near term.

Near-term fiscal stance is projected to be expansionary.

Fiscal Outlook, 2005-09 (In percent of GDP)

	2005	2006	2007		2008		2009	
			Actual	Adj. Budget	Staff	Adj. Budget	Staff	Adj. Budget	Staff
General government deficit 1/	-1.2	-0.8	-1.3	-0.6	-1.7	-0.7	-1.1	-0.3
Primary deficit 1/	0.0	0.3	-0.3	0.4	-0.7	0.3	-0.1	0.7
Structural fiscal balance	-0.9	-0.9	-1.4	-0.6	-1.8	-0.6	-1.0	-0.3
Structural primary balance	0.2	0.2	-0.4	0.2	-0.8	0.2	0.0	0.8
Change (Fiscal Impulse)		0.0	0.6	0.0	0.4	0.0	-0.8	-0.5
General government debt	28.0	28.5	28.2	...	28.3	...	27.7	...
General government deficit (ESA-95) 2/	-1.4	-1.4	-1.5	...	-2.0	...	-1.4	...

Source: Slovene authorities, and staff calculations.

1/ Corresponds to the cash budget deficit, adjusted to include railways agency deficit and exclude budgeted revenues from VAT rate increase (0.4 percent of GDP in 2008 and 2009) that will not be implemented.

2/ 2006 Stability Program adjusted for VAT in 2008 and 2009.

19. **In the medium term, the government targets a sharp decline in deficits, with a lower tax burden to be accompanied by reductions in spending.** The current plans envisage a deficit of 1.1 percent of GDP in 2009, and a structural balance by 2011. An ambitious tax reform is underway to reduce the high personal and corporate income taxes and gradually eliminate the payroll tax. To accommodate the decline in revenues without increases in indirect taxes, the authorities plan to contain wages and cut employment, and implement stricter eligibility for, and reindexation of, social benefits. Spending will also be reoriented towards growth-related priorities, such as R&D, active labor market policies, and

³ Recently passed legislation would bring the railway company within the general government budget beginning with the supplemental budget planned later this year.

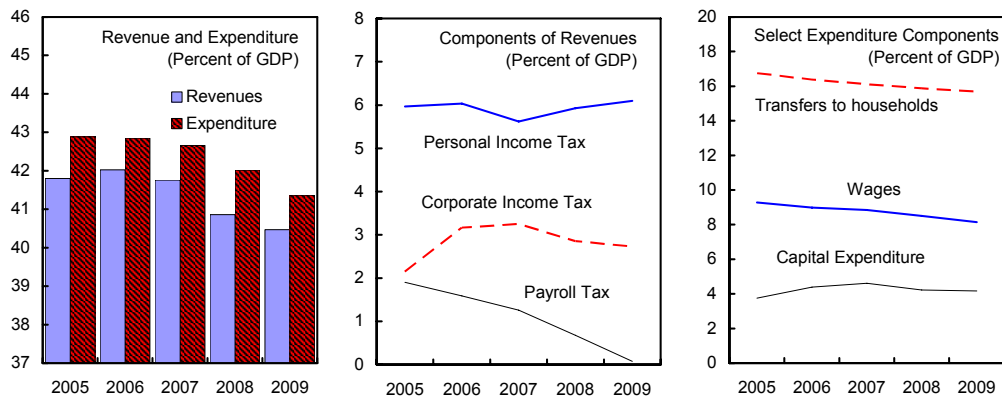
restructuring of the railway company. However, many of the required reductions in spending are delayed to 2009 and beyond, and the measures are not yet fully identified.

20. **Staff noted that a more frontloaded consolidation with up-front expenditure reforms would reduce risks to these targets and enhance flexibility to absorb potential shocks.** Projections for a number of budget categories appear optimistic: the expected rise in corporate income tax collections is highly uncertain given the windfall gains in 2006 (about ½-1 percent of GDP), and the tight wage bill and capital spending budgets, particularly in an election year, need to be backed up with more concrete measures. The planned introduction of regional governments and modernization of the railway (about 30 percent of GDP over the next decade) also add to spending pressures. To deal with these challenges and improve fiscal flexibility, staff urged more up-front expenditure reforms in rigid spending. Staff's cross-country analysis shows room for efficiency gains in areas such as health care, education, and social transfers.⁴

Fiscal Reform Package		
Direct Taxes	Key Measures	Estimated Impact (In percent of GDP)
Personal Income Taxes	Reduction of rates to 16, 27 and 41 percent. Tax brackets reduced from 5 to 3	-0.5 (in 2007)
Corporate Income Taxes	Single tax rate of 20 percent on capital income Rate reduced from 25 percent to 20 percent by 2010 Elimination of double taxation and investment tax allowance Introduction of R&D tax allowance	-0.5 (in 2007-09)
Payroll Taxes	Phased elimination	-1.8 (in 2007-09)
Indirect Tax		
Excise	Introduced excise on electricity, Increased in cigarette and alcohol excise	0.1 (in 2007-09)
Expenditure		
Social transfers	Reindexation of non pension social benefits to inflation Tighter eligibility of unemployment benefits, Active labor market policies	1.0 (in 2007-09)
Public sector wage bill	Increase in public wagebill limited to expected inflation Planned employment cut of 1 percent annually	0.8 (in 2007-09)
Goods and services	Rationalization of travel and transport allowance	--

Source: 2006 Stability Program.

Medium-term fiscal plans envisage reduced tax burden and spending cuts to achieve lower deficits.



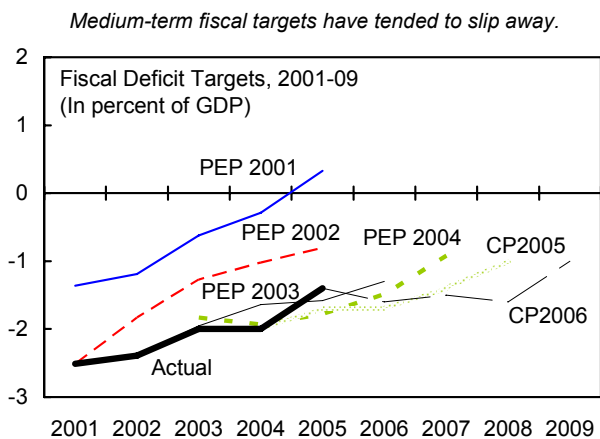
Source: Slovene Authorities.

⁴ IMF Country Report 06/250.

21. **While the authorities agreed on the desirability of expenditure reforms, they were less concerned about risks to the fiscal targets.** The authorities consider near-term fiscal risks as contained with revenues stronger than planned and spending under control. They also noted that recent measures to streamline social benefits and unify the registries in 2009 would reduce mandatory expenditure over the longer run, and that the fiscal burden from railways would be eliminated by seeking public-private-partnerships. Staff welcomed these measures, but noted that substantial fiscal risks are likely to remain given difficulties in transferring all financial risks in a railway to the private sector. Nevertheless, the authorities agreed with staff that speedy implementation of performance budgeting is needed to identify more specific and durable measures to reduce inefficient spending, but only over time.

22. **The authorities acknowledged that the pension system remains an important challenge for longer-term sustainability, but systemic reform is not politically feasible in the near term.** The public pension system faces one of the most rapidly aging populations, lowest average retirement age, and highest pension to wages ratio in Europe. Under current policies, the demographic pressures are expected to increase age-related expenditures from 19 percent of GDP presently to almost 28 percent by 2050, increasing the public debt to unsustainable levels (Appendix I). Staff reiterated that systemic reforms are needed to restore fiscal viability sooner than later with the increasing political clout of pensioners—in less than ten years more than half of voters are retirees. Noting that pension deficits are contained for the next decade, the authorities indicated that political support is lacking for more substantive reform beyond the current program of “active aging”—increasing incentives to retire later—and removal of restrictions on private pensions. In the absence of a more substantial reform, staff recommended that the medium-term fiscal consolidation should be more ambitious to generate savings for future pension payments.

23. **Staff proposed supporting expenditure reform with measures to strengthen the national fiscal framework.** Slovenia currently has a two-year rolling budget framework. The medium term budget implementation has, however, lagged behind initial plans as the targets are recurrently shifted out. Staff noted that strengthening the role of an independent fiscal institution in policy monitoring could enhance fiscal discipline. Furthermore, a nominal expenditure rule based on a structural balance could enable more expenditure-based consolidation while preserving cyclical gains (SIP). Citing lack of sufficient expertise for independent external analysis in a small country, the authorities stated that budgetary projections are already based on conservative and independently formed



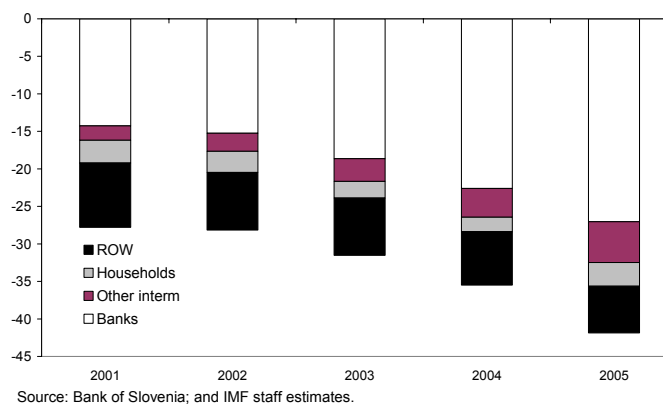
Source: Pre-Accession Economic Programs (PEP) and Convergence Programs (CP).

growth assumptions in line with international best practice. Discussions are underway for an annual deficit rule, and a fiscal rule is needed for the new regional governments.

C. Financial Sector

24. **The authorities and staff concurred that risks from rapid credit growth, especially to the leveraged enterprises, and foreign expansion warrant closer monitoring.** Attractive profits abroad are likely to entice further expansion of foreign operations of Slovene banks and enterprises increasing market-related risks, while competition for market share is likely to sustain strong credit growth despite rising credit risks. To mitigate these risks, the authorities have stepped up supervision, including close collaboration with foreign supervisors, and plan to broaden the coverage of credit registries. They agreed on the need for bank-specific stress tests and closer monitoring of balance sheet mismatches in the enterprise sector, and supported the development of the nonbank financial sector to improve access to equity finance. While a continued increase in mortgage credit from low levels (5 percent of GDP, compared to the EU average of 36 percent) is unlikely to threaten financial stability in the near term, house price developments and household credit will need to be followed closely to detect any asset bubbles (Figure 12).⁵

Corporate net liabilities have risen rapidly.
Slovenia: Corporate Non-equity Net Liabilities to Other Main Sectors, 2001-05
(Total assets less liabilities as share of GDP)



25. **To enhance future financial stability, the authorities agreed on the need to strengthen the banking sector in good times.** Although the sector remains sound and resilient to shocks as indicated by BoS stress tests (SIP), rapid expansion and margin compression could start stretching capital adequacy ratios (Figure 13).⁶ The high degree of state ownership in the bank and nonbank sectors may also have constrained competition

Bank profitability is under pressure.

Slovenia: 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
Net interest margin to average interest bearing assets	3.4	2.9	2.6
Return on average assets (before tax)	1.0	1.0	1.0
Average short-term assets to average short-term liabilities	93.2	88.4	84.8
Variable rate contracts (share of new loans of largest 8 banks)	30.1	38.5	54.5

Source: Bank of Slovenia.

⁵ IMF Country Report 05/266.

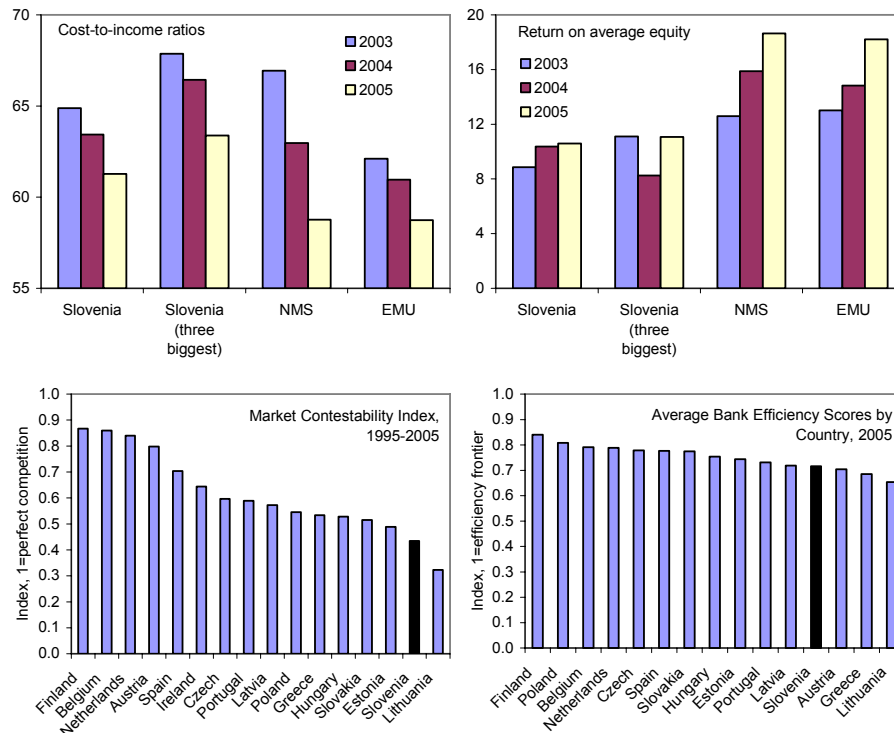
⁶The adoption of International Financial Reporting Standards in 2006 will lower required provisioning and support profits.

with adverse impact on efficiency as indicated by Slovenia's low rank on the market contestability index (Box 3). The Bank of Slovenia noted that regulations on bank board memberships are being improved in line with EU norms, which should help improve efficiency through better corporate governance. In this context, staff recommended rapid implementation of the government's plans for bank privatization and supported the listing of large banks and insurance companies in the stock exchange. Furthermore, a clear business strategy, including on eventual capital needs, is needed for banks in which the government holds important stakes. The authorities agreed in principle, although the Ministry of Finance expressed reservations on selling the largest bank as it might open the door to a majority foreign ownership, which it opposes until issues with home-host supervision under EU Directives are resolved in a way that does not separate supervisory decision-making power from the responsibility for bank failure.

Box 3. Performance of Slovene Banks in the Regional Context

Cost-to-income ratios and distance from the best-practice cost frontier show Slovene banks are less efficient than their EU peers, especially in the three large state-dominated banks. This is also reflected in stagnant bank profitability, in contrast with rapid improvements in much of EU. Slovenia also ranks low within the EU on banking sector contestability index, which may reflect still limited integration with EU markets and a dominant position of one large state-owned bank.

Selected Performance Indicators of Slovene Banking Sector



Source: Bankscope; and IMF staff calculations.

26. **The authorities also concurred on the need to boost capital market development along with stronger supervision.** Capital market development in Slovenia has lagged

behind its EMU peers (Figure 14), and integration with European capital markets is just beginning (SIP). The recent listing of the telecommunications company has been an important start for improving the depth and liquidity of the local stock market. The plans to link the local stock exchange to EU counterparts, and the recent implementation of several EU directives should also help market development. Staff recommended listings of other large companies and welcomed plans to relax the minimum required returns for private pension funds and insurance investments to further deepen markets. In addition, the introduction of new laws on venture capital funds and the amendment of the law on investment funds should help financial innovation and equity financing for SMEs. Staff also welcomed plans to strengthen non-bank supervision in a unified structure to ensure a balanced development in the sector.

Capital market development lags behind EMU peers.

Financial System by Assets, 2005
(Percent of GDP, EMU=100; end of period)

	Slovenia	Portugal	Spain	Greece	EMU
Total assets of credit institutions	39	86	84	55	100
Total investment of insurance corporat	21	63	52	14	100
Total assets of pension funds	26	125	81	0	100
Total assets of investment funds	14	42	44	21	100

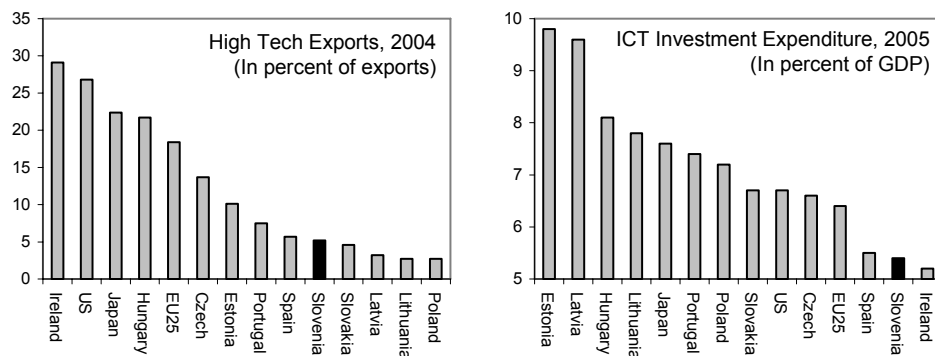
Source: EU Banking Structures, ECB, October 2006.

D. Structural Reforms

27. **The authorities agreed that reforms in the financial sector and greater labor participation and flexibility and are needed to boost growth.** To increase productivity, the authorities have attached high priority to high-tech products in exports and value-added, as shown by increasing R&D support in the budget. Reforms for an active aging strategy is likely to increase labor participation by the elderly, which is low compared to EU peers. Staff urged more substantive steps to liberalize employment protection regulations to lower the high costs of firing and hiring, thereby enhancing labor flexibility and demand. The staff also pointed out that structural weaknesses in the financial sector may have contributed to problems in allocating resources to higher productivity activities. The largely bank-based financial sector in Slovenia may have focused on providing credit to existing clients, while studies show that arms-length systems are better at allocating resources to new firms, technologies and activities (WEO 2006). The authorities agreed that the development of capital markets can also make a contribution to boosting technological upgrading and productivity.

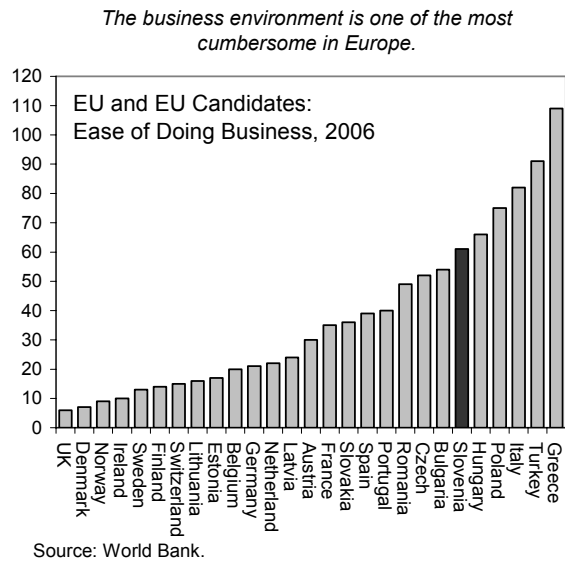
Technological upgrading is needed to boost productivity.

Selected EU and OECD Countries: Indicators of Technology Upgrading, 2004-05



Source: European Innovation Scoreboard, 2006.

28. **While acknowledging recent progress in improving the business climate, staff encouraged further privatization to boost productivity.** Slovenia has ranked relatively low among European economies in the ease of doing business. This has resulted in low FDI contributing to slow adoption of new technologies. Staff welcomed recent initiatives to impose a mandatory assessment of administrative burden for new regulatory proposals, and recommended speedy implementation of the one-stop-shop for business registration for corporations envisaged for November to alleviate the administrative burden on business enterprises. Rapid implementation of the government's privatization plans would also help attract FDI and enhance efficiency.



IV. STAFF APPRAISAL

29. **Slovenia's recent euro zone entry is a testimony of its commitment to sound macroeconomic policies.** Fiscal prudence, income policies that kept wage growth below productivity, and a cautious monetary stance brought down inflation and interest rates to Maastricht levels while keeping external deficits and net debt low. Macroeconomic stability and a deepening integration with the rest of Europe have helped sustain solid growth and lifted the standard of living for Slovenes.

30. **Sustaining macroeconomic policy discipline while increasing attention to structural reforms will be key for success in the euro zone.** The loss of the exchange rate instrument puts the burden of macroeconomic management on fiscal and wage policies, and reinforces the role of economic flexibility and productivity in maintaining competitiveness. Therefore, more emphasis is needed in Slovenia on policies that reduce structural rigidities, especially in the fiscal and financial sectors, boost productivity, and ensure sustainable public finances.

31. **While the outlook remains good, complacency is a risk going forward.** Growth is expected to slow down, reducing excess demand pressures, and inflation to remain contained, assuming continued prudent wage and fiscal policies. However, tightening capacity constraints suggest that overheating risks are rising. Sustained strong credit growth and rapid increases in asset prices add to the risks. Given the cyclical context, the policy mix should aim at reducing demand pressures with tight wage and fiscal policies. The current favorable

economic environment is an opportune time for ensuring future financial stability by reducing vulnerabilities, and speeding up additional structural reforms.

32. **To contain inflation risks in an economy facing growing pressures on resources, the fiscal stance in the near term should be at least neutral.** Implementing the 2007-08 budget and the railway investments would add an impulse of about 1 percent of GDP to the already strong domestic demand. A neutral stance requires a fiscal deficit of about 0.6 percent of GDP for 2007 and 0.7 percent in 2008. To preserve the gains from the lowering of the tax burden, fiscal consolidation needs to focus on reforming the rigid and inefficient spending structure.

33. **Over the medium term, achieving the fiscal targets without up-front spending reforms will be difficult against declining tax revenues and mounting fiscal pressures.** While the tax reform package is commendable, it is not revenue neutral. Much of the spending cuts to reach the medium-term fiscal targets are backloaded and measures remain to be fully identified. Higher-than-planned wage bill and capital spending, and uncertainties in income tax collections add to the risks. A faster and more front-loaded consolidation with cuts in non-discretionary spending and pension reform when times are still good would not only support balanced growth, but also increase budgetary flexibility and address longer-term fiscal sustainability concerns from age-related spending. In the absence of substantive pension reform, medium term fiscal consolidation should be more ambitious than envisaged.

34. **Although the financial sector is sound, the gradual rise in credit risks and increasing exposure to foreign markets requires close monitoring.** Risks from rapid credit growth, especially to the leveraged enterprise sector, and increasing foreign activities of banks warrants closer supervision. The active cooperation with foreign supervisors and the establishment of a credit registry are welcome, and should be complemented by greater use of bank specific stress tests, and vigilance on balance sheet mismatches.

35. **Using good times to reduce vulnerabilities would enhance future financial stability.** Bank profitability is under pressure from declining interest margins and loss of foreign exchange revenue. Rapid expansion is also starting to stretch capital adequacy ratios. Dominance by the state in the sector may be constraining competition, while the absence of the large banks from the stock exchange weakens transparency and oversight over management. To reduce these vulnerabilities, rapid progress should be made with bank privatization and the large banks should be listed in the stock exchange. The government should establish a clear strategy for banks in which it continues to hold important stakes, including for possible capital increases, in particular if the rapid pace of expansion in their foreign operations continues.

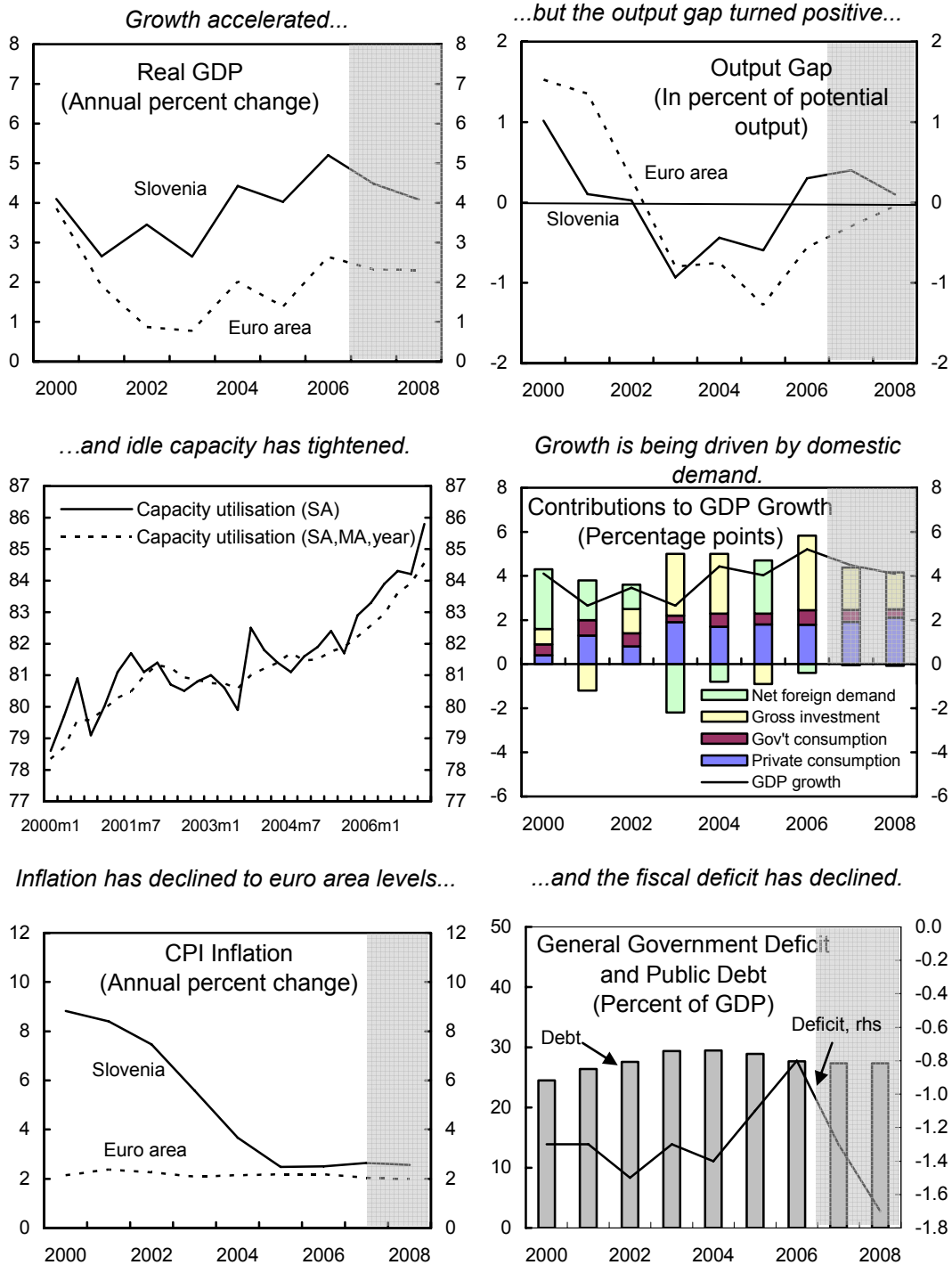
36. **Strengthening the role of capital markets in the economy would help contain vulnerabilities while boosting growth.** Financial development is lagging behind EU peers, and integration with EU capital markets is at early stages. More diversified financial products

and deeper integration with EU networks would help lower credit risks by risk transfer and improving access to equity finance. Plans to link the local stock exchange to EU networks, reduce minimum return restrictions on private pensions and the adoption of laws on investment funds and venture capital should deepen markets, help financial innovation and access to finance of new companies. This, in turn, can speed up technological upgrading of production and productivity growth.

37. **To maintain competitiveness, further structural reforms are needed in labor markets and the business environment.** At present the real exchange rate appears to be in line with fundamentals. However, the high cost of doing business and rigid labor markets have distracted FDI, and contributed to low innovation and structural change with Slovenia falling behind its peers in gaining market share in the EU in higher technology products. Recent initiatives for e-government, one-stop shops for company registration, and reduction of administrative burden are commendable. Linking unemployment benefits to work acceptance and implementation of the authorities' "active aging" initiative should increase labor participation. To safeguard competitiveness, firmer action is needed to implement privatization plans and reduce the high costs of employment protection regulations.

38. It is recommended that next Article IV Consultation with Slovenia be held on the standard 12-month cycle.

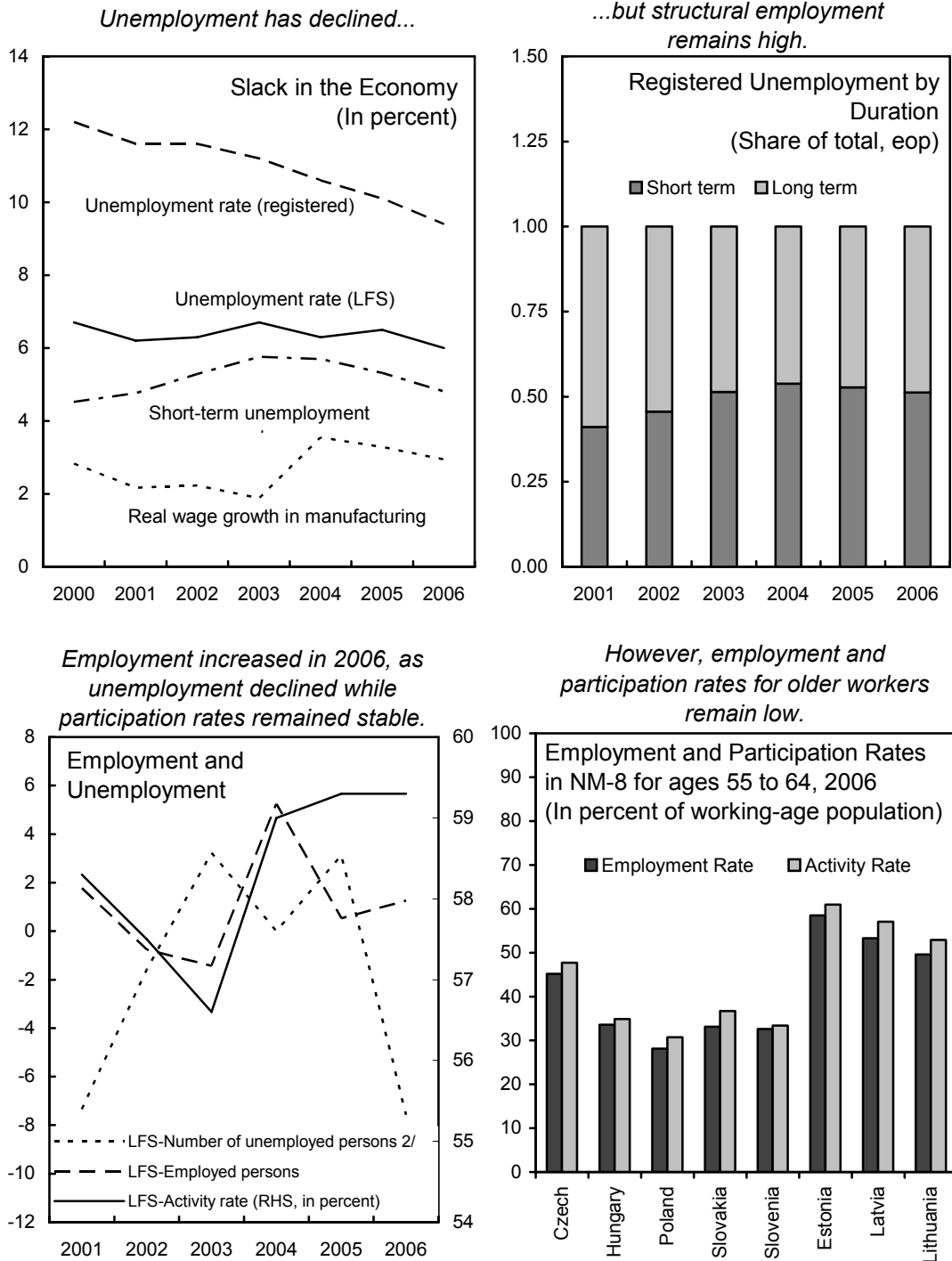
Figure 1. Slovenia: Economic Indicators, 2000–08



Sources: Bank of Slovenia; Ministry of Finance; Statistical Office; and IMF staff projections.

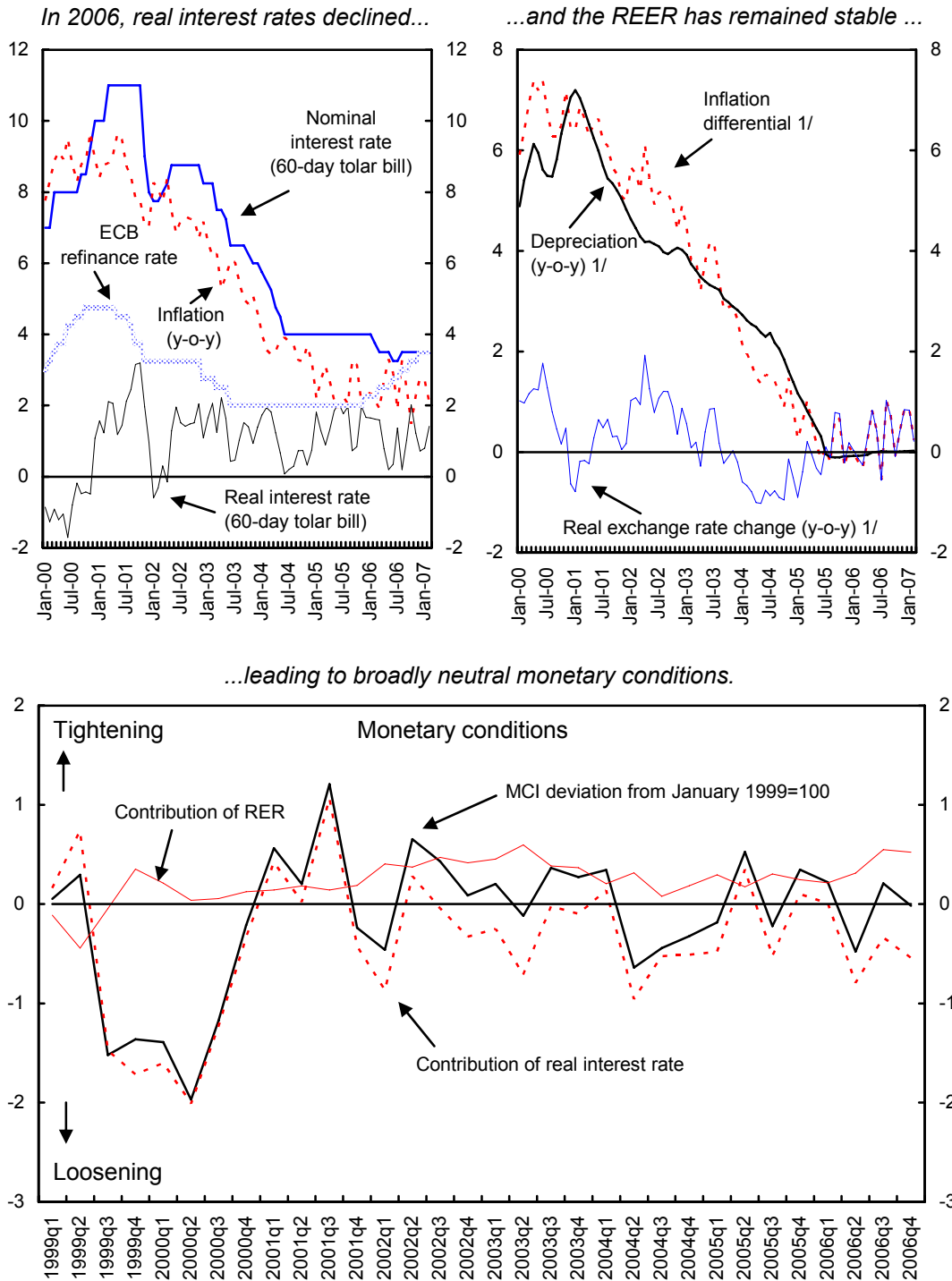
1/ Fiscal deficit and public debt as of end-2005; interest rate as of February 2006; inflation rate as of March 2006.

Figure 2. Slovenia: Labor Market Indicators, 2000-06
(y-o-y percent change, unless otherwise indicated)



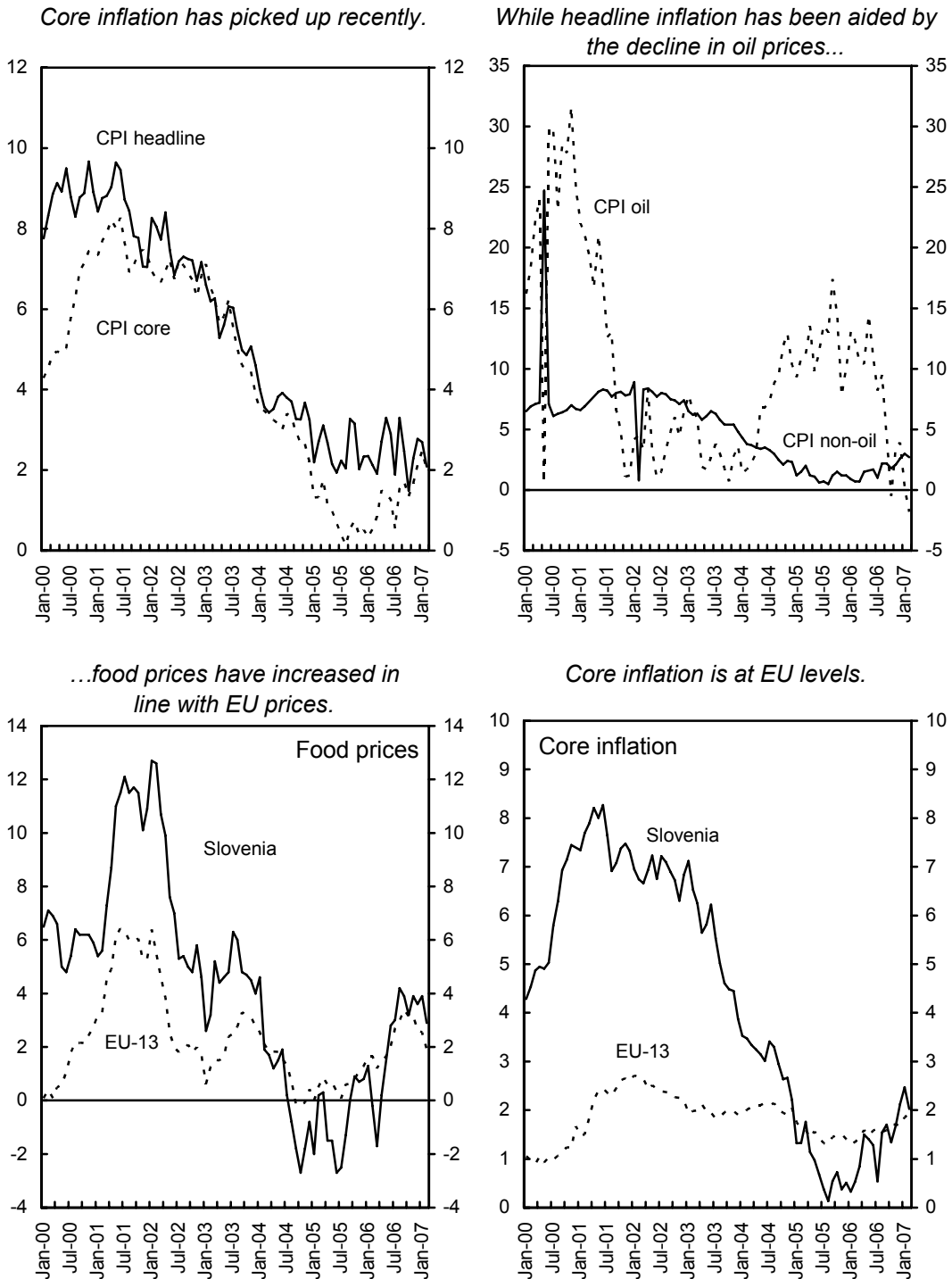
Sources: Employment Service of Slovenia; Monthly Bulletin, Bank of Slovenia; WEO; and IMF staff estimates.

Figure 3. Slovenia: Monetary Conditions, 2000-07
(In percent)



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

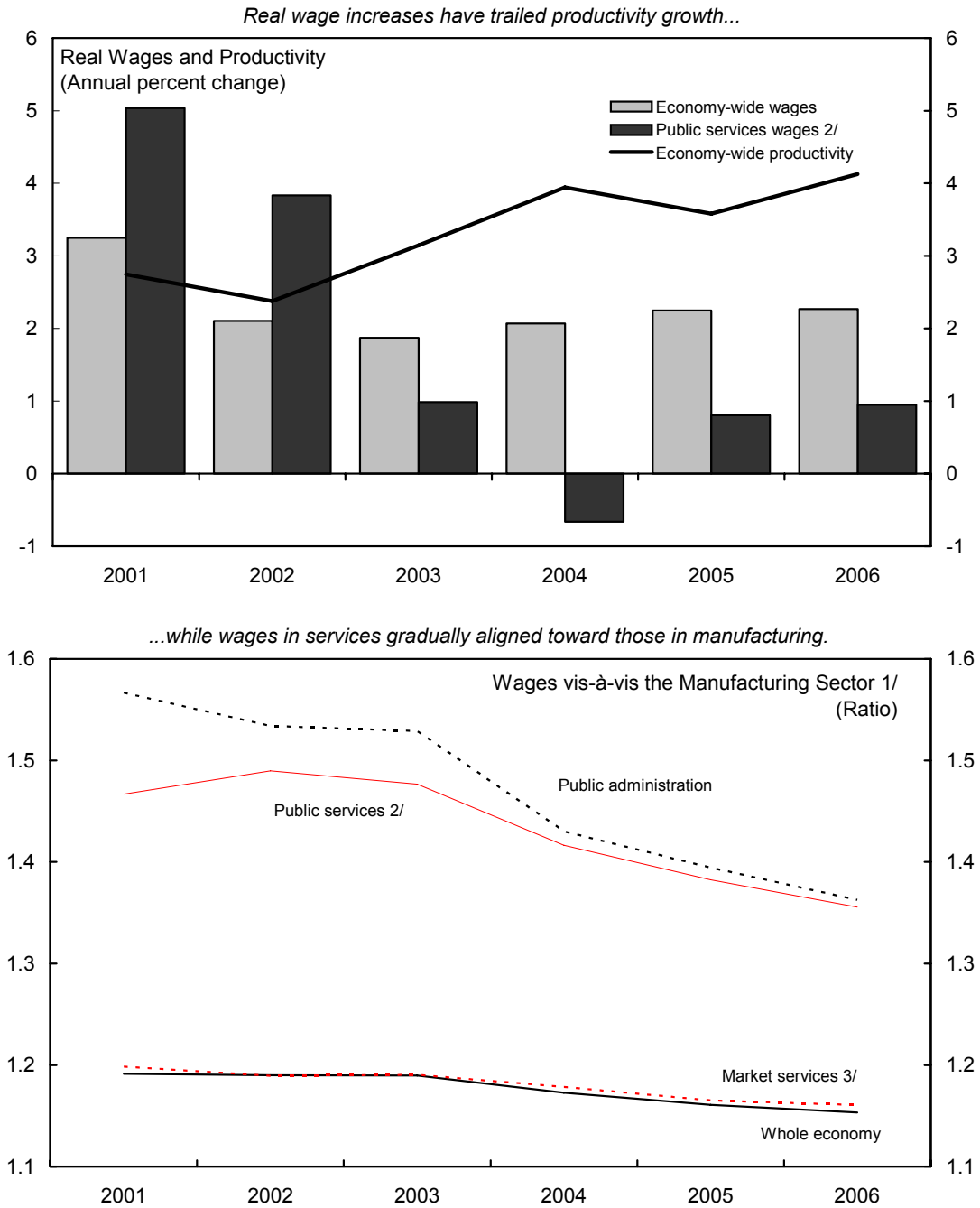
Figure 4. Slovenia: CPI Inflation and Components, 2000-07
(Year-on-year change, in percent)



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

1/ For EU-13, core inflation corresponds to total CPI excluding energy and seasonal food from the European Index of Consumer Prices.

Figure 5. Slovenia: Wages and Productivity, 2001-06



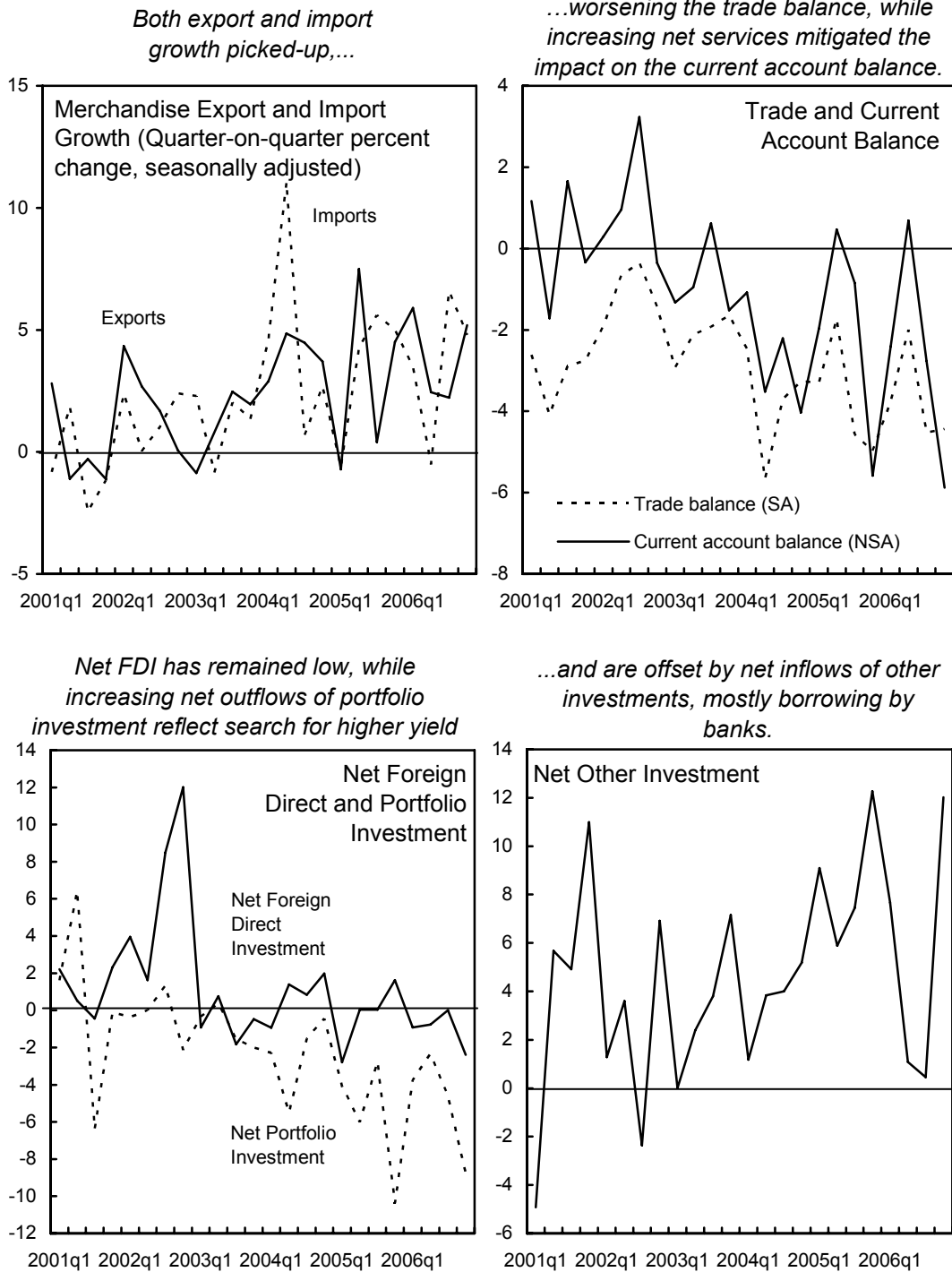
Source: Statistical Office of the Republic of Slovenia; and IMF staff calculations.

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

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

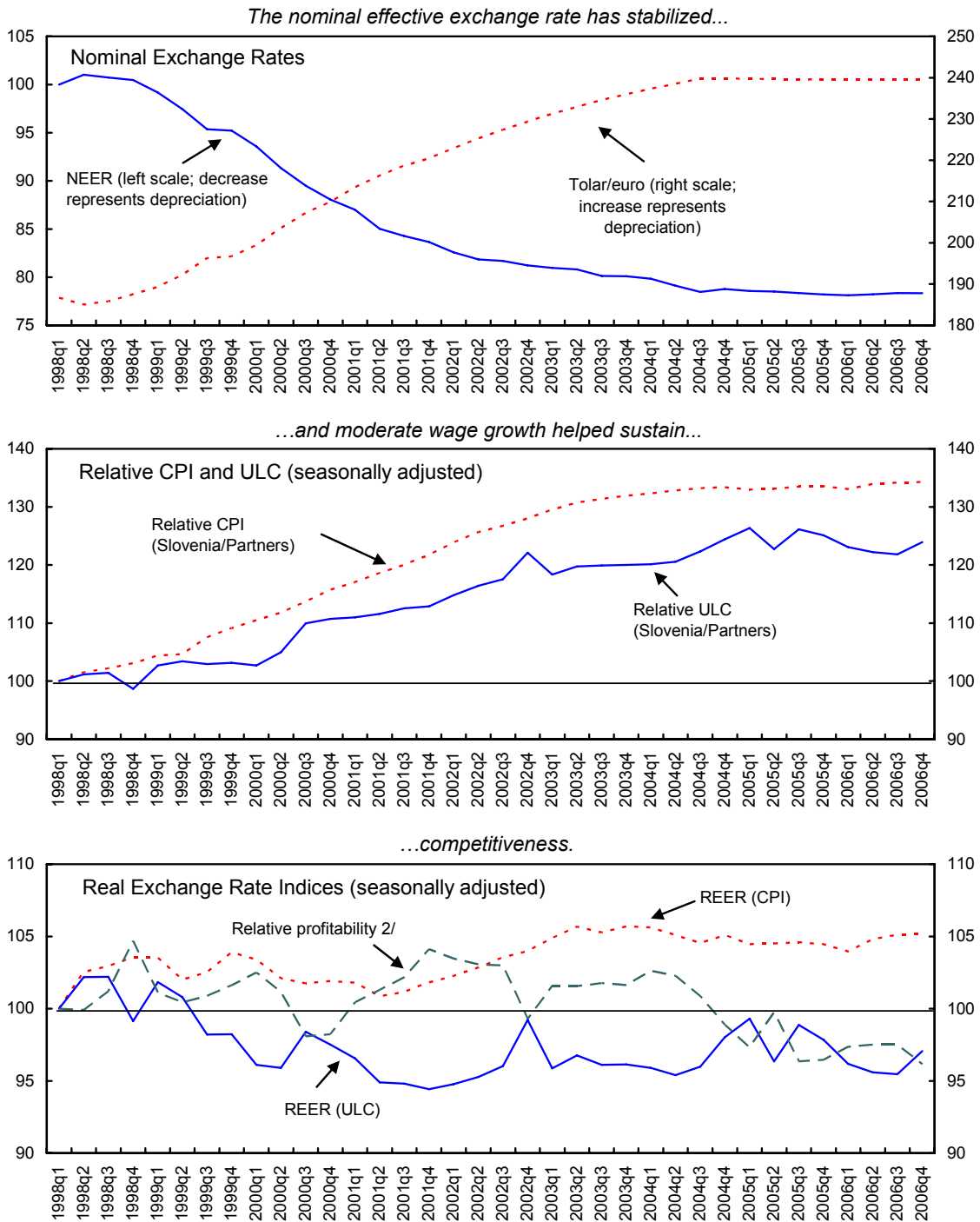
3/ Includes distributive trade; hotels and restaurants; transport, storage, and communications; financial intermediation; and real estate.

Figure 6. Slovenia: External Sector Developments, 2001-06
(In percent of GDP, unless otherwise indicated)



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

Figure 7. Slovenia: Exchange Rate Indicators, 1998-2006
(1998q1=100) 1/

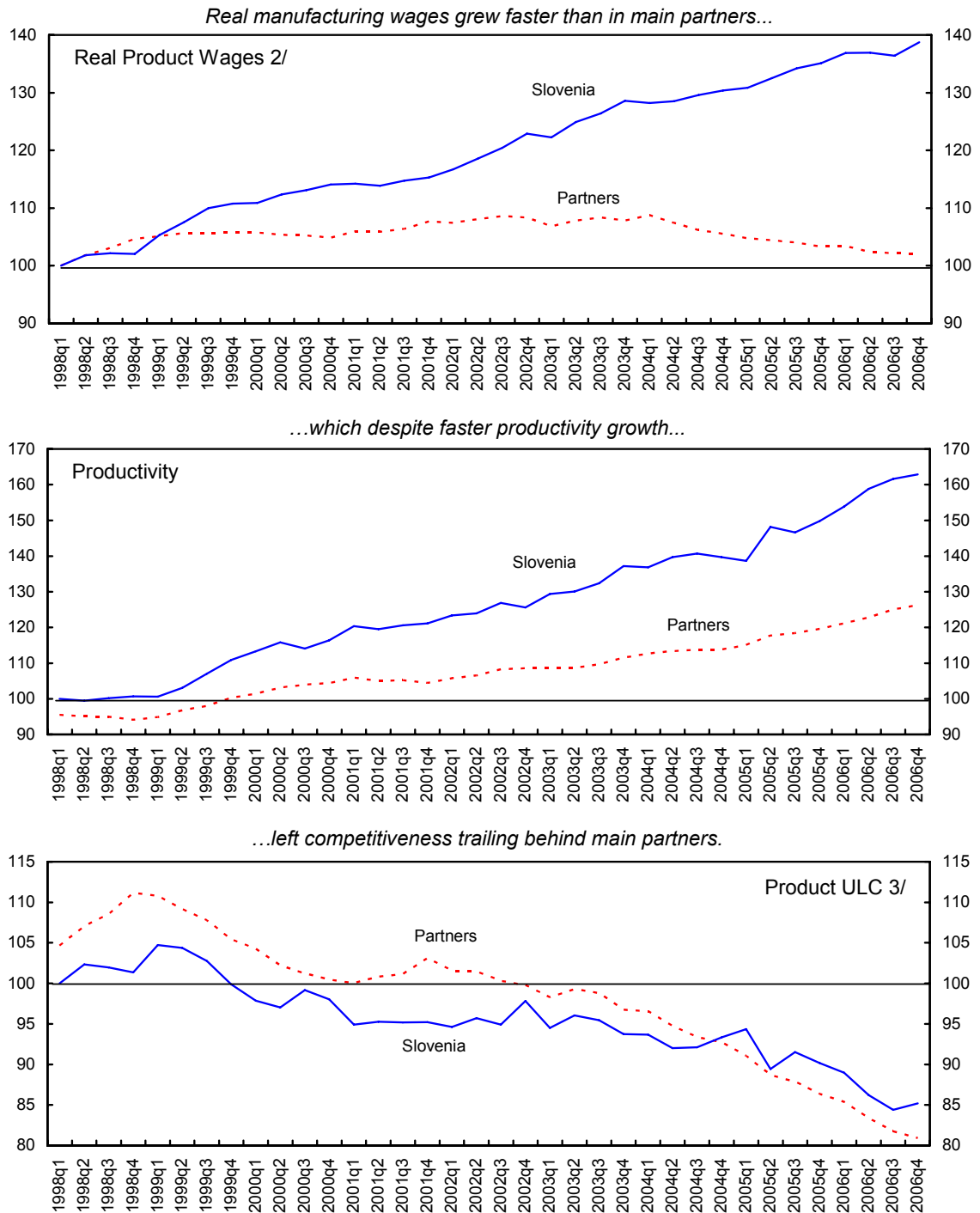


Sources: Bank of Slovenia Bulletin; Eurostat; IFS; and IMF staff calculations.

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.

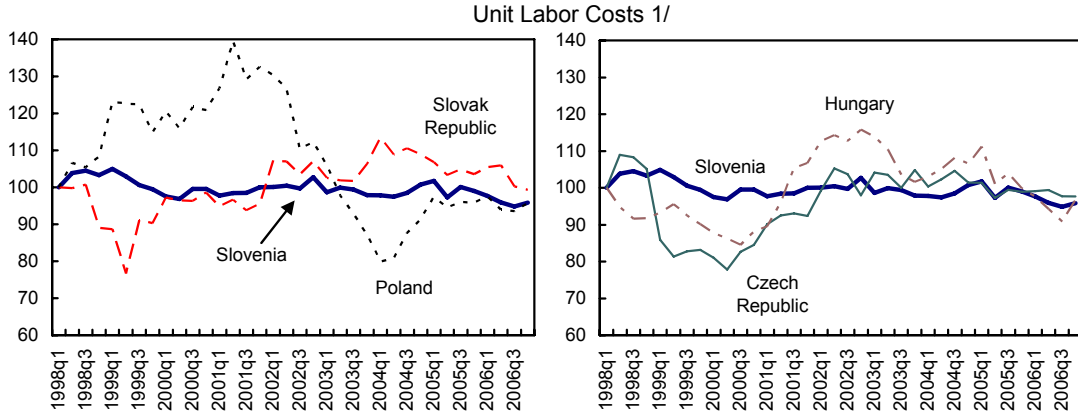
Figure 8. Slovenia: Wages, Productivity, and Product ULC in Manufacturing, 1998-2006 (1998q1=100) 1/



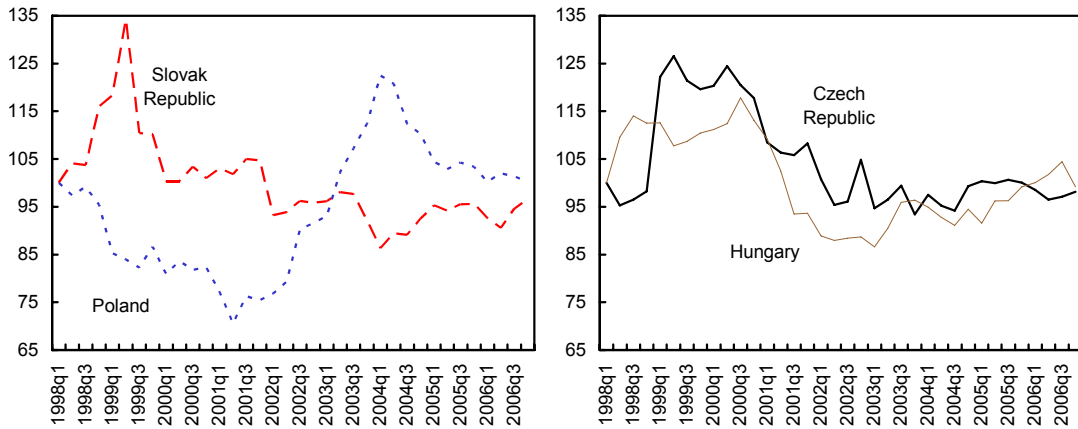
Sources: Statistical Office of the Republic of Slovenia; and IMF staff calculations.
 1/ Seasonally adjusted. Trade weights based on 1998-2000 data for exports of goods. Partner countries comprise: Austria, Croatia, France, Germany, Italy, Poland, United Kingdom, and United States.
 2/ Defined as the 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), 1998-2006

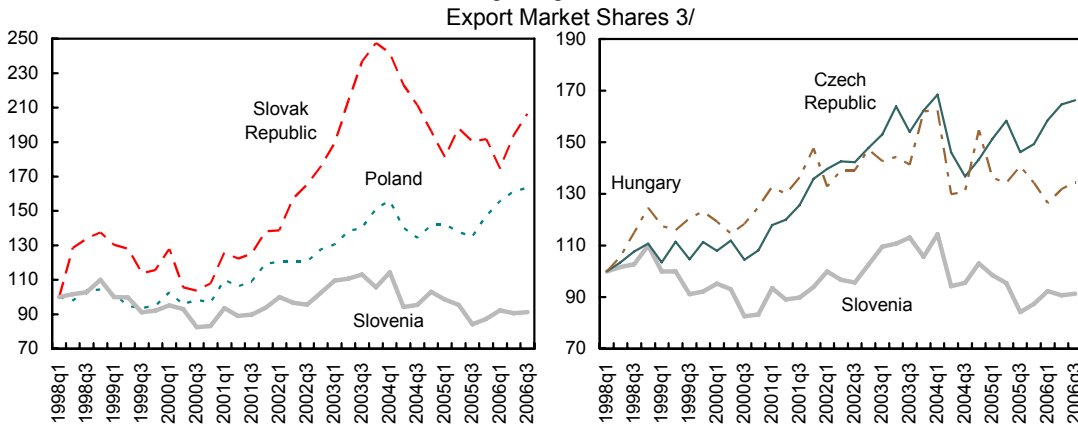
Unit labor costs in Slovenia have been stable compared to regional peers...



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



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



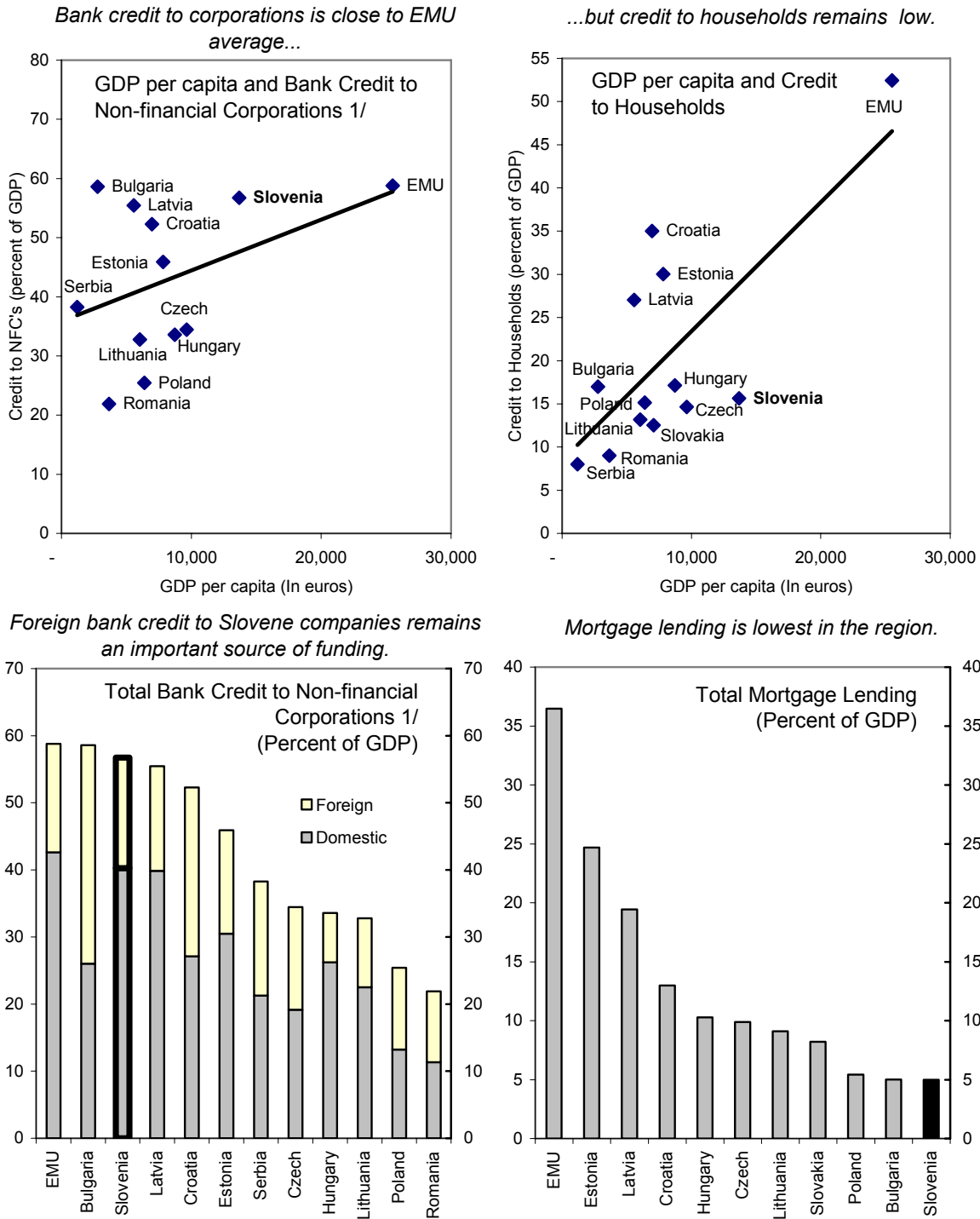
Sources: IMF Direction of Trade Statistics; and IMF staff calculations based on data from national authorities.

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. Bank Credit to Households and Non-financial Corporations in European Emerging Markets, 2005



Source: Eurostat; ECB; Country Authorities; and IMF staff calculations.

1/ Credit figures include domestic and foreign loans. For EMU, loans to enterprises include loans to domestic and (other) euro area countries.

Figure 11. Slovenia: Market Risk Indicators, 2005-07

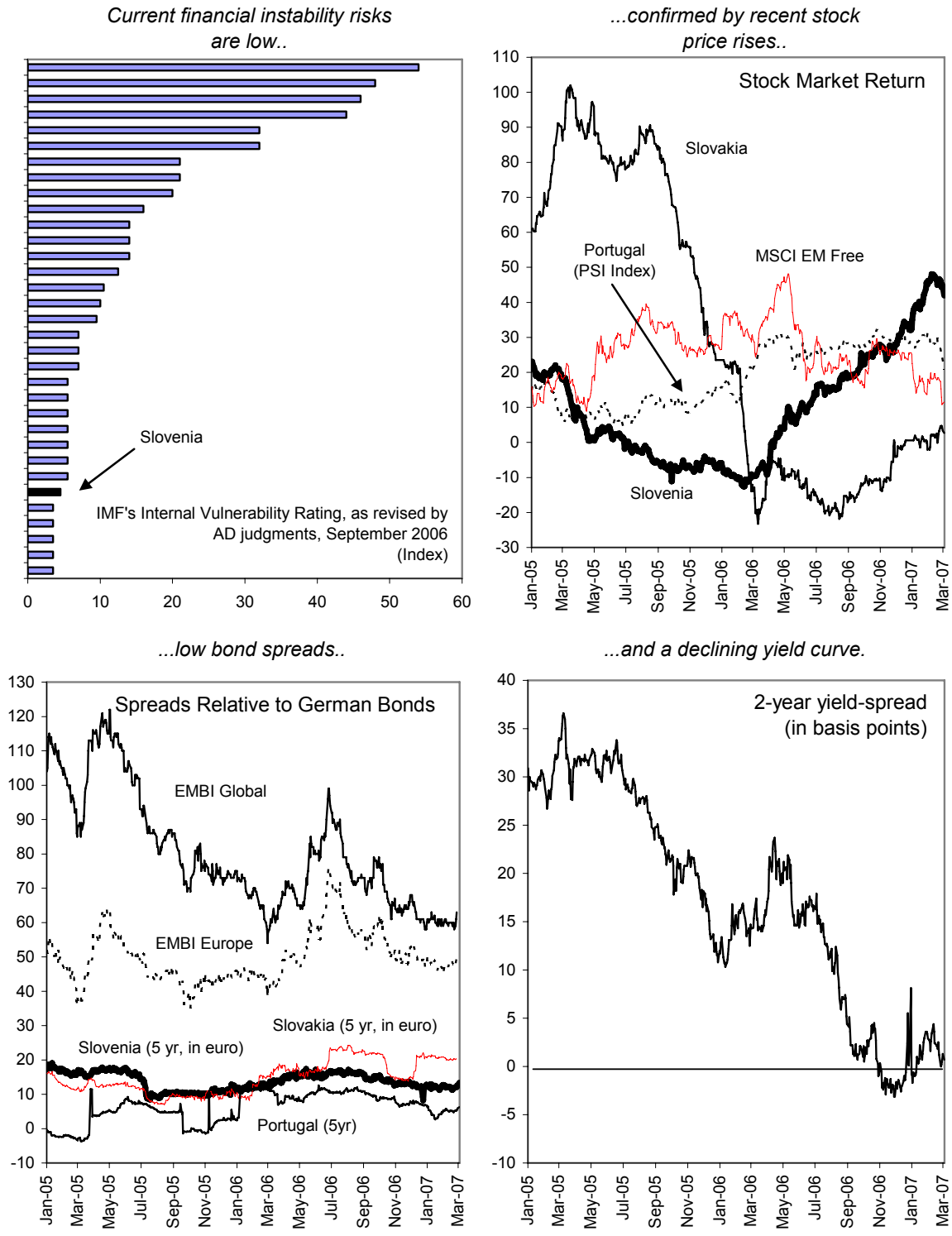
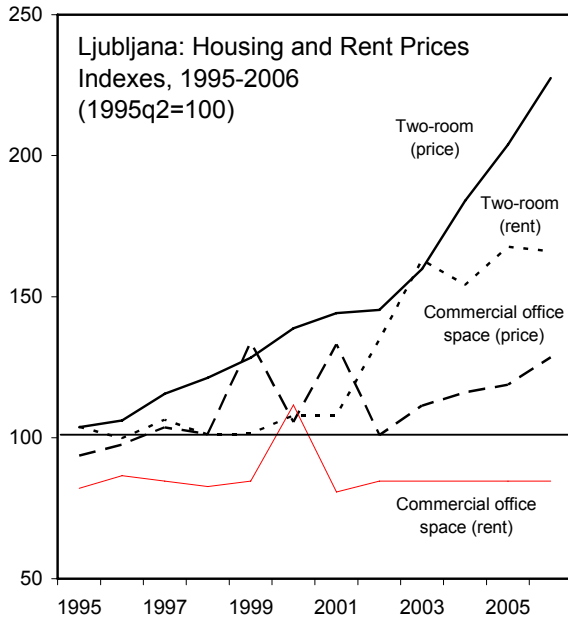
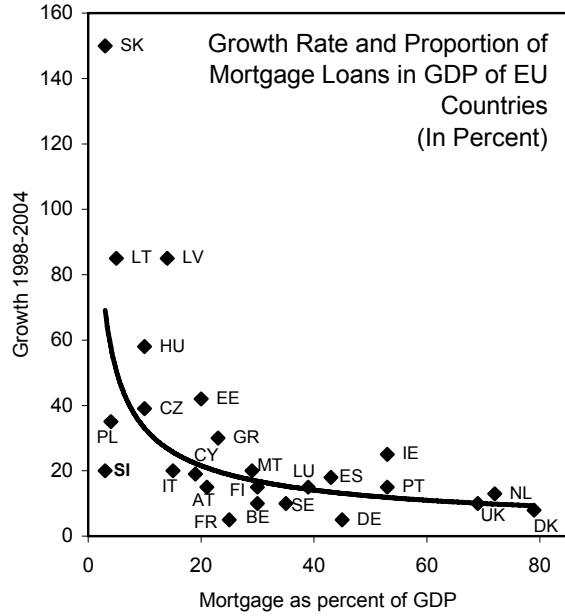


Figure 12. Slovenia: Housing Market Indicators, 1995-2006

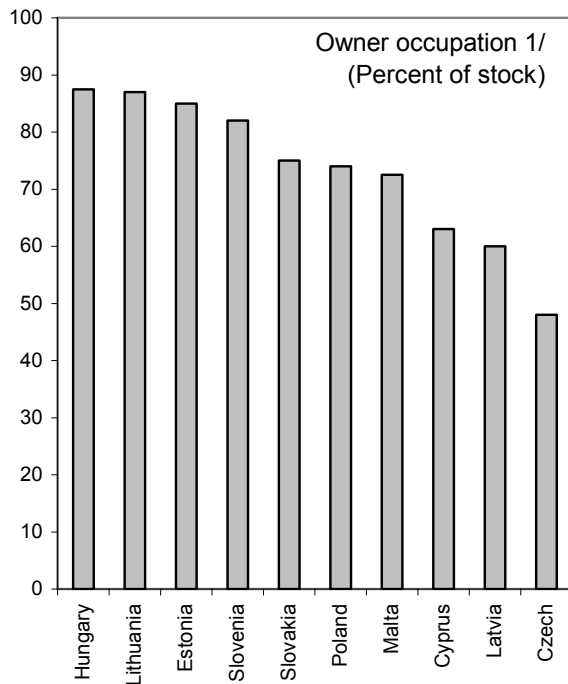
Residential housing prices have increased rapidly....



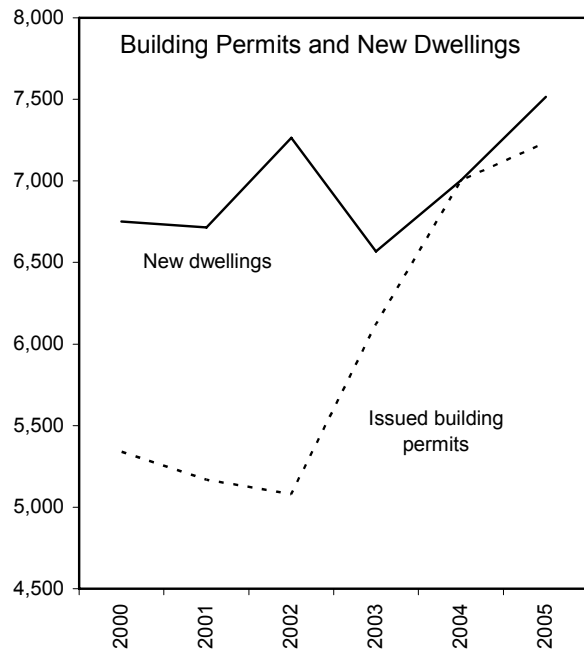
...supported by growth in mortgage lending, but from low levels.



The market is constrained by high ownership rates.



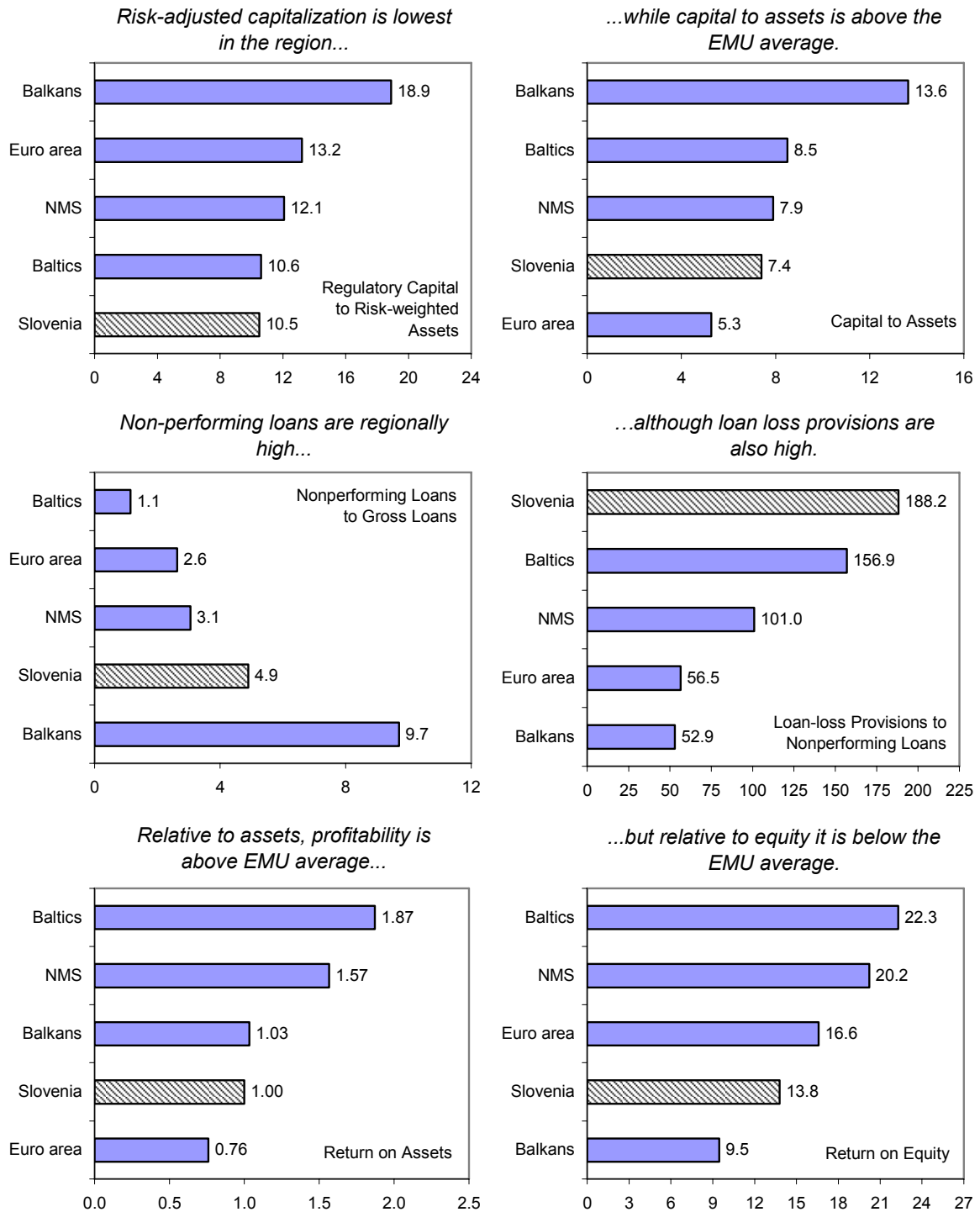
Housing supply has been growing gradually.



Source: Country authorities, Ljubljana; Bank of Slovenia; Statistical Office of the Republic of Slovenia; ECB; and RICS European housing review, 2005.

1/ Various years, usually 2000-02.

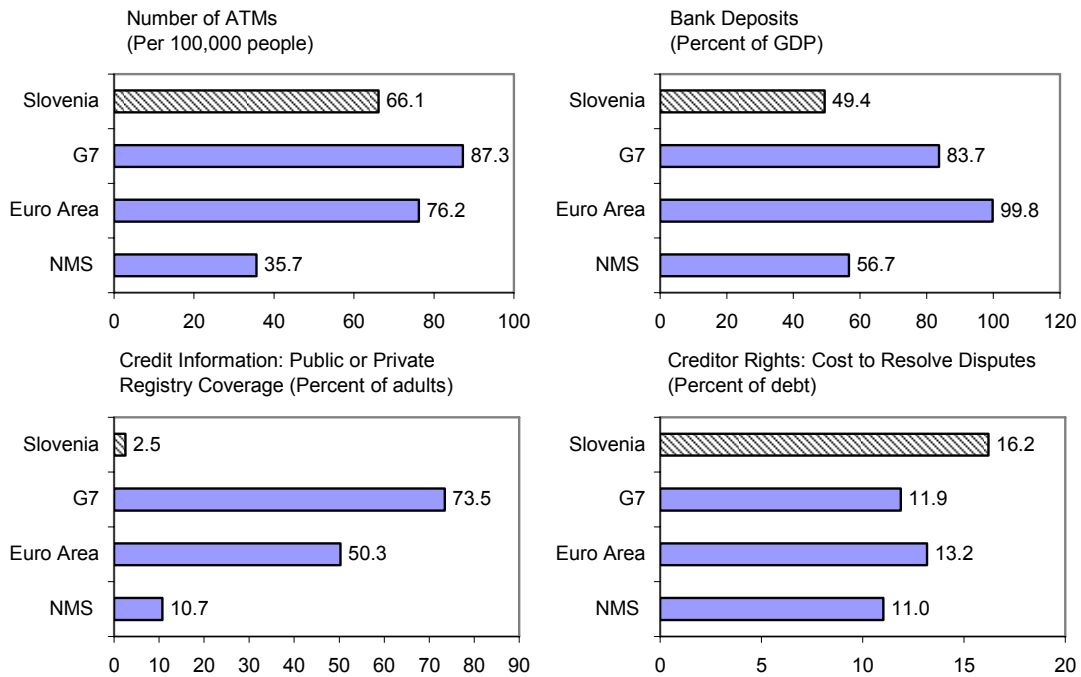
Figure 13. Financial Soundness Indicators, 2005 1/



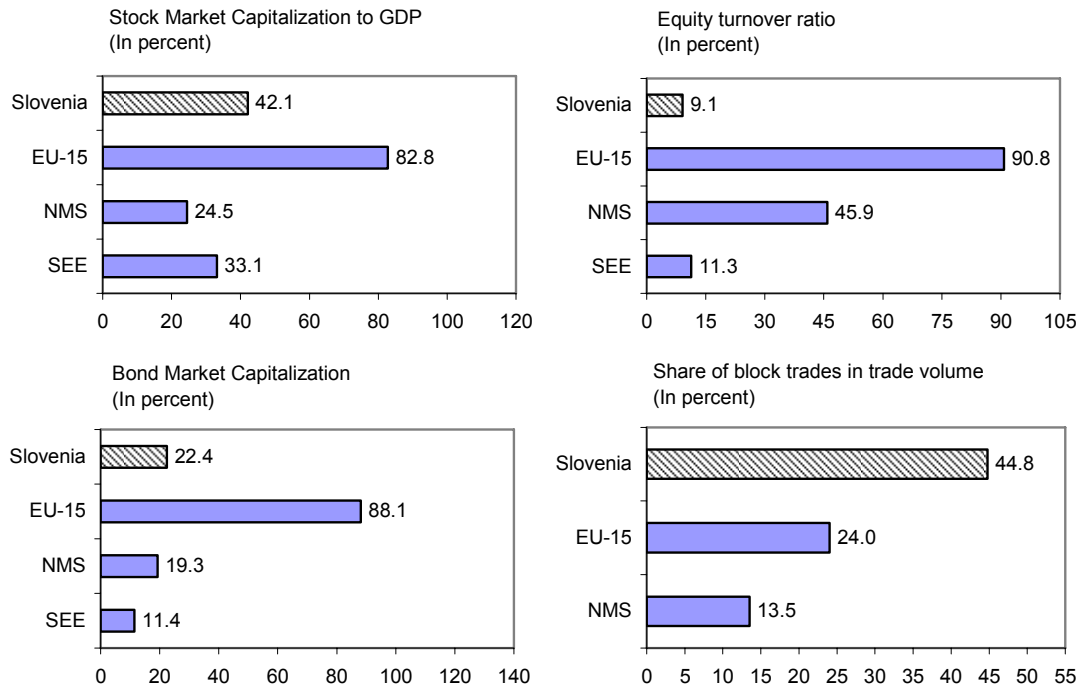
Source: FSI database, IMF.
1/ NMS excludes Cyprus and Malta.

Figure 14. Banking Sector, Equity and Bond Market Development Indicators, 2004

Household credit markets...



...and non-bank financial intermediation are less developed than in the other NMS or EMU.



Source: Financial Sector Development Indicators, World Bank.

Table 1. Slovenia: Selected Economic Indicators, 2003-08

	2003	2004	2005	2006	Projections	
					2007	2008
	(Annual percentage change)					
Real GDP	2.7	4.4	4.0	5.2	4.5	4.1
Domestic demand	4.7	4.9	2.0	5.5	4.8	4.1
Private consumption	3.5	2.6	3.4	3.3	3.6	4.0
Public consumption	1.6	3.4	2.2	3.8	3.1	2.2
Gross capital formation	10.1	11.4	-1.1	11.4	5.1	5.3
Output gap (in percent of potential GDP)	-0.9	-0.4	-0.6	0.3	0.4	0.1
Consumer prices						
Period average	5.6	3.6	2.5	2.5	2.6	2.6
End of period	4.6	3.3	2.3	2.8	2.6	2.4
Nominal wages (all sectors)	7.6	4.4	4.9	4.8	5.1	5.4
Real wages (all sectors)	1.8	2.0	2.3	2.3	2.8	3.3
Employment						
Person basis (period average)	-0.8	0.6	4.0	1.4	...	...
National Accounts basis	-0.4	0.5	0.3	1.2	0.8 1/	0.9 1/
Average unemployment rate (in percent, ILO definition)	6.7	6.3	6.5	6.0	6.0	6.0
General government finances 2/	(In percent of GDP)					
Revenue	40.9	41.2	41.8	42.0	41.8	40.9 2/
Expenditure	42.2	42.6	42.9	42.8	42.7	42.0
General government balance	-1.3	-1.4	-1.1	-0.8	-0.9	-1.2
General government balance (including railways)	-1.5	-1.5	-1.2	-0.8	-1.3	-1.7
Structural general government budget balance	-0.9	-1.2	-0.8	-0.9	-1.1	-1.2
Structural general government budget balance (including railways)	-1.1	-1.3	-0.9	-0.9	-1.4	-1.8
General government debt	28.5	28.8	28.0	28.2	28.3	28.4
Money and credit	(Percentage change, end-period)					
Interest rates (in percent)						
Government bond yield (5-year, average)	4.2	3.9	3.1	3.7	...	...
BoS Lombard rate	7.3	5.0	5.0	4.5	...	...
rate on 60-day BoS bills	6.0	4.0	4.0	3.5	...	...
Lending rates	9.0-10.3	7.9-8.5	6.2-7.8	6.7	...	...
Deposit rates 3/	4.8-4.9	3.2	3.6	3.2	...	...
Balance of payments	(In millions of euros, unless noted otherwise)					
Merchandise exports	11,420	12,936	14,599	17,011	18,832	20,669
Exports volume (percent change, volume)	4.4	12.8	10.3	10.8	8.6	8.3
Merchandise imports	-11,963	-13,945	-15,624	-18,121	-20,025	-21,916
Imports volume (percent change, volume)	7.3	14.6	6.8	10.5	8.3	8.0
Terms of trade (percent change)	0.5	-1.2	-2.4	0.2	-0.1	0.0
Trade balance	-3	-321	-170	-254	-290	-302
(in percent of GDP)	0.0	-1.2	-0.6	-0.9	-0.9	-0.9
Current account balance	-196	-720	-548	-773	-826	-845
(in percent of GDP)	-0.8	-2.7	-2.0	-2.6	-2.6	-2.5
Gross official reserves	6,808	6,533	6,917	5,421	...	...
External debt (percent of GDP, end-period)	53.2	58.4	71.0	79.5	86.6	91.4
Exchange rate						
Exchange regime			Euro-area member			
Tolars per U.S. dollar (end-period)	189.4	176.2	202.4	181.9	...	...
Tolars per euro (end-period)	236.7	239.7	239.6	239.6	239.6	239.6
Nominal effective exchange rate (1995=100, period average)	65.5	65.2	65.0	65.1	...	...
Real effective exchange rate						
(CPI based, 1995=100, period average)	104.3	105.4	105.4	106.1	...	...
(ULC based, 1995=100, period average)	100.5	98.1	98.8	94.8	...	...

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

1/ For 2007-08, forecasts in the Stability Program.

2/ Revenue and expenditure exclude social security contributions paid for government employees. 2007-08 projections correspond to the budget, but exclude VAT revenues of 0.4 percent of GDP in 2008. Additional deficit from railways of 0.4 and 0.5 percent of GDP in 2007 and 2008 are excluded.

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

Table 2. Slovenia: Summary of General Government Operations, 2003-2009

	2005	2006	2006	2007	2008	2009
		Budget	Prel Est. Mar-07	Budget Nov. 2006	Budget Nov. 2006	Budget Nov. 2006
Total revenues	41.8	42.5	42.0	41.8	40.9	40.5
Tax revenues	37.8	38.0	38.0	37.4	36.6	36.0
<i>Of which:</i>			0			
Personal income tax	6.0	5.9	6.0	5.6	5.9	6.1
Corporate income tax	2.2	2.4	3.2	3.3	2.9	2.7
Social security contributions	12.9	13.0	12.7	12.6	12.6	12.7
Taxes on payroll and workforce	1.9	1.5	1.6	1.3	0.7	0.1
Domestic taxes on goods and services	14.2	14.3	13.7	13.8	13.7	13.7
VAT 1/	9.2	9.3	9.1	9.0	9.0	9.1
Excise taxes	3.5	3.5	3.2	3.5	3.4	3.3
Other	1.5	1.5	1.4	1.3	1.3	1.3
Other taxes	0.8	0.8	0.8	0.8	0.8	0.7
Nontax revenues	2.3	2.4	2.1	2.2	2.1	1.8
Of which, interest receipts	0.2	0.1	0.1	0.1	0.1	0.1
Capital revenues and grants	0.4	0.4	0.6	0.3	0.2	0.2
Transfers from extrabudgetary funds	0.1	0.2	0.1	0.1	0.1	0.1
Receipts from the EU budget	1.1	1.6	1.2	1.8	1.8	2.4
Total expenditures	42.9	44.0	42.8	42.7	42.0	41.4
Current expenditures and transfers	38.1	38.5	37.5	37.1	36.7	36.2
Wages and personnel expenditures	9.3	9.4	9.0	8.9	8.5	8.1
Direct budget users	3.3	3.2	3.2	3.2	3.1	2.9
Other government institutions	6.0	6.2	5.8	5.6	5.4	5.2
Premium for supplementary pension insurance	0.2	0.2	0.2	0.2	0.1	0.1
Expenditure on goods and services	6.9	7.0	7.0	7.0	7.1	6.9
Interest payments	1.3	1.2	1.3	1.1	1.0	1.1
Reserves	0.2	0.3	0.2	0.2	0.3	0.4
Transfers to individuals and households	16.8	16.8	16.4	16.1	15.9	15.7
<i>Of which: Pensions</i>	10.8	10.9	10.6	10.5	10.5	10.5
Subsidies	1.4	1.4	1.4	1.5	1.6	1.8
Other current transfers	2.1	2.2	2.2	2.1	2.1	2.1
Capital expenditures and transfers	3.8	4.4	4.4	4.6	4.2	4.2
Acquisition of capital assets	2.4	2.9	3.0	3.0	2.5	2.4
Capital transfers	1.4	1.5	1.4	1.6	1.7	1.8
Transfers to the EU budget	1.0	1.1	1.0	1.0	1.0	1.0
General government balance	-1.1	-1.5	-0.8	-0.9	-1.2	-0.9
General government balance including railways	-1.2	-1.5	-0.8	-1.3	-1.7	-1.1
Primary Balance	0.1	-0.4	0.3	0.1	-0.2	0.1
Memorandum items:						
General government balance (ESA 95) 1/	-1.4	-1.6	-1.4	-1.5	-2.0	-1.4
Structural budget balance	-0.8		-0.9	-1.1	-1.2	-0.8
Structural primary balance	0.4		0.2	-0.1	-0.2	0.2
General government debt	28.0	29.6	28.2	28.3	28.4	27.9
Primary expenditures	41.5	42.8	41.6	41.6	41.0	40.3
Nominal GDP (in millions of euros)	27,626	28,943	29,737	31,614	33,678	35,822

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

1/ Excludes revenues for budgeted VAT increase in 2008 and 2009 (0.4 percent of GDP) that will be foregone.

Table 3. Slovenia: Balance of Payments, 2004-09

(In millions of euros, unless otherwise noted)

	2004	2005	2006	Projections		
				2007	2008	2009
Current account	-720	-548	-773	-826	-845	-739
Trade balance	-1,009	-1,026	-1,111	-1,193	-1,246	-1,260
Exports f.o.b.	12,933	14,599	16,991	18,832	20,669	22,636
Imports f.o.b.	-13,942	-15,625	-18,103	-20,026	-21,916	-23,896
Services	688	856	857	904	945	980
Exports	2,783	3,210	3,509	3,888	4,227	4,590
Imports	-2,095	-2,354	-2,652	-2,984	-3,282	-3,609
Income, net	-322	-283	-347	-472	-504	-454
Current transfers, net	-77	-94	-171	-65	-40	-5
Capital account	-96	-114	-116	-125	-139	-159
Financial account, excl. reserves	538	706	-210	951	984	898
Direct investment, net	224	-59	-304	744	408	98
In Slovenia	665	445	264	1,364	1,077	893
Abroad	-441	-503	-568	-610	-673	-667
Portfolio investment, net	-637	-1,618	-1,458	-917	-135	143
Equity securities	-229	-753	-844	-472	-125	-9
Debt securities	-409	-865	-614	-445	-9	152
Financial derivatives	6	-10	-13	-63	-67	-71
Other investment, net	945	2,393	1,565	1,188	778	728
Government	5	-27	-115	-71	-60	-49
Bank of Slovenia	-8	-2	-1	-5	-6	-6
Commercial banks	1,072	2,629	2,003	1,179	856	747
Nonbank private sector	-124	-208	-323	85	-12	37
Loans	630	188	471	532	416	356
Household currency and deposits	-630	-270	-816	-257	-244	-173
Trade credits	-24	41	-18	-32	-34	-36
Other	-100	-166	41	-158	-151	-110
Net errors and omissions	22	144	-183	0	0	0
Overall balance	-256	189	-1,281	0	0	0
Change in official reserves (-: increase)	256	-189	1,281	0	0	0
Memorandum items:						
Current account balance (percent of GDP)	-2.7	-2.0	-2.6	-2.6	-2.5	-2.1
Export of goods (percent change in value)	12.8	10.3	10.8	8.6	8.3	8.1
Import of goods (percent change in value)	14.6	6.8	10.5	8.3	8.0	7.7
Terms of trade (percent change)	-1.2	-2.4	0.2	-0.1	0.0	0.1
Gross external debt	15,343	19,614	23,652	27,386	30,761	33,798
(percent of GDP)	58.4	71.0	79.5	86.6	91.4	94.6
Net external debt (liabilities - assets) 1/	-882	411	1,361	2,104	2,874	3,754
(percent of GDP)	-3.4	1.5	4.6	6.7	8.5	10.5

Source: Bank of Slovenia and IMF staff projections.

1/ A negative number indicates net creditor position.

Table 4. Slovenia: Banking Sector Soundness Indicators, 2002–06
(In percent; end of period)

	2002	2003	2004	2005	2006
Capital adequacy					
Regulatory capital to risk-weighted assets	11.9	11.5	11.8	10.5	11.4 1/
Regulatory Tier 1 capital to risk-weighted assets	9.9	9.8	9.0	8.9	9.5 1/
Capital (net worth) to assets	8.3	8.3	8.1	8.4	8.4
Asset quality					
Nonperforming assets to total assets	3.9	3.7	3.0	2.5	2.7 1/
Large exposures to capital	195.3	214.1	196.2	226.2	211.4 1/
Earnings and profitability					
Net interest margin to average interest bearing assets	3.8	3.4	2.9	2.6	2.4
Operating expenses to average assets	3.2	3.0	2.7	2.5	2.2
Return on average assets (before tax)	1.11	1.00	1.03	1.00	1.25
Return on average equity (before tax)	12.6	11.9	12.5	12.7	15.1
Liquidity					
Average liquid assets to average total assets	6.9	4.9	5.3	4.8	4.5
Average liquid assets to average short-term deposits	12.11	8.9	9.68	9.51	9.72
Foreign exchange risk					
Foreign currency-denominated loans to total loans	32.6	35.1	38.6	48.7	55.9
Foreign currency-denominated liabilities to total liabilities	39.8	40.9	44.5	48.8	53.0
Net open position in foreign exchange to capital	51.6	58.6	55.1	58.8	7.7 1/
Market risk					
Assets with maturity of more than 1 year (percent of total loans to non-bank sector)	37.6	36.0	34.1	32.3	32.4
Liabilities with maturity of less than 3 months (percent of total liabilities to non-bank sector)	52.9	56.0	64.5	66.9	68.2
Memorandum item:					
Ownership of banking sector (percent of equity capital)					
Nonresidents	32.5	32.4	32.3	34.9	38
Central government	20.3	19.4	19.1	18.2	17.4
Other domestic entities	47.2	48.2	48.6	46.9	44.6

Source: Bank of Slovenia.

1/ 2006 data as of Q3.

Table 5. Slovenia: Vulnerability Indicators, 2002-07
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	Date
Financial Indicators (end of period)							
General government debt	29.1	28.5	28.8	28.0	28.2	28.3	Projection-06
Domestic credit	51.3	53.7	61.9	70.7	80.0	...	December-06
Private sector credit (percent change) 1/ 4/	12.0	15.4	21.0	23.6	25.7	...	December-06
Broad money (percent change) 4/	18.4	5.0	-13.0	7.4	7.7	...	December-06
Foreign exchange deposits (percent of broad money) 4/	27.5	27.2	35.3	58.4	69.6	...	December-06
Banks' nonperforming loans (percent of total gross loans)	3.9	3.7	3.0	2.9	...	...	December-05
Capital adequacy ratio	11.9	11.5	11.8	10.5	11.4	...	October-06
Financial Market Indicators (end of period)							
Stock market index	3,340	3,932	4,904	4,630	6,383	8,735	April-07
Stock market capitalization	30.5	29.5	33.9	35.6	52.1	...	December-06
Foreign currency debt rating (S&P, long-term)	A	A+	AA-	AA-	AA	AA	April-07
Spread of benchmark bond (basis points) 2/	45	29	17	16	10	10	January-07
External Indicators							
Exports of goods and services (percent change, value in euros)	7.0	2.7	13.2	13.3	15.1	10.8	Projection-07
Imports of goods and services (percent change, value in euros)	3.0	5.5	15.5	12.1	15.4	10.9	Projection-07
Current account balance	1.0	-0.8	-2.7	-2.0	-2.6	-2.6	Projection-07
Capital and financial account balance, excl. reserve assets	8.0	1.2	1.7	2.1	-1.1	2.6	Projection-07
Of which: Inward portfolio investment	...	-0.1	0.1	0.3	2.3	2.9	Projection-07
Inward foreign direct investment	7.3	1.1	2.5	1.6	0.9	4.3	Projection-07
Other investment, net	2.4	3.4	3.6	8.7	5.3	3.8	Projection-07
Net foreign assets of commercial banks (in billions of euros) 4/	-0.5	-1.6	-2.7	-5.1	-6.1	...	December-06
Short-term foreign assets of commercial banks (in billions of euros)	1.5	1.3	1.3	1.8	2.0	...	December-06
Short-term foreign liabilities of commercial banks (in billions of euros)	0.4	0.6	0.6	1.0	1.6	...	December-06
Foreign currency exposure of commercial banks (in billions of euros) 4/	-7.0	-8.0	-9.9	-13.9	-16.8	...	December-06
Gross official reserves (in billions of euros)	6.8	6.9	6.5	6.9	5.4	...	December-06
Gross official reserves (in months of imports of goods and services)	6.2	5.9	4.9	4.6	3.1	...	December-06
Net international reserves (in billions of euros)	4.3	4.4	4.2	5.3	4.9	...	December-06
Broad money to gross official reserves (in percent) 4/	230.6	232.2	209.8	214.0	293.1	...	December-06
Short-term external debt to gross official reserves (in percent) 3/	34.3	36.0	40.6	52.3	94.1	...	December-06
Principal payments and short-term external debt to gross official reserves (in percent)	66.1	66.7	81.9	95.3	125.6	...	November-06
Total external debt	48.7	53.2	58.4	71.0	79.5	86.6	Projection-07
Of which: Public and publicly guaranteed	14.5	14.6	14.3	13.8	14.6	...	December-06
Total external debt (in percent of exports of goods and services)	85.2	95.3	97.6	110.1	116.6	...	December-06
Total external debt service payments (in percent of exports of goods and services)	16.5	14.6	12.7	14.4	17.4	...	December-06
External interest payment (in percent of exports of goods and services)	3.0	2.9	2.6	2.7	3.1	...	December-06
External amortization payments (in percent of exports of goods and services)	14.4	12.6	10.9	12.5	14.9	...	December-06
Exchange rate (tolar per euro, period average)	226.2	233.7	238.9	239.6	239.6	...	December-06
REER (CPI-based, period-average basis, an increase indicates appreciation)	2.7	4.0	1.0	0.0	0.7	...	December-06

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/ Remaining maturity basis.

4/ Series present a structural break in 2004.

Table 6. Slovenia: Macroeconomic Framework, 2003-12

	2003	2004	2005	2006	Projections					
					2007	2008	2009	2010	2011	2012
(Percent of nominal GDP)										
Foreign saving	0.8	2.7	2.0	2.6	2.6	2.5	2.1	2.0	2.1	2.0
National saving	23.9	24.1	24.1	24.9	25.2	25.7	26.7	27.1	27.5	28.0
Government	2.7	2.5	2.7	3.6	3.7	3.5	3.7	3.9	4.1	4.3
Non-government	21.3	21.5	21.4	21.3	21.5	22.2	23.0	23.3	23.5	23.7
Domestic saving	24.7	25.6	25.4	26.6	26.9	27.3	28.0	28.4	28.9	29.3
Government 1/	2.8	2.9	3.1	3.9	3.9	3.5	3.5	3.7	3.8	4.1
Non-government	21.9	22.7	22.4	22.7	23.1	23.8	24.5	24.7	25.1	25.2
Gross capital formation	24.7	26.8	26.0	27.5	27.8	28.2	28.8	29.2	29.6	29.9
Government 1/	2.4	2.4	2.4	3.0	3.0	2.5	2.4	2.4	2.3	2.3
Non-government	22.3	24.4	23.7	22.8	24.9	25.7	26.4	26.8	27.3	27.6
Fixed investment	23.3	24.5	24.4	25.8	26.3	26.7	27.3	27.8	28.3	28.6
Change in stocks	1.4	2.3	1.6	1.6	1.6	1.5	1.4	1.4	1.3	1.3
(Percentage change in real terms)										
Real GDP	2.7	4.4	4.0	5.2	4.5	4.1	3.9	4.0	4.0	4.0
Domestic demand	4.7	4.9	2.0	5.5	4.8	4.1	3.9	4.0	4.1	4.1
Consumption	3.0	2.8	3.1	3.4	3.5	3.6	3.0	3.4	3.4	3.6
Government	1.6	3.4	2.2	3.8	3.1	2.2	-0.2	1.4	1.4	1.4
Non-government	3.5	2.6	3.4	3.3	3.6	4.0	4.0	4.0	4.0	4.2
Gross capital formation	10.1	11.4	-1.1	11.4	5.1	5.3	5.9	5.4	5.4	5.0
Fixed investment	7.1	7.9	1.5	11.9	5.4	5.6	6.2	5.7	5.7	5.2
Change in stocks (contribution to GDP growth) 2/	0.2	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	3.1	12.5	10.5	10.0	8.7	7.9	7.6	7.5	7.4	7.5
Imports of goods and services	6.7	13.4	7.0	10.4	8.6	7.8	7.6	7.5	7.5	7.5
(Contributions to growth, in percentage points)										
Domestic demand	4.7	4.7	1.6	5.5	4.8	4.2	4.0	4.1	4.1	4.1
Private consumption	1.9	1.7	1.8	1.8	1.9	2.1	2.1	2.1	2.1	2.2
Government consumption	0.3	0.6	0.5	0.7	0.5	0.4	0.0	0.2	0.2	0.2
Gross investment	2.8	2.7	-0.9	3.4	1.6	1.7	1.9	1.8	1.8	1.7
Net foreign demand	-2.2	-0.8	2.4	-0.4	0.0	-0.1	0.0	-0.1	-0.1	-0.1
Exports of goods and services	1.9	7.8	6.2	7.1	6.5	6.1	6.2	6.3	6.4	6.6
Imports of goods and services	4.2	8.6	3.8	7.5	6.6	6.2	6.2	6.4	6.5	6.8
Memorandum items:										
Productivity (percent change)	3.1	3.9	3.7	3.8	3.7	3.4	3.4	3.5	3.5	3.5
Real wages (percent change)	1.8	2.0	2.3	2.3	2.8	3.3	3.5	3.5	3.5	3.7
Terms of trade (percent change)	0.5	-1.2	-2.4	0.2	-0.1	0.0	0.1	0.1	0.1	0.1
Nominal GDP (millions of euros)	24,876	26,257	27,626	29,737	31,614	33,678	35,822	38,146	40,628	43,271

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.

Appendix I. Slovenia: Debt Sustainability Analysis

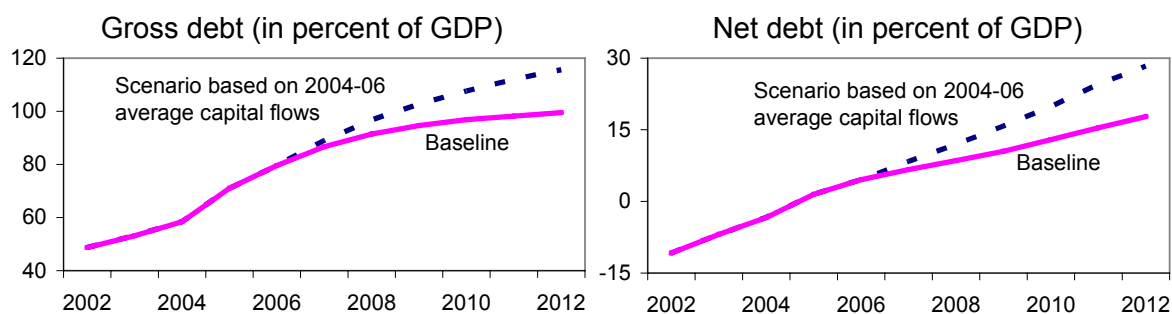
External sustainability

Although Slovenia's outlook does not raise major concerns regarding external sustainability, the recent deterioration in the external debt situation needs monitoring.

The external debt-to-GDP ratio increased by 12.6 percentage points in 2005 to 71 percent of GDP. Under the baseline scenario, it is projected to continue rising, albeit at a slower pace, reaching 99.5 percent in 2012 (Table A1). This increase is attributable to two main factors. First, as part of a worldwide financial globalization trend, gross debt levels for both claims and liabilities continue to increase. Second, current account deficit, projected at around 2.0 percent of GDP, is primarily financed through debt, as non-debt-generating capital flows, such as FDI and equity, have a considerably smaller weight in Slovene capital inflows than outflows. In 2005, such flows accounted for 12 percent of capital inflows and 34 percent of outflows. As a result, Slovene net debt-to-GDP has gradually increased from -10.8 percent in 2002 to 1.5 in 2005 and is projected to reach 18 percent by 2012.

Stress tests suggest that over the medium term, Slovenia's gross debt levels are resilient to standard macroeconomic shocks. Bound tests show a jump in the external debt-to-GDP ratio in 2008 by an average of 0.6 percentage points and further gradual increases to at most 103.2 percent by 2012 (3.7 points more than the baseline). A scenario with variables at historic averages would worsen debt trends slightly, increasing debt to 104.7 percent of GDP by 2012.

Slovene debt position is sensitive to assumptions about the size and composition of gross capital flows. The baseline projection assumes FDI inflows in Slovenia will be 2.4 percent of GDP and 40 percent of portfolio inflows will be in the form of equity during 2007-2012. By historical standards, this scenario is optimistic, as FDI inflows constituted 1.7 percent of GDP and 20 percent of portfolio inflows were in the form of equity over the past three years. An alternative projection, based on historical averages for FDI inflows, loan inflows and equity outflows, shows gross debt increasing to 116 percent of GDP, while net debt increases to 28 percent of GDP by 2012.



Source: Bank of Slovenia and staff calculations.

Public debt sustainability

Slovenia's general government debt remained at 28 percent of GDP at end-2006, well under the debt threshold under the Maastricht criterion. A decline in fiscal deficits, supported by growth rising to record levels in this decade, and early debt repayment contributed to a lowering of the debt burden over the past two years. This trend marks a reversal of debt dynamics in earlier years when government borrowing through inflation-linked instruments led to a rising debt profile despite a strong fiscal position.

Under the baseline scenario, assuming that deficits stay at currently planned levels, the medium term debt outlook is favorable. The government medium term budget plans to lower the deficit to around 1 percent of GDP in 2009, whereby tax reductions are broadly offset by tightening of some non-discretionary expenditures. Primary surpluses and strong growth would contribute to a gradual decline of the debt stock to below 26 percent of GDP by 2012 (Table A2). The public debt position is resilient to standard shocks to growth, interest rate and the exchange rate and public debt sustainability is not a concern in the medium term.

For Slovenia, the main challenge to debt sustainability arise from age-related spending pressures. With one of the fastest aging populations in Europe, and a generous pension system, Slovenia's debt is expected to rise rapidly after 2020 undermining its long-run fiscal sustainability and growth prospects.

Long run fiscal sustainability analysis shows that Slovenia will need to run surpluses and build up reserves to offset the future rise in age-related spending, in order to achieve a target debt to GDP ratio of 60 percent by 2050. Indeed, a fiscal adjustment of around 10 percent of GDP would be required to restore the intertemporal balance and each year of delay in adjustment will require additional adjustment by 1/8 percent of GDP to restore the balance, placing a significant debt burden for future generations.

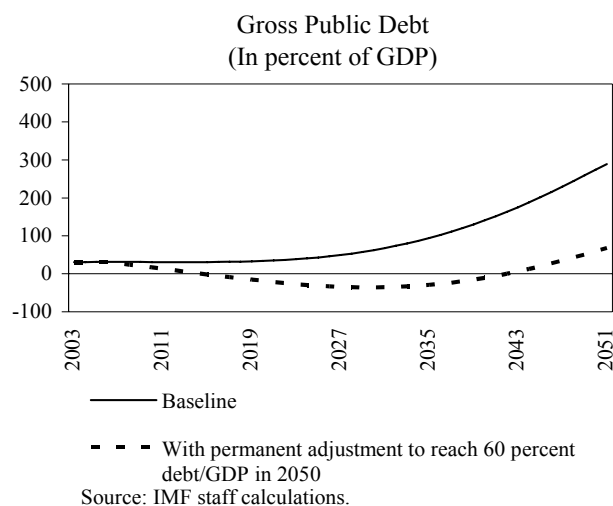
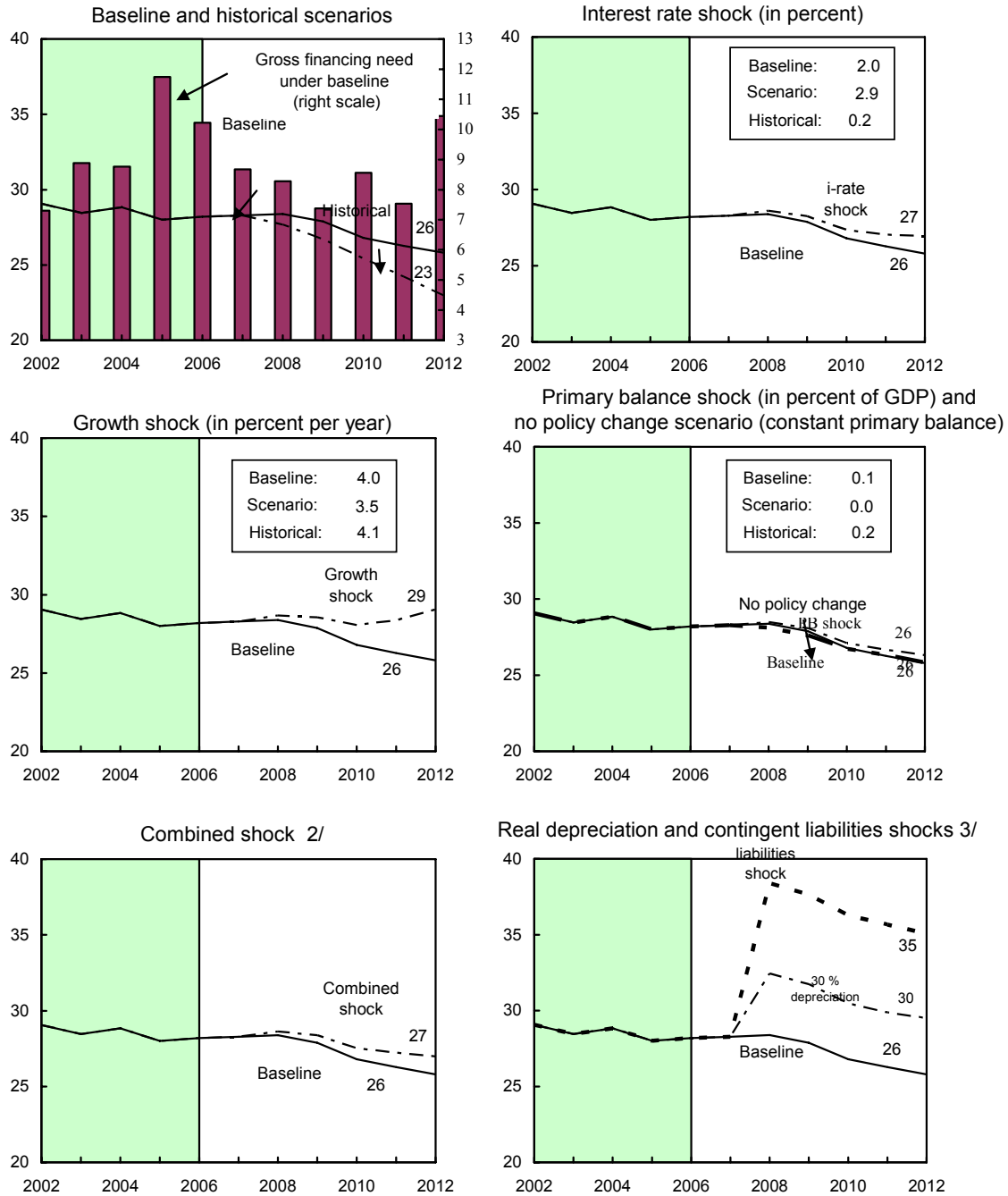


Figure A1. Country: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. Country: External Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual										Projections				Debt-stabilizing non-interest current account 6/ -4.1
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012				
1 Baseline: External debt	48.7	53.2	58.4	71.0	79.5	86.6	91.4	94.6	96.8	98.2	99.5				
2 Change in external debt	1.7	4.5	5.3	12.6	8.5	7.1	4.8	3.2	2.2	1.4	1.3				
3 Identified external debt-creating flows (4+8+9)	-10.5	-0.7	0.0	2.0	1.4	-1.6	-1.6	-1.9	-1.5	-1.5	-1.6				
4 Current account deficit, excluding interest payments	-2.8	-0.8	1.2	0.2	1.0	0.9	0.7	0.2	0.1	0.1	0.0				
5 Deficit in balance of goods and services	-1.5	0.0	1.2	0.6	0.9	0.9	0.9	0.8	0.7	0.7	0.7				
6 Exports	57.1	55.8	59.9	64.5	68.9	71.9	74.0	76.2	78.1	79.9	81.8				
7 Imports	55.6	55.8	61.1	65.1	69.8	72.8	74.9	77.0	78.8	80.6	82.4				
8 Net non-debt creating capital inflows (negative)	-6.3	0.9	0.0	2.9	3.9	-0.9	-0.8	-0.6	0.0	0.1	0.1				
9 Automatic debt dynamics 1/	-1.4	-0.7	-1.2	-1.2	-3.4	-1.6	-1.5	-1.5	-1.6	-1.7	-1.7				
10 Contribution from nominal interest rate	1.7	1.6	1.6	1.7	1.6	1.7	1.8	1.9	1.9	2.0	2.0				
11 Contribution from real GDP growth	-1.5	-1.2	-2.2	-2.2	-3.4	-3.4	-3.3	-3.4	-3.5	-3.6	-3.7				
12 Contribution from price and exchange rate changes 2/	-1.6	-1.1	-0.6	-0.7	-1.6	...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	12.2	5.1	5.3	10.5	7.1	8.7	6.5	5.1	3.7	2.9	2.9				
External debt-to-exports ratio (in percent)	85.2	95.3	97.6	110.1	115.4	120.5	123.6	124.1	124.0	122.9	121.7				
Gross external financing need (in billions of Euros) 4/	3.9	4.3	4.9	5.4	7.4	8.9	10.0	10.9	11.8	12.8	13.8				
in percent of GDP	16.5	17.2	18.7	19.6	25.0	28.0	29.7	30.5	31.1	31.6	31.8				
Scenario with key variables at their historical averages 5/						86.6	92.4	96.7	99.9	102.2	104.7		-2.8		
Baseline: Net external debt	-10.8	-6.9	-3.4	1.5	4.6	6.7	8.5	10.5	13.0	15.4	17.8				
Key Macroeconomic Assumptions Underlying Baseline															
Real GDP growth (in percent)	3.5	2.7	4.4	4.0	5.2	4.5	4.1	3.9	4.0	4.0	4.0				
GDP deflator in Euros (change in percent)	3.5	2.4	1.1	1.1	2.3	1.8	2.3	2.4	2.4	2.4	2.4				
Nominal external interest rate (in percent)	3.9	3.5	3.1	3.1	2.4	2.3	2.2	2.2	2.2	2.2	2.2				
Growth of exports (Euro terms, in percent)	7.0	2.7	13.2	13.3	15.1	10.8	9.6	9.4	9.2	9.1	9.1				
Growth of imports (Euro terms, in percent)	3.0	5.5	15.5	12.1	15.4	10.9	9.5	9.2	9.1	9.0	9.0				
Current account balance, excluding interest payments	2.8	0.8	-1.2	-0.2	-1.0	-0.9	-0.7	-0.2	-0.1	-0.1	0.0				
Net non-debt creating capital inflows	6.3	-0.9	0.0	-2.9	-3.9	0.9	0.8	0.6	0.0	-0.1	-0.1				

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

2/ The contribution from price and exchange rate changes is defined as $[-p(1+g) + \alpha(1+r)](1+g+p+g)$ times previous period debt stock. p increases with an appreciating domestic currency ($\alpha > 0$) 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/ 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 A2. Country: Public Sector Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual			Projections							Debt-stabilizing primary balance 9/	
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011		2012
1 Baseline: Public sector debt 1/ o/w foreign-currency denominated	29.1	28.5	28.8	28.0	28.2	28.3	28.4	27.9	26.8	26.3	25.8	-0.3
2 Change in public sector debt	12.1	11.3	9.7	6.9	8.9	8.9	8.9	8.8	8.4	8.3	8.1	
3 Identified debt-creating flows (4+7+12)	1.5	-0.6	0.4	-0.8	0.2	0.1	0.1	-0.5	-1.1	-0.5	-0.5	
4 Primary deficit	-0.1	0.0	0.1	0.1	-0.8	-0.6	-0.5	-0.8	-0.9	-0.5	-0.4	
5 Revenue and grants	0.0	-0.2	-0.1	-0.1	-0.3	-0.1	0.2	-0.1	-0.3	-0.2	-0.1	
6 Primary (noninterest) expenditure	40.3	40.9	41.3	41.8	42.0	41.8	40.9	40.5	40.2	40.0	39.8	
7 Automatic debt dynamics 2/	40.3	40.6	41.2	41.7	41.7	41.7	41.0	40.4	39.9	39.8	39.7	
8 Contribution from interest rate/growth differential 3/	-0.8	-0.3	-0.3	-0.3	-0.8	-0.7	-0.8	-0.7	-0.7	-0.3	-0.3	
9 Of which contribution from real interest rate	-1.3	-0.7	-0.6	-0.3	-0.8	-0.7	-0.8	-0.7	-0.7	-0.3	-0.3	
10 Of which contribution from real GDP growth	-0.5	0.0	0.6	0.8	0.5	0.5	0.3	0.3	0.3	0.7	0.7	
11 Contribution from exchange rate depreciation 4/	-0.9	-0.7	-1.2	-1.1	-1.4	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	
12 Other identified debt-creating flows	0.5	0.4	0.2	0.0	0.0	...	...	...	...	...	...
13 Privatization receipts (negative)	0.8	0.5	0.5	0.5	0.4	0.1	0.1	0.0	0.2	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.7	0.6	0.5	0.4	0.4	0.2	0.1	0.0	0.2	0.0	0.0	
Public sector debt-to-revenue ratio 1/	1.5	-0.6	0.3	-0.9	1.0	0.7	0.6	0.3	-0.2	0.0	-0.1	
Gross financing need 6/ in billions of U.S. dollars	72.1	69.6	69.8	67.0	67.1	67.7	69.5	68.9	66.6	65.6	64.8	
Scenario with key variables at their historical averages 7/	7.3	8.9	8.8	11.7	10.2	8.7	8.3	7.4	8.6	7.5	10.4	
Scenario with no policy change (constant primary balance) in 2007-2012	1.6	2.5	2.8	3.2	3.0	2.7	2.8	2.6	3.3	3.1	4.5	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.5	2.7	4.4	4.0	5.2	4.5	4.1	3.9	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	6.3	6.0	5.6	4.4	4.4	3.8	3.7	3.7	3.6	5.4	5.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.6	0.2	2.3	2.8	2.1	2.0	1.3	1.4	1.2	3.0	2.8	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-4.0	-3.2	-2.2	-0.3	0.0	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	7.9	5.8	3.2	1.5	2.3	1.8	2.3	2.4	2.4	2.4	2.4	
Growth of real primary spending (deflated by GDP deflator, in percent)	2.1	3.6	5.7	5.5	5.2	4.4	2.4	2.1	2.9	3.9	4.2	
Primary deficit	0.0	-0.2	-0.1	-0.1	-0.3	-0.1	0.2	-0.1	-0.3	-0.2	-0.1	

1/ General government gross debt.
2/ Derived as $[(r - \pi(1+g)) - g + \alpha\epsilon(1+\pi)] / [(1+g+\pi+\pi\pi)]$ 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 U.S. dollar).

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 $\alpha\epsilon(1+\pi)$.

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/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ 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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

May 2, 2007

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Appendix I. Slovenia: Fund Relations

(As of February 28, 2007)

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	210.97	91.05
Reserve position	20.76	8.96

III. **SDR Department**

Net cumulative allocation	25.43	100.00
Holdings	8.23	32.35

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

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund⁷**

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest	0.55	0.73	0.73	0.73	0.73
Total	0.55	0.73	0.73	0.73	0.73

VII. **Implementation of HIPC Initiative:** Not applicable.

VIII. **Implementation of Multilateral Debt Relief Initiative (MDRI):** Not applicable.

IX. **Exchange Rate Arrangement**

The currency of Slovenia is the euro. On June 28, 2004, Slovenia joined the ERM2 at the central parity of SIT239.64 per euro and the authorities maintained the exchange rate within a narrow, but unannounced band. Slovenia adopted the euro on January 1, 2007. Slovenia has

⁷ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

X. Article IV Consultation

Slovenia is on the standard 12-month Article IV consultation cycle. The 2007 mission visited Ljubljana during March 5-16, 2007 and held discussions with the Minister of Finance, Governor of the Bank of Slovenia, and other key economic ministers, government officials and representatives of the Parliament, financial sector, labor, business and media. Mr. Kiekens (Executive Director) and Ms. Maver (Adviser to the Executive Director) attended some of the meetings.

The mission comprised Ms. P. Sorsa (Head), Mr. R. Bems, and Ms. A. Tuladhar (all EUR) and Mr. J. Andritzky (MCM).

The mission held a press conference on the concluding statement and a seminar on the background papers on the financial and fiscal analysis. The authorities have agreed to the publication of the staff report.

XI. 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 (Country Report No. 01/161). 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.

XII. 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
April 2006	STA	Government Finance Statistics

Appendix II. Slovenia: Statistical Issues

39. **Data provision** is adequate for surveillance purposes.
40. **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>
41. **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.
42. 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.
43. **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)*.
44. 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)*.
45. 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.

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

47. **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.

48. **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, 2007

	Date of latest observation	Date received or posted	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of publication ⁶
Exchange Rates	4/1/07	4/1/07	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	3/30/07	4/2/07	M	M	M
Reserve/Base Money	3/30/07	4/2/07	M	M	M
Broad Money	3/30/07	4/2/07	M	M	M
Central Bank Balance Sheet	3/30/07	4/2/07	M	M	M
Consolidated Balance Sheet of the Banking System	3/30/07	4/2/07	M	M	M
Interest Rates ²	3/07	4/05/07	M	M	M
Consumer Price Index	4/07	4/28/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	1/07	4/18/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2/07	4/18/07	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2/07	4/18/07	M	M	M
External Current Account Balance	2/07	4/12/07	M	M	M
Exports and Imports of Goods and Services	2/07	4/12/07	M	M	M
GDP/GNP	Q4/06	3/15/07	Q	Q	Q
Gross External Debt	2/07	4/12/07	M	M	M

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/57
FOR IMMEDIATE RELEASE
May 23, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with the Republic of Slovenia

On May 18, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.¹

Background

Economic performance strengthened in 2006, supported by a recovery in investment and continued growth spillovers from the European Union. Declining real interest rates in the run-up to euro adoption on January 1, 2007 helped sustain credit growth and domestic demand. The strong economy boosted job creation, while unemployment declined and capacity utilization reached record high levels. In this environment, prudent incomes policies helped contain wage pressures, which, along with receding oil prices, sustained price stability.

Growth is projected to slow down slightly in 2007–08, as the investment boom decelerates. Domestic demand should remain the primary driver of growth as private consumption is expected to rise in line with higher disposable incomes and employment. Inflation is expected to remain broadly stable, assuming continued prudent policies. Overheating is a key risk—with tightening capacity constraints, the boost to demand from continued strong credit growth, climbing asset prices, and wage increases can unleash price pressures. Other risks to the outlook arise from higher world oil prices and euro appreciation.

While Slovenia's fiscal deficit narrowed in 2006, the authorities' fiscal plans for 2007 imply an expansionary fiscal stance despite the overheating risks and major medium-term policy

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.

challenges. The general government deficit amounted to $\frac{3}{4}$ percent of GDP in 2006, reflecting strong cyclical and one-off gains in revenues as well as a tighter-than-planned wage bill. In 2007, the government has started to implement an ambitious tax reform, which will lower revenues over a few years, and to increase infrastructure spending, which will be only partially offset by a tight wage bill and reforms in expenditures. These fiscal plans imply increases in the general government deficit to 1.3 percent and 1.7 percent of GDP in 2007–08, with a procyclical fiscal impulse of about 1 percent of GDP over the period. Over the medium term, the authorities target a deficit of about 1 percent of GDP in 2009 and structural balance by 2011, for which measures remain to be fully identified. With one of the most rapidly aging populations in Europe, the pension burden is also a major longer-term challenge for fiscal sustainability.

Cross-border integration of the financial sector has been on the rise as banks continued their borrowings abroad to finance strong domestic credit demand and expand their foreign operations. Despite increased vulnerability to credit risks and pressures on profitability, the financial sector remains sound to deal with these risks. Nevertheless, the largely state-owned banking sector is relatively inefficient by regional and EU standards and capital market development lags behind European Monetary Union (EMU) peers.

The main challenge to Slovenia's medium-term performance is to maintain competitiveness. Strong export growth and indicators of real exchange rate misalignment presently do not indicate a lack of competitiveness. Yet, sluggish growth in export market shares in the EU underscores the need for stronger technological upgrading of exports and productivity growth. Structural rigidities in the budget and in the labor and financial markets suppress economic flexibility, which contains potential growth and Slovenia's ability to deal with adverse shocks.

Executive Board Assessment

Executive Directors commended Slovenia's successful euro zone entry in January 2007, which was underpinned by sound macroeconomic policies that have allowed the full observance of the Maastricht Treaty convergence criteria. Economic growth has been robust and is projected to remain above the EU average for the next few years, while unemployment has continued to decline and inflation remains low and stable.

Looking forward, Directors observed that important challenges remain. They stressed that, to ensure successful euro area membership and sustained convergence, a strong commitment to fiscal and wage prudence and accelerated structural reforms will need to be maintained. The current favorable environment should be used to reduce structural rigidities and financial vulnerabilities, boost productivity and competitiveness, diminish state intervention in the economy, and improve the sustainability of public finances. Directors also noted that overheating risks remain and should be monitored closely.

Directors questioned the procyclical fiscal stimulus in 2007–08 implied by the government's fiscal plans at this cyclical juncture and recommended a neutral fiscal stance. To this end, they suggested that the consolidation should focus on reforming the rigid and inefficient spending structure.

Directors emphasized that, over the medium term, fiscal policy needs to deal with the challenges of an aging population while ensuring that the government's target of a structural balance can be achieved. They noted that, while reforms to reduce the tax burden are welcome, expenditure measures to support these targets remain to be fully identified and that the envisaged adjustment is backloaded. Therefore, up-front reforms in nondiscretionary spending and the relatively generous pension system would not only ensure a balanced expansion, but enhance budgetary efficiency and flexibility and address long-term fiscal sustainability concerns. Directors encouraged the authorities to take steps to forge the necessary political consensus for early reforms.

Directors observed that, while the banking system remains sound, Slovene banks are less profitable and efficient than their EU counterparts. Directors noted the pressure on bank profitability from declining interest margins, high costs, and state dominance in the banking sector, and encouraged the authorities to take measures to increase bank competition and efficiency, including privatization of state-dominated banks. Given the rapid credit expansion and increasing foreign activities of banks, Directors welcomed the steps being taken to strengthen bank supervision, including increased cooperation and information-sharing with foreign bank supervisors, and urged supervisors to closely monitor credit risks and exposures to foreign markets.

Directors noted that Slovenia's capital market development lags behind EU levels, resulting in heavy dependence on bank intermediation and in corporate leverage ratios that are well above the euro-area average. They therefore commended the authorities' efforts to foster integration with EU financial markets, which will expand saving and financing options and help strengthen the financial sector's contribution to Slovenia's development.

Directors stressed that further reforms in labor markets and the business environment would enhance competitiveness and Slovenia's long-run growth potential. They welcomed recent initiatives to remove administrative barriers to doing business, and called for additional efforts to attract foreign direct investment. While they also welcomed the improved incentives to work, Directors emphasized that increasing labor market flexibility further will require easing of employment protection regulations. Some Directors also questioned the sustainability of improving competitiveness by keeping wage increases below productivity gains.

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, 2003–08						
	2003	2004	2005	2006	Projections	
					2007	2008
	(Annual percentage change)					
Real GDP	2.7	4.4	4.0	5.2	4.5	4.1
Domestic demand	4.7	4.9	2.0	5.5	4.8	4.1
Consumer prices						
Period average	5.6	3.6	2.5	2.5	2.6	2.6
Real wages (all sectors)	1.8	2.0	2.3	2.3	2.8	3.3
Average unemployment rate (in percent, ILO definition)	6.7	6.3	6.5	6.0	6.0	6.0
	(In percent of GDP)					
Public finance						
General government balance 1/	-1.5	-1.5	-1.2	-0.8	-1.3	-1.7
General government debt	28.5	28.8	28.0	28.2	28.3	28.4
	(Percentage change, end-period)					
Money and credit						
Credit to Private Sector	15.4	21.0	23.6	25.7	...	...
Government bond yield (5 year, in percent)	4.2	3.9	3.1	3.7	...	...
Balance of payments	(In percent of GDP)					
Trade balance	0.0	-1.2	-0.6	-0.9	...	...
Current account balance	-0.8	-2.7	-2.0	-2.6	-2.6	-2.5
External debt (percent of GDP, end-period)	53.2	58.4	71.0	79.5	86.6	91.4
Exchange rate						
Exchange regime	Member of EMU					
Nominal effective exchange rate (1995=100,	65.5	65.2	65.0	65.1	...	...
Real effective exchange rate						
(CPI based, 1995=100, period average)	104.3	105.4	105.4	106.1	...	...
(ULC based, 1995=100, period average)	100.5	98.1	98.8	94.8	...	...

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

1/ Revenue and expenditure exclude social security contributions paid for government employees. 2007–08 projections correspond to the budget, but exclude VAT revenues of 0.4 percent of GDP in 2008. Additional deficit from railways of 0.4 and 0.5 percent of GDP in 2007 and 2008 are excluded

**Statement by Willy Kiekens, Executive Director for the Republic of Slovenia
and Ksenija Maver, Advisor to Executive Director
May 18, 2007**

The Slovene authorities appreciate the staff's work and meaningful consultations, as well as the staff's report and assessment of economic developments in Slovenia.

Euro adoption

The introduction of the Euro on January 1, 2007 was smooth and with low costs for companies and households. It is estimated that the changeover to the Euro caused a minimal increase in inflation, only about 0.2 to 0.3 percentage points. Reduced transaction costs, absence of exchange rate risk, and low Euro area interest rates have added momentum to the economy. Also, confidence in the economy has strengthened further. The Euro adoption process was facilitated by a decade of prudent macroeconomic and financial policies. These policies have laid ground for further economic expansion and job creation.

Economic developments in the first quarter of 2007

Slovenia's economic growth accelerated from 4 percent in 2004 – 2005 to 5.2 percent in 2006. This positive trend has thus far also continued in 2007. The first quarter recorded an increase of 9.3 percent in industrial production and 18 percent in exports over the same period in 2006. Wage increases continue to be moderate, at 3.1 percent year-on-year in the first two months of 2007.

Inflation is low. Since early 2005, headline inflation (HIPC) is practically unchanged at about 2.5 percent. After a small pick up in the last quarter of 2006, core inflation declined to 1.5 - 1.7 percent.

Fiscal developments in the first quarter of 2007 seem to be on track and consistent with a budget deficit target of 0.9 percent. Total government revenues are broadly in line with the projections. Expenditures continue to be on a downward trend.

The business climate indicator also remained high, at its peak level since 1996.

On May 16, 2007, Slovenia received OECD's invitation to start negotiations for membership.

Short-term economic outlook

Considering these positive economic trends and the improved economic climate in some of Slovenia's important trading partners, forecasts for 2007 – 2009 have been revised upwards. Strong investment activity and employment growth are expected to contribute to an expansion in the economy's potential supply capacity. The government's base scenario projects economic growth at 4.7 percent for this year, which is slightly above the staff's 4.5 percent forecast. For the remaining period until 2009, growth is expected to remain above

4 percent, hence facilitating the process of real convergence with the EU. The expansion during the period 2007 – 2009 is expected to be driven mostly by domestic demand, but the contribution made by net trade will be positive.

The favorable growth in aggregate demand is expected to exceed the output potential marginally, but the risks for inflation are considered moderate given the expected continuation of moderate low growth of labor costs. The 2007 – 2008 inflation is expected to exceed, the 2005 – 2006 level of 2.5 percent only slightly, by 0.2 percentage points, mostly because of the prices for food and services. But in 2009, it is expected to return to its present level of 2.6 percent.

Financial sector

The staff rightly points out that deepening EU financial integration and liberalized capital flows bring about new challenges, especially to small and open economies like Slovenia. There is no doubt that the stability and soundness of the financial system, a robust macroeconomic environment and increased coordination among supervisors make up the first line of defense. In Europe, financial sector consolidation has been advanced primarily at a national level. However, EU-wide integration is becoming more significant. In most central European countries, a large share of the banking sector is foreign owned. Although these banks are often of systemic importance in the host country, they are supervised by the authorities of the home country according to EU banking supervision directives. The Slovene authorities place great emphasis on improving for these banks the flow of information between bank supervisors, enhancing risk management and improving the cost sharing arrangements in crisis situations between home and host countries. Discussions of these issues at the EU level would be timely and welcome.

In early May, the government decided to list on the stock exchange, by the end of this year, the second largest state-owned bank and offer 49 percent of the shares to institutional and individual investors. Floating the remaining shares will be decided at a later stage. For now, the long term strategy is to keep at least 25 percent plus one share under the control of the state. The government aims at building a strong financial conglomerate around this bank and including three predominately state-owned insurance companies. The revenues from this sale would be used for reducing public debt.

Structural agenda

With the Euro adoption successfully completed and the convergence criteria met, structural policies will be critical for Slovenia to benefit fully from its participation in the Euro zone. In this regard, some important steps have been taken.

As a result of the government's Program of Measures for Reducing Administrative Burden, competitiveness has been increased through improved quality of administrative services and simplified procedures. In line with this program more than thirty measures have been adopted. Each new regulation must now pass a test that its implementation can be efficient.

Establishing new businesses, especially small ones, has been facilitated. A portal called “e-VEM” has been recently launched, providing user friendly services such as registration in Slovenia’s business register and providing essential information for entrepreneurs, including on taxation. The portal will be further improved and constantly updated.

Slovenia’s integration in the global economy is deepening mainly through trade and outward investments. Inward foreign direct investment that would promote technological restructuring in Slovenia’s manufacturing sector is still relatively modest. Thus, the authorities plan to improve further the competitiveness and flexibility of the economy, including by providing larger support for R&D. In this context, some important measures are under preparation.

In the fiscal sector, the government plans to make the budget more flexible and to reform the pension and health care systems to contain the costs as the population ages.