May 2001
IMF Country Report No. 01/76

Republic of Slovenia: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of 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 2001 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 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 13, 2001,** 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 April 18, 2001.** 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 staff statement of **May 11, 2001** updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its May 11, 2001, discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of the Republic of Slovenia.

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623 7430 • Telefax: (202) 623 7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with the Republic of Slovenia

Approved by C. M. Watson and G. Russell Kincaid

April 18, 2001

- The 2001 Article IV consultation discussions were held in Ljubljana during January 31–February 13, 2001. The mission met Prime Minister Drnovšek, Finance Minister Rop, Economy Minister Petrin, Labor, Family, and Social Affairs Minister Dimovski, Bank of Slovenia Governor Arhar, members of the Finance and Monetary Affairs Committee of parliament, and other senior officials, including members of the Government Office for European Affairs, the Bank of Slovenia, the Statistics Office, and the Institute of Macroeconomic Analysis and Development, as well as representatives of the business, financial, and academic communities.

- The staff team comprised Mr. Demekas (head), Ms. Belaisch, Mr. Vamvakidis (all EU1), Mr. Gershenson (INS), and Ms. Sekera (PDR) as assistant. Mr. Repanšek, of the office of the Executive Director for Slovenia, participated in the discussions and Mr. Kiekens, Executive Director for Slovenia, attended the concluding policy meetings. Mr. Marston (MAE) and Mr. Aghdaey (World Bank) joined the mission to follow up the work of the FSAP mission last November.

- Slovenia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles. The Fund has not identified any restrictions on payments and transfers for current international transactions in existence in Slovenia.

- Slovenia has subscribed to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance, and the quality of Slovenia's statistics is rapidly approaching international standards (for details, see Appendix II).

- At the conclusion of the 1999 Article IV consultation on March 3, 2000 (EBM/00/21), Executive Directors endorsed the stance of macroeconomic policies and focused on the medium-term challenges arising from the process of harmonization with the EU, particularly the ongoing capital account liberalization. Directors stressed the key role of fiscal policy and urged the government to move toward a comprehensive medium-term fiscal framework; recommended that monetary authorities focus on disinflation and accept greater exchange rate flexibility; and emphasized the need for structural reforms to reduce rigidities.

- In the October 15, 2000 general elections, Mr. Drnovšek was returned to power at the head of a new center-left coalition government with an outright parliamentary majority.

- Slovenia is among the most advanced EU accession candidates. The EU Association Agreement came into force on February 1, 1999 and the government's National Program for the Adoption of the *Acquis Communautaire* aims at completing all preparations for membership by end-2002. So far, 18 chapters of the *Acquis* have been provisionally closed, while 11 remain open.

- There was a joint press conference with the Governor of the Bank of Slovenia and the Minister of Finance at the end of the mission, and the authorities intend to consent to the publication of the consultation documents.

Contents

Page

I. Economic Background

1. ***Slovenia is among the most successful transition economies of central and eastern Europe***. It has a stable macroeconomic environment (Figure 1), the highest per capita income and investment rating in emerging Europe, and is well advanced in its membership negotiations with the EU. The Commission's last Regular Report concluded that Slovenia has a functioning market economy and should be able to deal with competitive pressures in the EU in the medium term, provided it completes remaining reforms.

Convergence indicators, 2000

	Inflation	Int. rate 1/	Fiscal def.	Pub. debt	GDP/cap.	Spread 2/	Rating 3/
	(% avg)		(ratio to GDP)		(US$)	(bp)	(S&P)
Slovenia	**8.9**	**13.6**	**1.3**	**37.0**	**10,109**	**67**	**A**
Czech R.	3.9	5.6	5.6	17.5	5,007	83	A-
Hungary	9.8	9.7	3.4	58.2	4,527	53	A-
Poland	10.1	14.6	3.2	42.5	4,149	78	BBB+
Estonia	4.0	10.5	0.4	6.2	3,477	...	BBB+
EU-11	2.4	5.4	0.2	71.0	23,867	--	...

Sources: IMF, countries' authorities.

1/ Long-term government bonds or equivalent.

2/ Long-term benchmark bond with German Bund of similar maturity.

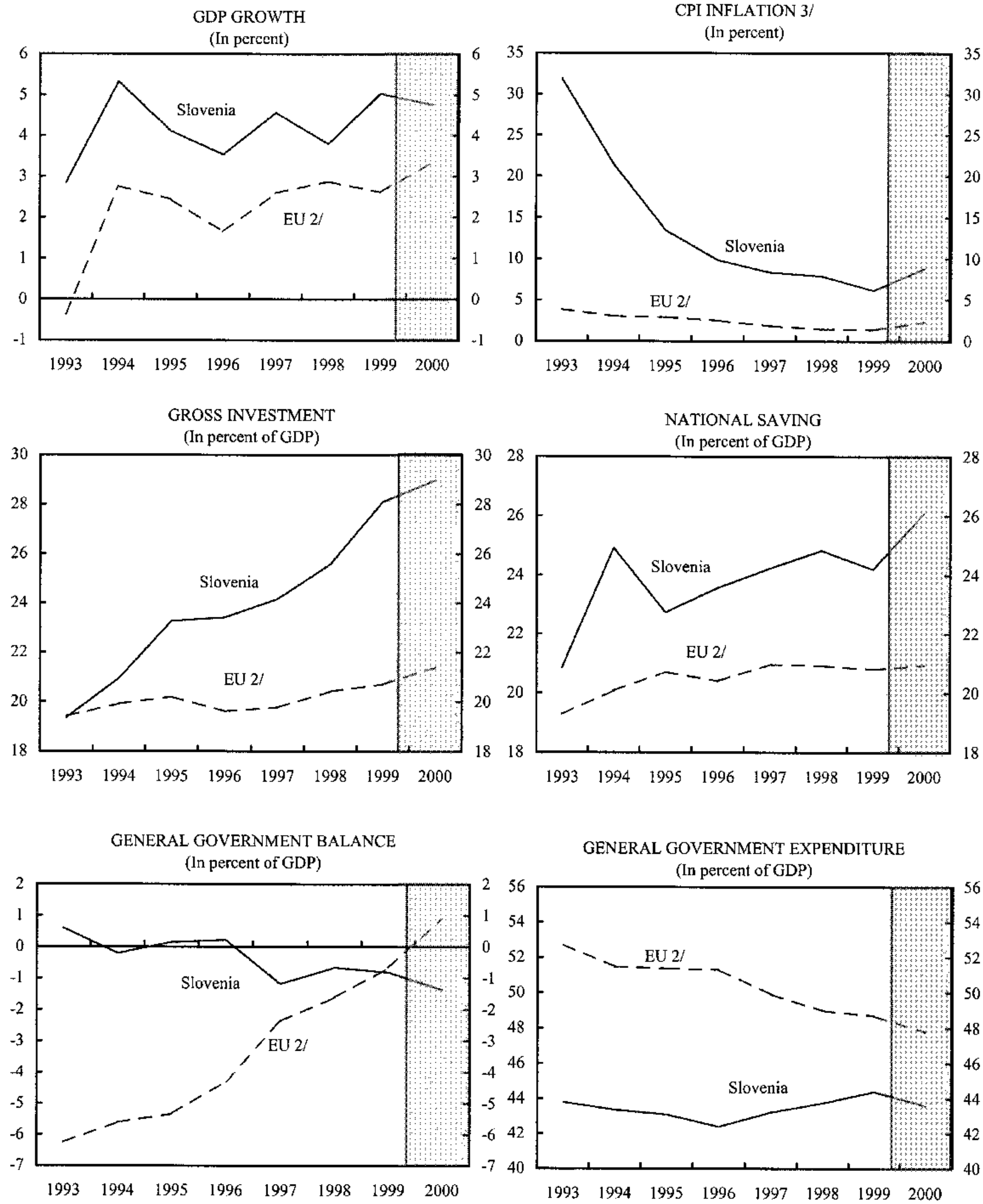
3/ Long-term foreign currency debt.

2. ***Since independence in 1991, the Slovene authorities have followed prudent macroeconomic policies and a gradualist approach to structural reform.*** Broadly balanced budgets (although small deficits have emerged since 1997)[1] and a conservative monetary policy in the context of monetary targeting and a managed float for the tolar brought inflation down to the single digits since 1997, kept government debt to about 25 percent of GDP, and maintained a balanced current account until 1998. On the structural front, the authorities proceeded gradually for most of the 1990s: price liberalization was slow; capital controls were pervasive until recently; state banks were rehabilitated and, for most of the decade, shielded from competition by a ban on foreign branch banking and ceilings on deposit interest rates; privatization took place mostly through a voucher scheme or internal buyouts at preferential terms; newly-privatized firms were protected from hostile takeovers by a two-year freeze on share transfers (which expired in 1999); many ailing enterprises were placed under the Slovene Development Corporation for restructuring with state funds before privatization; and most financial contracts and—until very recently—wages were fully indexed. The gradualist approach was successful given the relatively good starting point and, since a critical report by the EU Commission in 1998, the pace of reform has picked up significantly, including in capital account liberalization, which is now largely completed (Box 1).

---

[1] On the ESA95 statistical basis, which Slovenia will have to adopt vis-à-vis the EU, the annual general government deficits in the past were about ½–1 percent of GDP higher than those reported under the national definition, also used in this report. This discrepancy is mainly due to the reporting of interest on indexed debt (notably bank rehabilitation bonds issued in the early 1990s) and various other expenditure items on a cash rather than accrual basis in the national statistics. Also, state aid extended by various state agencies and funds is still to be fully included in the general government deficit, but the effect of this correction will be minor.

Figure 1. Slovenia: International Comparisons, 1993-2000 1/



Sources: World Economic Outlook, Bank of Slovenia; and Statistical Office of the Republic of Slovenia.

1/ Shaded areas are estimates.

2/ EU includes 12 countries through 1994, 15 thereafter.

3/ Period average.

Box 1. Capital account liberalization

Recent measures: In 1999–2000, restrictions on foreign branch banking were removed; controls on portfolio inflows were gradually relaxed; the 40 percent foreign exchange surrender requirement on foreign loans was eliminated; and enterprises were allowed to hold foreign currency accounts in domestic banks (individual accounts were already allowed). On January 1, 2001, restrictions on portfolio inflows with maturity of 6 months or more were eliminated.

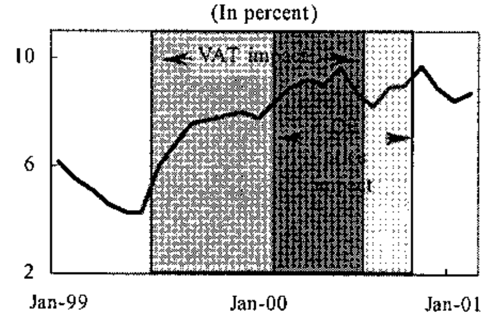
Current status: There are no controls on capital movements except for portfolio flows with maturity of less than 6 months. FDI in some sectors is limited (e.g., media) or subject to supervisory approval (e.g., in the financial sector). For residents, the only remaining restriction is the prohibition on keeping bank accounts or purchasing securities abroad. In addition, the Bank of Slovenia preserves the right to impose temporary restrictions for up to 6 months in the event of large capital movements that could jeopardize the monetary and exchange rate policy framework. There are no restrictions on nonresidents' acquisition of real estate in Slovenia, provided reciprocity conditions are fulfilled.

Plans: The Bank of Slovenia plans to remove the restriction on enterprises to open accounts abroad by mid-2001; remaining restrictions on portfolio inflows by year-end; and all other restrictions by the time of EU accession.

3. ***The economy enjoyed fast and stable growth in 2000 thanks to a favorable competitiveness position and strong investment.*** Real GDP growth reached 4.8 percent in 2000, and unemployment fell to 7 percent—a record low, which the authorities believe is probably close to the NAIRU (Table 1). After very rapid growth in 1999, real consumption grew only 1 percent in the first 9 months of 2000, but the share of investment in GDP is estimated to have reached an all-time high for the year as a whole (28½ percent). Continuing real wage moderation in the private sector and the depreciation of the tolar during the year (8 percent in nominal effective terms) led to a historically strong competitiveness position, especially in terms of unit labor costs (Figure 2). Export volumes grew by over 10 percent and, despite deteriorating terms of trade, the current account deficit declined to 3.3 percent of GDP in 2000. The bulk of imports consisted of capital and intermediate goods. The current account deficit was mainly financed by medium- and long-term borrowing abroad, and reserve coverage in terms of imports and short-term debt remained broadly unchanged (Table 2).

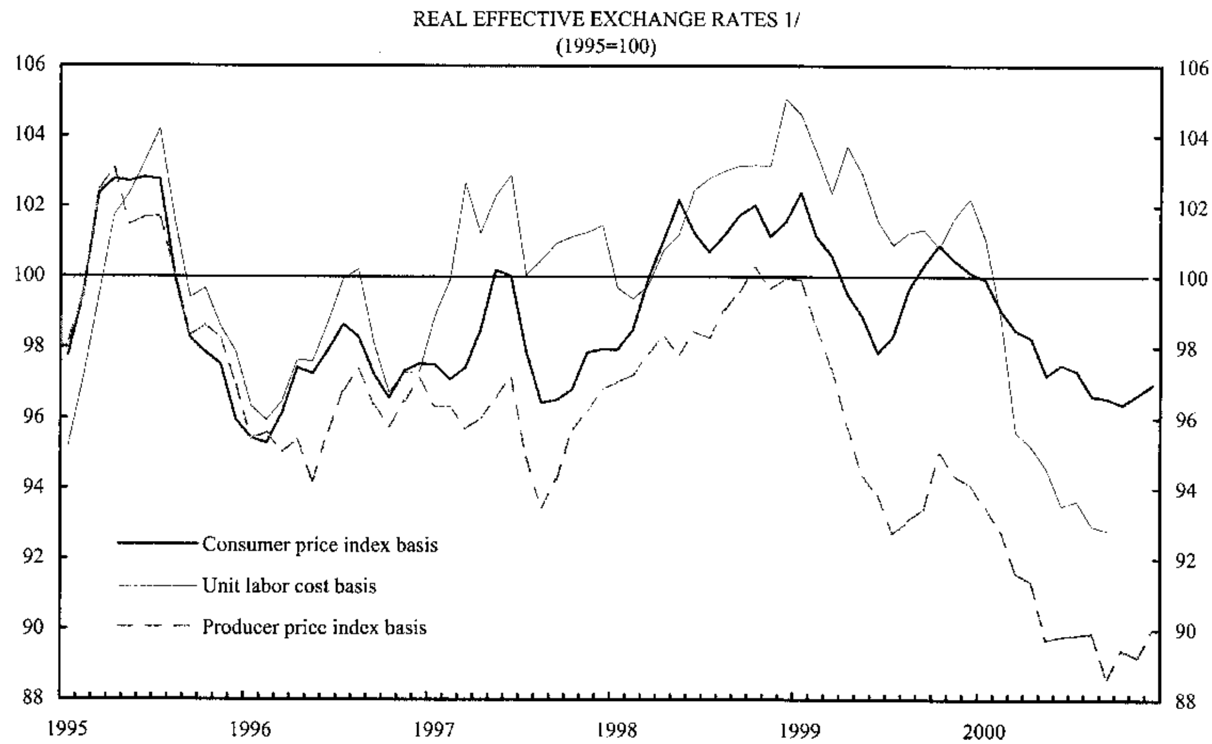
4. ***Inflation accelerated as a result of successive price shocks and remains high.*** The introduction of the VAT in July 1999, the sharp increase in oil prices in 2000, and the weakness of the euro caused 12-month inflation to jump from 4.3 percent in June 1999 to an average of 8.9 percent in 2000. Administered price increases (mostly energy) accounted for about 2½ percentage points of this increase, with the rest mostly attributable to the rapid depreciation of the exchange rate, reflecting the lax monetary conditions prevailing in the first half of 2000. Although the impact of the price shocks had lapsed by late 2000, inflation has persisted at a high level: the average annualized monthly rate during the last six months was around 10 percent, and the 12-month inflation rate in March 2001 was still 8.9 percent.

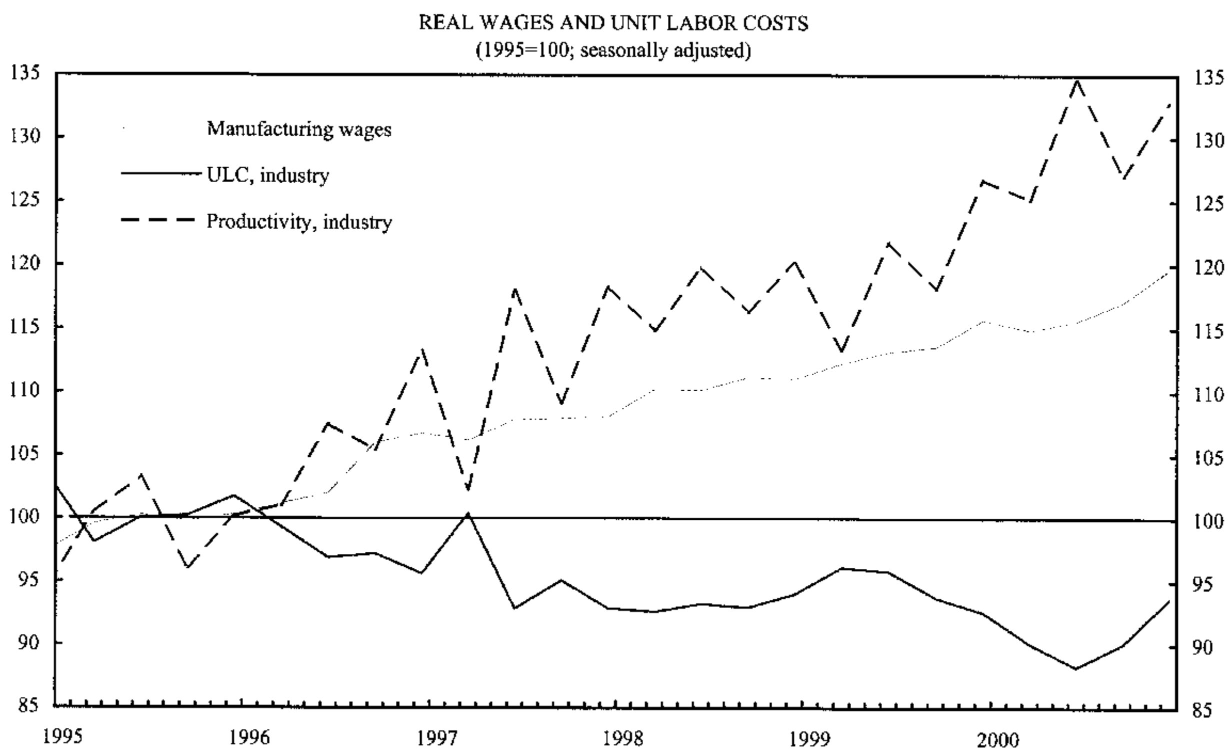
12-MONTH INFLATION
(In percent)



5. ***Fiscal slippages in the run up to the October elections were contained when the new government froze most expenditures in the last quarter of 2000.*** Revenues were lower-than-budgeted owing to a larger-than-projected shift in the composition of demand toward exports.

Figure 2. Slovenia: Competitiveness Indicators, 1993-2001





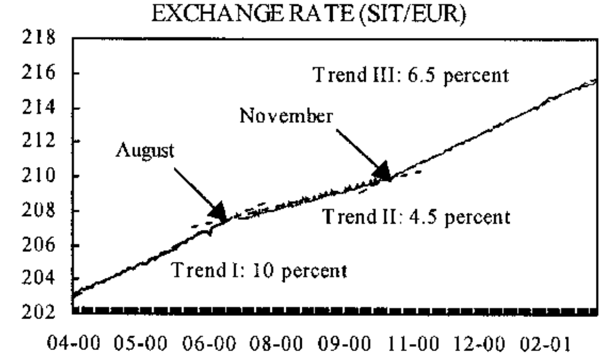
Sources: Bank of Slovenia; Statistical Office; Institute for Macroeconomic Analysis and Development; and staff calculations.

1/ An increase is an appreciation.

Spending increased very rapidly in the first half of the year due to higher-than-expected indexation payments for wages, pensions, and social transfers. Closer to the elections, the government also yielded to union pressures and raised some public sector wages (notably in healthcare). The new government, however, took drastic steps to restrain spending in the last two months of 2000, and the general government deficit for the year as a whole was contained to 1.3 percent of GDP, compared to the budgeted 1 percent (Table 3).

6. ***Monetary conditions were lax during the first half of the year and were tightened haphazardly in the second half, as the Bank of Slovenia frequently shifted its priorities in an effort to balance the pursuit of disinflation with its desire to support competitiveness.*** At the beginning of 2000, the Bank of Slovenia (BoS) did not react to the rapid depreciation of the tolar (at an annualized rate of 10 percent vis-à-vis the euro) and interest rates were kept unchanged; consequently, monetary conditions eased. Following concerns about inflation, discussed also with the staff during a visit in July, the BoS raised interest rates and intervened in the foreign exchange market to slow the depreciation to an annualized 4½ percent. In November, current account preoccupations led the Bank to intervene in order to accelerate somewhat the rate of depreciation but, at the same time, raise interest rates again to stave off inflation expectations (Figure 3). Although broad money growth—the BoS's primary intermediate target—ended the year within the target range of 12-18 percent (defined as the fourth quarter average over the corresponding period of the previous year), credit statistics underestimate private sector liquidity as they do not capture borrowing from abroad.[2] The lax monetary conditions prevailing during the first part of 2000 accommodated price shocks, while the frequent changes in monetary policy sent conflicting signals to the market and probably contributed to an increase in currency substitution (Figure 4).

EXCHANGE RATE (SIT/EUR)

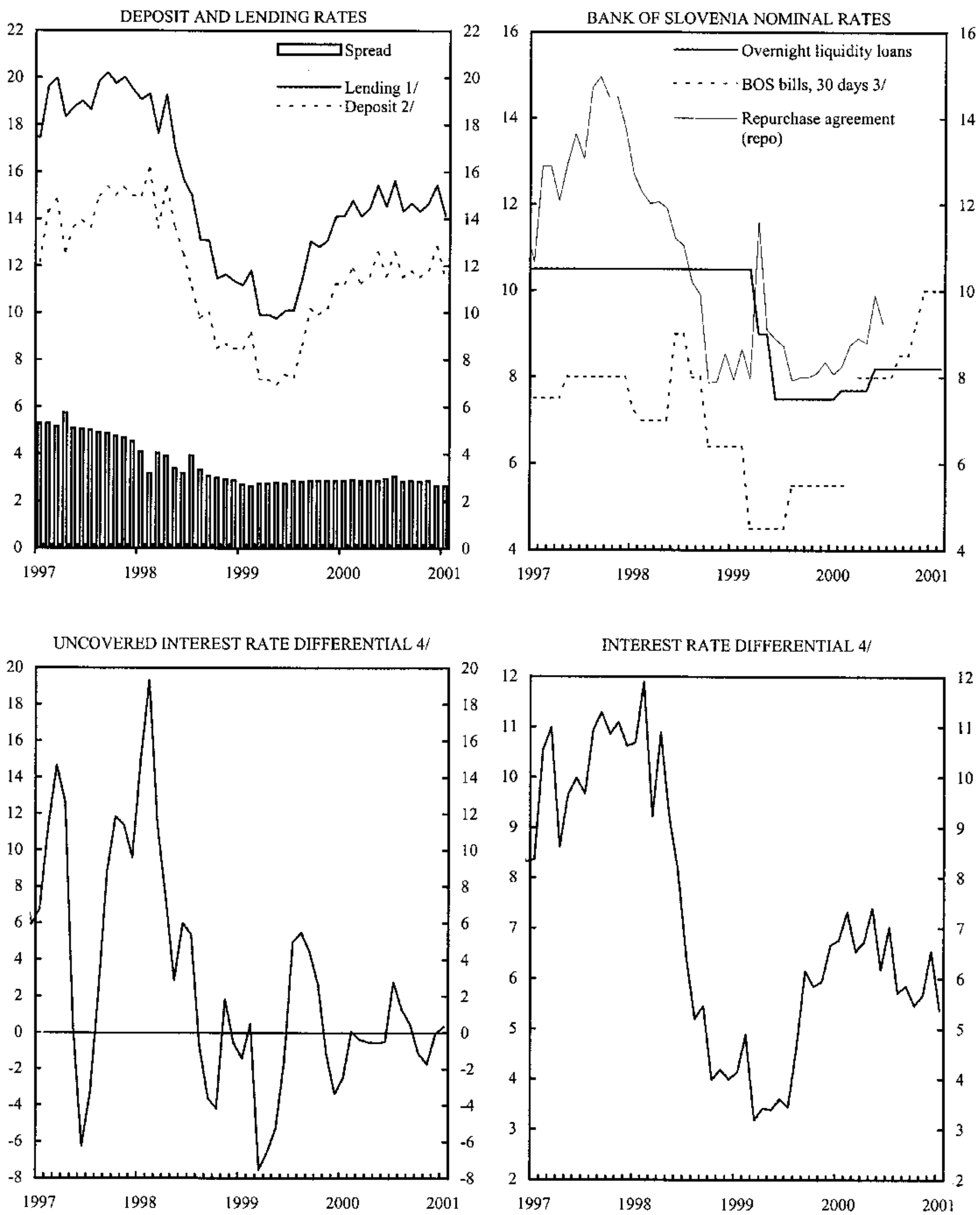


7. ***Due to the pre-election period, progress in structural reforms was limited in 2000.*** Steps were taken toward the resolution of the outstanding legal issues concerning the ownership of insurance companies, which pave the way for the disinvestments of government holdings; an energy regulatory agency was created, a precondition for the liberalization of the sector according to the 1999 Energy Law; and a new law on railway traffic was passed, paving the way for railways liberalization. But there was no progress in the macroeconomically more relevant areas of bank privatization, labor market deregulation, or tax reform, and the pace of corporate restructuring remained sluggish. Moreover, indexation of financial contracts is still widespread.

---

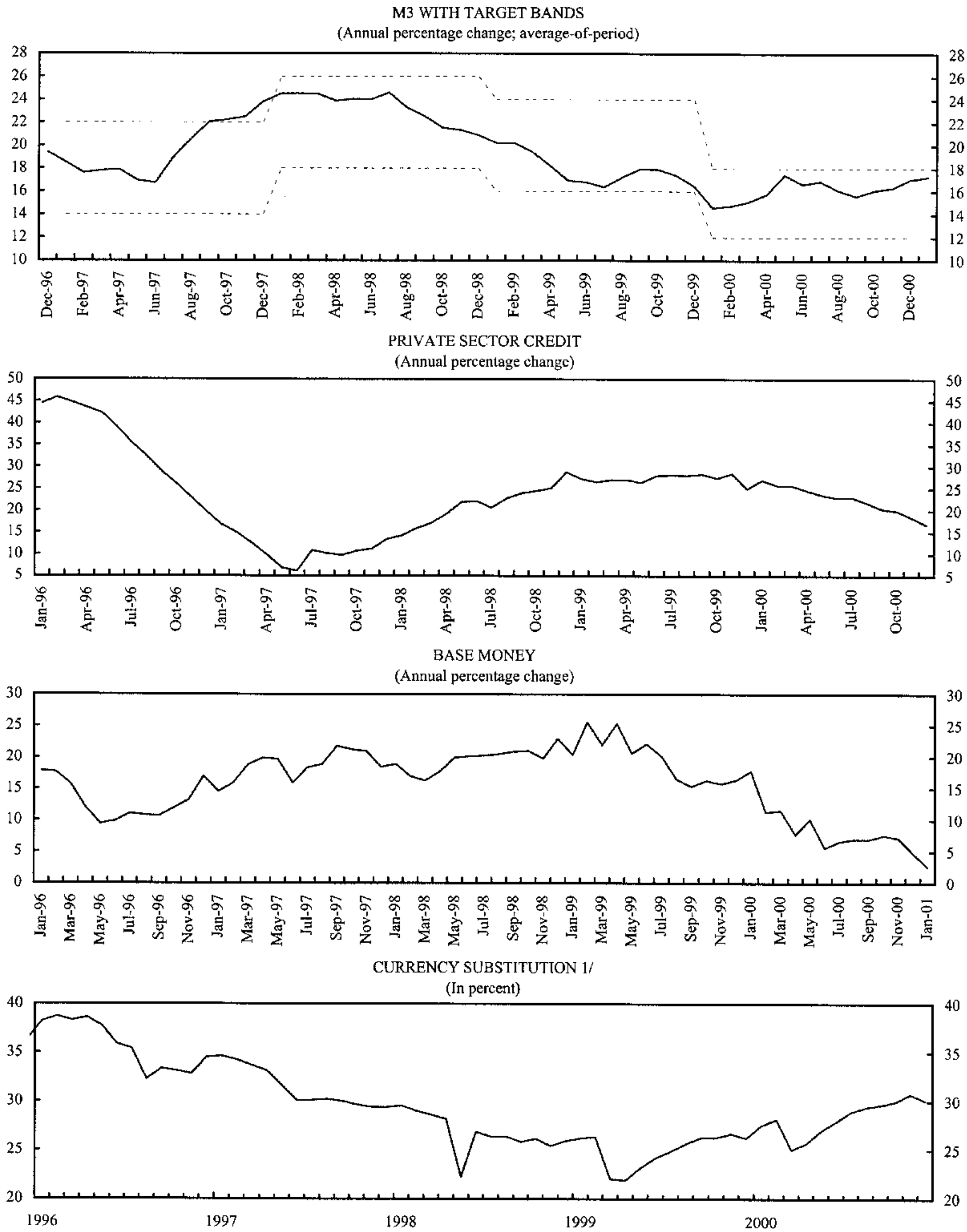
[2] Although the stock of foreign loans is still relatively low, it has started increasing rapidly as a result of capital account liberalization: about half of new loans granted to the private sector in 2000 were contracted directly from abroad.

Figure 3. Slovenia: Interest Rates, 1997-2001



Source: Bank of Slovenia; and IMF staff calculations.
1/ Average of lending rates on capital loans and consumer credits.
2/ Average of deposit rates with maturities ranging from 30 days to over a year.
3/ In April 2000, this instrument was replaced with 60-day bills, which caused a jump in the series.
4/ Differential between short-term deposit rates in Slovenia and Germany; the uncovered differential is adjusted for the one-month ahead change in the SIT/DEM exchange rate.

Figure 4. Slovenia: Monetary Developments, 1996-2001



Source: Bank of Slovenia; and IMF staff calculations.

1/ Foreign exchange deposits as percent of broad money (M3).

8. ***The state continues to have a pervasive presence in the economy***. Despite its success, the gradualist approach to reform has maintained a sizeable presence of the state in the economy. The banking sector is dominated by two state-owned banks. Enterprises of public or mixed ownership produce about half of total value added and are present in various sectors, from steel to insurance. Distortions in the taxation of financial assets inhibit the development of the capital market. Regulation, including in the labor market, is extensive. And the method of privatization of the socially-owned enterprises has resulted in a widely dispersed ownership among institutional investors (including different state funds), insiders (management and employees), and small investors. This has impaired effective shareholder control and slowed the consolidation and restructuring of the privatized enterprises (see also SM/00/30, 2/14/00).

9. ***The macroeconomic outlook for 2001 is positive and the risks to growth are manageable***. Slovenia's strong competitiveness will continue to provide the stimulus for exports and investment, including in the Balkans, where Slovene businesses enjoy comparative advantages and have been recently expanding rapidly. This will cushion the impact of the slowdown now projected in the EU. The staff's current central projection is that growth would decelerate only marginally relative to last year and, at about 4½ percent, remain strong. In the event of a deeper slowdown in western Europe, Slovenia will experience weaker export demand but the effect on domestic demand is projected to be small, thus limiting the impact on overall growth. Provided real wage growth continues to be moderate, thereby preserving competitiveness, the current account deficit will likely be further reduced to under 3 percent of GDP. Inflation pressures, however, will remain high, at least in the first part of the year, as a result of the lagged effects of lax monetary conditions in 2000 and the impact of wage indexation. This creates a significant risk of entrenchment of the inflationary process that needs to be addressed through policies. Encouragingly, the exogenous price shocks of 2000 are expected to be reversed—notably lower energy prices and an appreciation of the euro vis-à-vis the U.S. dollar—which would create a conducive environment for disinflation.

II. REPORT ON THE DISCUSSIONS

10. ***There was agreement on the key challenges facing policy makers: to keep up the strong economic performance and complete the reforms necessary to secure early and successful EU entry***. The authorities were alert to the immediate need for steering inflation to a downward path in order to strengthen the foundations for sustained growth and ensure the credibility of the policy framework. In the medium term, they felt priority should be given to reforms that would allow Slovenia to cope with the costs of EU harmonization—including the risks associated with the ongoing capital account liberalization—and reap the benefits of eventual EU membership. The consultation discussions thus focused on two broad themes:

- short-term policies to bring inflation down and set it again on a downward trend; and
- medium-term reforms to enhance efficiency in both the public and the private sector. These involve building a multi-year budgetary framework in which the government could establish a firm fiscal position and improve the allocation of scarce public resources; strengthening the efficiency of the financial system to speed its integration with global financial markets; and reducing the role of the state to make more room for a competitive private sector.

A. The Macroeconomic Conjuncture

11. ***The authorities and staff agreed that the immediate policy challenge was to reduce inflation***. The rise in currency substitution was seen as an indication of uncertainty about inflation and exchange rate developments. Lower inflation was also seen as a prerequisite for tackling important structural reforms, such as the deindexation of wages and financial assets—a legacy from the times of high inflation in former Yugoslavia that today facilitates the transformation of price shocks into persistent inflation.

12. ***The authorities were confident that the combination of a benign economic outlook and a prudent policy stance would ensure a reduction in inflation to 6¼ percent by end-2001***. Exogenous price pressures domestically and—especially—from abroad were projected to decline during 2001, as wage moderation was expected to continue and oil prices to fall. At the same time, the authorities intended to maintain tight macroeconomic policies in 2001. In February, the government approved a draft 2001 budget that aimed at reducing the general government deficit to 1.0 percent of GDP from 1.3 percent in 2000. The authorities felt a moderate tightening was warranted to correct the slippage of last year and set the stage for the government's medium-term fiscal consolidation plan (paragraph 17). Indeed they pointed out that the extent of fiscal adjustment in 2001 on a commitments basis would be larger than the reduction in the cash deficit, because the 2001 budget was burdened with spending commitments made during the pre-election period. As regards monetary policy, following the tightening in the latter part of 2000, the BoS announced a slightly lower target range for M3 growth (11–17 percent) for 2001, signaling its intention to maintain a conservative stance this year.

13. ***The staff agreed with this positive assessment, but saw the burden falling on monetary policy to deliver the desired inflation outcome***. The staff agreed with the authorities' assessment of the exogenous influences on prices. The staff also supported the 2001 fiscal policy stance: the planned moderate fiscal tightening was appropriate given the central projection of continued strong economic activity, the unemployment rate probably close to NAIRU, and high capacity utilization. This fiscal stance created a positive environment for disinflation and, at the same time, allowed plenty of room for the automatic stabilizers to operate in the event of a deeper-than-expected slowdown. However, the staff stressed that the responsibility for achieving the desired inflation outcome in 2001 rested primarily with monetary policy.

14. ***Within the existing policy framework, the BoS could rise to this challenge successfully only if it focused on price stability and resisted the desire to boost competitiveness***. The authorities and staff agreed that capital flows in both directions could be expected to increase this year as a result of privatizations and capital account liberalization. Within the current monetary targeting framework, higher and more volatile capital flows would make it increasingly difficult for the BoS simultaneously to achieve disinflation and support external competitiveness. The staff thus argued that continuing to pursue both objectives risked confusing markets, as in 2000: with its frequent changes in policy focus last year, the BoS had failed to lead public opinion and expectations regarding the prospects for disinflation, and contributed to currency substitution. Given the urgent need to lower inflation significantly before it became entrenched, the staff urged the BoS to stay steadfastly focused on price stability in 2001.

15. ***The BoS stressed that the constraints facing monetary policy in Slovenia argued for a pragmatic approach; nonetheless, it agreed with the need to focus on inflation in the current conjuncture, and indeed raised interest rates following the mission's visit.*** The BoS was mindful of the importance of the exchange rate for current account sustainability, inflation expectations, and the credibility of the overall policy framework in a small export-oriented economy like Slovenia, and argued it could not really afford a policy of "benign neglect" of the exchange rate. Exchange rate intervention was often necessary to supplement interest rate action and guide the market, as distortions in the domestic money market limited the effectiveness of the interest rate transmission mechanism. The BoS thus saw monetary policy as a balancing act between different constraints, with capital account liberalization another element adding to the complexity of the task. Nonetheless, the BoS agreed that the balance of risks in 2001 dictated a more aggressive pursuit of disinflation than last year. Indeed, shortly after the discussions, in response to high liquidity growth (the M3 target variable moved outside its target range in February), the BoS raised interest rates by 100 basis points effective April 1. Given the recent liquidity developments, continued depreciation of the exchange rate in early 2001, and the outlook for inflation, the staff viewed this measure as a move in the right direction. Further policy tightening may well be required if overall monetary conditions continue to be easy and jeopardize the achievement of the end-year inflation objective.

B. Medium-Term Challenges: "Competitiveness, Sustainable Growth, and Social Peace"

16. ***The authorities' goal is the creation of an "innovative, entrepreneurial economy" that enjoys "competitiveness, sustainable growth, and social peace" in the context of EU membership.*** This vision is set out in the coalition agreement between the parties that have formed the present government. The authorities and staff agreed that making progress in this direction would depend crucially on how Slovenia tackles three major challenges:

- *Balancing competing claims on budgetary resources within an appropriate overall envelope.* Claims on budgetary resources will steadily increase as a result of the burden of EU harmonization (estimated at a cumulative 1½–3 percent of GDP net of projected transfers) and—in the longer run—adverse demographic trends. In addition, recent trends in the wage bill and entitlements have been unsustainable. To provide adequate resources for these needs without a sharp rise in the tax burden will require a far-reaching and flexible shifting of spending priorities. The current structure of spending and budgetary policy, however, makes such policy shifts difficult.

- *Leading the financial system successfully into the global financial market.* A key condition for EU accession—and desirable in its own right—capital account liberalization will expose Slovenia's financial system to greater competition. Coping with it requires strengthening the efficiency of the system (see the accompanying FSSA document).

- *Completing "unfinished business" from the past.* Slovenia's gradual transition has left parts of the economy sheltered from competition; state involvement is still significant in many sectors; regulation and the slow pace of restructuring have discouraged foreign investment; and a sclerotic labor market has limited enterprise restructuring and resource reallocation.

Building a medium-term fiscal policy framework

17. ***The new government has set itself an ambitious set of medium-term fiscal objectives.*** The deficit is to be gradually reduced to a balance or a small surplus by 2004. This is to be achieved mainly through spending cuts, with the overall expenditure-to-GDP ratio (including EU accession costs) reduced from about 44 percent currently to 42 percent by 2004, and maintained at that level thereafter. A full-fledged medium-term fiscal framework is currently in preparation to flesh out these objectives. The authorities explained that the framework would rationalize spending plans across ministries; reduce gradually subsidies and state aid; and help manage additional spending needs related to EU accession and demographic trends affecting the pension and health funds. Also, the system of extra-budgetary funds would be reorganized, with those that perform public policy functions consolidated in the general government, and the others run along profit-maximizing lines or privatized. Finally, the authorities' medium-term fiscal framework calls for direct tax reform aimed at reducing the top marginal income tax rate and expanding the tax base by including social transfers and interest as part of taxable income. The former would also narrow the scope for tax avoidance created by the large gap between personal and corporate tax rates. Any loss of revenue is to be offset by an increase in the VAT rate.

18. ***On the basis of its own medium-term analysis, the staff endorsed the authorities' quantitative fiscal targets.*** The staff's adjustment scenario (Box 2 and Table 4) suggests that, under fairly conservative assumptions regarding the external environment and the evolution of private savings, a medium-term balanced budget rule is an appropriate target. While not required from the point of view of public debt or external sustainability, a balanced budget provides more room for conducting countercyclical fiscal policy and is consistent with macroeconomic stability and a strong external position, thus minimizing the vulnerability to sudden changes in market conditions. This is particularly important for a small, open economy like Slovenia that will be faced with increasing capital account volatility as a result of liberalization. Within this budgetary envelope, restructuring spending and the tax system are key for stimulating long-term growth.

Box 2: Staff's Policy Adjustment Scenario

Assumptions: The external environment (growth, interest rates, and inflation in Slovenia's partners, and oil prices) is taken from the WEO forecasts. Growth is estimated to slow to about 4 percent in 2002–03 due to the fiscal retrenchment and projected slowdown in Europe, and then gradually converge to potential, estimated at around 5 percent. The interest premium on Slovene government debt, both foreign and domestic, is assumed to decline gradually. The private savings rate is conservatively projected to decline somewhat over the medium term.

Measures: The authorities' objective of reducing spending to about 42 percent of GDP is assumed to be achieved by stabilizing government employment at about its current level, while public wages grow in line with productivity; halving the ratio of subsidies to GDP; stabilizing health transfers at their 2001 share of GDP; and reducing the share of transfers to households by about half a percentage point of GDP during 2001–04. In addition, pension spending is assumed to remain broadly constant as a share in GDP. No major changes are assumed in the tax system. Privatization receipts of approximately 0.5 percent of GDP during 2001–04 are used to reduce debt.

Outcomes: The general government deficit is reduced to near-zero in 2004 and continues to improve thereafter, and the government debt-to-GDP ratio declines steadily. The increase in public savings keeps the current account deficit at 2–2½ percent of GDP, maintaining a sustainable level of external debt and a declining debt service burden.

19. ***Staff cautioned, however, against underestimating the effort required to achieve these targets***. Although the size of the cumulative adjustment required during 2001–04 was not large, staff noted a number of factors that would make this adjustment harder than might appear. ***First***, the adjustment in 2001 was largely based on one-off savings resulting from a revision in the pension indexation formula, and temporary measures, such as revenues from bandwidth concessions. Sustainable adjustment, however, required permanent measures. ***Second***, the public sector wage bill was on a sharp upward trend, growing by an average annual rate of more than 10 percent in recent years, and an even higher increase was projected for 2001. This trend, which reflected both wage and employment increases, was clearly unsustainable, especially in view of the need to make room for the additional hiring required for EU harmonization. The system of public wage determination, in particular, was complicated and nontransparent, and recent wage awards in various segments of the public sector did not reflect efficiency or fairness considerations, but rather the power of the unions in these sectors. ***Third***, spending pressures related to EU accession and demographic trends affecting the pension and health funds would increasingly burden the budget in the years to come, requiring significant shifts in spending priorities. ***Fourth***, however, about three-quarters of total outlays was legally mandated or spent on entitlements, which constrained severely the flexibility of the government to shift resources between different areas. In addition, social transfers were not means-tested, thus undermining the fairness and efficiency of the social safety net.[3]

20. ***The authorities agreed with the staff's identification of the stress points in the medium-term fiscal framework***. They shared, in particular, the sense of urgency regarding the need to arrest the growth of the public wage bill. They noted that public administration reform had already started: the government was in the process of centralizing the system of wage bargaining in the public sector, and an agreement had been reached to move from backward- to forward-looking indexation of wages. As regards pensions, the authorities noted that recent measures were sufficient to stabilize expenditure over the next few years, while the short-term spending pressures resulting from higher-than-expected inflation in 2000 had been alleviated thanks to a re-basing of the indexation formula; they acknowledged, however, that additional reforms may be needed in the long term. Finally, the planned health care reform was aimed at rationalizing expenditure and strengthening voluntary insurance. The authorities noted that since these measures would require a long gestation period and extensive consultations before they bear fruit, their strategy was to use temporary savings, such as receipts from bandwidth concessions, to create room for maneuver in the short term. The authorities were aware of the risk of complacency from using temporary measures, and for this reason had deliberately provided cautious estimates of their size.

Preparing the financial system for the challenge of capital account liberalization

21. ***The findings of the FSAP mission provided the starting point for the discussions on the financial system (Box 3)***. The FSSA report describes a sector that is sound and well-

[3] For a cross-country perspective on fiscal policy challenges on the path to EU accession, see the accompanying background paper on medium-term fiscal frameworks.

Box 3. Financial Sector Assessment Program: Main Findings

The Slovene financial system displays considerable institutional strength, is systemically sound, and does not create significant macroeconomic risks. However, it is highly interconnected—which can be a cause of strength as well as weakness—and has so far evolved in a protected environment. Deepening integration in the international financial market will thus test the resilience of the system.

The banking system is sound and efficient assessed against the benchmark of selected western and central European countries, but is oligopolistic. Stress tests indicate that the system is resilient to exchange rate and interest rate volatility, as well as to a sudden economic downturn that would affect credit quality. However, its profitability is boosted by inflation and the asymmetric impact of indexation on banks' balance sheets (deposits below a month maturity—about one-fifth of broad money—are not indexed, while virtually all assets are).

Slovenia complies with most Basle Core Principles but there are some important gaps to be addressed, notably the absence of supervision on a consolidated basis and lax connected lending rules.

While the monetary policy framework has been effective overall, liquidity arrangements and the BoS's conduct of monetary policy thus far have contributed to the low level of development of the domestic money market. By inhibiting effective policy transmission through interest rates, this reduces the effectiveness of monetary policy at a time when external volatility is likely to increase as a result of capital account liberalization.

No major systemic problems arise in the nonbank financial system, but weaknesses exist in insurance supervision, and the unequal tax treatment of various forms of capital income inhibits the development of the capital market.

supervised—although some important gaps exist. The analysis does not reveal any macroeconomic risks arising from the general condition of the system, and stress tests indicate that the Slovene banking system is robust to a range of likely macroeconomic shocks. However, the sector had grown in a protected environment for most of the 1990s. The banking system, in particular, is still dominated by state-owned banks and partly relies for its profitability on large net interest margins, which would be progressively challenged as capital account liberalization forced margins to adjust gradually to European levels. In addition, until recently, a cartel-like arrangement among banks had all but eliminated competition on the liability side. Limited competition also contributed to the lack of consolidation. The slow privatization process and the preferential tax treatment of deposit interest income have kept the capital market at a state of infancy. Finally, the financial sector is highly interconnected, with extensive cross-shareholdings within the banking system and across the sector as a whole.

22. ***The authorities agreed with the main FSSA conclusion that the financial system needs to be exposed to greater competition and its efficiency strengthened.*** The liberalization of the capital account, which is already placing competitive pressures on commercial banks as large corporate customers increasingly borrow abroad, will test the resilience of the system as a whole. Slovene banks and other financial institutions are well-placed to meet this challenge, but will require further consolidation and efficiency gains. This will not only boost the ability of the system to cope with capital account volatility but, more importantly, will also have significant benefits for the economy as a whole. A key step in this direction, which the staff endorsed, was to start the process of ***privatization of the two state-owned banks*** without further delay. Staff reiterated the importance that the process guarantee transparency, efficiency, and good governance through the involvement of a core or strategic investor (or small group of core investors) with proven banking expertise, either from Slovenia or from abroad. Staff also urged the authorities to ***de-index financial assets***. The combination of inflation and asymmetric

indexation of bank assets and liabilities created a guaranteed source of profits that sapped banks' incentive to compete. The authorities agreed, but stressed that successful de-indexation required a lasting and credible reduction in inflation, and could thus not take place this year. Finally, it was agreed that further competition in the financial system would result from removing impediments to the ***deepening of the nonbank sector***, which would also expand saving and financing alternatives in the economy. This required completing the restructuring of privatization investment funds so that they could be transformed into open-ended mutual funds or holding companies; privatizing insurance companies; and equalizing the tax treatment of various forms of capital income to level the playing field among financial assets.

23. ***In response to the FSAP findings, the authorities have prepared a comprehensive Action Plan to improve further financial supervision, enhance risk management within and across sectors of the financial system, and improve liquidity management by the BoS.*** The Action Plan (Box 4) aims at improving further the standards of supervision and, in particular, address urgently issues arising from the interconnectedness of the Slovene financial system. This is key for limiting the risk of contagion as banks diversify across sectors and borders in response to competition.

Box 4. The Authorities' Financial Sector Action Plan

Strengthening prudential oversight. Consolidated supervision will be conducted over the different holdings of financial intermediaries by end-2001. Memoranda of Understanding will formalize cross-border coordination with foreign supervisors. The law will be amended to address issues of connected lending and exposure to shareholders. Shareholders acquiring a qualifying share in banks will be required to have appropriate expertise in banking business. Licensing requirements for financial institutions will be tightened. The Insurance Law will be amended to address investment policies. Supervisors will receive regular training to upgrade expertise in new banking activities and supervisory frameworks.

Improving risk management in banks. Banks will be encouraged to develop their own internal models, following standards prepared by supervisors, to assess credit and market risks and set capital requirements to cover them.

Improving liquidity management. The BoS will rationalize the multitude of intervention instruments so that they reflect liquidity conditions in the market and enhance policy transmission through interest rates. Specifically, the tap placement of BoS bills will be replaced by auctions open to a wide range of participants; the reserve requirement will be made uniform across maturities and remunerated at market-related rates; the foreign currency liquidity requirement will be replaced by rules on currency and maturity matching. Also, the BoS and the Ministry of Finance are jointly to develop a government securities market that will generate a benchmark yield curve for the pricing of other assets.

Completing the reform of the payments system. After-hours money market rules will be modified to reduce settlement risk during the transition to the new RTGS system.

24. ***The Action Plan also contains measures to improve the operation of the monetary policy framework.*** The authorities and staff agreed that the existing framework of monetary targeting and a managed float has worked well given the history and circumstances of Slovenia's transition to a market economy: it has ensured macroeconomic stability and brought inflation into the single digits. However, the lack of a competitive financial market structure has resulted in rigidities that handicap the capacity of the BoS to signal and implement its monetary policy, especially in the new environment of free capital movements. For this reason, the Action Plan

includes measures to rationalize and improve the design of monetary policy instruments, in order to encourage and facilitate the development of the money market. More broadly, the authorities felt that, as Slovenia moved closer to EU accession in the coming years, the monetary policy framework itself would have to change in the direction of less exchange rate flexibility, and eventually adapt to the requirements of the ERM-II system.

Reducing the role of the state and developing a dynamic private sector

25. ***The authorities were fully aware that achieving the ultimate goal of an "innovative, entrepreneurial economy" required developing a more efficient private sector.*** They saw the current situation as favorable: Slovene producers had been exposed to EU export markets since before independence and are currently competitive, and profitability has improved in recent years. The staff agreed, but pointed to unfinished business—notably from Slovenia's privatization process—that now needed to be urgently addressed. The privatization of the formerly socially-owned enterprises had not always created an effective shareholding structure, and this had in turn delayed the consolidation and restructuring of the privatized enterprises. The privatization of state-owned property (including public utilities) had yet to begin. Finally, a number of state funds still held a considerable number of shares in privatized companies. Although the operation of most of these funds did not give rise to quasi-fiscal costs,[4] the staff argued that it raised doubts about the effectiveness of corporate governance. The authorities were aware of these shortcomings, and were planning measures to reduce the involvement of the state in the economy. This would also attract much-needed foreign direct investment.

- *Privatization.* Besides banks, the government intended to start the privatization of utilities (telecommunications, energy, railways) this year. A draft law was also in preparation to privatize the assets of the Slovene Development Corporation. The staff also urged the government to rationalize the multitude of state funds, and privatize or sell the assets of those that did not perform a public policy function.

- *Labor market.* The government has launched ambitious negotiations with the social partners on an overhaul of the wage determination system. Specifically, the government plans to replace backward- with forward-looking wage indexation and include an explicit link of wages to productivity. It also intends to review labor market regulation and employment protection legislation with a view to harmonizing it to that in the EU.

- *Private sector development.* The government has already taken steps to simplify the steps involved in obtaining permits and registering companies and streamline bankruptcy procedures, and has identified 45 laws that require amendments to reduce red tape. Besides opportunities that will be offered through the privatization program, the government intends to attract foreign investment in Slovenia by removing administrative barriers identified by the study of the World Bank's Foreign Investment Advisory Service last year.

---

[4] With the exception of the Slovene Development Corporation, a state fund in charge of restructuring loss-making enterprises. The liabilities of some of these, as well as those of the steel company, are implicitly or explicitly guaranteed by the government.

26. ***Slovenia's trade policy is determined by its agreements with the EU and CEFTA.*** Full trade liberalization with the EU is planned for 2001, and adoption of EU's common external tariff in 2002. Consistent with this schedule, the staff reiterated the recommendation to relax the remaining agricultural trade restrictions.

III. Staff Appraisal

27. ***The Slovene economy has continued to perform very well, and remains among the strongest and most stable economies in central and eastern Europe.*** Slovenia has the highest per capita income and investment rating among central and eastern European countries, and is making good progress in its negotiations to join the EU. Despite a significant deterioration in the terms of trade in 2000, growth accelerated and the current account improved on the back of strong exports, underpinned by continuing wage moderation and a historically strong competitiveness position. These factors will continue to form the basis of balanced growth in 2001 despite the impact of the projected slowdown in Slovenia's export markets.

28. ***Inflation is the darkest cloud in an otherwise bright short-term outlook.*** The persistence of inflation long after the impact of the exogenous price shocks of 1999–2000 had lapsed indicates that inflationary expectations are becoming entrenched. The reversal of the decade-long decline in currency substitution corroborates this indication. And the recent liquidity developments, combined with price and wage rigidities, suggest that inflation risks remain high in 2001. If these developments are allowed to take hold, they could eventually undermine the capacity of the current policy framework to achieve price stability.

29. ***The immediate short-term policy priority should thus be to reduce inflation, a task that is primarily the responsibility of the Bank of Slovenia.*** The anticipated decline in world oil prices in 2001 and prospects for continued wage moderation will reduce cost pressures. The small fiscal withdrawal envisaged in the 2001 draft budget, which would essentially correct for the slippage in 2000, is appropriate from a macroeconomic point of view, and creates the right policy environment for disinflation. In the context of the current monetary policy framework, to achieve this objective the BoS needs to focus on price stability. Given the constraints facing monetary policy, in addition to its primary M3 growth target, the BoS should continue to monitor a broader range of indicators of monetary conditions, including credit growth, balance of payments developments, and the exchange rate. However, it should avoid shifts in policy priorities and instead take decisive policy action to persuade markets that price stability is indeed its primary goal. The interest rate hike following the mission's visit was a step in the right direction. However, given the continuing inflation risks, further tightening may well be required in the coming months if overall monetary conditions continue to remain easy.

30. ***Securing the medium-term objectives of "competitiveness, sustainable growth, and social peace" will be a challenge.*** These objectives, outlined in the agreement between the parties of the current government coalition, are indeed within reach, given Slovenia's current strong economic position and solid track record of prudent macroeconomic policies. But achieving them, as well as completing the process of EU accession, will require tying the loose ends left by Slovenia's gradualist approach to reform. Although successful on the whole, this approach has preserved a disproportionately large role of the state in the economy, through both

ownership and regulation of product and factor markets, and created a rigid structure of government spending, where the tensions between competing claims on public resources are rising. The deadweight of these distortions and rigidities will become increasingly evident as Slovenia is taking the final—and most demanding—steps in its preparation for EU accession.

31. ***An appropriate fiscal policy framework is the key component of Slovenia's medium term strategy***. The authorities' quantitative medium-term fiscal targets are consistent with balanced growth and macroeconomic stability, and the emphasis on containing expenditure is welcome. These targets now need to be backed by a detailed multi-year plan, with concrete measures and timetable. For the desired adjustment to be sustainable, measures must be permanent and focus first and foremost on the two largest categories of spending: entitlements, especially pensions and health, which, in the absence of structural measures, will come under increasing demographic pressure in the long term; and the public wage bill, whose growth in the last few years has been unsustainable. In both areas, reforms should aim not only at controlling the growth of spending over the medium term but—just as important—improving efficiency and enhancing transparency. Such reforms would also provide room for accommodating the significant new spending associated with the process of EU harmonization within the overall budgetary envelope. Because these reforms would require a long gestation period, it is important that the government start the process without delay.

32. ***Tax reform should aim at expanding the tax base, lowering tax rates, and eliminating distortions***. The government's intention to include in the income tax base all forms of income, including social transfers and interest, is commendable. The government should also review the direct tax system more broadly with a view to keeping exemptions to a minimum and eliminating distortions, such as the tax on bank assets.

33. ***The financial system stands to benefit from greater openness and competition resulting from capital account liberalization, but measures are needed to improve its efficiency***. The FSAP findings confirm that the Slovene financial system is in a good position to benefit from capital account liberalization, and that the macroeconomic risks arising from greater capital flow volatility are limited. In order fully to reap the benefits of the new, liberalized environment and pass them through to the rest of the economy, however, the financial system needs more competition and consolidation. Key reforms in this regard are the privatization of state-owned banks, de-indexation of financial assets, and equalization of the tax treatment of all financial savings instruments, and these should be set in motion as soon as possible. Further delays in bank privatization, in particular, are bound to raise questions about Slovenia's commitment to it.

34. ***Exposure of the financial system to greater competition should go hand in hand with strengthening further its supervision and improving risk management***. The authorities are to be commended for their comprehensive Action Plan prepared in response to the FSAP recommendations. The Plan aims at improving further the prudential standards and—even more important in the context of Slovenia's interconnected financial system—strengthen cross-sectoral supervision and coordination between supervisory agencies. The Plan also includes long-needed measures to improve liquidity management in the banking system. Since several of the Plan's measures require legislative action, the government, as well as the Bank of Slovenia and other supervisory agencies, should now focus their energies on its implementation.

35. ***Strengthening the economy and preparing it for the competitive pressures in the EU requires reducing the role of the state, deregulating markets, and accelerating private sector development.*** The new government is in a strong position to turn its welcome intentions in this area into practice. In addition to the privatization of banks and state-owned enterprises, it is also important to rationalize the network of the various state funds by consolidating those that perform public policy functions in the government and privatizing or selling the assets of the rest. In the area of the labor market, the intention to abolish backward-looking wage indexation is to be commended. The planned introduction of forward-looking indexation and a link to productivity should proceed as soon as possible although, as inflation declines to EU levels, the scope for wage indexation will diminish. Finally, employment protection legislation should be liberalized with a view less towards the practice in the EU and more towards competitiveness and employment creation.

36. ***Slovenia has subscribed to the SDDS and its statistics are adequate for surveillance.*** Slovenia meets the SDDS specifications for coverage, periodicity, and timeliness of data, and for dissemination of advance release calendars. An area of relative weakness is government finance statistics, where improvements are underway.

37. The next ***Article IV consultation*** with Slovenia should remain on the 12-month cycle.

Table 1. Slovenia: Selected Indicators

	1995	1996	1997	1998	1999	2000	2001 1/
Demand and Supply				(Contributions to growth)			
Total aggregate demand	10.7	4.7	11.3	10.1	10.5	8.9	6.5
Domestic demand	10.1	2.7	4.9	6.1	9.4	2.5	2.6
Private consumption	5.1	1.2	1.6	1.9	3.4	0.4	0.1
Public consumption	0.5	0.7	0.9	1.2	0.9	0.6	1.5
Gross investment	4.5	0.9	2.4	3.1	5.1	1.5	1.0
Foreign balance	-6.0	0.8	-0.3	-2.3	-4.2	2.4	1.9
Exports of goods and non-factor services	0.6	2.0	6.4	4.0	1.1	6.4	3.9
Imports of goods and non-factor services	6.0	1.2	6.7	6.3	5.3	4.0	1.1
				(Annual percentage change)			
Real GDP	4.1	3.5	4.6	3.8	5.2	4.8	4.5
Industrial production index	2.0	1.0	1.0	3.7	-0.5	6.2	...
Gross domestic investment (in percent of GDP)	21.4	22.5	23.4	24.6	27.2	28.3	28.1
Gross national savings (in percent of GDP)	20.8	22.7	23.4	23.9	23.2	25.0	25.4
Employment and Unemployment							
Labor force (in thousands)	867	862	869	871	877	874	...
Employment rate (in percent)	86.0	86.1	85.6	85.5	86.4	87.8	...
Unemployment rate (in percent) 2/							
Registered unemployed 3/	14.0	13.9	14.4	14.5	13.6	12.2	...
Annual survey (ILO definition)	7.4	7.3	7.4	7.9	7.6	7.0	6.7
Prices and Incomes							
Consumer prices (percentage change, end-period)	9.0	9.0	8.8	6.5	8.0	8.9	8.9 4/
Consumer prices (percentage change, period average)	13.5	9.9	8.4	8.0	6.1	8.9	8.7 5/
Terms of trade (1995=100)	100.0	100.3	101.0	103.2	103.9	98.6	...
Real gross wages (percentage change, average)	4.4	4.9	3.2	1.6	3.3	1.7	7.0 6/
Public Finance				(In percent of GDP)			
General Government 7/							
Revenue	43.1	42.7	42.1	43.0	43.6	42.3	43.1
Expenditure	43.1	42.4	43.2	43.6	44.2	43.6	44.1
General balance	...	0.4	-1.1	-0.6	-0.8	-1.3	-1.0
Net lending 8/	-0.1	0.1	...	-0.1	...	-0.1	-0.3
Overall balance 8/	0.1	0.2	-1.2	-0.5	-0.7	-1.2	-0.7
Overall balance excluding privatization receipts	-0.2	-0.2	-1.7	-0.9	-0.9	-1.2	-1.0
Debt	18.7	22.9	23.3	23.8	24.7	25.0	24.6

(Continued...)

Table 1. Slovenia: Selected Indicators (concluded)

	1995	1996	1997	1998	1999	2000	2001 1/
Money and Credit			(Annual percentage change)				
Broad money (inc. foreign exchange deposits) 9/	32.3	19.4	23.8	20.9	15.1	16.0	18.0 6/
Reserve Money 10/	17.4	16.9	18.4	22.9	16.4	11.9	...
Credit to the private sector (real; end of period)	25.4	9.9	4.5	18.8	13.8	8.0	...
Broad money velocity (level)	2.4	2.3	2.1	1.9	1.9	2.0	...
Nominal interbank interest rate (percent, overnight)	12.0	13.8	9.6	7.4	6.8	6.8	7.5 4/
Lending rates (percent)	24-25	17-18	16-17	12-13	12-14	15-17	14-18 4/
Deposit rates (percent)	15-18	8-10	7-10	4-7	6-9	8-12	11-15 4/
External Sector and Vulnerability Indicators			(In millions of U.S. dollars unless otherwise indicated)				
Trade balance	-953	-825	-776	-789	-1,245	-1,081	-602
(in percent of GDP)	-5.1	-4.4	-4.3	-4.0	-6.2	-6.0	-2.9
Current account	-99	31	11	-147	-783	-594	-563
(in percent of GDP)	-0.5	0.2	0.1	-0.8	-3.9	-3.3	-2.7
Gross official reserves of the Bank of Slovenia 10/	1,802	2,279	3,297	3,573	3,059	2,859	3,105 4/
(in months of imports of goods and services)	2.0	2.6	3.7	3.8	3.2	3.0	...
Reserves to reserve money (end of period, percent)	2.3	2.8	4.0	3.4	3.3	3.5	...
Broad money to reserves (end of period, ratio)	4.1	3.5	2.5	2.9	3.2	2.8	...
Net international reserves (end of period)	1,987	2,329	3,305	3,684	3,200	3,075	...
Net Foreign Assets of commercial banks (end of period)	673	902	459	465	239	271	...
External debt	2,970	4,010	4,176	4,959	5,491	6,217	...
(in percent of exports of goods and services)	28.6	38.2	39.9	44.6	52.2	58.1	...
of which: Public (percent of total)	48.4	50.5	49.5	47.8	46.3	42.9	...
Short-term external debt to reserves (in percent) 11/	2.8	2.2	4.1	3.1	3.8	3.2	...
External debt service	739	936	921	1536	846	1,034	...
(in percent of exports of goods and services)	7.1	8.9	8.8	13.8	8.0	9.7	...
Exchange rates							
Tolars per U.S. dollar (end-period)	126.0	141.5	169.2	161.2	196.8	227.4	234.0 4/
Tolars per DM (end-period)	87.9	91.0	94.4	96.4	100.9	108.1	109.4 4/
Nominal effective exchange rate (1995=100, avg.)	100.0	90.2	85.4	83.2	78.0	71.5	69.3 6/
Real effective exchange rate (CPI based, 1995=100, avg.)	100.0	97.1	97.8	100.8	100.0	97.6	97.7 6/
Financial market indicators							
Stock market index	1,449	1,183	1,405	1,705	1,806	1,808	1,808 4/
Stock market capitalization (percent of GDP)	4.5	6.9	13.7	21.9	25.2	27.9	...
Foreign currency debt rating (S&P, long-term)	...	...	A	A	A	A	A
Spread of benchmark bonds (bps): DM eurobond	...	...	76	73	70	67	53 4/

Sources: Slovene authorities; and Fund staff calculations and projections.

1/ Fund staff projections, unless otherwise indicated.
2/ The fall in unemployment in 1999 results from the reclassification of persons taking part in public work schemes as employed, rather than unemployed as was the case until January 1999.
3/ Statistical Office definition.
4/ March 2001.
5/ Year average as of March.
6/ February 2001.
7/ Preliminary budget.
8/ Official statistics: include privatization revenues in net lending.
9/ Daily average of latest month relative to the same period of previous year.
10/ Excludes gold, SDRs, and IMF position.
11/ Debt is on original maturity; reserves are the official reserves of the Bank of Slovenia.

Table 2. Slovenia: Balance of Payments, 1995-2001

	1995	1996	1997	1998	1999	2000	2001 Proj.
			(In millions of U.S. dollars)				
Current account	-99	31	11	-147	-783	-594	-563
Trade balance	-953	-825	-776	-789	-1,245	-1,081	-602
Exports f.o.b	8,350	8,353	8,407	9,091	8,623	8,806	10,107
Imports f.o.b.	-9,303	-9,178	-9,184	-9,880	-9,868	-9,887	-10,709
Services	578	633	630	492	364	426	315
Exports	2,028	2,135	2,047	2,027	1,899	1,885	1,948
of which: travel	1,084	1,240	1,187	1,088	954	957	888
Imports	-1,449	-1,502	-1,417	-1,535	-1,535	-1,460	-1,633
Income, net	179	132	39	28	-24	-60	-388
Current transfers, net	96	91	118	122	123	121	112
Capital and financial account 1/	531	561	1,198	243	663	719	1,072
Direct investment, net	183	188	340	250	143	133	370
Portfolio investment, net	-14	637	236	90	343	189	520
Other investment, net	368	-261	622	-95	178	396	181
Government 2/	141	-68	-23	-22	17	126	95
Non government	228	-193	645	-73	160	270	86
Bank of Slovenia	-70	129	-9	-5	-6	-6	-6
Private sector	298	-322	654	-68	166	275	91
Net errors and omissions	-195	-5	77	62	27	53	0
Overall balance	237	587	1,287	158	-92	179	509
Change in official reserves	-237	-588	-1,287	-158	81	-179	-509
			(Percentage change)				
Memorandum items:							
Merchandise exports	22.2	0.0	0.7	8.1	-5.2	2.1	14.8
Merchandise imports	29.8	-1.4	0.1	7.6	-0.1	0.2	8.3
Tourism receipts	18.7	14.4	-4.3	-8.3	-12.4	0.0	-7.2
			(In percent of GDP)				
Trade balance	-5.1	-4.4	-4.3	-4.0	-6.2	-6.0	-2.9
Current account	-0.5	0.2	0.1	-0.8	-3.9	-3.3	-2.7
Capital and financial account 1/	1.8	2.9	7.0	1.6	3.5	4.3	5.1
Change in official reserves	-1.3	-3.1	-7.1	-0.8	0.4	-1.0	-2.4
			(In millions of U.S. dollars, end of period)				
Foreign exchange reserves							
Bank of Slovenia	1,802	2,279	3,297	3,573	3,059	2,859	3,368
(in months of MGNFS)	2.0	2.6	3.7	3.8	3.2	3.0	3.3
Deposit money banks	1,624	1,845	1,080	1,209	1,056	1,124	974
(in months of MGNFS)	1.8	2.1	1.2	1.3	1.1	0.0	0.9
			(In billions of U.S. dollars)				
Gross domestic product	18.7	18.9	18.2	19.6	20.0	18.3	21.0

Sources: Bank of Slovenia and staff estimates.

1/ Excludes Slovenia's share of debt associated with the 1988 New Financing Agreement as settled in June 1996.
2/ Excludes government eurobonds.

Table 3. Slovenia: Summary of General Government Operations

	1995	1996	1997	1998	1999	2000 Preliminary 1/	2001 Projected
	(In millions of tolars)						
Total Revenue	958	1,092	1,223	1,398	1,590	1,724	1,964
Tax revenue	916	1,032	1,156	1,303	1,499	1,601	1,800
Taxes on Income and Profits	160	197	228	253	274	311	351
Social Security Contributions	363	376	401	448	496	553	624
Domestic taxes on goods and services	298	349	412	480	601	603	675
Taxes on international trade	78	77	58	47	46	38	36
Payroll, property and other taxes	17	33	57	74	82	95	114
Nontax revenue	39	57	61	88	80	95	137
Capital revenue	2	2	4	4	6	7	9
Other revenue	1	1	2	2	4	22	18
Total Expenditure	956	1,083	1,256	1,419	1,613	1,777	2,009
Current expenditure	421	487	564	642	708	790	905
Salaries and wages	194	234	285	313	349	387	453
Expenditures on goods and services	201	220	243	277	297	329	369
Interest Payments	26	31	35	42	51	61	73
Reserves	1	2	2	11	11	13	10
Current transfers	442	489	570	637	738	820	915
of which: Subsidies	42	35	40	49	63	59	76
Transfers to households	392	444	519	574	648	731	805
Capital expenditure and transfers	93	107	121	140	168	167	189
General Balance (authorities)	2	9	-33	-21	-23	-52	-45
Lending minus repayments	2	-3	0	4	-1	6	13
Overall Balance	4	6	-34	-17	-25	-47	-32
Financing (NET)	-4	-6	34	17	25	47	32
Total borrowing	-5	11	32	36	43	56	32
Changes in cash deposits (increase = +)	-1	17	-2	19	19	9	0
Memorandum items							
Surplus/Deficit (priv. receipts as financing)	-5	-4	-49	-31	-34	-51	-45
Balance ESA 95	-35	-29	-80	-56	-64	-81	-75
	(In percent of GDP)						
Total Revenue	43.1	42.7	42.1	43.0	43.7	42.3	43.1
Tax revenue	41.2	40.4	39.8	40.0	41.2	39.3	39.5
Taxes on Income and Profits	7.2	7.7	7.8	7.8	7.5	7.6	7.7
Social Security Contributions	16.3	14.7	13.8	13.8	13.6	13.6	13.7
Domestic taxes on goods and services	13.4	13.7	14.2	14.7	16.5	14.8	14.8
Taxes on international trade	3.5	3.0	2.0	1.5	1.3	0.9	0.8
Payroll, property and other taxes	0.7	1.3	2.0	2.3	2.3	2.3	2.5
Nontax revenue	1.8	2.2	2.1	2.7	2.2	2.3	3.0
Capital revenue	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Other revenue	0.0	0.0	0.1	0.1	0.1	0.5	0.4
Total Expenditure	43.1	42.4	43.2	43.6	44.4	43.6	44.1
Current expenditure	19.0	19.1	19.4	19.7	19.5	19.4	19.9
Salaries and wages	8.7	9.2	9.8	9.6	9.6	9.5	10.0
Expenditures on goods and services	9.0	8.6	8.4	8.5	8.2	8.1	8.1
Interest Payments	1.2	1.2	1.2	1.3	1.4	1.5	1.6
Reserves	0.1	0.1	0.1	0.3	0.3	0.3	0.2
Current transfers	19.9	19.1	19.6	19.6	20.3	20.1	20.1
of which: Subsidies	1.9	1.4	1.4	1.5	1.7	1.5	1.7
Transfers to households	17.6	17.4	17.9	17.6	17.8	17.9	17.7
Capital expenditure and transfers	4.2	4.2	4.2	4.3	4.6	4.1	4.1
General Balance (authorities)	0.1	0.4	-1.1	-0.6	-0.6	-1.3	-1.0
Lending minus repayments	0.1	-0.1	0.0	0.1	0.0	0.1	0.3
Overall Balance	0.2	0.2	-1.2	-0.5	-0.7	-1.2	-0.7
Financing (NET)	-0.2	-0.2	1.2	0.5	0.7	1.2	0.7
Total borrowing	-0.2	0.4	1.1	1.1	1.2	1.4	0.7
Changes in cash deposits (increase = +)	-0.1	0.7	-0.1	0.6	0.5	0.2	0.0
Memorandum items							
Surplus/Deficit (priv. receipts as financing)	-0.2	-0.2	-1.7	-0.9	-0.9	-1.2	-1.0
Balance ESA 95	-1.6	-1.1	-2.8	-1.7	-1.7	-2.0	-1.6
Nominal GDP, SIT bn	2,221	2,555	2,907	3,254	3,648	4,074	4,555

Source: Ministry of Finance of the Republic of Slovenia and staff estimates.

1/ Data as of January 2001.

Table 4. Slovenia: Staff Adjustment Scenario, 1997-2005

				Estimate	Projection				
	1997	1998	1999	2000	2001	2002	2003	2004	2005
				(Contributions to growth)					
Real GDP	4.6	3.8	5.2	4.8	4.5	4.0	4.0	4.4	4.9
Domestic demand	4.9	6.1	9.4	2.5	2.6	4.7	4.4	4.6	5.3
Private consumption	1.6	1.9	3.4	0.4	0.1	3.0	2.8	2.9	3.0
Public consumption	0.9	1.2	0.9	0.6	1.5	0.7	0.8	0.9	1.0
Investment	2.4	3.1	5.1	1.5	1.0	1.0	0.8	0.8	1.3
Exports GNFS	6.4	4.0	1.1	6.4	3.9	6.6	6.8	6.6	7.3
Imports GNFS	6.7	6.3	5.3	4.0	1.1	6.3	5.9	8.1	7.1
Consumer Price Inflation (average)	8.4	7.9	6.2	8.9	7.0	5.0	4.0	3.5	3.5
				(In percent of GDP)					
Savings-Investment Balance									
Foreign savings (current account deficit)	-0.1	0.8	3.9	3.3	2.7	2.3	2.3	2.2	2.2
Gross national savings	23.4	23.9	23.2	25.0	25.4	25.6	25.3	25.1	25.1
Private	22.3	22.0	20.9	23.7	23.6	23.8	23.1	22.6	22.5
Public	1.2	1.9	2.4	1.4	1.8	1.8	2.2	2.5	2.6
Gross domestic investment	23.4	24.6	27.2	28.4	28.1	27.9	27.6	27.2	27.3
Private	19.9	21.3	23.6	24.3	23.9	24.0	23.6	23.2	23.3
Public	3.5	3.3	3.5	4.1	4.1	3.9	4.0	4.0	4.0
Public finance									
Government revenue	42.1	43.0	43.6	42.3	43.1	42.5	42.5	42.4	42.3
Government expenditure	43.2	43.6	44.2	43.6	44.1	43.2	43.0	42.5	42.4
Net lending 1/	0.0	-0.1	0.0	-0.1	-0.3	-0.5	-0.4	0.0	0.0
Overall balance 1/	-1.2	-0.5	-0.7	-1.2	-0.7	-0.3	-0.1	-0.2	0.0
General government debt	23.3	23.8	24.6	25.0	24.6	24.2	23.6	23.0	22.2
Balance of payments									
Current account	0.1	-0.8	-3.9	-3.3	-2.7	-2.3	-2.3	-2.2	-2.2
Trade balance	-4.3	-4.0	-6.2	-6.0	-2.9	-3.2	-3.2	-3.1	-3.2
Services balance	3.5	2.5	1.8	2.3	1.5	1.5	1.5	1.6	1.7
Capital and financial account	7.0	1.6	3.5	4.3	5.1	4.4	3.7	3.0	2.6
FDI, net	1.9	1.3	0.7	0.7	1.8	1.6	1.5	1.4	1.3
Portfolio investment, net	1.3	0.5	1.7	1.0	2.5	2.0	1.8	1.8	1.5
Other investment, net	-2.3	-1.2	-0.5	-2.2	2.4	-1.6	-2.4	-2.5	-2.9

Sources: Slovene authorities; and Fund staff projections.

1/ Official definition including privatization receipts in net lending.

SLOVENIA: FUND RELATIONS
(As of February 28, 2001)

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	100.0
Fund Holdings of Currency	171.52	74.0
Reserve position in Fund	60.19	26.0
Operational budget transfers (net)	9.00	...

III. **SDR Department**:	SDR Million	%Allocation
Net cumulative allocation	25.43	100.0
Holdings	3.19	12.5
Designation Plan	2.00	...

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**

The currency of Slovenia is the tolar (SIT). Slovenia maintains a managed floating exchange rate. The exchange rate of the tolar for transactions by legal entities is determined in the interbank market, in which the Bank of Slovenia (BoS) is a major participant. Like any other market participant, the BoS buys and sells foreign exchange at the market determined exchange rate. On April 15, 2001, the middle rate for spot transactions in the interbank market was SIT 243 = US$1.

VIII. **Last Article IV Consultation**

The last Article IV consultation was concluded on March 7, 2000 on the basis of SM/00/30, (February 14, 2000). It was agreed that Slovenia would remain on the standard 12-month cycle. The Acting Chairman's summing-up of the discussion was circulated as SUR/00/23.

IX. 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	Deindexation 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	FAD	Public Expenditure Management (ends 6/00)
March 1999	FAD	Fiscal Management
April 1999	FAD	Tax Administration/VAT
October 1999	STA	Government Finance Statistics
November 2000	MAE	FSAP

Slovenia: Review of Statistical Issues

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

Real Sector Statistics: The Statistical Office (SO) follows primarily the European System of Accounts 1995. Annual GDP estimates by industry and expenditure categories are compiled at both current and constant 1992 prices. Quarterly GDP estimates at constant prices by industry are regularly published within 80 days after the reference quarter. A 1997 STA mission noted several outstanding issues, notably (i) implementing improved procedures for estimating changes in inventories to appropriately exclude holding gains; (ii) including installation costs in the valuation of gross fixed capital formation; (iii) replacing, as possible, the use of physical quantity indicators with volume indices obtained by deflation of output in the derivation of constant price estimates; (iv) reconciling the external transactions in the national accounts with the balance of payments data; and (v) compiling current price quarterly GDP estimates. The SO, in concert with OECD and EUROSTAT, has not agreed that improvements are needed in its inventory data (point (i) above), but has taken steps to address all other recommendations.

As regards consumer and producer prices, the indices are compiled in accordance with international standards. The SO also compiles a retail price index (RPI) which differs from the consumer price index in weights only. As suggested by the national accounts mission, the SO has plans to discontinue the compilation of the RPI.

Government Finance Statistics: With assistance from FAD experts, the Ministry of Finance has implemented a chart of accounts based on GFS classification concepts. Subsequently the authorities reported data for 1992–2000 for publication in the 2000 *GFS Yearbook*. Consolidated central government data do not show all extrabudgetary operations. The government intends to review the activity of extrabudgetary funds with a view to clarifying whether they should be included in the general government.

Money and Banking Statistics: Monetary statistics are timely and of good quality. Recently, the authorities requested advice on the treatment of subordinated debt in the monetary aggregates, and immediately took steps to implement STA's recommendations.

Balance of Payments Statistics: At present, balance of payments data for Slovenia are comprehensive and of high quality, and have been published in the *Balance of Payments Statistics Yearbook* since 1993 (with estimates of the international investment position published since 1996).

Slovenia: Survey of Reporting of Main Statistical Indicators
(as of March 20, 2001)

	Exchange rates	International reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Central government balance	GDP/GNP	External debt
Date of latest observation	Mar. 19,01	Feb-01	Feb-01	Feb-01	Feb-01	Feb-01	Feb-01	Dec-00	Dec-00	Feb-01	Q3-00	Dec-00
Date received	Mar. 19,01	Mar. 7, 01	Mar. 7, 01	Mar. 14, 00	Feb. 28, 01	Mar. 14, 00	Feb. 28, 01	Feb. 19, 01	Feb. 19, 01	Feb. 21, 01	Jan. 17, 01	Feb. 28, 01
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of reporting/publication	Daily/ Daily	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Quarterly/ Quarterly	Monthly/ Monthly
Source of data	BOS/ Bloomberg	BOS	BOS	BOS	BOS	BOS	BOS/ SORS/ Reuters	BOS/ SORS/ Reuters	BOS/ Reuters	MoF/ BOS	BOS/ SORS	BOS
Mode of reporting	On-line	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public

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

Statement by the IMF Staff Representative
May 11, 2001

This statement updates the staff report (SM/01/113) to reflect information that has become available since its issuance (April 19, 2001). The new information reinforces the thrust of the staff appraisal.

Recent economic developments are consistent with the staff's projections. During the first quarter of 2001, activity continued to be strong and the external position improved. Industrial production rose 4.7 percent year on year. Exports in January–February were 11.7 percent higher than a year earlier, while imports were broadly at the same level, leading to a small current account surplus (US$65 million, compared to a US$51 million deficit in the first two months of last year). Inflation, however, remains high: partly due to increases in administered prices, the 12–month rate of CPI inflation in April rose to 9 percent, for an annual average of 8.8 percent in the first four months of the year.

Policy implementation has been in line with the authorities' plans. In April, parliament approved the 2001 budget without changes relative to the draft discussed in the staff report. A two-year budget for 2002–03, consistent with the government's medium-term fiscal objectives, is now under preparation. Implementation of the authorities' Action Plan developed in response to the FSAP findings is moving forward. A crucial measure (prudential oversight of banks on a consolidated basis) has been implemented, and supervisory coordination and related-party lending rules have started to be strengthened. Measures were also taken to improve liquidity management: the Bank of Slovenia (BoS) eliminated certain little-used instruments, redesigned its Lombard facility, and announced auctions for 60-day tolar bills. Furthermore, the Ministry of Finance, in cooperation with the BoS, started issuing a benchmark one-month Treasury bill, which is not indexed.

Steps have also been taken in the structural area. The government and the social partners agreed in principle to replace backward-looking wage indexation with partial forward-looking indexation and a link of real wages to productivity in the private sector starting in 2002. Parliament approved the decision to privatize the two state-owned banks, and the government has started preparations for this. The government also announced its plan to sell the state holdings in the major port operator and in Ljubljana airport.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

Public Information Notice (PIN) No. 01/50
FOR IMMEDIATE RELEASE
May 21, 2001

IMF Concludes Article IV Consultation with the Republic of Slovenia

On May 11, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.[1]

Background

Slovenia is among the most successful transition economies of central and eastern Europe. Broadly balanced budgets (although small deficits have emerged since 1997) and a conservative monetary policy in the context of monetary targeting and a managed float for the tolar have brought inflation down to the single digits since 1997, kept government debt to about 25 percent of GDP, and maintained a balanced current account until 1998. The economy is very open to trade and increasingly integrated with western Europe (exports amount to almost 60 percent of GDP, and more than two-thirds are directed to the EU). Growth has averaged around 4 percent in the 1990s, largely driven by exports.

The economy enjoyed fast and stable growth in 2000 thanks to a favorable competitiveness position and strong investment. Real GDP growth reached 4.8 percent in 2000, and unemployment fell to 7 percent—a record low. Continued real wage moderation in the private sector and the depreciation of the tolar during the year led to a historically strong competitiveness position. Export volumes grew by over 10 percent and, despite deteriorating terms of trade, the current account deficit declined to 3.3 percent of GDP in 2000. The current account deficit was mainly financed by medium- and long-term borrowing abroad, and reserve

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the May 11, 2001 Executive Board discussion based on the staff report.

coverage in terms of imports and short-term debt remained broadly unchanged. However, inflation accelerated and remains high, partly as a result of successive exogenous price shocks and partly reflecting accommodating policies in the first part of 2000. Twelve-month inflation jumped from 4.3 percent in June 1999 to an average of 8.9 percent in 2000, and the 12-month inflation rate in April 2001 was still 9 percent.

Macroeconomic policies were adjusted during the second half of 2000 to contain fiscal slippages and rising inflation. Spending increased in the first half of the year due to higher-than-expected indexation payments for wages, pensions, and social transfers, and closer to the elections due to increases in some public sector wages, while revenues were lower-than-budgeted owing to a shift in the composition of demand toward exports. The new government froze most expenditures in the last quarter of 2000 and contained the general government deficit (excluding privatization receipts) for the year as a whole to 1.3 percent of GDP, compared to the budgeted 1 percent. Monetary conditions were lax during the first half of the year and were tightened in the second half, as the Bank of Slovenia gradually shifted its priority towards the pursuit of disinflation. Although broad money growth ended the year within the target range of 12-18 percent, the easy conditions prevailing during the first part of 2000 allowed price shocks to turn into inflation, while the frequent changes in monetary policy sent conflicting signals to the market and probably contributed to an increase in currency substitution.

Progress in structural reforms was relatively limited in 2000 due to the pre-election period and the state continues to have a significant presence in the economy. Steps were taken toward the resolution of the outstanding legal issues concerning the ownership of insurance companies; an energy regulatory agency was created; and a new law on railway traffic was passed, but there was little progress in the macroeconomically more relevant areas of bank privatization, labor market deregulation, or tax reform, and the indexation of financial contracts is still widespread.

Economic prospects for 2001 are good, and policies have been tightened in an effort to reduce inflation. Growth is projected to decelerate only marginally vis-à-vis 2000, as the competitiveness position continues to be strong. The 2001 budget aims at a reduction in the general government cash deficit to 1 percent of GDP. The Bank of Slovenia lowered its M3 target growth range for end-2001 and raised interest rates in April. The external current account deficit is expected to be reduced to about 2.7 percent of GDP.

Executive Board Assessment

Executive Directors noted that the Republic of Slovenia is among the most successful transition economies in Central and Eastern Europe. It has already achieved significant economic convergence with the European Union, and has built up an impressive record of sustained, broad-based growth, reflecting strong competitiveness and investment. However, Directors considered that an acceleration in the pace of remaining structural reforms would be appropriate.

Directors regarded the near-term economic outlook as favorable, even if external demand slackens. However, they noted the worrisome persistence of inflation. Directors recognized that this partly reflected the one-time impact of introducing a VAT as well as higher world oil prices last year, but they also considered that backward-looking wage indexation and accommodating financial policies had been important contributory factors.

Directors stressed that a rapid reduction in inflation should be a central aim of economic policy. Lower inflation would provide a favorable environment for the envisaged de-indexation of the economy; it would underpin the prospective continuing moderation in real wages; it would help safeguard competitiveness; and it would secure a convergence of inflation rates with EU countries. Against this background, Directors welcomed the tightening of policies in late 2000, as well as the moderately contractionary fiscal policy envisaged in the budget for 200l. Directors stressed, however, that monetary policy should be the main tool for lowering inflation, and should be guided principally by that objective. Directors considered that, in setting monetary policy, the authorities should give less emphasis than hitherto to preserving external competitiveness, which should preferably be achieved through appropriate structural and incomes policies. Directors welcomed the recent increase in interest rates, and urged the authorities to take further action if domestic liquidity remains excessive or the rate of exchange rate depreciation jeopardizes the goal of disinflation.

Directors regarded the envisaged de-indexation of the economy as another critical part of the authorities' strategy to lower inflation and dampen price shocks. They welcomed the agreement in principle between the government and the social partners to move to forward-looking wage indexation and to link wages and productivity in the private sector as of 2002, as well as the ongoing efforts by the Ministry of Finance and the Bank of Slovenia to promote de-indexed financial instruments.

Directors supported the authorities' medium-term objectives of competitiveness, sustainable growth, and social peace. They saw these objectives as within reach, provided that structural reform is boldly pursued, notably with regard to deregulation, privatization, corporate governance, and accelerating private sector development. Directors noted that, until now, the pace of structural reforms had deliberately been gradual. However, they considered that the outstanding reform agenda should now be addressed decisively in order to boost the economy's potential growth rate, increase its resilience to external shocks, increase its attractiveness to foreign investors, and prepare it for EU membership.

Directors endorsed the authorities' quantitative medium-term fiscal goal of moving to budget balance as well as the preparation of the two-year budget for 2002/03, which they saw as critical to their overall medium-term strategy. They welcomed the emphasis on containing expenditure, noting that, without restraining measures, several factors would combine to cause excessive expenditure growth. These factors include: unsustainable growth in public sector wages; the large share of entitlements; and the net costs of EU harmonization. Directors underlined the need to reform public administration, including wage-setting arrangements, and to restructure entitlement programs. Regarding the revenue side of the budget, Directors called for a reform of direct taxes that should expand the tax base, lower the tax burden, and eliminate distortions. They welcomed the government's intention to include all forms of income in the income tax base.

Directors observed that a fiscal policy emphasizing expenditure restraint would complement and facilitate a reduction in the economic role of the state. They considered such a reduction appropriate in the interests of efficiency and promoting an entrepreneurial private sector, and in view of Slovenia's prospective accession to the EU. They noted that the state's economic role remains disproportionately large compared to other advanced transition economies. Directors welcomed the authorities' intention to begin privatizing state-owned enterprises and utilities and to discontinue the operations of the Slovene Development Corporation. Directors urged the authorities to proceed decisively in making the labor market more flexible and to liberalize employment protection legislation, which continues to be very restrictive.

Directors welcomed the findings of the Financial Sector Assessment Program, noting the resilience of the Slovene financial system to a range of likely macroeconomic shocks. However, in light of the liberalization of the capital account, they encouraged the authorities to enhance competition and provide incentives for consolidation and greater efficiency in the financial sector and strengthen further its supervision. The privatization of the two state-owned banks is a key step in this direction, and the authorities' intention to proceed rapidly in this area is welcome. Equalizing the tax treatment of all financial savings instruments and de-indexing financial assets would also provide strong incentives for efficiency gains and help capital market development. Directors commended the comprehensive Action Plan prepared by the authorities to strengthen prudential standards, improve liquidity management, and deepen the money market. In this context, Directors welcomed the recent introduction of consolidated supervision.

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

Slovenia: Selected Economic Indicators

	1995	1996	1997	1998	1999	2000 1/ Estimates	2001 Staff Proj.	
Real economy								
Real GDP (percentage change)	4.1	3.5	4.6	3.8	5.2	4.8	4.5	
Unemployment rate (in percent)								
Labor force survey (ILO definition)	7.4	7.3	7.4	7.9	7.6	7.0	6.7	
Registered unemployed 2/	14.0	13.9	14.4	14.5	13.6	12.2		
Consumer prices (percentage change, end of period)	9.0	9.0	8.8	6.5	8.0	8.5	7.0	
Real wages (percentage change, period average)	4.4	4.9	3.2	1.6	3.3	1.7	7.0	3/
Gross national saving (in percent of GDP)	20.8	22.7	23.4	23.9	23.2	25.0	25.4	
Gross domestic investment (in percent of GDP)	21.4	22.5	23.4	24.6	27.2	28.3	28.1	
Public finance (percent of GDP)								
General government balance 4/	0.1	0.2	-1.2	-0.5	-0.7	-1.2	-0.7	
of which: privatization receipts	0.3	0.4	0.5	0.4	0.2	0.0	0.3	
General government debt	18.7	22.9	23.3	23.8	24.7	25.0	24.6	
Money and credit (end of period, percent change)								
M3	32.3	19.4	23.8	20.9	15.1	16.0	...	
Real credit to the private sector	25.4	9.9	4.5	18.8	13.8	8.0	...	
Interest rates (percent)								
Nominal interbank interest rate (overnight)	12.0	13.8	9.6	7.4	6.8	6.8	...	
Nominal lending rates	24-25	17-18	16-17	12-13	12-14	15-17	...	
Nominal deposit rates	15-18	8-10	7-10	4-7	6-9	8-12	...	
Balance of payments								
Trade balance (percent of GDP)	-5.1	-4.4	-4.3	-4.0	-6.2	-6.0	-2.9	
Current account balance (percent of GDP)	-0.5	0.2	0.1	-0.8	-3.9	-3.3	-2.7	
Gross Official reserves (US$ billion) 5/	1,802	2,279	3,297	3,573	3,059	2,859	...	
Reserve cover (months of imports of GNFS)	2.0	2.6	3.7	3.8	3.2	3.0	...	
Exchange rates								
Exchange rate regime						Managed float		
Tolars per U.S. dollar (end-period)	126	141.5	169.2	161.2	196.8	227.4	...	
Nominal effective exchange rate (1995=100)	100.0	90.2	85.4	83.2	78.0	71.5	...	
Real effective exchange rate (1995=100) 6/	100.0	97.1	97.8	100.8	100.0	97.6	...	

Sources: Slovene authorities; and Fund staff calculations and projections.

1/ IMF staff projections or latest actual.

2/ Statistical Office definition. The fall in unemployment in 1999 results from the reclassification of persons taking part in public work schemes as employed, rather than unemployed as was the case until January 1999.

3/ February 2001.

4/ Official statistics: include privatization revenues in net lending.

5/ Excludes gold, SDRs, and IMF position.

6/ Based on the consumer price index.

Statement by Johann Prader, Alternate Executive Director
and Borut Repanšek, Assistant
for Republic of Slovenia
May 11, 2001

1. In 1991 Slovenia became an independent state and introduced its own currency. Ten years later Slovenes expect that their country will be ready to join the EU at the end of 2002. From that point of view Slovenia's transformation has been rapid.

2. Slovenia has never needed the Fund's financial support, contributes to the Fund's finances and complies with the SDDS standard. Since the last Article IV consultations there have been three characteristics of Slovenia's cooperation with the Fund:

- The exchange of views intensified because of the complex final macroeconomic and structural adjustments before EU membership. This resulted in comprehensive Article IV and FSAP reports. The authorities thank the staff for their dedicated, highly professional, and beneficial work.
- The staff and the authorities broadly agree on the pursued policies. They assess monetary policy in 2000 from somewhat different angles, as explained in paragraphs 14 and 15 of the Article IV Staff Report. But they both see the recent tightening of the policy and changing instruments as appropriate steps towards price stability.
- The Slovene authorities have been very active in implementing several policy measures discussed with the staff.

3. Last year the Slovene economy remained macroeconomically stable and vibrant. Growth was high, unemployment fell to 6.6 percent in November 2000, and investment reached the highest level ever. This was supported by a sound combination of a further increase in domestic savings and foreign borrowing. The current account deficit shrank, while the fiscal deficit increased somewhat. However, inflation has been hovering between 8 and 9 percent. We will comment on fiscal policy, monetary and exchange rate developments, structural reforms and the FSSA report.

Fiscal policy

4.1 In view of the huge fiscal policy challenges in recent years -- establishing the new state, three major bank rehabilitations, transition reforms, and the EU harmonization -- the burden on the Slovene taxpayers in the form of general government debt of 25 percent of GDP is reasonable. However, the general government deficit rose from 0.8 in 1999 to 1.3 percent of GDP in 2000. It was on the one hand a consequence of more specific developments in 2000 (a larger shift in composition of demand towards export, and spending increases due to higher indexation and public sector wage increases granted in the election year), and on the other hand longer-term factors (aging population; EU harmonization). The authorities are aware that public finances are under severe pressure. To offset it, they are combining short-term measures (freezing most expenditures after last fall's elections, using revenues from bandwidth concessions) and others which bring results more gradually; all in order to at least balance the budget by 2004.

4.2 In addition to what is explained in paragraphs 19 and 20 of the staff report, the following four budgetary developments are relevant:

First, in April the Parliament approved the 2001 budget. The deficit of one percent of GDP is 0.3 percent lower than a year before, although it includes correction of the inherited election-year slippage.

Second, the Government is closing down the Slovene Development Corporation, which acted as the channel for subsidizing the enterprise sector.

Third, the reform of direct and indirect taxes will be adopted by the end of this year. Draft laws on personal income tax, corporate income tax, and a tax on immovable property are being prepared. Legislation changes are also being introduced for the alignment of the value-added tax, excise duties and customs procedures with the EU legislation.

Fourth, a two-year budget for 2002/03 is under preparation and planned for adoption in fall. The medium-term fiscal policy orientation is consistent with last year's Board recommendation and the recent paper "*Balancing Fiscal Priorities - Challenges for the Central European Countries on the Road to EU Accession*". Unfortunately, medium-term fiscal planning will become more complex and even impossible if a clear decision on the timing of EU accession is not made soon. We would like to encourage continuation of the dialogue between the Fund and the EU on how to decrease the fiscal costs of EU enlargement.

Monetary and exchange rate policy

5.1 Monetary policy has been crucial for macroeconomic stabilization by lowering the inflation rate, managing the exchange rate float, and gradually opening the capital account. Some observers noted that it was not focused enough on price stability as its ultimate goal. However, the results are striking: inflation was reduced from 207 percent in 1992 to 4.3 percent in June 1999. In 2000, the effects of the VAT introduction, the increase in oil prices and liberalization of controlled prices pushed inflation back to around 8 percent. The authorities consider bringing down inflation significantly an immediate task. For that, moderate wage agreements will be crucial.

5.2 The central bank's intermediate target is M3, which moves within the band announced a year in advance. For reaching the money target, the central bank cannot rely only on price instruments; they are not developed enough and appropriate responsiveness of the money market is not assured. But more importantly, raising interest rates, and consequently increasing interest rate differentials, would attract more capital inflows that would adversely affect the money supply and endanger the intermediate monetary target. Therefore the central bank is also using exchange rate interventions to close the gap between foreign and domestic interest rates in a way that supports achieving the money target.

5.3 In an external environment conducive to disinflation, the central bank policy remains tight. The central bank is intensively preparing changes of its instruments in order to deepen the money market and prepare it for an increased use of price instruments. It is also working on a medium term monetary framework. A few remaining steps towards full capital account liberalization will be taken as planned. Slovenia has closed negotiations with the EU on the chapter on freedom of capital movements. The abolition of indexation is a major step for Slovenian economic policy considered possible when inflation falls to 5-6 percent In preparation, a non-indexed one-month Treasury bill was issued this Wednesday, while the Slovene Institute of Auditors is preparing the adjustment of accounting standards to the deindexed environment.

Structural policies

6. In 2000, the Government changed twice: in June after the Parliament's non-confidence vote and in November after the regular elections. Still, the key reforms and EU harmonization under implementation continued without significant interruptions.

7. With respect to privatization, it is useful to keep things in perspective. First, privatization was prepared in the early '90s according to the model that the society could agree upon, and partly also under the influence of external advice. Certain drawbacks of voucher privatization are largely unavoidable, and corporate governance can be among them. However, taking into account the size and growth of Slovene exports, corporate governance is not a major problem. Second, privatization of the two largest banks is technically prepared and will begin before summer. Third, the privatization of the largest insurance company has been delayed by court proceedings rather than by economic policy.

Financial Sector Stability Assessment

8. In line with the views of the staff and taking advantage of an excellent FSAP, the Slovene authorities responded vigorously by preparing and executing a comprehensive action plan.

9. The FSSA Report reveals a number of strengths of the Slovene financial system, and also notes areas where further improvement is needed. It also sends somewhat contradictory messages about banking sector developments. One presents banks that were strongly shielded from competition, the other states that banks in Slovenia are now sound, well capitalized and their performance compares favorably with those in selected EU and Central European countries. The two state-owned banks, that went through costly rehabilitation in the early '90s that arguably should have been sold years ago, are performing very well and score the highest rating that Moody's assigned to banks in Central and Eastern Europe.

10. Although all factors mentioned that worked against higher competition in banking were relevant, we should also note that foreign banks could and have been entering the market since the early '90s. Foreign-owned banks have been competing with the Slovene owned banks on the same basis. Later, allowing foreign bank branches to open led to the one symbolic application ever submitted and granted. With capital account liberalization allowing the private sector to raise in 2000 almost half of the new loans abroad, competition has obviously increased substantially. The banking industry continues to change – the sale of the third largest bank in the country to Societe Generale is only the most recent proof of that.