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Republic of Slovenia: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Slovenia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 18, 2002 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 March 31, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 16, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Slovenia.

The document listed below will be separately released.

Statistical Appendix

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SLOVENIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Article IV Consultation with the Republic of Slovenia

Approved by Alessandro Leipold and G. Russell Kincaid

March 31, 2003

- The consultation discussions were held in Ljubljana during December 4–18, 2002. The mission met with Prime Minister Rop (then Finance Minister), Finance Minister designate Mramor, Bank of Slovenia Governor Gaspari, members of the Finance and Monetary Affairs Committee of parliament, other senior officials of the government and Bank of Slovenia, and representatives of trade unions and the business, financial, and academic communities.

- The staff team comprised Messrs. Banerjee (head), Antolín-Nicholás, Dyczewski, and Tzanninis (all EU1). Ms. Maver, of the office of the Executive Director for Slovenia, participated in the discussions and Mr. Prader, Alternate Executive Director for Slovenia, attended the concluding policy meeting.

- Slovenia has accepted the obligations of Article VIII, sections 2, 3, and 4, and maintains no restrictions on payments and transfers for current international transactions. As of February 1, 2003, external capital account transactions are fully liberalized (Appendix I).

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

- Following the election of Prime Minister Drnovšek as President of Slovenia in December 2002, Finance Minister Rop was appointed as the new prime minister. The next parliamentary elections are scheduled for October 2004.

- A joint press conference was held with Prime Minister Rop and Governor Gaspari at the end of the mission. The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

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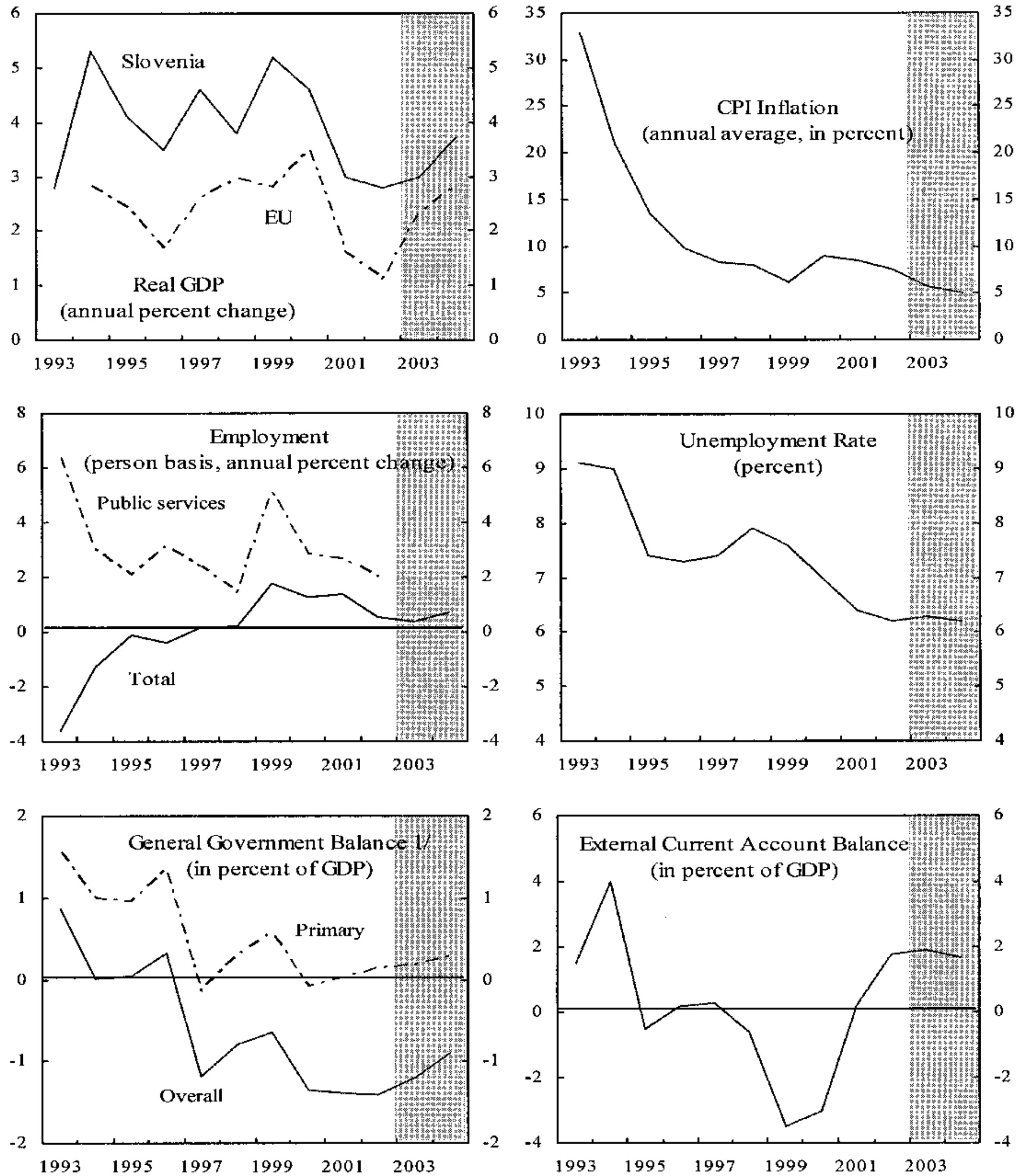
I. BACKGROUND

1. **Slovenia's road to European Union (EU) accession, scheduled for May 2004, has been marked by sustained real convergence in per capita income, but progress in nominal convergence has stalled and its resumption represents the main policy challenge in the period ahead**. Adjusted for differences in purchasing power, Slovenia's per capita GDP and labor productivity are currently around 70 percent of the EU average, and well above the level in other Central European accession countries (Table 1) and above some EU members. The sectoral composition of GDP also is broadly similar to the EU average. Inflation has got stuck at about 8 percent since 1997, in part owing to the persistence of indexation of wages and financial contracts and continued adjustments in administered prices.

2. **For most of the 1990s, Slovenia experienced sustained rapid growth, against a backdrop of prudent macroeconomic policies and a gradualist approach to structural reform**. The general government deficit averaged below 1 percent of GDP in the second half of the decade, after a surplus in the earlier years. This sound fiscal position coupled with a high private saving ratio helped keep external imbalances at bay (Table 2 and Figure 1). Until they began to be liberalized in 1999, capital controls played a key role in the authorities' strategy of avoiding liquidity growth fueled by capital inflows. With privatization taking place mostly through a voucher scheme and insider buyouts, Slovenia attracted little foreign direct investment (FDI) until 2000. However, this did not impede the manufacturing sector from restructuring, raising productivity, and maintaining its export orientation. The pace of structural reforms accelerated toward the end of the 1990s. Since then, capital account transactions have been fully liberalized and significant strides have been made in reforms of the tax and pension systems and the financial sector, but important challenges remain. Slovenia has closed all the negotiation chapters of the *acquis communautaire*.

3. In concluding the last consultation on March 20, 2002 (EBM/02/29), Executive Directors emphasized the need to pursue disinflation, and considered that exchange rate policy should be subordinated to this goal. They endorsed the authorities' medium-term goal of a balanced budget. Directors welcomed the progress in strengthening financial sector supervision, and encouraged the authorities to press ahead with bank privatization. **The authorities have received considerable technical assistance from the Fund in institution building and have generally heeded the Fund staff's policy advice**. They have taken prompt steps to implement the recommendations of the 2001 Financial Sector Assessment Program (FSAP). However, the authorities have pursued a more gradual approach to tackling inflation than advocated by the staff (see ¶15–19), and foreign investment in the banking sector has met with some resistance.

Figure 1. Slovenia: Economic Indicators, 1993–2004



Sources: Data provided by the Slovene authorities; and IMF staff projections.
1/ Figures for 2002 have been adjusted for the shift in the budget accounting to a pure cash basis. The general government balance for 2003-04 refers to the budget approved by parliament.

4. **Economic growth slowed during 2001–02 to around 3 percent, owing to a weak external environment and subdued domestic demand, opening up a small output gap.** Investment fell in 2001 with the erosion of business confidence, but recovered modestly in 2002 with the revival of construction activity. Private consumption growth moderated, as households' propensity to spend was restrained by the jump in indebtedness in 1999 arising from credit-financed pre-VAT purchases, layoffs in many sectors in manufacturing and a general slowdown in employment growth, and the introduction of attractive long-term savings schemes. Export growth slowed as demand from the EU weakened, but the impact was cushioned by a rapid expansion of exports to southeastern Europe and Russia. With imports growing more slowly than exports and the terms of trade improving, the external current account swung into a small surplus in 2001 that widened to 1¾ percent of GDP in 2002.

GDP and its Components
(Real growth rates in percent, unless otherwise noted)

	Average		Est.	Proj.	
	1996-2000	2001	2002	2003	2004
Real GDP	4.3	3.0	2.9	3.2	3.8
Domestic demand	4.7	0.5	2.2	3.1	4.0
Of which:					
Private consumption	2.9	1.7	1.8	2.3	3.7
Gross capital formation	9.0	-3.7	3.7	5.8	6.0
Net foreign demand contribution					
to growth (percentage point)	-0.5	2.5	0.7	0.1	-0.3
Merchandise exports	8.0	6.6	6.2	6.6	7.0
Merchandise imports	8.1	2.2	4.5	6.2	7.3
External current account					
balance (in percent of GDP)	-1.3	0.2	1.8	1.9	1.7
Output gap (in percent of potential GDP)	0.4	0.5	-0.6	-1.4	-1.7

Sources: Statistical Office; and IMF staff projections.

5. **Progress with disinflation was less than envisaged**. Inflation at end-2002 (7.2 percent) remained above the Bank of Slovenia's (BoS) original projection of 5.8 percent and its revised mid-year projection of 7.0 percent. Thus, although down from the highs observed in 2000, inflation has remained in the 7–8 percent range that has prevailed since 1997. In 2002, increases in indirect taxes, oil prices, municipal services charges, and non-oil administered prices accounted for about two-fifths (or 3 percentage points) of inflation, and were larger than anticipated by the BoS. The slippage in disinflation translated into higher wages on account of catch-up clauses in the wage indexation mechanism. However, real wage increases were smaller in 2002, and

Factors Contributing to Inflation
(Percentage points)

	1999	2000	2001	2002
Fiscal policy measures	2.3	0.4	1.3	1.7
Excise tax	...	0.4	1.3	0.8
VAT	2.3	0.0	0.0	0.6
Other taxes	...	...	...	0.3
Administered prices	1.5	2.2	1.4	1.3
Gasoline	0.7	1.2	0.4	0.4
Municipal services	0.2	0.4	0.5	0.5
Telephone services	0.1	0.1	0.2	0.3
Electricity	0.2	0.3	0.2	0.1
Other	0.3	0.2	0.1	0.0
Other factors 1/	4.2	6.3	4.3	4.2
CPI inflation (end year)	8.0	8.9	7.0	7.2

Source: Institute of Macroeconomic Analysis and Development.
1/ A proxy for underlying inflation.

receded below national productivity growth. Real wage increases in public administration were sharply curtailed, but increases in some public services (e.g., education and health) continued to outpace economy-wide real wage increases and productivity gains by a wide margin (Figure 2).

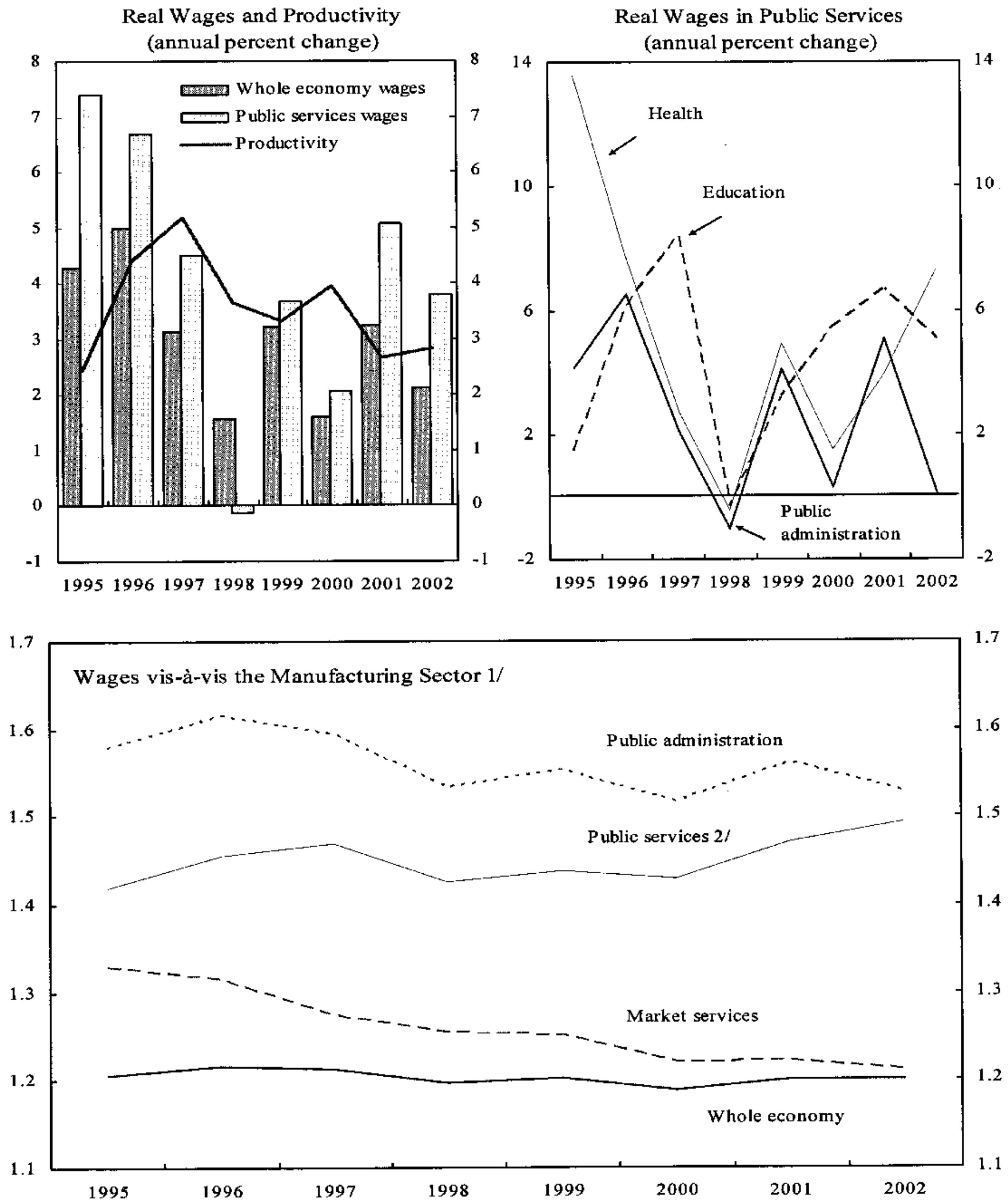
Productivity and Real Wages
(Percent change)

				Proj.	
	2000	2001	2002	2003	2004
Productivity					
(entire economy)	3.5	2.4	2.8	3.0	3.5
Real wages					
Entire economy	1.6	3.2	2.1	2.0	2.5
Public services	2.1	5.1	3.8	2.0	2.0
Of which					
Public administration	0.3	5.4	0.4	0.7	0.9

Sources: Statistical Office; and Ministry of Finance.

6. **Monetary conditions have varied over time**. In real terms, the key policy rate has exhibited periodic sharp increases and decreases, including turning negative during much of 1999-2000 and in the later part of 2001 (when large deposits of euro-legacy currencies were made with banks). Real interest rates on 60-day tolar bills rose in 2002, but remained below the peak reached in October 2001. Because of indexation, the changes in policy rates did not induce significant adjustments in real lending rates of commercial banks during the period through mid-2002. Following the de-indexation of short-term financial instruments in July 2002, lending rates of banks became more sensitive to movements in the interest rate on foreign currency-denominated credit and declined in real terms; the relationship with developments in policy rates remained weak. The exchange rate of the tolar vis-à-vis the euro has depreciated at varying rates, around a decelerating trend path. As a result, there have been alternating swings in the exchange rate-adjusted interest differential with abroad (Figure 3). While this did not trigger interest-sensitive capital inflows, foreign direct investment increased sharply in 2002 to the equivalent of about 9 percent of GDP, particularly in the pharmaceutical and banking sectors. The privatization receipts of the government were deposited in the BoS, and the rest of the inflows were largely sterilized through open market operations. Thus, base money growth in 2002 was limited to 8½ percent, compared with 21 percent in 2001. Domestic credit growth to the private sector slowed significantly, reflecting weak demand (Table 3 and Figure 4).

Figure 2. Slovenia: Wages and Productivity, 1995-2002

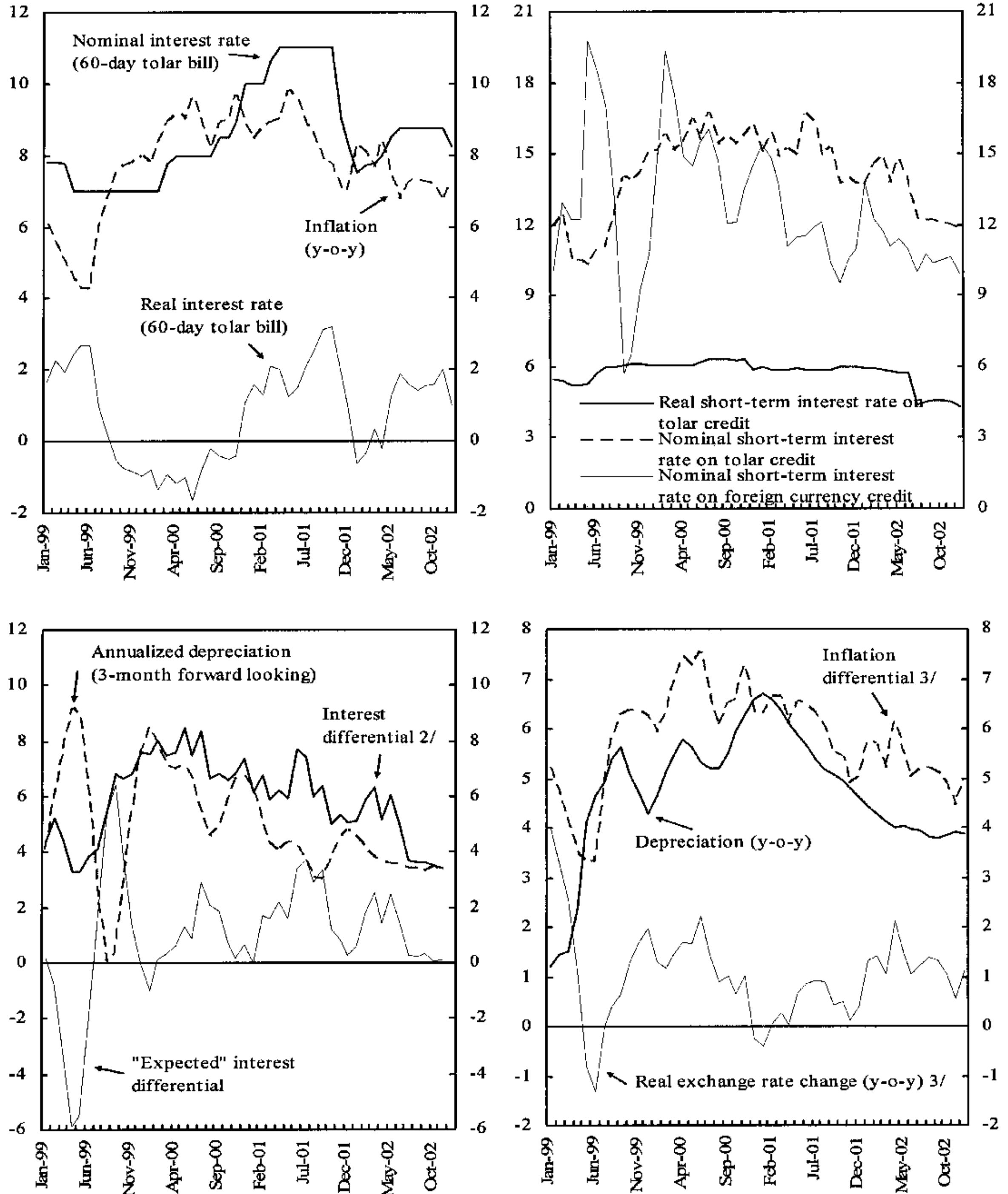


Source: Statistical Office of the Republic of Slovenia.

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

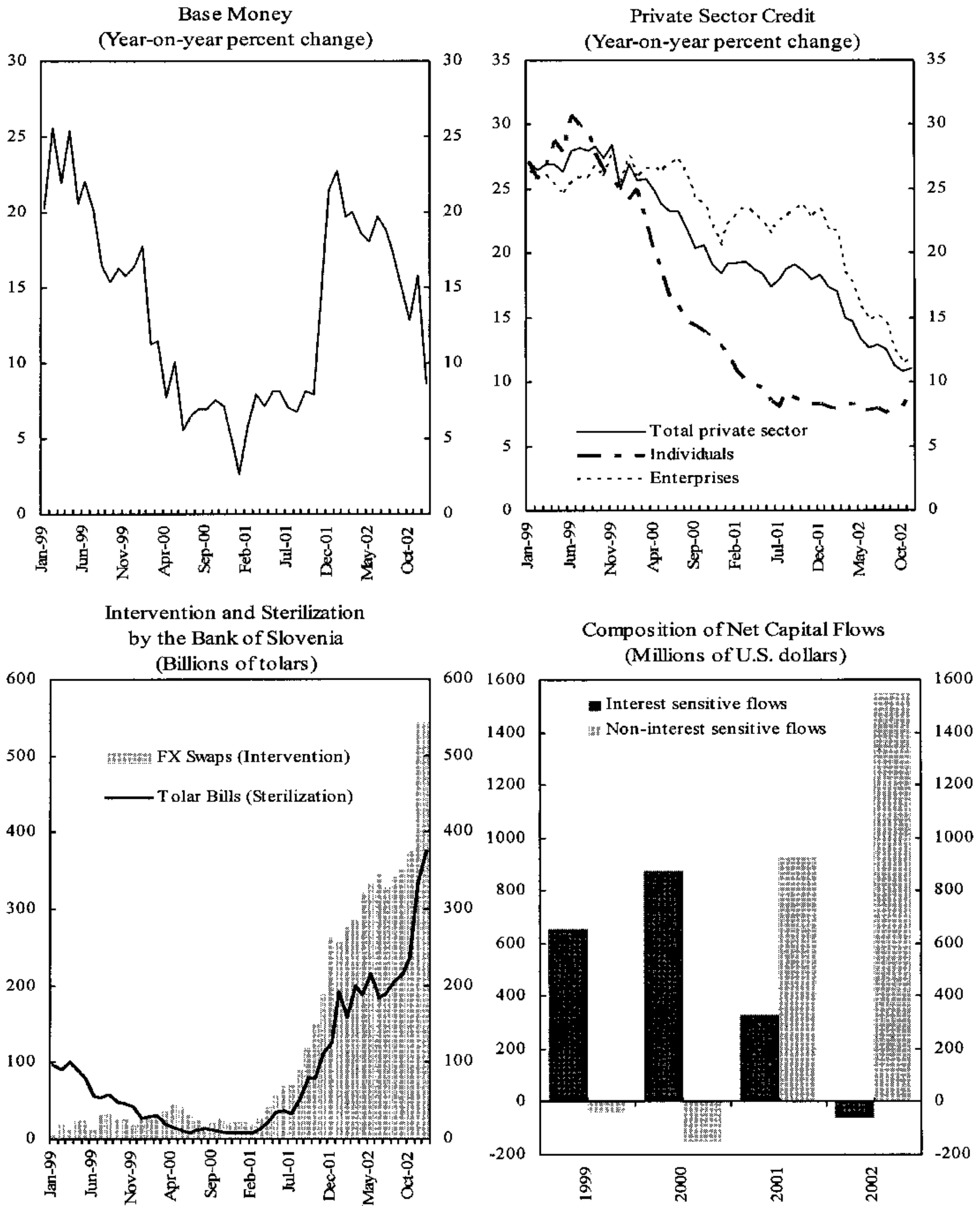
2/ Includes public administration, education, health, and other social services.

Figure 3. Slovenia: Inflation, Interest Rates, and Depreciation, 1999-2002 1/
(In percent)



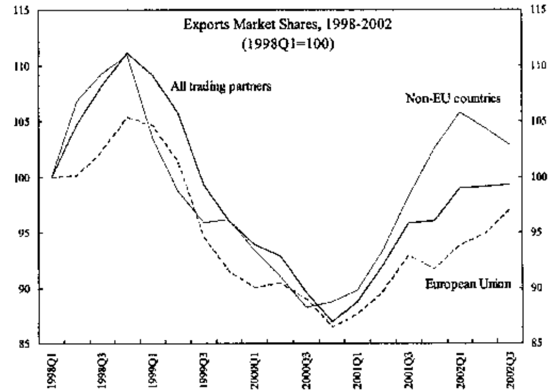
Sources: Bank of Slovenia; Eurostat; and Statistical Office of the Republic of Slovenia
1/ Depreciation vis-à-vis the euro.
2/ Difference between short-term lending rates in Slovenia and Germany.
3/ Vis-à-vis the Euro zone.

Figure 4. Slovenia: Selected Monetary Developments, 1999-2002



Source: Bank of Slovenia.

7. **Competitiveness indicators have been broadly stable.** The real effective exchange rate (REER) indicators and relative profitability index have remained broadly unchanged since early 1998 (Figures 5 and 6). During the past two years, Slovenia has regained the loss in export market share experienced during 1999–2000, mainly through market penetration in non-EU countries. Beginning in 2000, Slovene exporters have progressively increased their presence in the former Yugoslav republics and other non-EU countries, and are consolidating their footholds by investing in local distribution companies and production facilities. This trade diversification has been facilitated by improved political and macroeconomic stability in the destination countries, brand recognition by local consumers, and past business connections. The role of trade credits in supporting exports has been modest: nonetheless, the proportion of trade credit-financed exports to the former Yugoslav republics (11½ percent) has been higher than to the EU (6½ percent). However, Slovenia's share in EU imports has fallen slightly, while those of the Czech Republic, Hungary, Poland, and Slovak Republic have been rising, despite Slovenia's REER having depreciated vis-à-vis these countries. (Figure 7). The better export performance of the other Central European accession candidates to the EU is likely to reflect higher foreign direct investment from EU countries and the associated beneficial market linkages.

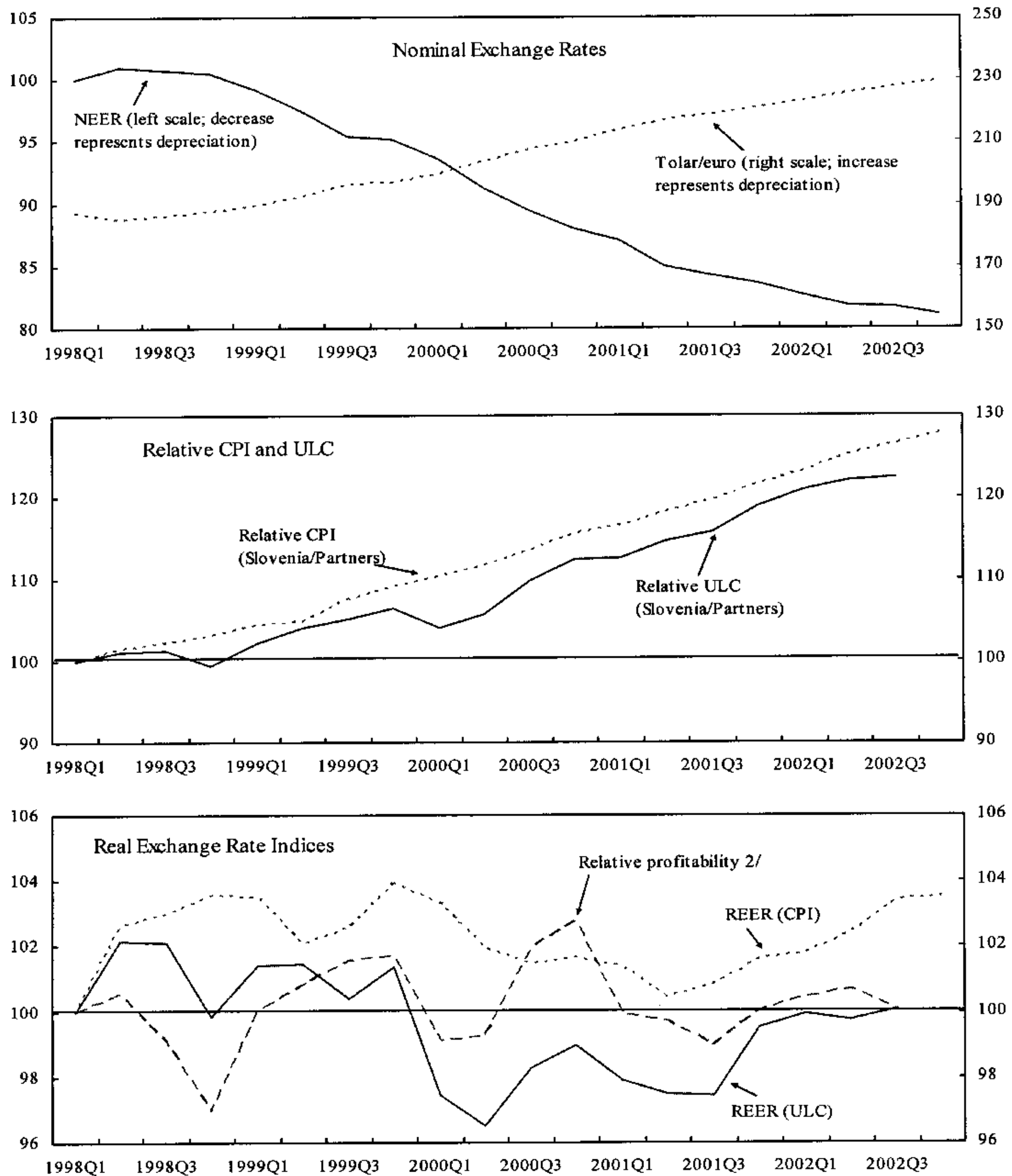


8. **Other external vulnerability indicators also were satisfactory**. With a widening of the current account surplus and large inflows of foreign direct investment, gross official reserves at end-2002 rose to more than five times the level of base money as well as of short-term debt on a residual maturity basis. Total external debt remained moderate (42 percent of GDP), and external debt service payments in 2002 were about 14 percent of exports of goods and services (Table 4).

9. **The general government deficit has remained slightly below 1½ percent of GDP since 2000.**[1] With output growing below estimated potential (4 percent), this stable ratio implies discretionary withdrawals of about ½ percentage point of GDP a year in 2001–02. In contrast to 2001 when there were expenditure overruns, the budget came under pressure in 2002 because of revenue shortfalls that are not well understood. The revenue-to-GDP ratio,

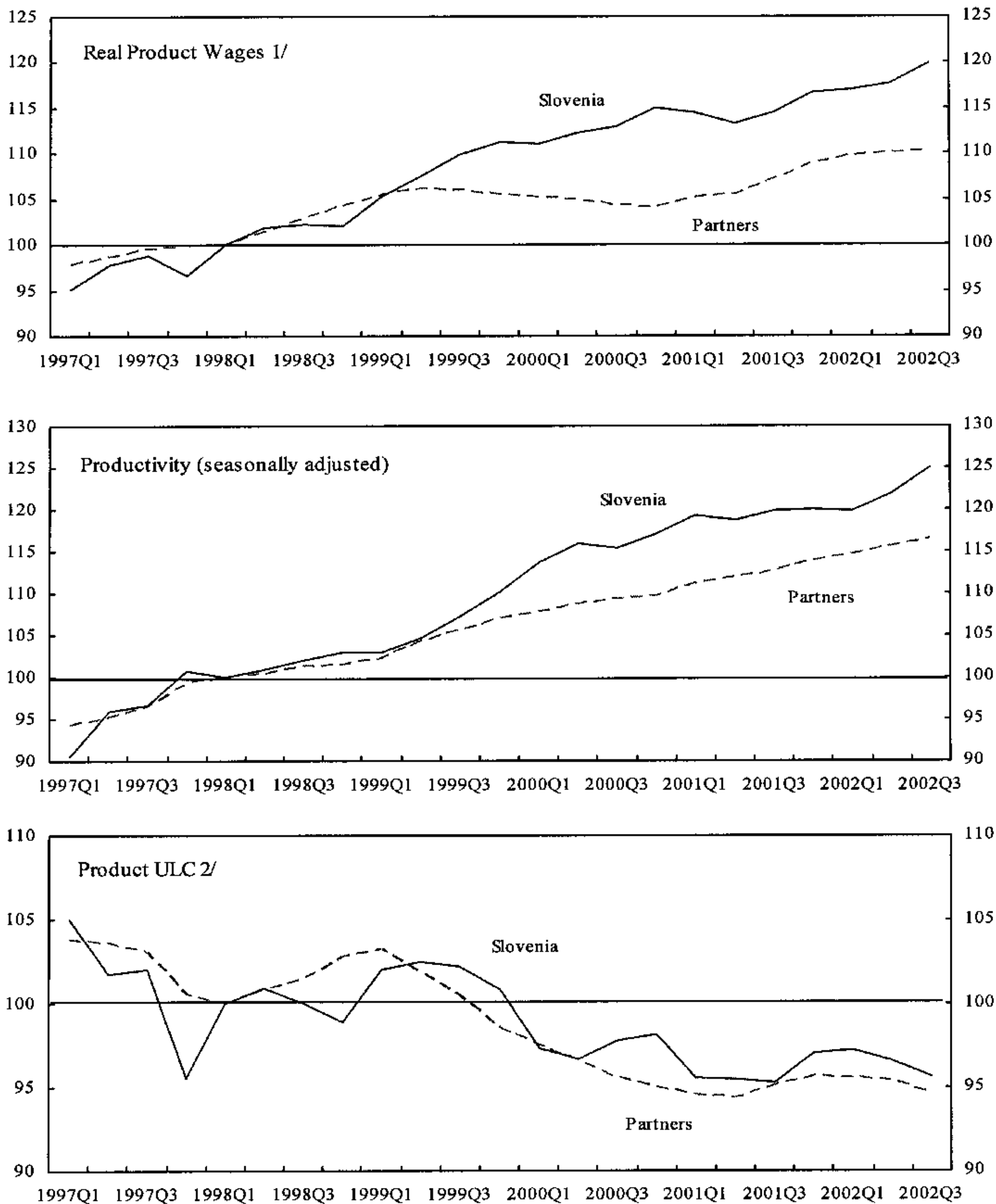
[1] Adjusting for the one-time impact of an accounting shift in 2002; otherwise, the measured deficit in that year was slightly below 3 percent of GDP.

Figure 5. Slovenia: Exchange Rate Indicators, 1998-2002
(1998Q1=100) 1/



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

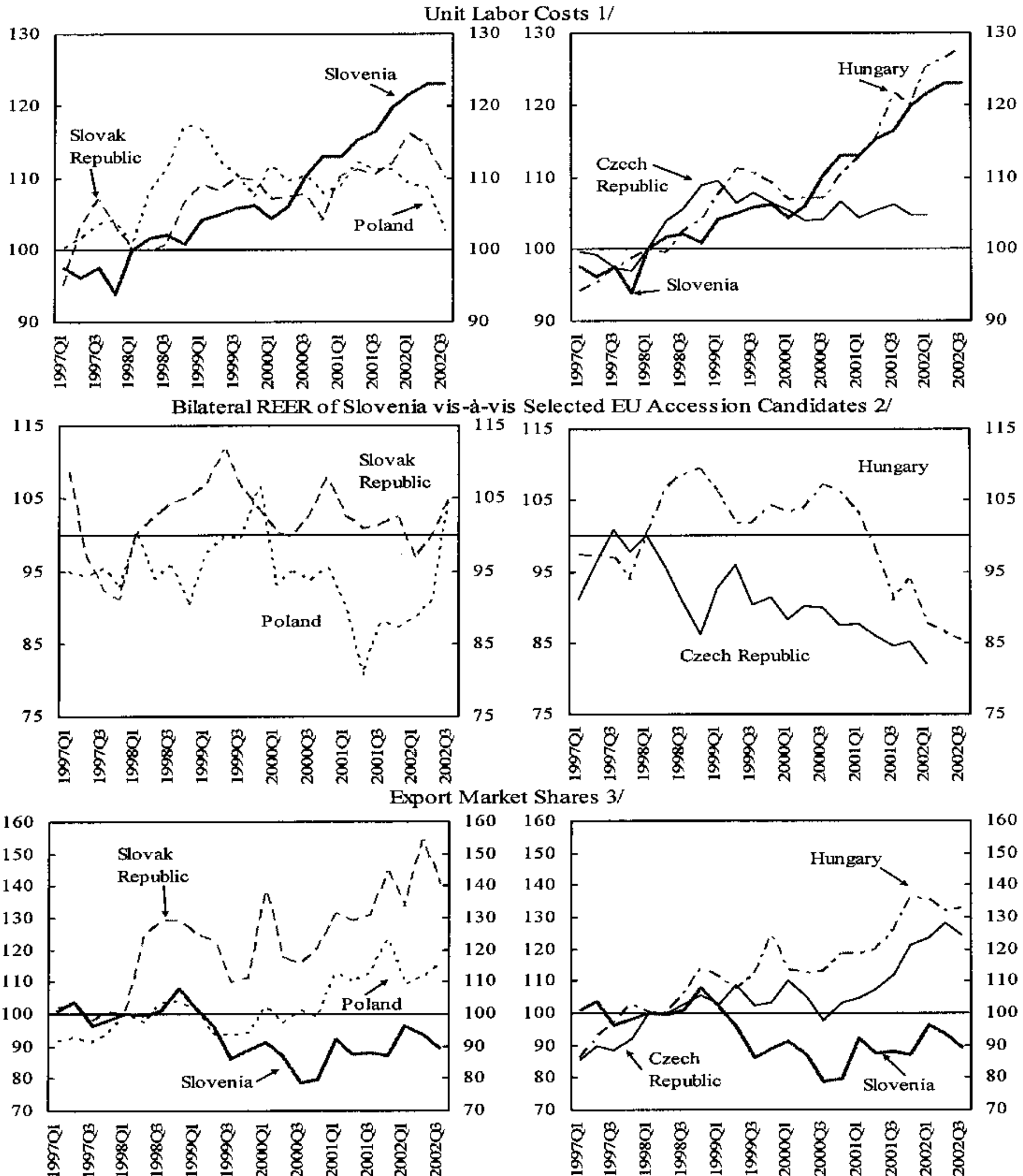
Figure 6. Slovenia: Wages, Productivity, and Product ULC in Manufacturing, 1997-2002
(1998Q1=100)



Sources: Statistical Office of the Republic of Slovenia; and IMF staff calculations.
1/ Defined as the ratio of nominal wages to producer price index.
2/ Defined as the ratio of real product wages to productivity.

Figure 7. Slovenia: Competitiveness Indicators and Export Market Shares of Slovenia and EU Accession Candidates, 1997-2002

(1998Q1=100)



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

1/ ULC in manufacturing in national currencies. ULC in industry for Hungary and the Slovak Republic.

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

3/ Calculated as the share of exports of each individual country in the combined imports of the following countries: Austria, France, Germany, Italy, United Kingdom, and United States.

corrected for the shift in budget accounting, fell by ¾ percentage point, notwithstanding increases in VAT and excise tax rates introduced in the original budget to align them with EU standards. The government responded through a combination of expenditure cuts and upward revision of the fiscal deficit target.

General Government Operations, 2000-02
(In percent of GDP)

	2000		2001		2002		
	Budget	Actual	Budget	Actual	Original Budget 1/	Supp. Budget 1/	Actual 1/
Total revenue	42.9	42.8	43.0	43.1	43.3	42.8	42.3
Tax revenue	40.3	39.6	39.4	39.4	40.0	39.3	38.9
Total expenditure	43.8	44.1	44.0	44.5	44.4	44.2	43.7
Current expenditure	39.0	39.9	39.9	40.1	40.1	40.0	39.6
Capital expenditure	4.9	4.2	4.1	4.4	4.3	4.3	4.0
Overall balance	-1.0	-1.4	-1.0	-1.4	-1.0	-1.4	-1.4
Primary balance	0.4	-0.1	0.4	0.0	0.4	0.1	0.1
Structural balance		-2.0		-1.6			-1.1

Source: Ministry of Finance.

1/ Adjusted for the one-off shortfall in recorded revenue as a result of a shift in accounting practice to full cash basis.

10. **Some key structural measures were implemented in 2002, but a backlog developed on the privatization front**. As of July, financial contracts with maturity of less than one year ceased to be indexed to inflation, as a partial step toward enhancing the interest rate transmission channel of monetary policy. Thirty-nine percent of the shares of Nova Ljubljanska Banka (NLB, the largest bank) were sold to foreign investors. However, the privatization of Nova Kreditna Banka Maribor (NKBM, the second largest bank) stalled because no offer met the guidelines. Telecom privatization was postponed owing to unfavorable market conditions. Ownership transformation of insurance companies remained held up on account of a court challenge.

II. Report on the Discussions

11. The authorities plan to enter ERM2 by end-2004 and to adopt the euro at the earliest possible date. Thus, in addition to the macroeconomic outlook, the discussions focused on the main policy priorities for achieving these objectives. The major challenges for Slovenia are to bring inflation down to 3–4 percent level,[2] while entering ERM2 at a viable exchange rate; address the institutional factors that have contributed to inflation inertia and real wage rigidity; consolidate public expenditure within a clear medium-term framework in order to

[2] Taking into account the Balassa-Samuelson effect on inflation, estimated at around 1½ percentage points.

secure the government's fiscal goal specified in the updated 2002 Pre-Accession Economic Programme (PEP); and complete the remaining agenda for financial sector reform. Slovenia already meets the Maastricht criteria for the fiscal deficit and debt ratio.[3]

A. Macroeconomic Outlook

12. **During the December mission, the authorities were upbeat about the prospect of real GDP growth climbing back to the growth rate of potential output by 2004, but have subsequently revised downward their near-term forecast.** The rolling two-year budget for 2003–04, prepared in mid-autumn 2002, projected real GDP growth to rise to 3.7 percent in 2003 and 4.1 percent in 2004, premised on a strong recovery of both domestic and foreign demand. The staff argued that expectations indicators pointed to a slow pickup in both private consumption and private investment. There also were uncertainties about the strength of the EU's expected recovery and the drag from higher international oil prices. The authorities acknowledged the downside risks to their growth projections, and have subsequently lowered their GDP forecast for 2003 to a range of 3–3.4 percent, overlapping with the staff's current projection of 3.2 percent. Updated official projections for 2004 are not available; the staff projects real GDP growth to climb to 3¾ percent, on the basis of a continued recovery in Europe, and the expectation of a strong pickup in private consumption driven by the release of funds from the housing savings scheme.

13. **There was consensus that the external current account would likely remain in sizable surplus in 2003–04 by about 1¾–2 percent of GDP, but that the evolution thereafter was uncertain.** Export growth should remain robust, with demand from the EU strengthening but the scope for gains in market share in non-EU countries tapering off. Imports should be boosted by the pickup in domestic demand and overtake export growth in due course. BoS officials cautioned that uncertainties surrounding the likely evolution of the external current account beyond 2004 were greater than usual, given the risk of a demand boom brought about by a convergence-related decline in interest rates. Assuming strong private consumption growth based on a decline in the private saving ratio toward its historical average, and taking into account domestic investment plans of Slovene enterprises, the staff projects the current account surplus to fade away over the medium term. BoS officials expected a modest increase in the reliance of enterprises and households on foreign financing upon EU accession.[4] Thus, the external debt ratio is anticipated to decline to about 33 percent over the medium term. Gross official reserves are projected to exceed external debt by 2007 (Tables 5 and 6). Stress tests point to modest risks to the staff's baseline external projections, but sustainability is not a serious concern (see Appendix III).

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[3] IMF staff's judgment based on ESA95-basis data provided by the authorities.

[4] While the options for sourcing finance abroad would increase, the opening-up of the domestic financial system would enhance competition and lower interest rates.

14. **The BoS has revised upward its inflation projection for 2003**. Inflation is now officially projected to fall to 5.3 percent at end-2003—compared with a forecast of 4 percent established when the BoS adopted the new monetary framework in January 2002—and to decline further to 3.5 percent at end-2004. BoS officials were concerned about the risks to disinflation arising from higher oil prices.[5] Subsequent to the discussions, in order to avoid higher inflation that could get locked in because of wage indexation, the government lowered the excise tax on gasoline in response to higher international oil prices, and decided to offset the decrease in tax revenue by cuts in expenditure. The staff considered the BoS's revised end-2003 inflation goal to be feasible, given the authorities' plans for administered price adjustments (see ¶22), but was skeptical that the current policy setting would yield the disinflation path envisaged in 2004. Taking into account the price impact (estimated at ½ percentage point) of a further increase in excise duty on tobacco to progressively align it to the EU average, the staff projects inflation to fall to around 4¾ percent at end-2004.

B. Monetary and Exchange Rate Policy

15. **The authorities viewed the partial shift toward an inflation-targeting framework in early 2002 as a useful adaptation to a changed environment**. With capital account liberalization reducing the central bank's control over broad money, the BoS shifted at the beginning of 2002 from monetary targeting to a discretionary approach bearing some hallmarks of inflation targeting.[6] The main innovations of the new approach were the announcement of a medium-term inflation objective and publication of BoS inflation forecasts twice a year. However, the authorities explained that the operational mechanisms of policy had not greatly changed. The focus still was on trying to control inflation primarily by keeping a grip on liquidity, though over a longer horizon. Toward this end, efforts continued to be directed toward adjusting interest rates while also managing the exchange rate with the aim of discouraging interest-sensitive capital inflows. The BoS conducts its exchange rate policy through temporary swaps (rather than outright purchases) of foreign currency from banks, while restricting the growth of base money by means of sterilization operations. Because of the reliance on swaps and an associated swap fee paid by banks to the BoS, the cost of sterilized intervention is reduced.

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[5] The official inflation projections assume an average oil price per barrel of US$25 in 2003 and US$23.3 in 2004, and an exchange rate of US$1.01 per euro. In comparison, the *World Economic Outlook* projects an average oil price of US$31 in 2003 and US$25 in 2004, and an exchange rate of US$1.09 per euro. An increase in oil price of US$6 (or 12 percent) results in an increase in consumer prices of 1.2 percentage points over a six-month period. The more appreciated euro (8 percent) will mitigate partially the impact of higher oil prices in U.S. dollars.

[6] The new monetary policy framework was described in detail in Appendix V of the Staff Report for the 2002 Article IV Consultation (SM/02/77).

16. **The authorities agreed that the main challenge facing monetary policy was how to disinflate while entering ERM2 at a viable exchange rate**. In this regard, the staff noted that the record of the past several years pointed to broad stability for the real exchange rate (see Figures 3 and 5) but also for the inflation rate. Even after discounting the impact of changes in administered prices and indirect taxes, there had been little progress in disinflation (see text table next to ¶5). While the reasons for this record were complex and included institutional rigidities (see below), one aspect seemed to be that periodic steps toward policy tightening were not sustained long enough. The series of missed and revised inflation forecasts may also have adversely affected the entrenchment of disinflationary expectations. In this light, the mission asked about the relative role of competitiveness and other considerations in shaping monetary policy.

17. **The BoS officials indicated that while their primary focus was on disinflation, the policy stance was also influenced by concerns that the burden of disinflation not fall unduly upon the tradable sector and that short-term gains in disinflation through a stronger tolar might not prove sustainable**. They explained that the observed broadly stable real exchange rate was not a policy objective, but an outcome of the attempt to equalize the domestic and foreign costs of finance (in order to discourage capital inflows) and the prevailing dynamics of domestic and foreign interest rates. Nevertheless, competitiveness also was a consideration in the policy stance, given its importance for a small open economy. Also, the BoS had accommodated the first- and second-round effects of price shocks originating from increases in taxes and administrative prices out of concerns that a more restrictive monetary policy would hurt the tradable sector and further dampen economic activity. BoS officials further argued that efforts to lower inflation more rapidly through a stronger tolar entailed risks of capital inflows or, if the expected interest differential with abroad was maintained by a reduction of interest rates, an expenditure boom that could lead to external imbalances as well as undermine the disinflation efforts. They were also wary of large exchange rate fluctuations as experienced by some EU accession candidates in the region.

18. **Given the aim of nominal convergence with the euro area and the likely significant costs to the real economy of bringing down inflation once a central exchange rate with the euro had been adopted, the staff called for a greater and more sustained effort to bring inflation down in the period immediately ahead**. In this regard, the mission observed that there seemed to be scope for further "testing the waters" through a stronger tolar without unduly exposing the economy to risks, especially given the strong external current account position. BoS officials did not dispute this assessment, but emphasized that complementary efforts from the government and social partners were necessary. They explained that in the past when the BoS had pressed ahead with disinflation, these entities had felt less constrained and created additional price pressures that offset the disinflation gains achieved through monetary policy.

19. **The staff also stressed the importance of the BoS investing greater credibility and accountability in its inflation objectives**, which should become cast as targets rather than projections. In this respect, the staff recommended that the BoS also forecast and

monitor a measure of inflation that excluded administered prices and indirect taxes, to help it better assess underlying price pressures, assume accountability, and shape public expectations.

20. **The BoS is aiming to formally eliminate indexation of all financial contracts by mid-2003, based on the recent initiative taken by the banking sector**. As de-indexation of short-term financial contracts in July 2002 did not show any adverse impact on banks' balance sheets, the leading commercial bank began to offer in November 2002 long-term deposits and loans at nominal interest rates linked to the 60-day BoS tolar bill rate, and other banks followed suit quickly. The government also issued a small amount of three-year securities with nominal interest rates in the second half of 2002, though longer-term public debt issues mainly remained indexed. Against this background, BoS officials agreed that there was little to be gained from delaying nominalization of all financial instruments, even though conditions for a first-best reference rate were not yet in place, and indicated that steps would be initiated to repeal the relevant law.

C. Price and Wage Policies

21. **The authorities' disinflation strategy also entails addressing the cost-push factors that have contributed substantially to inflation inertia over the past years**. Efforts are being geared mainly toward reducing the pressures from changes in administered prices and indirect taxes, moderating public sector wage growth, and making wage indexation weaker.

22. **In this regard, the authorities pointed to the decision to defer increases in taxes on water supply and environmental discharges, and to cap increases in administered and regulated prices in 2003 at the projected inflation rate**. Unlike in previous years, the size and timing of the price increases were being coordinated with the BoS, a development welcomed by the staff. The authorities argued that many of the recent increases in administered and regulated prices did not reflect legitimate cost recovery, and that the price cap imposed by the government would not result in losses for the service providers. They agreed with the staff's observation that administered and regulated price adjustments needed to be approached from a medium-term perspective—in order to eliminate uncertainties for service providers and encourage them to generate internal savings through efficiency gains—and indicated that they would take steps to prepare and coordinate a multiyear program.

23. **The authorities' goal is to have public sector wages rise at a slower pace than private sector wages**. Toward this end, the government has already taken steps to restrict extraordinary promotions. Also, a new wage setting system for the public sector (including education and health workers) will be introduced in 2004 under which collective agreements would be centralized, and bonus payments would be performance-based and subject to an upper limit.

24. **Changes are envisaged in the wage indexation mechanism in 2004, with the aim of making it weaker**. The existing indexation mechanism for economy-wide basic wages is

forward-looking with respect to the CPI, and has a clause for almost full catch-up for higher inflation by year-end. Social partners in the private sector have agreed to move to a wage indexation formula in 2004 that will take into account inflation in Slovenia and in the main EU trading partner countries, and changes in the tolar/euro exchange rate; the details will be worked out in the coming months. In the public sector, individual-level indexation would be reduced in 2004, as one-half of the budgetary funds earmarked for wage bill indexation would be applied toward implementation of a new wage structure aimed at reducing wage dispersion.[7] Negotiations on job grading and the allocation principles for set-aside funds between job categories are expected to start in May 2003. The authorities anticipated pressure from the social partners for additional resources for implementing the new wage structure, and indicated that if collective bargaining stretched into 2004, an election year, a successful resolution would be at risk.

25. **The staff encouraged the authorities to work toward ensuring that wage indexation was not formalized in the 2004 collective agreements for the public sector.** Recognizing that wage flexibility in both the public and private sectors was essential in the context of ERM2 entry and the eventual adoption of the euro, the authorities indicated that efforts would be initiated with the social partners to achieve full understanding of the need to eliminate wage indexation. However, in the meetings with the mission, labor union representatives emphatically stated that they would not consider elimination of wage indexation until inflation came down to EU levels.

D. Fiscal Policy

26. **The authorities explained that the rolling two-year budget for 2003–04 had been formulated consistent with Slovenia's medium-term goal of attaining close to structural balance before adopting the euro.** The budget targets a modest reduction of the general government deficit to 1.2 percent of GDP in 2003 and 0.9 percent of GDP in 2004, implying a small structural withdrawal in both years. The budget authorizes additional borrowing of up to SIT 15 billion (¼ percent of GDP) each year in the event of revenue shortfalls. No new revenue measures are planned, except for increases of excise duties on tobacco in line with EU accession commitments. Large increases have been budgeted for border policing and defense, in line with EU and NATO requirements, and for investment. However, efforts would be also directed toward restraining spending on goods and services of most direct users of the state budget, keeping wage increases moderate, obtaining a saving in pension expenditure in 2003 from a change in the indexation formula, and avoiding additional entitlements for social transfers beginning in 2004 (Table 7). Because negotiations were still

[7] The objective is to reduce the dispersion between the lowest and the highest basic wage in the public sector from 1:13 to 1:10 over a four-year period. The authorities justified this initiative by noting that, in recent years, wage increases in the public sector had been larger for the higher-paid workers.

ongoing at the time of budget preparation, the full fiscal effects of EU accession had not been incorporated in the budget proposal.

General Government Operations, 2002-04
(In percent of GDP)

	2002	2003		2004	
	Actual 1/	Budget	Rev. Proj (Official)	Budget 2/	Rev. Proj (Staff proposal) 3/
Total revenue	42.3	42.9	42.2	42.7	41.9
Total expenditure	43.7	44.1	43.8	43.6	43.3
Overall balance	-1.4	-1.2	-1.6	-0.9	-1.4
Structural balance	-1.1	-0.6	-1.0	-0.2	-0.7
Structural primary balance	0.4	0.8	0.3	0.9	0.5

Sources: Ministry of Finance; and IMF staff projections.

1/ Adjusted for the one-off shortfall in recorded revenue as a result of a shift in accounting practice to full cash basis.

2/ As in the rolling two-year budget for 2003-04. Does not incorporate the fiscal effects of EU accession.

3/ Net transfers from EU are included as revenue. Assumes decrease in VAT and customs duties on account of EU accession, and other revenue shortfall of 3/4 percent of GDP on account of slower output growth than assumed in budget.

27. **The budget is subject to risks, and the achievement of the fiscal deficit targets for 2003–04 may not be feasible.** Indeed, in mid-February, following the discussions, the ministry of finance announced that it expected the general government deficit in 2003 to be 0.3–0.4 percentage point of GDP higher than budgeted (i.e., 1.5–1.6 percent of GDP), implying near elimination of the planned structural withdrawal. The pressures on the budget are likely to be greater in 2004, and the staff projects a deficit of 2¼–2¾ percent of GDP in the absence of measures. The additional budgetary pressures arise from the following sources:

- The revenue projections do not take into account the shortfalls experienced in the second half of 2002, and are based on optimistic assumptions for GDP growth and tax elasticity. The staff estimates that there would be a revenue gap of ½–¾ percent of GDP in 2003 and ¾–1¼ percent of GDP in 2004. The authorities agree with this assessment.

- The decrease in the excise tax on gasoline in January 2003 was not foreseen in the budget. The full-year cost of this measure is officially estimated at about ⅓ percent of GDP.

- While Slovenia is expected to be a net recipient of EU funds during 2004–06, the authorities estimate that the overall fiscal position still could be worse by about ½ percentage point of GDP annually, owing to costs not taken into account in the accession negotiations. The authorities were worried that the elimination of border

customs controls upon EU accession could adversely affect VAT collection efficiency. Also, slightly over one-half of the Schengen border-related expenditure would have to be covered from own resources.

- The authorities saw a risk of the budgeted wage bill for 2004 being breached. Since the new public sector wage structure would be implemented over a four-year period, the outcome of the 2004 collective agreement would also have medium-term resource implications.

Projected Net Budgetary Impact of EU Accession
(In millions of euros)

	2004	2005	2006
Net transfers	88.4	91.0	94.5
Receipts from EU budget 1/	293.8	416.5	434.5
Contributions to EU budget	205.4	325.5	340.0
Additional negative impact on budget 2/	207.9	266.6	281.2
Decrease in VAT collection	86.4	141	153.1
Decrease in customs duties 3/	27.1	42.5	44.2
Obligations to EU institutions	9.7	9.9	25.9
"Top up" of direct payments 3/	17.6	21.5	32.2
Schengen border-related expenditure 4/	67.1	51.7	25.8
Net impact on budget	-119.5	-175.6	-186.7
In percent of GDP	-0.5	-0.6	-0.6

Source: Ministry of Finance.
1/ Includes budgetary compensation and cash flow lump-sum.
2/ Items not a theme of or only partly addressed in accession negotiations.
3/ Change relative to 2003.
4/ Excludes expenditure to be covered by receipts from EU budget.

28. **The staff indicated understanding for a partial accommodation of the additional fiscal pressures through a higher-than-budgeted deficit in 2003, but encouraged the authorities to resume the originally intended pace of structural consolidation in 2004 and to initiate efforts at an early stage to restrain expenditure within a medium-term framework**. In a recent conversation with the Finance Minister, following the upward revision of the deficit projection in mid-February, the staff recommended that the authorities firmly adhere to the virtually neutral stance in 2003 implied by the revised projection, and act to avoid any further widening of the deficit. For 2004, it advocated a resumption of the underlying consolidation path toward the intended structural balance, by aiming for a withdrawal relative to 2003 similar to that originally planned in the budget (⅓ percentage point of GDP). This would imply limiting the general government deficit in 2004 to 1.4 percent of GDP. Such a policy stance would enhance credibility in the government's commitment to medium-term fiscal consolidation elaborated in the PEP, and would also complement—even though in a small way, given the openness of the economy—the authorities' disinflation efforts.

29. **Medium-term expenditure consolidation efforts will need to focus on restraining increases in the wage bill and social transfers, given their large share in government expenditure**. The staff proposed that the authorities specify wage bill ceilings consistent with the overall budget constraints, instead of having a prior target for public sector wage growth in relation to economy-wide wage growth. The staff also advocated switching indexation of pensions to inflation instead of wages, and suggested that the authorities take durable measures to tackle rising health care costs (especially the wage bill and cost of medicines) and seek efficiency gains in other social spending through improved targeting.

30. **The authorities were in broad agreement with the staff's views**. They intended to prepare a supplementary budget for 2003 by mid-year, and revise the 2004 budget in November in the context of the next rolling two-year budget for 2004–05. Priority would be given to meeting the additional budget pressures through resource reallocation. The authorities noted that reform of the health care system was on the policy agenda and would be gradually implemented by 2006. However, having introduced wide-ranging pension reforms in 2000, they saw limited scope in the near term for reaching agreement with social partners on a further change in the basis for pension indexation. The authorities also felt that social benefits were generally well targeted, and that the system of social protection had a relatively high degree of cost effectiveness. Nevertheless, they acknowledged that integrating the different benefit schemes and consolidating the institutions administering the benefits could increase efficiency.

31. **The authorities stated that the government's debt management would be oriented toward reducing the debt ratio, increasingly issuing securities at nominal interest rates, and facilitating the development of the domestic primary and secondary market for government securities**. At end-2002, general government debt stood at 28 percent of GDP—well below the Maastricht limit—and government guarantees of debt amounted to an additional 6 percent of GDP. The authorities' central scenario projects a reduction in the debt-to-GDP ratio to 22 percent by 2007. This objective is to be achieved mainly through fiscal consolidation, using a part of the privatization proceeds (1½ percent of GDP) to pre-pay debt, and not taking over any additional debt from third parties. In 2002, the government had restructured a part of its debt to domestic banks, which would lower interest costs and borrowing requirements over the medium term. In general, roll-over risk was deemed to be modest; the annual general government gross borrowing requirement was projected at 15 percent of outstanding debt, or around 4 percent of GDP, in the next few years. The authorities noted that the law on issuing government guarantees had been tightened to conform to EU regulations, and that the risk of guarantees being called was low; the equivalent of only about 0.1 percent of GDP would lapse during the next five years. Staff calculations show that if the government fully accommodated the revenue shortfalls and the fiscal pressures arising from EU accession, government debt would remain steady around 28 percent of GDP over the medium term. Further analysis of fiscal sustainability appears in Appendix III.

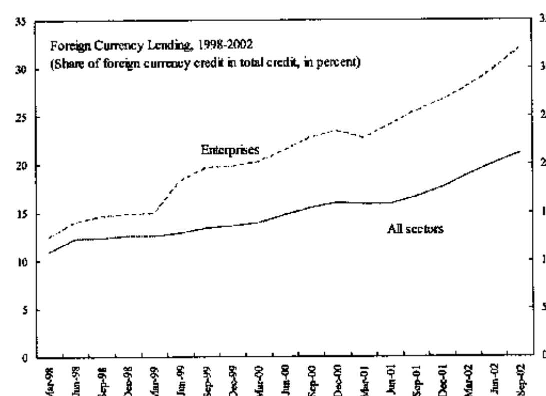
E. Financial Sector Issues

32. **The authorities considered the financial system fundamentally sound.** Banks remained adequately capitalized and profitable. The quality of banks' portfolios had deteriorated slightly with the economic slowdown, but full provisioning had been made for nonperforming assets. The BoS was not unduly concerned about the rapid increase in foreign currency denominated loans to enterprises, which had been facilitated by the harmonization of financial sector regulations with the *acquis*. Banks emphasized that they strictly adhered to the prudential guidelines on foreign exchange and credit risk exposure, and that these loans mainly were to exporters who were hedging their balance sheets. In addition, banks also provided advice and services to help nonexporting clients hedge their currency risk. The BoS expected to complete the implementation of its action plan based on the recommendations of the 2001 FSAP by spring 2003.[8] They indicated that progress in reducing connected lending—the deadline for compliance was August 2004—was slower than envisaged. Banks were handicapped in this task by the small size of the banking sector.

Banking Sector Soundness and Profitability

	1999	2000	2001	2002 Sept.
Net interest margin (as percent of average earning assets)	4.1	4.7	3.6	3.7
Return on average assets (before tax, in percent)	0.8	1.1	0.5	1.2
Return on average equity (before tax, in percent)	7.8	11.3	4.8	14.3
Nonperforming assets (as percent of total assets)	5.2	5.2	7.0	6.5
Loan-loss provisions (as percent of legal requirement)	114.9	101.0	100.5	102.9
Capital adequacy ratio (in percent)	14.0	13.5	11.9	11.9
Memorandum item:				
Share of nonresidents in equity capital of banks (in percent)	11.3	12.0	15.4	32.5

Source: Bank of Slovenia.



33. **With the entry of foreign investors in the banking sector, retail competition had increased.** Net interest margin had fallen, and banks were focusing on introducing new products and increasing their noninterest income. The authorities agreed with the staff that although the current performance of NKBM—whose privatization in 2002 fell through—was adequate, injection of private capital would be desirable for the bank to remain competitive in the new environment. However, they did not see privatization necessarily involving foreign investors. The authorities noted that NKBM was likely to be merged with the Postal Bank to create a strong banking/financial pillar to compete with the largest commercial bank.

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[8] The key areas covered in the action plan are: strengthening prudential oversight and risk management, improving liquidity management, and completing the reform of the payments system (see Appendix IV of SM/02/77, 3/6/02). The authorities have requested a follow-up FSAP.

A constitutional court ruling in February 2003 has cleared the path for ownership transformation of insurance companies. The socially owned capital will be temporarily transferred to two funds, which would later ensure the division among claimants.

34. **Based on the authorities' response to the questionnaire on anti-money laundering and combating terrorist financing, the legal framework for anti-money laundering provides for the fundamental safeguards**. While there is currently no specific offence for financing of terrorism, the authorities explained that financing of any criminal act could be prosecuted under the general provisions of the penal code. They indicated that amendments to the penal code would be submitted to parliament in March/April 2003, including specific provisions on combating terrorist financing.

F. Other Structural Issues

35. **Initiatives were underway to reduce the role of the state in the steel and energy sectors**. At the time of the mission, bids had been received for two steel companies, and tenders were in preparation for the privatization of the electricity distribution system. The authorities planned to start liberalization of the natural gas market in 2003. They also anticipated that disposition of the remaining 26 loss-making enterprises in which the Slovene Development Corporation (closed in early 2002) had more than 10 percent shareholding would be completed by end-2003.

36. **Slovenia's foreign investment regime is fairly liberal, with no a priori general restrictions**. On the basis of a review in 2000 by the Foreign Investment Advisory Service (FIAS), the authorities have taken measures to simplify and shorten administrative procedures for setting up enterprises, and reforming zoning laws. The FIAS study identified problems in acquiring industrial locations, relatively rigid and unbalanced labor legislation, and low labor mobility as some of the main barriers to FDI. The authorities expected that Slovenia's integration into the EU and the privatization of public utilities would be the major determinants of FDI inflows in the period ahead.[9]

37. **Slovenia's trade regime is moderately restrictive, having an overall restrictiveness index of 5 in the IMF's 10-point rating scale**. Slovenia's trade policies are driven by its agreements with the EU and Central European Free Trade Area (CEFTA), and several other preferential agreements. Exclusively MFN rates apply to only 15 percent of imports. Slovenia's trade with its largest trading partners is virtually duty free: for example, the average tariff on industrial imports from the EU is 0.5 percent, compared with the average MFN tariff rate of 9.5 percent. In agriculture, products considered as sensitive are protected by tariff quotas negotiated with each preferential partner, resulting in a wide variety of product- and country-specific preferences; access is adjusted on an ongoing basis. The

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[9] For a detailed analysis of FDI in Slovenia, see *OECD Investment Policy Reviews: Slovenia*, January 2002.

only remaining quantitative restrictions per se are those on textiles and clothing, which are to be phased out under the World Trade Organization (WTO) Agreement on Textiles and Clothing. Upon EU accession, Slovenia will adopt the common external tariff. In concluding its first trade policy review of Slovenia in May 2002, the WTO praised Slovenia for its strong commitment to the multilateral trading system, and commended its strong support for the launching of the Doha Development Agenda. However, some members noted that, in general, falling trade barriers under preferential agreements had not been matched by similar improvements for MFN partners, and encouraged Slovenia to narrow the gap.

III. Staff Appraisal

38. **Slovenia is among the most successful EU accession candidates.** Slovenia achieved sustained real convergence toward EU levels during the 1990s, against a backdrop of prudent economic policies and a gradualist approach to structural reform. The economy slowed during 2001–02, but showed considerable resilience to a weakening of the economic environment. The mildness of the slowdown can be attributed mainly to a further expansion of exports to southeastern Europe and other non-EU countries. This diversification of trade appears durable, and testifies to the strength and dynamism of Slovene firms. Judging by the standard indicators, external competitiveness of the manufacturing sector remains adequate. Monetary conditions varied during 2001–02, and the fiscal outturn implied small discretionary withdrawals. However, owing in part to increases in indirect taxes and administered prices as well as to wage and financial indexation, inflation remained high.

39. **With EU accession scheduled for May 2004, policy makers now have to focus on laying the ground for a smooth transition to ERM2 and the eventual adoption of the euro.** Although the economy is well positioned in many respects (most notably on the fiscal front), some major challenges remain for the period ahead: the inflation rate is well above the euro-area average; wage indexation mechanisms contribute to real wage stickiness and sustain inflation; the planned fiscal consolidation in line with medium-term Stability and Growth Pact requirements is under threat from revenue shortfalls and net costs of EU accession. These challenges have to be met in an environment where the macroeconomic outlook is subject to downside risks.

40. **Inflation has become quite persistent, and lowering it sharply before entering ERM2 is essential and will require a resolute and sustained effort.** Given the limited disinflation gains even after discounting the impact of increases in indirect taxes and administrative prices, the role of monetary policy will be key, and further slippage in achieving the inflation objective would be problematic for credibility. There appears to be scope for a more aggressive disinflation effort through accepting a stronger tolar without undermining competitiveness or unduly exposing the economy to the risks of capital inflows. To further accountability, it would be useful for the BoS to also forecast and monitor a core inflation measure that excludes administered prices, indirect taxes, and oil prices. The de-indexation of short-term financial contracts in mid-2002 and the subsequent initiative taken by banks to offer long-term financial instruments at nominal interest rates should help

strengthen the interest rate transmission channel of monetary policy. The authorities are encouraged to eliminate indexation of all financial instruments at an early date.

41. **Cost-push factors account for much of the persistence of inflation over the past years and need to be tackled vigorously**. In this regard, the enhanced coordination between the government and the BoS on plans for adjustments of administered prices is a welcome step. Care should be taken to ensure that caps on administered price increases are not ad hoc and do not disguise latent inflationary pressures or contribute to losses for the service providers.

42. **Lower public sector wage increases and elimination of wage indexation are priorities for securing sustained low inflation and meeting the government's medium-term fiscal goals**. The authorities have taken a number of important measures aimed at containing public sector wage increases below economy-wide increases. However, key aspects of the 2004 public sector collective agreements still remain to be negotiated. It would be important to restrict the cost of the new wage structure within the budgeted wage bill envelope for 2004. Both the government and social partners are encouraged to avoid incorporating a wage indexation clause in the agreements. This would serve as an example for wage negotiations in the private sector, and allow the economy to respond more flexibly to shocks under ERM2 and, eventually, monetary union.

43. **The deficit targets of the rolling two-year budget for 2003–04 are unlikely to be achieved under present policies, and durable expenditure savings will be critical for securing the government's commendable medium-term fiscal goal of attaining close to structural balance before adopting the euro**. The fiscal projections have to be revised to take into account a more realistic assessment of the revenue outlook and the EU accession-related transfers and unanticipated fiscal pressures. For 2003–04, fully adjusting expenditures to these budgetary pressures may not be possible, and a somewhat higher deficit than originally envisaged may have to be accepted. However, the pace of underlying adjustment toward structural balance needs to be resumed. Given that wages and social transfers constitute the bulk of public spending, efforts to restrain expenditures over the medium term will have to focus on these areas and be initiated at an early stage. Wage bill ceilings should be specified consistent with the overall budget constraint rather than imposed on the basis of any prior target for relative wages. The authorities are encouraged to seek further savings on pension expenditure by indexing pensions to inflation instead of wages. Health care reforms are on the authorities' policy agenda and should be aggressively pursued.

44. **While Slovenia's banking system appears to be generally sound, new challenges call for vigilance**. The implementation of the authorities' action plan based on the recommendations of the FSAP is almost complete, putting the BoS in a strong position to cope with any evolving risks under a liberalized financial sector and external capital account. The rising foreign currency borrowing by enterprises should be closely monitored by banks and their supervisors, with a view to ensuring that credit risks are well contained. Competition in the banking system has increased with the entry of foreign investors. The

authorities are encouraged to enhance the competitiveness of NKBM through an infusion of private capital in a transparent fashion.

45. **The momentum behind structural reform in other areas should be maintained.** In this regard, the staff welcomes the initiatives underway to reduce the role of the state in the steel and energy sectors.

46. **Slovenia's data are adequate for effective surveillance.**

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

Table 1. Selected Indicators of Central European EU Accession Candidates, 1993-2002

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
					(Index, EU average = 100)					
GDP per capita										
(in purchasing power standard, relative to EU)										
Czech Republic	...	...	62	64	62	60	59	57	59	...
Hungary	...	...	46	46	47	48	49	50	53	...
Poland	...	...	34	36	38	38	39	41	40	...
Slovak Republic	...	...	46	48	49	50	50	47	48	...
Slovenia	...	...	63	64	66	67	68	68	70	...
Labor productivity										
(in purchasing power standard, relative to EU)										
Czech Republic	...	...	54	55	54	54	55	54	56	...
Hungary	...	...	54	54	56	57	57	58	62	...
Poland	...	...	37	39	40	41	44	47	49	...
Slovak Republic	...	...	48	48	51	51	53	52	53	...
Slovenia	...	...	63	65	67	69	71	71	73	...
					(Annual percentage change)					
Real GDP										
Czech Republic	0.1	2.2	5.9	4.3	-0.8	-1.0	0.5	3.3	3.3	1.9
Hungary	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.3
Poland	4.3	5.2	6.8	6.0	6.8	4.8	4.1	4.0	1.0	1.3
Slovak Republic	-3.7	5.2	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.1
Slovenia	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6	3.0	2.9
European Union	-0.3	2.8	2.5	1.7	2.6	3.0	2.8	3.5	1.6	1.0
					(Annual average, in percent)					
Inflation										
Czech Republic	20.8	10.0	9.1	8.8	8.5	10.6	2.1	3.9	4.7	1.8
Hungary	22.4	18.8	28.3	23.5	18.3	14.3	10.0	9.8	9.2	5.3
Poland	35.3	32.2	27.9	19.9	14.9	11.8	7.3	10.1	5.5	1.9
Slovak Republic	23.0	13.5	9.8	5.8	6.1	6.7	10.7	12.0	7.3	3.3
Slovenia	31.9	21.5	13.5	9.9	8.4	8.0	6.1	8.9	8.4	7.5
European Union	3.9	3.0	2.9	2.5	1.8	1.5	1.4	2.3	2.6	2.3
					(In percent of GDP)					
External current account										
Czech Republic	1.3	-1.9	-2.6	-7.1	-6.7	-2.2	-2.7	-5.3	-4.6	-5.7
Hungary	-8.9	-9.3	-5.6	-3.7	-2.1	-4.9	-4.4	-2.9	-2.1	-5.8
Poland	-3.3	0.7	4.2	-1.0	-3.0	-4.3	-7.4	-6.3	-4.1	-3.4
Slovak Republic	-5.4	6.6	3.4	-8.8	-8.5	-9.7	-4.9	-3.6	-8.6	-8.3
Slovenia	1.5	4.0	-0.4	0.3	0.3	-0.6	-3.5	-3.0	0.2	1.8
European Union	0.1	0.1	0.6	0.9	1.3	0.8	0.1	-0.4	0.1	0.7
General government balance										
Czech Republic	2.6	-1.9	-1.4	-0.9	-1.6	-1.4	-3.1	-3.5	-3.0	-6.1
Hungary	-9.2	-8.6	-6.2	-3.1	-4.8	-4.8	-3.7	-3.7	-3.0	-9.8
Poland	-3.4	-3.0	-3.1	-3.3	-3.2	-3.3	-3.4	-3.1	-5.1	-6.7
Slovak Republic	-6.4	-1.2	0.3	-1.2	-4.8	-4.7	-3.3	-3.5	-4.0	-5.5
Slovenia	0.9	0.0	0.0	0.3	-1.2	-0.8	-0.6	-1.4	-1.4	-1.4
European Union	-6.4	-5.6	-5.3	-4.3	-2.4	-1.7	-0.7	0.8	-0.9	-1.9
Foreign direct investment										
Czech Republic	1.9	2.1	4.9	2.5	2.5	6.5	11.5	9.7	8.7	11.4
Hungary	6.3	2.7	10.8	5.1	4.8	4.3	4.2	3.5	4.7	1.2
Poland	2.0	1.9	2.9	3.1	3.4	4.0	4.7	5.9	3.2	2.0
Slovak Republic	1.2	1.2	0.7	1.0	0.9	2.1	3.8	10.8	5.8	17.9
Slovenia	0.9	0.8	0.8	0.9	1.8	1.1	0.5	0.7	2.7	8.8

Sources: World Economic Outlook; Balance of Payments database; and Eurostat.

Table 2. Slovenia: Selected Economic Indicators, 1999-2004

	1999	2000	2001	Prelim.	Proj.	
				2002	2003 1/	2004 1/
	(Annual percentage change)					
Real GDP	5.2	4.6	3.0	2.9	3.2	3.8
Domestic demand	9.1	1.1	0.5	2.2	3.1	4.0
Private consumption	6.0	0.8	1.7	1.8	2.3	3.7
Public consumption	4.6	3.1	3.2	1.0	1.5	2.1
Gross capital formation	18.9	0.5	-3.7	3.7	5.8	6.0
Industrial production	-0.5	6.2	2.9	2.4	...	...
Consumer prices						
Period average	6.1	8.9	8.4	7.5	5.7	5.0
End of period	8.0	8.9	7.0	7.2	5.3	4.8
Wages						
Nominal						
All sectors	9.6	10.6	11.9	9.8	7.8	7.0
Manufacturing	9.1	11.9	10.8	9.9	...	...
Public services	10.1	11.2	13.9	11.6	7.8	6.5
Real						
All sectors	3.3	1.6	3.2	2.1	2.0	2.5
Manufacturing	2.8	2.8	2.2	2.2	...	...
Public services	3.7	2.1	5.1	3.8	2.0	2.0
Employment						
Person basis	1.8	1.3	1.4	0.6	0.4	0.7
Full-time equivalent	1.2	1.1	0.6	0.1 2/	0.2	0.4
Unemployment rate (in percent, ILO definition)	7.6	7.0	6.4	6.3 2/	6.3	6.2
General government finances	(In percent of GDP)					
Revenue	43.6	42.8	43.1	40.8 3/	42.9	42.7
Expenditure	44.2	44.1	44.5	43.7	44.1	43.6
General government balance	-0.6	-1.4	-1.4	-2.9 3/	-1.2	-0.9
State budget balance	-0.5	-0.9	-1.1	-2.8 3/	-1.0	-1.0
General government debt	24.9	25.8	27.5	28.4	26.3	25.8
Money and credit	(Percentage change, end-period)					
Broad money (including foreign exchange deposits)	13.2	15.3	30.4	17.3	...	...
Base money	16.4	4.8	21.4	8.6	...	...
Credit to the private sector	25.0	18.4	18.3	11.1	...	...
Interest rates (in percent)						
BoS discount rate	8.0	8.7	10.8	10.0	...	...
Rate on 60-day BoS bills	7.1	8.2	10.4	8.3	...	...
Lending rates	12.4-14.2	15.8-17.7	15.1-17.1	11.9-14.7	...	...
Deposit rates 4/	7.2-8.9	10.0-12.1	9.8-12.3	7.6-8.6	...	...
Balance of payments	(In millions of U.S. dollars)					
Merchandise exports	8,623	8,808	9,343	10,473	12,149	13,208
Exports volume (percent change)	2.7	12.8	6.6	6.2	6.6	7.0
Merchandise imports	-9,858	-9,947	-9,962	-10,716	-12,364	-13,471
Imports volume (percent change)	8.8	6.1	2.2	4.5	6.2	7.3
Current account balance	-698	-548	31	375	476	441
(in percent of GDP)	-3.5	-3.0	0.2	1.8	1.9	1.7
Gross official reserves	3,168	3,196	4,397	7,064	8,230	8,945
(in months of imports of goods and nonfactor services)	3.3	3.4	4.6	6.8	6.8	6.8
External debt (percent of GDP, end-period)						
Total	26.9	34.3	35.7	41.5	37.9	38.4
Of which: Public and publicly guaranteed	12.2	14.7	14.4	15.3	14.0	14.2
External debt service	840	1,012	1,652	1,820	2,014	2,310
(in percent of exports of goods and nonfactor services)	8.0	9.5	14.6	14.3	13.6	14.4
Exchange rate						
Tolars per U.S. dollar (end-period)	196.8	227.4	250.9	221.1	...	...
Tolars per euro (end-period)	197.3	211.5	221.4	230.3	...	...
Nominal effective exchange rate (1998Q1=100, period average)	96.8	90.6	85.0	81.8	...	...
Real effective exchange rate						
CPI based (1998Q1=100, period average)	103.0	102.1	101.1	102.8	...	...
ULC based (1998Q1=100, period average)	100.7	97.2	98.1	100.1 2/	...	...

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

1/ IMF staff projections for real GDP and components, inflation, employment, balance of payments, and external debt. Figures for general gove finances for 2003-04 refer to the budget approved by Parliament.

2/ Average of the first three quarters of 2002.

3/ Figures reflect a shift in the budget accounting to a pure cash basis entailing 11 months of VAT and excise tax revenues. Adjusted for this, re 42.3 percent of GDP and the general government deficit would be 1.4 percent of GDP.

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

Table 3. Slovenia: Monetary Survey, 1998-2002

	1998	1999	2000	2001	2002
	(In billions of tolars, end-of-period)				
Net Foreign Assets	668.8	667.5	774.2	1,187.3	1,439.0
Assets	884.0	951.0	1,150.1	1,649.7	2,034.0
Bank of Slovenia	594.1	629.8	739.9	1,122.5	1,580.3
Deposit money banks	322.8	355.7	447.2	565.5	493.7
Less claims on National Bank of Yugoslavia	-33.0	-34.5	-37.0	-38.3	-39.9
Liabilities	-215.1	-283.5	-375.9	-462.4	-595.0
Bank of Slovenia	-0.2	-0.1	-0.1	-0.3	0.0
Deposit money banks	-215.0	-283.4	-375.8	-462.1	-595.0
Net Domestic Assets	1,021.5	1,245.5	1,432.2	1,690.0	1,935.3
Claims on government (net)	359.6	371.0	417.2	489.4	530.2
Credit	423.3	444.7	496.7	558.0	701.4
Central government	16.0	16.6	17.8	9.8	9.2
Other general government	407.3	428.1	479.0	548.2	692.2
Deposits	-63.7	-73.7	-79.5	-68.6	-171.2
Claims on enterprises	736.8	848.4	1,022.3	1,261.8	1,405.4
Claims on individuals	302.8	438.9	495.0	535.8	578.5
Claims on nonbanking financial institutions	20.4	37.8	51.6	59.1	79.0
Claims on National Bank of Yugoslavia	33.0	34.5	37.0	38.3	39.9
Securities	-73.2	-63.9	-79.2	-113.6	184.2
Restricted deposits	-8.5	-8.2	-9.7	-11.2	-9.3
Other items (net)	-349.4	-413.1	-502.0	-569.5	-872.6
Broad Money (M3)	1,690.3	1,912.9	2,206.4	2,877.4	3,374.3
Currency	93.7	125.0	119.8	142.1	143.1
Demand deposits	239.1	274.7	304.2	380.0	553.0
Quasi money	1,357.6	1,513.2	1,782.4	2,355.3	2,678.2
Tolar deposits	929.5	1,015.4	1,118.7	1,432.3	1,694.5
Foreign currency deposits	428.1	497.8	663.6	922.9	983.8
Memorandum item:					
Base Money	171.1	199.0	208.6	253.3	275.1
	(Percent change; end-of-period)				
Base money	22.9	16.4	4.8	21.4	8.6
M1 (currency + demand deposits)	23.0	20.2	6.1	23.1	33.3
M2 (M1 + tolar deposits)	26.5	12.1	9.0	26.7	22.3
M3 (M2 + foreign currency deposits)	20.5	13.2	15.3	30.4	17.3
	(Percentage points)				
Contributions to M3 growth					
Net foreign assets	2.3	-0.1	5.6	18.7	8.7
Net domestic assets	18.3	13.3	9.8	11.7	8.5

Source: Bank of Slovenia, *Monthly Bulletin.*

Table 4. Slovenia: Vulnerability Indicators, 1998-2002
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	Latest 2002	Date 1/
Financial indicators						
General government debt	24.0	24.9	25.8	27.5	27.8	*September-02*
Domestic credit	45.6	48.5	51.2	52.9	54.2	
Private sector credit (percent change, end-period)	28.7	25.0	18.4	18.3	11.1	
Broad money (percent change, end-period)	19.8	13.2	15.3	30.4	17.3	
Foreign exchange deposits (percent of broad money)	25.3	26.0	30.1	32.1	29.2	
Banks' nonperforming assets (percent of total assets)	5.4	5.2	5.2	7.0	6.5	*September-02*
Banks' bad assets (percent of total assets)	3.3	3.2	3.1	3.3	3.7	*September-02*
Capital adequacy ratio	16.0	14.0	13.5	11.9	11.9	*September-02*
External indicators						
Exports of goods and NFS 2/ (percent change, in US$)	6.3	-5.4	1.6	5.7	21.6	
Imports of goods and NFS (percent change, in US$)	7.7	-0.1	-0.1	0.2	18.3	
Current account balance	-0.6	-3.5	-3.0	0.2	1.8	
Capital and financial account balance	1.1	2.9	3.8	6.4	6.9	
Of which: Inward portfolio investment	0.6	1.8	1.4	1.0	0.1	
Inward foreign direct investment	1.1	0.5	0.7	2.7	8.8	
Other investment, net	-0.5	0.8	2.3	4.0	-1.1	
Net foreign assets of commercial banks (in billions of US$)	0.7	0.4	0.4	1.5	2.1	
Gross official reserves (in billions of US$)	3.6	3.2	3.2	4.4	7.1	
Net international reserves (in billions of US$)	3.0	2.5	2.4	3.5	4.2	
Short-term foreign assets of commercial banks (in billions of US$)	1.4	1.3	1.4	1.7	1.6	
Short-term foreign liabilities of commercial banks (in billions of US$)	0.4	0.4	0.4	0.5	0.7	
Foreign currency exposure of commercial banks (in billions of US$)	-1.7	-1.3	-1.4	-1.6	-2.3	
Official reserves (in months of imports of goods and NFS)	3.8	3.3	3.4	4.6	6.8	
Base money to gross official reserves (in percent)	29.2	31.9	28.7	23.0	17.6	
Broad money to gross official reserves (in percent)	288	307	304	261	216	
Short-term external debt to gross official reserves (in percent)	3.0	3.7	3.1	2.9	1.7	
Principal payments and short-term external debt to gross official reserves (in percent)	38.0	22.6	25.5	32.3	22.2	
Total external debt	25.1	26.9	34.3	35.7	41.5	
Of which: Public and publicly guaranteed	11.9	12.2	14.7	14.4	15.3	
Total external debt (in percent of exports of goods and NFS)	44.2	51.3	58.1	59.4	68.9	
Total external debt service payments (in percent of exports of goods and NFS)	13.5	8.0	9.5	14.6	14.3	
External interest payment (in percent of exports of goods and NFS)	2.1	2.3	2.8	3.1	2.9	
External amortization payments (in percent of exports of goods and NFS)	11.5	5.7	6.7	11.5	11.4	
Exchange rate (tolar per US$, period average)	166	182	223	243	240	
REER (CPI-based, percent change period-average basis, appreciation +)	3.4	0.7	-0.9	-1.0	1.7	
Financial market indicators (end of period)						
Stock market index	1,706	1,806	1,808	2,152	3,340	
Stock market capitalization (in percent of GDP)	21.8	25.2	28.2	30.2	42.7	
Foreign currency debt rating (S&P, long term)	A	A	A	A	A	*January-03*
Spread of benchmark bond (basis points) 3/	71	71	60	43	35	

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

1/ December, unless otherwise indicated.

2/ NFS denotes nonfactor services.

3/ Yield differential on a seven-year DEM-denominated Slovene government bond, maturing in 2004.

Table 5. Slovenia: Balance of Payments, 1998-2004

(In millions of U.S. dollars, unless noted otherwise)

	1998	1999	2000	2001	Prelim. 2002	Proj. 2003	Proj. 2004
Current Account	-118	-698	-548	31	375	476	441
Trade balance	-792	-1235	-1139	-620	-243	-215	-262
Exports f.o.b.	9,091	8,623	8,808	9,343	10,473	12,149	13,208
Imports f.o.b.	-9,883	-9,858	-9,947	-9,962	-10,716	-12,364	-13,470
Services	501	354	450	502	556	623	651
Exports	2,025	1,875	1,888	1,960	2,292	2,682	2,881
Imports	-1,524	-1,522	-1,438	-1,458	-1,736	-2,060	-2,230
Income, net	56	64	26	19	-71	-59	-64
Current transfers, net	117	120	115	129	134	127	117
Capital account	-2	-1	4	-4	2	1	-1
Financial account	216	576	680	1,204	1,457	622	273
Direct investment, net	221	59	71	371	1,748	729	490
In Slovenia	216	107	136	503	1,865	889	689
Abroad	6	-48	-65	-133	-117	-160	-199
Portfolio investment, net	90	354	188	81	-67	-53	-244
Other investment, net	-95	163	422	752	-224	-55	27
Government	-22	-3	79	-28	-1	-20	-63
Bank of Slovenia	-5	-6	-6	-6	-6	-8	-9
Commercial banks	39	253	37	-73	449	110	186
Nonbank private sector	-106	-80	312	859	-666	-137	-87
Of which: Trade credits	-426	-316	-182	-203	-352	-366	-398
Net errors and omissions	61	42	42	53	33	0	0
Overall balance	158	-81	178	1,285	1,866	1,098	714
Change in official reserves (-, increase)	-158	81	-178	-1,285	-1,866	-1,098	-714
Memorandum items:							
Current account balance (percent of GDP)	-0.6	-3.5	-3.0	0.2	1.8	1.9	1.7
Exports volume (percent change)	9.2	2.7	12.8	6.6	6.2	6.6	7.0
Imports volume (percent change)	10.9	8.8	6.1	2.2	4.5	6.2	7.3
External debt (percent of GDP)	25.1	26.9	34.3	35.7	41.5	37.9	38.4
(in millions of U.S. dollars) 1/	4,915	5,400	6,217	6,717	8,799	9,466	10,166
Debt service (in millions of U.S. dollars)	1,505	840	1,012	1,652	1,820	2,014	2,310
(percent of exports of goods and NFS)	13.5	8.0	9.5	14.6	14.3	13.6	14.4
Official reserves (in millions of U.S. dollars) 1/	3,639	3,168	3,196	4,397	7,064	8,230	8,945
(in months of imports of goods and NFS)	3.8	3.3	3.4	4.6	6.8	6.8	6.8

Sources: Bank of Slovenia; and IMF staff projections.

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

Table 6. Slovenia: Medium-Term Macroeconomic Scenario, 1999–2008

	1999	2000	2001	Est. 2002	Proj. 2003	2004	2005	2006	2007	2008
	(Percent of nominal GDP)									
Foreign saving	3.5	3.0	-0.2	-1.8	-1.9	-1.7	-1.5	-1.1	-0.5	0.0
National saving	24.9	24.8	25.6	26.5	27.0	27.2	27.4	27.4	27.1	26.8
Domestic saving	24.0	24.1	24.8	26.2	26.7	27.0	27.0	26.9	26.7	26.4
Nongovernment	20.0	21.2	21.9	23.6	23.4	23.5	23.6	23.2	22.5	22.0
Government	4.0	2.8	3.0	2.7	3.3	3.5	3.5	3.8	4.2	4.3
Gross capital formation	28.4	27.8	25.4	24.7	25.1	25.5	25.9	26.3	26.6	26.8
Nongovernment	23.8	23.6	21.1	20.7	20.6	21.1	21.8	22.1	22.4	22.5
Government	4.6	4.2	4.4	4.0	4.5	4.4	4.2	4.2	4.2	4.3
Gross fixed capital formation	27.4	26.7	24.9	24.0	24.6	25.1	25.5	25.8	26.1	26.4
Change in stocks	1.0	1.1	0.5	0.7	0.5	0.5	0.5	0.5	0.5	0.5
General government balance	-0.6	-1.4	-1.4	-1.4	-1.2	-0.9	-0.7	-0.4	0.0	0.0
	(Percentage change in real terms)									
Gross domestic product	5.2	4.6	3.0	2.9	3.2	3.8	4.3	4.4	4.3	4.1
Domestic demand	9.1	1.1	0.5	2.2	3.1	4.0	4.9	5.1	5.0	4.8
Private consumption	6.0	0.8	1.7	1.8	2.3	3.7	4.4	5.0	5.1	5.0
Public consumption	4.6	3.1	3.2	1.0	1.5	2.1	3.5	3.7	3.9	3.7
Gross capital formation	18.9	0.5	-3.7	3.7	5.8	6.0	6.6	6.2	5.7	5.2
Exports of goods and services	1.7	12.7	6.2	6.2	6.3	6.8	7.1	6.8	6.2	5.9
Imports of goods and services	8.2	6.1	2.1	5.1	6.1	7.2	7.9	7.8	7.2	6.8
	(Contribution to growth; percentage points)									
Domestic demand	9.4	1.2	0.5	2.2	3.1	4.1	4.9	5.2	5.1	5.0
Of which: Private consumption	3.4	0.4	0.9	1.0	1.2	2.0	2.4	2.6	2.7	2.7
Gross capital formation	5.1	0.1	-1.1	1.0	1.6	1.7	1.9	1.8	1.7	1.6
Net foreign demand	-4.2	3.4	2.5	0.7	0.1	-0.3	-0.6	-0.8	-0.9	-0.9
Memorandum items:										
General government debt (percent of GDP)	24.9	25.8	27.5	28.4	26.3	25.8	24.8	23.8	22.3	21.0
External debt (percent of GDP)	26.9	34.3	35.7	41.5	37.9	38.4	37.0	35.4	34.0	33.1
Ratio of official reserves to external debt (in percent)	58.7	51.4	65.5	80.3	86.9	88.0	91.6	96.3	101.1	102.9

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

Table 7. Slovenia: Summary of General Government Operations, 1999-2004

	1999	2000	2001	2002		2003	2004
				Supp. Budget	Actual (Prelim.)	Budget	
				(In billions of tolars)			
Total revenues	**1,590**	**1,727**	**1,968**	**2,102**	**2,078**	**2,375**	**2,562**
Tax revenues	1,499	1,600	1,798	1,922	1,904	2,179	2,364
Personal income tax	232	260	289	327	320	358	382
Corporate income tax	42	52	69	75	75	86	98
Social security contributions	496	553	621	688	682	745	811
Taxes on payroll and workforce	55	68	83	97	94	108	122
Domestic taxes on goods and services	601	603	673	669	666	814	878
VAT	207	399	439	425	423	533	582
Excise taxes	70	134	166	169	171	194	203
Other	325	70	68	76	72	86	93
Other taxes	72	65	63	66	68	68	73
Nontax revenues	80	95	139	141	135	156	155
Capital revenues and grants	11	17	21	39	38	42	43
Total expenditures	**1,613**	**1,781**	**2,031**	**2,254**	**2,226**	**2,440**	**2,616**
Wages and personnel expenditures	351	388	456	512	515	560	596
State budget	117	132	155	178	174	192	205
Other	234	256	301	334	341	367	391
Expenditure on goods and services	296	336	386	423	416	443	477
Interest payments	51	61	73	83	85	88	86
Transfers to individuals and households	207	240	280	311	309	344	367
Pensions	441	491	541	600	601	635	685
Subsidies	63	59	63	68	60	77	82
Other current transfers	37	36	33	40	35	46	58
Total capital expenditures	168	171	199	217	206	248	265
General government balance	**-23**	**-55**	**-63**	**-152**	**-149**	**-65**	**-54**
				(In percent of GDP)			
Total revenues	**43.6**	**42.8**	**43.1**	**41.2** 1/	**40.8** 1/	**42.9**	**42.7**
Tax revenues	41.1	39.6	39.4	37.7	37.4	39.4	39.4
Of which: Personal income tax	6.3	6.4	6.3	6.4	6.3	6.5	6.4
Social security contributions	13.6	13.7	13.6	13.5	13.4	13.5	13.5
Domestic taxes on goods and services	16.5	14.9	14.7	13.1	13.1	14.7	14.6
Total expenditures	**44.2**	**44.1**	**44.5**	**44.2**	**43.7**	**44.1**	**43.6**
Current expenditures	39.6	39.9	40.1	40.0	39.6	39.6	39.2
Wages and personnel expenditures	9.6	9.6	10.0	10.1	10.1	10.1	9.9
Expenditure on goods and services	8.1	8.3	8.4	8.3	8.2	8.0	8.0
Transfers to individuals and households	5.7	6.0	6.1	6.1	6.1	6.2	6.1
Pensions	12.1	12.2	11.9	11.8	11.8	11.5	11.4
Total capital expenditures	4.6	4.2	4.4	4.3	4.0	4.5	4.4
General government balance	-0.6	-1.4	-1.4	-3.0 1/	-2.9 1/	-1.2	-0.9
Memorandum items:							
Structural budget balance	-1.0	-2.0	-1.6	-1.2	-1.1	-0.6	-0.2
Structural primary balance	0.2	-0.7	-0.2	0.3	0.4	0.8	0.9
Central government debt	24.5	25.1	26.9	28.1	28.1	25.9	25.3
Domestic	13.7	12.5	13.9	15.5	16.1	...	...
Foreign	10.8	12.6	13.0	12.6	11.9	...	...
General government debt	24.9	25.8	27.5	28.7	28.4	26.3	25.8
Nominal GDP (in billions of tolars) 2/	3,648	4,035	4,566	5,097	5,097	5,535	5,994

Sources: Ministry of Finance; and IMF staff calculations.

1/ Due to a shift in the budget accounting to a pure cash basis, there were only 11 months of VAT and excise tax revenues. Adjusted for this shift, the revenue ratio would be 42.3 percent of GDP and the general government deficit would be 1.4 percent of GDP.

2/ IMF staff projections.

SLOVENIA: FUND RELATIONS
(As of February 28, 2003)

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

II. **General Resources Account**	**SDR Million**	**% Quota**
Quota	231.70	100.00
Fund holdings of currency	143.62	61.99
Reserve position in Fund	88.09	38.02
Financial Transaction Plan Transfer (net)	4.00	1.73

III. **SDR Department**		
Net cumulative allocation	25.43	100.00
Holdings	5.42	21.29
Designation plan	0.00	0.00

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). The external value of the tolar is determined in the interbank exchange market, in which the Bank of Slovenia (BoS) participates. On March 1, 2003, the middle rate for spot transactions in the interbank market was SIT 209.68 = US$1.

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

VIII. **Last Article IV Consultation**

The last Article IV consultation was concluded on March 20, 2002 (SM/02/77, 3/6/02). 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/02/37.

IX. FSAP Participation and ROSCs

An FSAP mission took place during November 6–20, 2000, and follow-up meetings were held with the authorities on February 8–9, 2001 in the context of the 2001 Article IV consultation mission. An FSSA report (SM/01/129) was prepared on April 24, 2001 and published on September 18, 2001 (Country Report No. 01/161). The report includes assessments of the following standards: banking supervision, securities regulation, insurance regulation, and payments systems.

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

X. Technical Assistance

Date	Dept.	Subject/Identified Need
December 1991	STA	Balance of Payments
October 1992	FAD	Tax Reform Strategy
April–May 1993	FAD	Tax Administration
July 1993	FAD	Tax Policy
September 1993	STA	Money and Banking
July 1994	STA	Money and Banking
February 1995	LEG	Foreign Exchange Law
January–February 1995	FAD	Public Expenditure Management
March 1995	STA	Balance of Payments
April 1995	MAE	De-indexation of Financial Assets
May 1995	MAE	Seminar on Monetary Policy
June 1995	LEG	Income Tax Law
September–October 1995	FAD	Social Insurance System
November–December 1995	STA	National Accounts
December 1996	FAD	Tax Policy
December 1996	FAD	Public Expenditure Management
February–March 1997	FAD	Treasury Single Account and Ledger Accounting System
May 1997	STA	National Accounts
September 1997	STA	Money and Banking
November 1997	STA	Government Finance
January 1998	FAD	GFS-Based Budget and Accounting Classification
April 1998	FAD	GFS-Based Budget and Accounting Classification
July 1998	FAD	Public Expenditure Management and Treasury Single Account
September 1998	FAD	Public Expenditure Management
November 1998	FAD	Public Expenditure Management

December 1998	STA	Flow-of-Fund and Financial Programming
March 1999–Nov. 2002	FAD	Public Expenditure Management
March 1999	FAD	Fiscal Management
April 1999	FAD	Tax Administration/VAT
October 1999	STA	Government Finance Statistics
November 2000	MAE	FSAP
August 2001	FAD	VAT
November 2001	FAD	Direct Tax Reform
February 2003	FAD	Public Expenditure Management

SLOVENIA: REVIEW OF STATISTICAL ISSUES

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

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

The SORS is currently revising the national accounts following recommendations of Eurostat to bring them further into compliance with ESA95. The revision also involves rebasing GDP in constant prices to 2000. The SORS plans to start publishing the revised quarterly GDP data from the first quarter of 2003.

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

As of February 2002, owing to changes in the classification of enterprises primarily employing handicapped persons, wage and employment statistics disaggregated by activity are not comparable with previous data, particularly with regard to the health and manufacturing sectors.

Government Finance Statistics: Slovenian fiscal statistics are timely and of a high quality. The ministry of finance publishes a comprehensive monthly *Bulletin of Government Finance*, which presents monthly data on the operations of the "state budget" (Budgetary Central Government), local governments, social security (Pension and Health funds), and the consolidated general government. The coverage of general government excludes the operations of extrabudgetary funds and own revenues of general government agencies *(zavods)*. However, these operations are small in size. Monthly fiscal indicators are reported for publication in *IFS* on a timely basis. The latest data published in the *GFS Yearbook* cover 2001.

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

Balance of Payments Statistics: Balance of payments data are comprehensive and of high quality. The data have been published in the *Balance of Payments Statistics Yearbook* since 1993 (with estimates of the international investment position published since 1994). In 2002, the Bank of Slovenia revised the balance of payments statistics going back to 1994; the most significant revisions were related to the income component of the current account and to the other investment component of the financial account.

Slovenia: Survey of Reporting of Main Statistical Indicators
(as of March 11, 2003)

	Exchange rates	International reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ imports	Current account balance	Central government balance	GDP/GNP	External debt
Date of latest observation	3/11/03	1/31/03	1/31/03	1/31/03	1/31/03	2/03	2/03	1/02	12/02	1/03	Q3/02	12/31/02
Date received	3/11/03	2/28/03	2/14/03	2/14/03	2/28/03	2/26/03	2/28/03	2/11/03	2/14/03	2/28/03	12/02	2/03
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of reporting/ Publication	Daily/ Daily	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Monthly/ Monthly	Quarterly/ Quarterly	Monthly/ Monthly
Source of data	BoS	BoS	BoS	BoS	BoS	BoS	BoS/ SORS/ Reuters	BoS/ SORS/ Reuters	BoS/ Reuters	MoF	SORS	BoS
Mode of reporting	On-line	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail	On-line/ E-Mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public

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

SLOVENIA: SUSTAINABILITY ANALYSIS

1. This appendix presents the baseline medium-term projections for general government and external debt as well as the results of sensitivity tests based on shocks (expressed as temporary deviations from historical means) applied to the baseline scenario in 2003–04.

A. Fiscal Sustainability

2. **At 28½ percent of GDP in 2002, Slovenia's general government debt is low among transition economies and well below the Maastricht ceiling.** Despite a strong fiscal position in the 1990s, general government debt rose from 18¾ percent of GDP in 1994 to 28½ percent of GDP in 2002 (Figure 8). This increase was mainly owing to two factors: (i) the assumption of large amounts of debt from bank and enterprise restructuring as well as the inheritance of liabilities from the former Yugoslavia; and (ii) extensive debt indexation, which implied capitalization of the indexed component of debt. Reflecting debt indexation, effective interest payments were negative in real terms through the 1990s.

3. **The authorities' baseline scenario projects a decline in the general government debt ratio of about 7½ percentage points to 21 percent of GDP in 2008.** This is predicated on the following assumptions: (i) eliminating the general government deficit by 2007; (ii) using a part of the privatization proceeds (1½ percent of GDP) to prepay debt; (iii) a steady decline in the share of indexed debt; (iv) not taking over any additional debt from third parties; and (v) lower inflation and exchange rate depreciation.

4. **The baseline scenario is subject to risks.** To adhere to the planned fiscal consolidation path, the government will need to address revenue shortfalls that are likely to arise in 2003–04, the EU accession-related fiscal pressures, and the implications of any breach in the budgeted wage bill for 2004 (see ¶27 of the main text). Staff calculations show that, if the first two pressures were fully accommodated through higher fiscal deficits, general government debt would remain at around 28 percent of GDP over the medium term (alternative scenario in Figure 8). Results of other sensitivity tests are noted below.

5. **The outlook for general government debt appears to be resilient to various macroeconomic shocks** (Figure 9; and Tables 8 and 9). The general government debt ratio increases most seriously under an exchange rate shock and "assumption of debt" scenarios. However, in both cases the debt ratio would resume its decline once the impact of the shock fades. Thus, a one-time 30 percent real depreciation in 2003 (scenario 6) would increase the debt ratio by about 9 percentage points to 37½ percent of GDP in 2003, but the ratio would gradually decline to under 31 percent of GDP in 2008. The pattern and magnitudes are similar when other debt-creating flows (i.e., assumption of debt) rise by 10 percent of GDP in 2003 (scenario 7). While a scenario that presumes bank or other bailouts is rather unlikely given that these tasks have been completed, its implications are nonetheless manageable. Because of the negative effective real interest rates and the strong fiscal position in the 1990s, scenarios involving shocks to real interest rates and other macroeconomic variables do not show any lasting negative impact. When the historical means of real GDP growth, real

interest rate, and primary balance are used over the projection period (scenario 1), the debt-to-GDP ratio falls by close to 9 percentage points to around 19¾ percent by 2008, 1¼ percentage points lower than in the baseline. In the face of it, it would appear that the staff's baseline scenario represents a deterioration from historical norms. However, this stress test result should be interpreted with caution because it projects into the future the peculiarities of past characteristics—especially negative real interest rates—that are no longer present. In the case of other macroeconomic shocks (scenarios 2, 3, 4, 5, and 8), the debt ratio declines to between 21–25 percent of GDP by 2008.

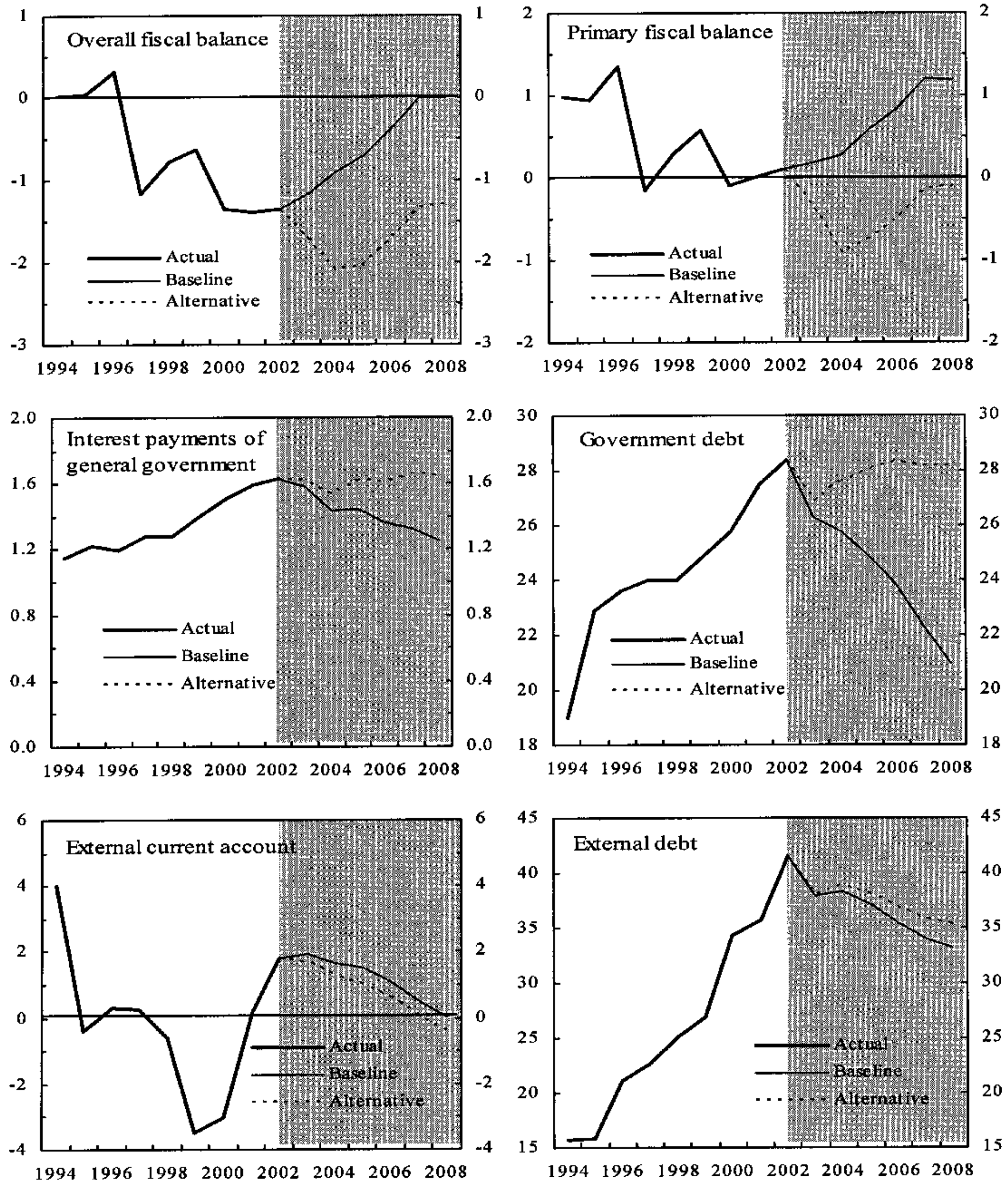
B. External Sustainability

6. **Under the baseline scenario, the external debt ratio is envisaged to fall from 41½ percent of GDP in 2002 to 33 percent of GDP in 2008** (Tables 10 and 11).[10] The decline derives mainly from four factors: (i) modest—albeit gradually tapering off—current account surpluses over the medium term; (ii) the increasing reliance on domestic rather than foreign borrowing by the general government; (iii) a projected modest rise in nondebt creating inflows; and (iv) reduced scope for domestic currency depreciation owing to the planned entry in ERM2 in late 2004 and adoption of the euro in 2007.

7. **The stress tests point to modest risks to the baseline external projections, but sustainability does not appear to be a serious concern.** Slovenia appears to withstand well shocks to nominal interest rates and real GDP growth, and—to a lesser extent—shocks to the noninterest current account and nominal depreciation (scenario 2, 3, 5, and 7, respectively). However, resilience to certain isolated shocks (namely the U.S. dollar GDP deflator—scenario 4) or to a combined shock to various macroeconomic and external variables (scenario 6) appears to be weaker. The debt-to-GDP ratio rises sharply to 67½ percent and 65½ percent, respectively, in the short run before falling to more moderate levels by 2008 (60 percent and 58 percent, respectively). However, this result should be discounted because it derives from projecting into the future the high historical depreciation rates of the tolar vis-à-vis the U.S. dollar. If the historical means of real GDP growth, nominal interest rate, U.S. dollar deflator, noninterest current account, and nondebt inflows were to prevail, the external debt-to-GDP ratio would rise by over 18 percentage points over the medium term to 60 percent of GDP (scenario 1). This deviation from the baseline is explained by the fact that the baseline assumes a better current account and a larger role for nondebt creating flows than the historical averages.

[10] Much of the changes in the external debt-to-GDP ratio in 2002–03 reflect movements of the actual and projected exchange rate of the euro vis-à-vis the U.S. dollar (about 90 percent of the external liabilities of Slovenia are denominated in euros).

Figure 8. Slovenia: General Government and External Indicators, 1994-2008 1/
(In percent of GDP)

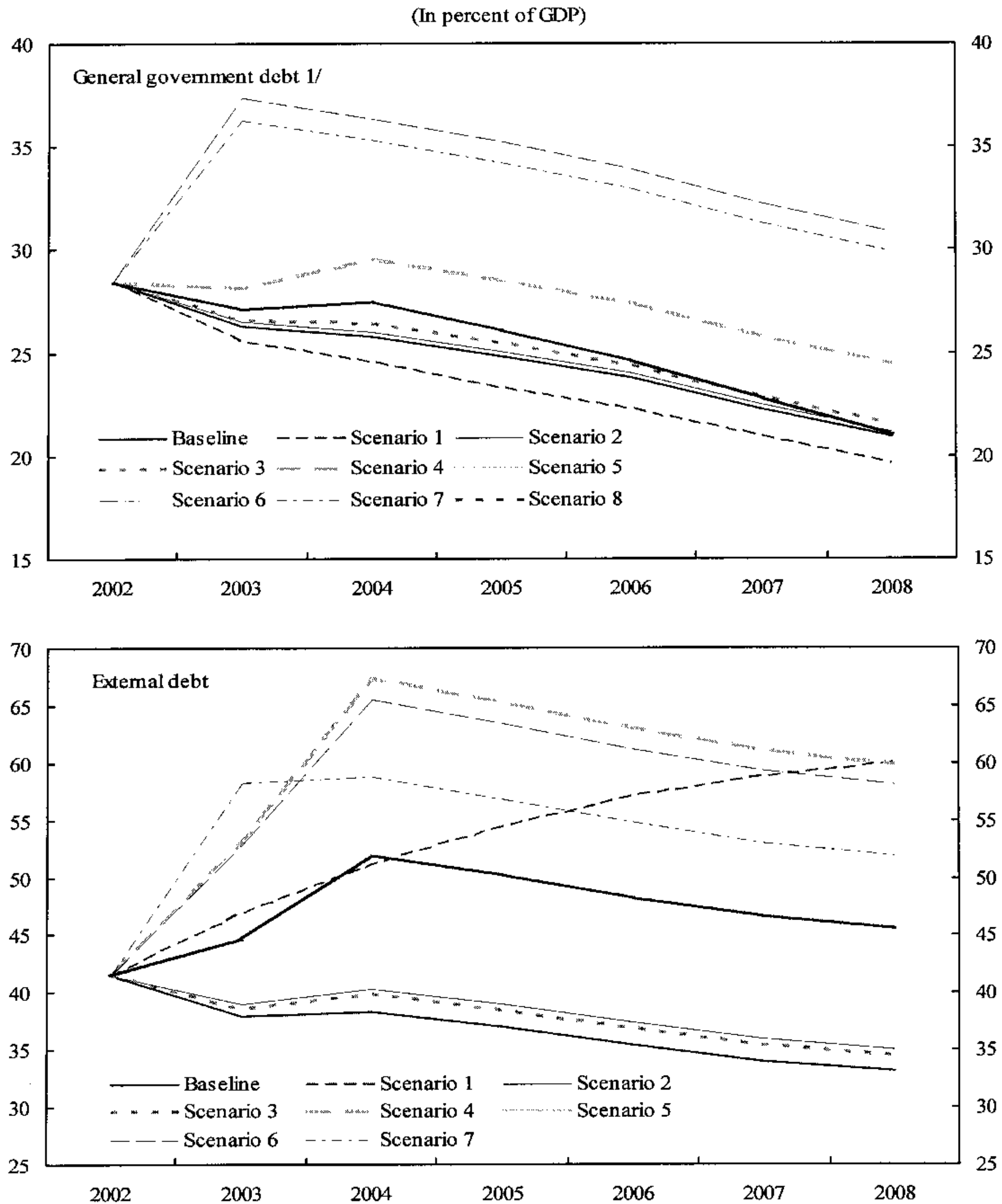


Sources: Data provided by the Slovene authorities; and IMF staff calculations and projections.

1/ The general government comprises the state government, local governments, and the pension and health funds. Debt figures are in gross terms.

Figure 9. Slovenia: Debt Sustainability Analysis—Baseline and Stress Testing Scenarios, 2002-08

(In percent of GDP)



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

1/ The general government comprises the state government, local governments, and the pension and health funds.

Table 8. Slovenia: General Government Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

		Actual					Projections					
		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	I. Baseline Medium-Term Projections											
1	General government debt 1/	24.0	24.9	25.8	27.5	28.4	26.3	25.8	24.8	23.8	22.3	21.0
	Of which: foreign-currency denominated	12.5	12.2	13.8	15.8	16.4	13.6	14.6	11.6	9.9	8.4	8.5
2	Change in General government debt	0.4	0.9	0.9	1.7	0.9	-2.1	-0.5	-0.9	-1.0	-1.5	-1.3
3	Identified debt-creating flows (4+7+12)	-1.8	2.2	3.0	1.3	-0.9	-1.1	-1.0	-0.9	-1.1	-1.5	-1.3
4	Primary deficit	-0.5	-0.8	-0.2	-0.2	1.3	-0.4	-0.5	-0.7	-1.0	-1.3	-1.2
5	Revenue and grants	43.0	43.6	42.8	43.1	40.8	42.9	42.7	42.6	42.9	43.3	43.3
6	Primary (non-interest) expenditure	42.5	42.8	42.6	42.9	42.1	42.5	42.2	41.9	41.9	42.0	42.1
7	Automatic debt dynamics 2/	-1.8	1.2	1.1	0.0	-3.0	0.3	-1.1	-0.6	-0.6	-0.4	-0.2
8	Contribution from interest rate/growth differential 3/	-1.2	-1.2	-0.9	-1.4	-1.2	-0.7	-0.6	-0.6	-0.5	-0.4	-0.2
9	*Of which*: contribution from real interest rate	-0.4	-0.1	0.2	-0.7	-0.5	0.2	0.3	0.4	0.5	0.6	0.7
10	*Of which*: contribution from real GDP growth	-0.8	-1.1	-1.0	-0.7	-0.7	-0.8	-0.9	-1.0	-1.0	-0.9	-0.8
11	Contribution from exchange rate depreciation 4/	-0.5	2.4	2.0	1.4	-1.8	1.0	-0.5	0.0	0.0	0.0	0.0
12	Other identified debt-creating flows	0.4	1.7	2.0	1.5	0.8	-1.1	0.6	0.4	0.4	0.2	0.1
13	Privatization receipts (negative)	-0.4	-0.3	-0.1	-0.1	0.0	-1.7	0.0	0.0	0.0	0.0	0.0
14	Recognition of implicit or contingent liabilities	0.1	0.2	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
15	Other (specify, e.g., bank recapitalization)	0.7	1.8	2.0	1.4	0.8	0.6	0.6	0.4	0.4	0.2	0.1
16	Residual, including asset changes (2-3)	2.2	-1.3	-2.0	0.4	1.8	-1.0	0.5	0.0	0.0	0.0	0.0
	General government debt-to-revenue ratio 1/	55.8	57.1	60.3	63.9	69.7	61.2	60.3	58.3	55.4	51.4	48.4
	Gross financing need 5/	6.4	6.0	8.0	8.7	9.2	8.3	8.2	7.3	6.7	6.0	5.6
	in billions of U.S. dollars	1.3	1.2	1.4	1.6	2.0	2.0	2.1	2.1	2.1	2.0	2.0
	Key Macroeconomic and Fiscal Assumptions											
	Real GDP growth (in percent)	3.8	5.2	4.6	3.0	2.9	3.2	3.8	4.3	4.4	4.3	4.1
	Average nominal interest rate on public debt (in percent) 6/	6.1	6.5	6.7	7.0	6.6	6.1	5.9	6.1	5.9	6.0	6.0
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.7	-0.1	1.0	-2.9	-1.9	0.8	1.6	2.0	2.2	2.8	3.2
	Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	5.0	-18.1	-13.5	-9.4	13.5	-6.6	3.8	-0.3	0.3	0.0	0.0
	Inflation rate (GDP deflator, in percent)	7.8	6.6	5.7	9.9	8.5	5.3	4.3	4.1	3.7	3.2	2.7
	Growth of real primary spending (deflated by GDP deflator, in percent)	4.9	6.1	4.1	3.6	0.9	4.3	3.1	3.5	4.6	4.4	4.3
	II. Stress Tests for General Government Debt Ratio											
	1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-08					28.4	25.5	24.5	23.3	22.2	20.9	19.7
	2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					28.4	26.5	26.0	25.0	24.0	22.5	21.2
	3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					28.4	26.6	26.4	25.5	24.4	22.9	21.5
	4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					28.4	28.1	29.5	28.5	27.4	25.8	24.5
	5. Combination of 2-4 using one standard deviation shocks					28.4	27.1	27.4	26.1	24.6	22.7	21.0
	6. One time 30 percent real depreciation in 2003 7/					28.4	37.3	36.4	35.2	33.9	32.3	30.9
	7. 10 percent of GDP increase in other debt-creating flows in 2003					28.4	36.3	35.3	34.2	32.9	31.3	29.9
	8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					28.4	28.4	29.8	28.8	27.7	26.1	24.8

Historical Statistics for Key Variables (past 7 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	-0.3	0.9	-0.9
Real GDP growth (in percent)	3.9	0.9	4.0
Nominal interest rate (in percent) 6/	6.6	0.5	6.0
Real interest rate (in percent)	-1.8	1.7	2.1
Inflation rate (GDP deflator, in percent)	8.4	1.8	3.9
Revenue to GDP ratio	42.6	0.9	43.0

1/ The general government comprises the state government, local governments, and pension and health funds. Debt figures are in gross terms.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α= share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.

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

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Slovenia: General Government Debt Sustainability Framework--Gross General Government Financing Need, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Projections											
Gross financing need 1/	6.4	6.0	8.0	8.7	9.2	8.3	8.2	7.3	6.7	6.0	5.6
in billions of U.S. dollars	1.3	1.2	1.4	1.6	2.0	2.0	2.1	2.1	2.1	2.0	2.0
II. Stress Tests											
Gross financing need 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07					9.2	7.7	7.4	6.5	6.1	5.7	5.2
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					9.2	8.6	8.3	7.3	6.8	6.1	5.7
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					9.2	8.4	8.5	7.4	6.9	6.2	5.8
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					9.2	10.4	11.1	8.4	7.8	7.1	6.7
5. Combination of 2-4 using one standard deviation shocks					9.2	9.2	9.4	7.4	6.7	5.9	5.4
6. One time 30 percent real depreciation in 2003 3/					9.2	9.7	11.9	10.6	9.9	9.2	8.8
7. 10 percent of GDP increase in other debt-creating flows in 2003					9.2	9.5	11.5	10.2	9.6	8.9	8.5
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					9.2	10.8	11.3	8.5	7.9	7.2	6.8
Gross financing need in billions of U.S. dollars 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-08					2.1	1.8	2.0	1.9	1.9	1.9	1.8
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					2.1	2.0	2.2	2.1	2.1	2.0	2.0
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					2.1	1.9	2.2	2.1	2.1	2.0	2.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					2.1	2.4	2.9	2.4	2.4	2.4	2.4
5. Combination of 2-4 using one standard deviation shocks					2.1	2.1	2.4	2.1	2.0	1.9	1.9
6. One time 30 percent real depreciation in 2003 3/					2.1	1.6	2.2	2.1	2.1	2.1	2.2
7. 10 percent of GDP increase in other debt-creating flows in 2003					2.1	2.2	3.0	2.9	3.0	3.0	3.0
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					2.1	2.5	3.0	2.4	2.5	2.4	2.4

1/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 10. Slovenia: External Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						I. Baseline Medium-Term Projections					
1 **External debt**	25.1	26.9	34.3	35.7	41.5	**37.9**	**38.4**	**37.0**	**35.4**	**34.0**	**33.1**
2 Change in external debt	2.2	1.8	7.4	1.4	5.8	-3.6	0.5	-1.3	-1.6	-1.4	-0.9
3 Identified external debt-creating flows (4+8+11)	-2.2	2.6	5.5	-3.2	-13.9	-12.0	-6.6	-7.5	-7.0	-6.0	-5.0
4 Current account deficit, excluding interest payments	-0.6	2.2	1.4	-2.1	-3.5	-3.9	-3.8	-3.5	-3.0	-2.4	-1.9
5 Deficit in balance of goods and services	1.5	4.4	3.8	0.6	-1.5	-1.6	-1.5	-1.1	-0.6	-0.1	0.4
6 Exports	56.8	52.3	59.0	60.1	60.2	59.4	60.7	61.3	61.9	62.5	63.2
7 Imports	58.2	56.7	62.8	60.7	58.7	57.7	59.2	60.2	61.3	62.4	63.7
8 Net nondebt creating capital inflows (negative)	-1.2	-0.3	-0.4	-1.8	-8.1	-3.8	-2.8	-2.9	-3.1	-2.9	-2.7
9 Net foreign direct investment, equity	1.1	0.3	0.4	2.0	8.2	2.9	1.8	2.0	2.1	2.0	1.9
10 Net portfolio investment, equity	0.0	0.0	0.1	-0.1	-0.1	0.9	0.9	0.9	1.0	0.9	0.8
11 Automatic debt dynamics 1/	-0.4	0.6	4.6	0.7	-2.3	-4.3	-0.1	-1.0	-0.9	-0.7	-0.4
12 Contribution from nominal interest rate	1.2	1.2	1.7	1.9	1.7	2.0	2.1	2.0	2.0	1.9	1.8
13 Contribution from real GDP growth	-0.8	-1.3	-1.4	-1.0	-0.9	-1.1	-1.4	-1.5	-1.5	-1.4	-1.3
14 Contribution from price and exchange rate changes 2/	-0.8	0.7	4.3	-0.3	-3.1	-5.1	-0.8	-1.5	-1.4	-1.2	-0.9
14 Residual, incl. change in gross foreign assets (2-3)	4.3	-0.8	1.9	4.7	19.7	8.4	7.1	6.2	5.4	4.6	4.1
External debt-to-exports ratio (in percent)	44.2	51.4	58.1	59.4	68.9	63.8	63.2	60.4	57.2	54.4	52.4
Gross external financing need (in billions of U.S. dollars) 3/	0.9	2.1	1.3	0.8	1.0	1.2	1.4	1.6	1.7	2.0	2.2
in percent of GDP	4.8	10.4	7.0	4.2	4.9	4.6	5.4	5.6	5.5	6.0	6.2
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	3.8	5.2	4.6	3.0	2.9	3.2	3.8	4.3	4.4	4.3	4.1
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-3.9	-8.6	-18.4	-8.3	1.0	8.4	-2.0	0.1	0.2	0.2	0.1
GDP deflator in U.S. dollars (change in percent)	3.6	-2.6	-13.7	0.8	9.6	14.1	2.2	4.2	3.9	3.4	2.8
Nominal external interest rate (in percent)	5.7	5.0	5.6	5.8	5.5	5.6	5.9	5.8	5.7	5.7	5.7
Growth of exports (U.S. dollar terms, in percent)	6.4	-5.6	1.9	5.7	12.9	16.2	8.5	9.8	9.5	8.9	8.2
Growth of imports (U.S. dollar terms, in percent)	7.8	-0.2	0.0	0.3	9.0	15.8	8.8	10.5	10.3	9.8	9.1
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-08					41.5	**46.9**	**51.2**	**54.4**	**57.0**	**58.7**	**60.0**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					41.5	**38.9**	**40.4**	**39.0**	**37.3**	**35.9**	**35.0**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					41.5	**38.5**	**39.9**	**38.5**	**36.9**	**35.4**	**34.5**
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004					41.5	**53.1**	**67.4**	**65.3**	**63.0**	**61.1**	**59.9**
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					41.5	**44.7**	**51.9**	**50.2**	**48.3**	**46.6**	**45.6**
6. Combination of 2-5 using one standard deviation shocks					41.5	**52.8**	**65.5**	**63.5**	**61.2**	**59.3**	**58.1**
7. One time 30 percent nominal depreciation in 2003					41.5	**58.3**	**58.7**	**56.8**	**54.8**	**53.0**	**51.9**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	-1.4	2.1	-3.1
Net nondebt creating capital inflows	1.7	2.3	3.0
Nominal external interest rate (in percent)	6.3	1.1	5.7
Real GDP growth (in percent)	4.0	1.3	4.0
GDP deflator in U.S. dollars (change in percent)	1.8	10.4	5.1

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 11. Slovenia: External Sustainability Framework—Gross External Financing Need, 1998-2008

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						I. Baseline Projections					
Gross external financing need in billions of U.S. dollars 1/	0.9	2.1	1.3	0.8	1.0	1.2	1.4	1.6	1.7	2.0	2.2
in percent of GDP	4.8	10.4	7.0	4.2	4.9	4.6	5.4	5.6	5.5	6.0	6.2
						II. Stress Tests					
Gross external financing need in billions of U.S. dollars 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-08					1.0	2.1	2.6	3.0	3.3	3.7	4.0
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					1.0	1.5	1.8	1.8	1.9	2.2	2.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					1.0	1.2	1.5	1.7	1.8	2.0	2.3
4. Change in U.S. dollar GDP deflator is at historical average minU.S. two standard deviations in 2003 and 2004					1.0	1.4	1.8	2.0	2.1	2.4	2.6
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					1.0	3.1	3.9	2.5	2.7	3.0	3.3
6. Combination of 2-5 using one standard deviation shocks					1.0	2.6	3.2	2.5	2.6	2.9	3.1
7. One time 30 percent nominal depreciation in 2003					1.0	1.5	1.8	2.0	2.1	2.3	2.5
Gross external financing need in percent of GDP 2/											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-08					4.9	9.2	10.8	12.1	12.5	13.2	13.4
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					4.9	5.9	6.7	6.1	6.0	6.4	6.7
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					4.9	4.8	5.7	6.0	5.9	6.3	6.6
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004					4.9	8.1	12.3	12.6	12.1	12.6	12.7
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					4.9	12.5	14.9	8.9	8.6	9.0	9.2
6. Combination of 2-5 using one standard deviation shocks					4.9	13.1	16.9	12.1	11.7	12.1	12.3
7. One time 30 percent nominal depreciation in 2003					4.9	9.2	10.2	10.5	10.2	10.6	10.8

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

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

INTERNATIONAL MONETARY FUND

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IMF Concludes 2003 Article IV Consultation with the Republic of Slovenia

On April 16, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Slovenia.[1]

Background

Slovenia's road to European Union (EU) accession, scheduled for May 2004, has been marked by sustained real convergence in per capita income to around 70 percent of the EU average, but progress in nominal convergence has stalled, with inflation remaining stuck at about 8 percent since 1997. Against a backdrop of prudent macroeconomic policies and a gradualist approach to structural reform, Slovenia experienced strong growth in the 1990s. A high domestic saving ratio and a sound fiscal position helped keep external imbalances at bay. Slovenia attracted little foreign direct investment until 2000. However, this did not impede the manufacturing sector from restructuring, raising productivity, and maintaining its export orientation. The pace of structural reform accelerated toward the end of the 1990s. Since then, capital account transactions have been fully liberalized and significant strides have been made in fiscal and financial sector reforms, though important challenges remain.

Economic growth slowed during 2001–02 to around 3 percent, owing to a weak external environment and subdued domestic demand. Export growth slowed as demand from the EU weakened, but the impact was cushioned by a rapid expansion of exports to southeastern Europe and Russia. With imports growing more slowly than exports and the terms of trade

[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.

improving, the external current account swung into surplus in 2001 and strengthened further in 2002, reflecting a satisfactory competitive position.

Progress with disinflation continued to be slower than envisaged, in part owing to unanticipated large increases in indirect taxes, oil prices, and non-oil administered prices. Wage pressures lessened in 2002, and real wage increases receded below productivity growth.

Monetary conditions varied during 2001–02. The real interest rate on 60-day tolar bills exhibited sharp swings, including turning negative for a brief period in the later part of 2001. The exchange rate of the tolar vis-à-vis the euro depreciated continuously at varying rates, around a decelerating trend path. Foreign direct investment increased sharply to the equivalent of about 9 percent of GDP in 2002. The privatization receipts of the government were deposited in the Bank of Slovenia (BoS), and the rest of the inflows were largely sterilized through open market operations. Thus, base money growth in 2002 was limited to 8.6 percent. Domestic credit growth to the private sector and corporate borrowing abroad slowed significantly, reflecting weak demand.

The general government deficit has remained slightly below 1.5 percent of GDP since 2000.[2] In contrast to 2001 when there were expenditure overruns, the budget came under pressure in 2002 because of revenue shortfalls arising from weaker-than-expected domestic demand. The government responded through a combination of expenditure cuts and upward revision of the fiscal deficit target.

Some key structural measures were implemented in 2002, but a backlog developed on the privatization front. As of July, financial contracts with maturity of less than one year ceased to be indexed to inflation. Thirty-nine percent of the shares of Nova Ljubljanska Banka (NLB), Slovenia's largest bank, were sold to foreign investors. However, the privatization of Nova Kreditna Banka Maribor and Telecom was postponed.

Growth is expected to pick up only slightly in 2003, in the face of uncertainties about the strength of the EU's expected recovery and the drag from higher international oil prices. For 2004, real GDP growth is projected to climb to 3.8 percent on the basis of a continued recovery in Europe and a strong pickup in private consumption. The current account would likely remain in surplus of about 1.8–2 percent of GDP in 2003–04. The two-year rolling budget is subject to risks and the deficit targets (1.2 percent of GDP in 2003 and 0.9 percent in 2004) are unlikely to be achieved under present policies. The BoS has announced inflation forecasts of 5.3 percent for end-2003 and 3.5 percent for end-2004; staff projection for end-2004 suggests an outcome of around 4.8 percent unless policies are tightened further.

Executive Board Assessment

Executive Directors commended the authorities for their prudent macroeconomic management, noting that Slovenia had achieved sustained real convergence toward EU

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[2] Adjusting for the one-time impact of an accounting shift in 2002; otherwise, the measured deficit that year was slightly below 3 percent of GDP.

levels during the 1990s and already met the Maastricht fiscal criteria. Full fiscal consolidation is broadly on track, foreign exchange reserves are at a comfortable level, foreign investment inflows remain strong, and productivity growth has supported export competitiveness. Directors observed that in 2001–02, Slovene exports had gained market shares in non-EU countries, which had helped offset weaker demand from the EU.

Directors considered that, with EU accession scheduled for May 2004, and taking into account the limited progress made on the disinflation front since 1997, the main policy challenge now is to lower inflation and inflation expectations, while entering ERM2 at a viable exchange rate. The widespread indexation in economic transactions, especially wages, pensions, and financial contracts, is an important factor behind the stickiness of inflation, and Directors encouraged the authorities and social partners to eliminate indexation mechanisms to speed up disinflation.

Directors stressed that sustained efforts by monetary policy would also be needed to contribute to achieving the disinflation objective. In this regard, Directors saw scope for lowering inflation by accepting a stronger tolar, without unduly exposing the economy to risks, given the strong external current account position. Directors recommended that, to increase accountability, the BoS forecast and monitor a core inflation measure that excludes administered prices, indirect taxes, and oil prices. Treating inflation goals as targets rather than projections would also help to build policy credibility and convince economic agents of the seriousness of the authorities' disinflation agenda.

Directors considered that cost-push factors, which had accounted for much of the persistence of inflation in recent years, should be tackled vigorously. They welcomed, in this regard, the enhanced coordination between the government and the BoS on plans for adjustments of administered prices. However, caps on administered price increases should not be allowed to substitute for policy tightening, or to lead to losses for service providers.

Directors endorsed the government's medium-term fiscal goal of attaining close to structural balance before adopting the euro. However, they noted that the deficit targets of the rolling two-year budget for 2003–04 might not be achieved under present policies, given the uncertainty of the revenue projections and the likely initial adverse fiscal effect of EU accession. While a somewhat higher deficit than originally envisaged might result in 2003, Directors underscored the need to return in 2004 to the previously planned pace of fiscal adjustment.

Directors considered that efforts to restrain expenditures over the medium term would have to focus at an early stage on wages and social transfers, which constitute the bulk of public spending. Lower public sector wage increases, maintaining the freeze on public sector hiring, and elimination of wage indexation are priorities for meeting the medium-term inflation and fiscal goals. Directors commended the authorities for taking measures to contain public sector wage increases to below economy-wide increases. They welcomed the recent social agreement on public and private sector wages, which links wages to the average EU inflation rate. At the same time, Directors encouraged the government and social partners to keep the cost of the new wage structure within the budgeted wage bill for 2004. Directors pointed out that further savings on pension expenditure could be achieved by indexing pensions to inflation instead of to wages. They urged the authorities to pursue with determination the planned health care reforms.

Directors noted that significant strides in structural reforms have been made in the past few years, and encouraged the authorities to maintain the momentum. Directors welcomed the initiatives underway to reduce the role of the state in the steel and energy sectors, and encourage them to accelerate privatization in general.

Directors considered the banking system to be generally sound. They welcomed the progress in the implementation of the authorities' financial sector action plan, which had strengthened the BoS's ability to cope with any evolving risks under a liberalized financial sector and external capital account. Directors stressed the importance of monitoring closely the rising foreign currency borrowing by enterprises, so that credit risks remain well contained. Directors observed that competition in the banking system has increased with the entry of foreign investors, and they encouraged the authorities to enhance the competitiveness of Nova Kreditna Banka Maribor, the second-largest bank, through an infusion of private capital.

Directors endorsed the de-indexation of short-term financial contracts in mid-2002 and the subsequent initiative taken by banks to begin offering long-term financial instruments at nominal interest rates. These measures have strengthened the interest rate transmission channel of monetary policy and improved the operation of the money market. Directors encouraged the authorities to eliminate indexation of all financial instruments at an early date.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Slovenia is also available.

Slovenia: Selected Economic Indicators, 1999-2004

	1999	2000	2001	Prelim. 2002	Proj. 2003 1/	2004 1/
	(Annual percentage change)					
Real GDP	5.2	4.6	3.0	2.9	3.2	3.8
Domestic demand	9.1	1.1	0.5	2.2	3.1	4.0
Private consumption	6.0	0.8	1.7	1.8	2.3	3.7
Public consumption	4.6	3.1	3.2	1.0	1.5	2.1
Gross capital formation	18.9	0.5	-3.7	3.7	5.8	6.0
Industrial production	-0.5	6.2	2.9	2.4	...	...
Consumer prices						
Period average	6.1	8.9	8.4	7.5	5.7	5.0
End of period	8.0	8.9	7.0	7.2	5.3	4.8
Wages						
Nominal						
All sectors	9.6	10.6	11.9	9.8	7.8	7.0
Manufacturing	9.1	11.9	10.8	9.9	...	...
Public services	10.1	11.2	13.9	11.6	7.8	6.5
Real						
All sectors	3.3	1.6	3.2	2.1	2.0	2.5
Manufacturing	2.8	2.8	2.2	2.2	...	...
Public services	3.7	2.1	5.1	3.8	2.0	2.0
Employment						
Person basis	1.8	1.3	1.4	0.6	0.4	0.7
Full-time equivalent	1.2	1.1	0.6	0.1 2/	0.2	0.4
Unemployment rate (in percent, ILO definition)	7.6	7.0	6.4	6.3 2/	6.3	6.2
General government finances	(In percent of GDP)					
Revenue	43.6	42.8	43.1	40.8 3/	42.9	42.7
Expenditure	44.2	44.1	44.5	43.7	44.1	43.6
General government balance	-0.6	-1.4	-1.4	-2.9 3/	-1.2	-0.9
State budget balance	-0.5	-0.9	-1.1	-2.8 3/	-1.0	-1.0
General government debt	24.9	25.8	27.5	28.4	26.3	25.8
Money and credit	(Percentage change, end-period)					
Broad money (including foreign exchange deposits)	13.2	15.3	30.4	17.3	...	...
Base money	16.4	4.8	21.4	8.6	...	...
Credit to the private sector	25.0	18.4	18.3	11.1	...	...
Interest rates (in percent)						
BoS discount rate	8.0	8.7	10.8	10.0	...	...
Rate on 60-day BoS bills	7.1	8.2	10.4	8.3	...	...
Lending rates	12.4-14.2	15.8-17.7	15.1-17.1	11.9-14.7	...	...
Deposit rates 4/	7.2-8.9	10.0-12.1	9.8-12.3	7.6-8.6	...	...
Balance of payments	(In millions of U.S. dollars)					
Merchandise exports	8,623	8,808	9,343	10,473	12,149	13,208
Exports volume (percent change)	2.7	12.8	6.6	6.2	6.6	7.0
Merchandise imports	-9,858	-9,947	-9,962	-10,716	-12,364	-13,471
Imports volume (percent change)	8.8	6.1	2.2	4.5	6.2	7.3
Current account balance	-698	-548	31	375	476	441
(in percent of GDP)	-3.5	-3.0	0.2	1.8	1.9	1.7
Gross official reserves	3,168	3,196	4,397	7,064	8,230	8,945
(in months of imports of goods and nonfactor services)	3.3	3.4	4.6	6.8	6.8	6.8
External debt (percent of GDP, end-period)						
Total	26.9	34.3	35.7	41.5	37.9	38.4
Of which: Public and publicly guaranteed	12.2	14.7	14.4	15.3	14.0	14.2
External debt service	840	1,012	1,652	1,820	2,014	2,310
(in percent of exports of goods and nonfactor services)	8.0	9.5	14.6	14.3	13.6	14.4
Exchange rate						
Tolars per U.S. dollar (end-period)	196.8	227.4	250.9	221.1	...	...
Tolars per euro (end-period)	197.3	211.5	221.4	230.3	...	...
Nominal effective exchange rate (1998Q1=100, period average)	96.8	90.6	85.0	81.8	...	...
Real effective exchange rate						
CPI based (1998Q1=100, period average)	103.0	102.1	101.1	102.8	...	...
ULC based (1998Q1=100, period average)	100.7	97.2	98.1	100.1 2/	...	...

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

1/ IMF staff projections for real GDP and components, inflation, employment, balance of payments, and external debt. Figures for general government

finances for 2003-04 refer to the budget approved by Parliament.

2/ Average of the first three quarters of 2002.

3/ Figures reflect a shift in the budget accounting to a pure cash basis entailing 11 months of VAT and excise tax revenues. Adjusted for this, revenues would be 42.3 percent of GDP and the general government deficit would be 1.4 percent of GDP.

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

Statement by Johann Prader, Alternate Executive Director for the Republic of Slovenia, and Ksenija Maver, Assistant to the Executive Director
April 16, 2003

The Slovenian authorities would like to thank the staff for its excellent report, and for the constructive, stimulating discussions during the consultation process. The authorities broadly agree with the staff's view of Slovenia's economic situation.

Prudent macroeconomic management has help smooth the way toward EU accession. Slovenia's successful EU accession negotiations, concluded in December 2002, were followed in March 2003 by a strong referendum vote in favor of EU membership, and the signing of the Treaty and Act of Accession on April 16, the very day when this Article IV consultations is to reach the Board, will mark the next major milestone. Slovenia will officially join the EU in May 2004. The next major priority on Slovenia's policy agenda is to achieve early entry into ERM 2.

Slovenia's retention of its resilience despite the slowdown in neighboring countries resulted mainly from its sound fundamentals and vigorous export sector. Slovenia's growth in 2002 was a solid 3.2 percent, up from 3 percent in 2001. Following the downward adjustments reflecting recent global developments, growth of 3.1 percent is still expected for 2003, down from the 3.7 percent projected last fall. This trend was supported in 2002 by a comfortable current account surplus of 1.8 percent, a moderate fiscal deficit of 1.4 percent of GDP, and a general government debt ratio of 28 percent of GDP. Despite a slowdown in its major trading partners, in 2002 Slovenia maintained its market shares and in some cases even increased them by 0.5 to 1 percentage points.

The first months of 2003 have seen a resumption of the disinflation interrupted by the introduction of the VAT in 1999. In 2002 the original target of 5.8 percent was missed due mainly to cost-push factors, and the year ended with inflation still slightly above 7 percent. In January 2003, the authorities reacted by adjusting the excise duties on oil, and by taking a coordinated approach to administered prices. By the end of February 2003 the annualized inflation rate had been reduced to 6.2 percent. In early March the central bank followed up reducing the policy rate and the pace of depreciation. If there are no external surprises, inflation targets of 5.3 percent for end-2003 and of 3.5 percent for end-2004 are within reach, and are consistent with the stability required for ERM-2 entry in January 2005.

Smooth and balanced progress towards ERM-2 and the euro, with minimal costs and disruptions, is now the core objective of fiscal and monetary policy. This will involve a number of complex challenges, such as maintaining the momentum of disinflation, achieving a structurally balanced budget, abolishing indexation, deepening the money market, and further reinforcing the financial sector. One of the most important tasks at present, both for Slovenia and other ERM-2 candidates, is to have a viable central exchange rate with an appropriate band by the time of ERM-2 accession. Slovenia looks to the Fund for an active dialog on its policy options and continuing advice.

Monetary Policy

The central bank's main goal is to maintain price stability by controlling the money supply. Given the free flow of capital, the money supply must be controlled by adjusting both interest rate and the exchange rate dynamics.

To achieve its inflation targets, the central bank must depend on the Government to support its monetary policies by adhering to the planned restraints on public spending and public sector wage growth, and direct or indirect price curbs to keep prices in line with underlying trends.

The Bank of Slovenia's monetary policy under an exchange rate regime consisting of a managed float is tailored to Slovenia's specific circumstances. It has attracted some academic discussion and deserves a brief explanation here. The managed float was chosen to permit some monetary flexibility even in a context of unrestrained capital flows. The central bank's ability to sterilize net foreign exchange inflows is an important aspect of the monetary framework.

The central bank has two levers for controlling the money supply: interest rates and the exchange rate. Interest rates must be adjusted in response to inflation dynamics and inflation expectations. Exchange rate adjustments, expressed as annual growth rates, must minimize differentials between domestic and foreign interest rates (except those caused by country risk) in order to discourage short-term speculative flows. In effect, the central bank uses its exchange and money market interventions to ensure an appropriate supply of base money.

In conditions of strong, unrestricted capital flows, foreign exchange interventions are an important way of managing the exchange rate. In Slovenia's case this is based on an agreement between the central bank and the commercial banks to cooperate in the foreign exchange market which enables the central bank to set the range of rates for the commercial bank's dealings with other parties.

This special agreement serves the interests of both the central bank and the commercial banks, and ensures the transparency of monetary policy. Practically all of Slovenia's commercial banks have signed on. These commercial banks have a standing facility for the temporary sale of foreign currency to the Bank of Slovenia, with a compulsory repurchase after seven days; and in some cases for the temporary sale of foreign currency with the option of an outright sale after 270 days. This swap facility enables the central banks to adjust supply and demand in the foreign exchange market. It gives the commercial bank a way of managing their foreign exchange positions, as well as a major source of liquidity. The commercial banks pay interest on this liquidity, based on the swap rate set by the central bank. This swap rate, added to the Euro interest rate, represents the central bank's main policy rate. To sterilize excess liquidity caused by the extensive monetization of foreign exchange inflows, the Bank of Slovenia issues tolar-denominated central bank bills. It is

important to understand that the swap rate and the tolar bill rate are such as to make these monetary operations financially viable for the central bank.

The Bank of Slovenia's monetary policy is aimed at bringing down inflation to the established target in time for ERM-2 accession. So far, monetary policy has also succeeded in supporting the external account. And the relatively stable real effective exchange rate was the welcome result--but not a target--of the monetary policy interventions.

During 2002, monetary policy was complicated by two major factors, high inflation and record investments inflows. These high inflows, amounting to 8.8 percent of GDP were mostly caused by sales of equity shares in Lek, a big pharmaceutical company, and Nova Ljubljanska Banka d.d., the largest Slovenian bank. The central bank's policies just described succeeded in sterilizing liquidity in the banking sector and preventing an excessive increase in the money supply and a sudden unsustainable appreciation of the nominal exchange rate.

The higher inflation rates at the beginning of 2002 caused the central bank to make several increases in its main policy rate and the interest rates of other monetary instruments. These adjustments, together with a decreasing trend in foreign interest rates, interrupted the desired slowing of the tolar's depreciation. The ECB's cut in its main refinancing rate was followed, in December 2002, by the Slovenian central bank's policy rate cut of 0.5 percentage points. This would not have been possible without the successful coordination of policies that had been established between the government and the central bank. A second cut, last month, of 0.75 percentage points, was a response both to the decline in inflation, and to the ECB's rate cut. Declining inflation was also the reason for the slowing of the nominal depreciation of the tolar. The real appreciation of the tolar in the 12 months preceding February 2003 amounted to 5.3 percent.

For 2003, the Bank of Slovenia foresees no major changes in its conduct of monetary policy. The lowering of interest rates will go hand in hand with the expected decline in inflationary expectations, subject to the influence of movements in foreign interest rates. The central bank will also continue to slow the rate of tolar depreciation in order to support the disinflation. In addition, the central bank has already begun to reduce its presence in the foreign exchange market. Its various policy options will be weighed with due regard to their effects on capital flows and on the behavior of investors and domestic consumers.

Fiscal Policy

Slovenia's public finances ran small surpluses until the mid-1990s, and have since registered deficits of less than 1.5 percent of GDP. The 2003-2004 budget, which targets deficits of 1.2 percent of GDP in 2003 and 0.9 percent of GDP in 2004, sets the stage for a gradual fiscal consolidation, with emphasis on expenditure, in preparation for the adoption of the euro.

The fiscal situation became difficult in early 2003, with revenue shortfalls and weaker growth prospects due to the weakening global environment. The figures for the first two months pointed to a possible slippage of as much as 1 percent of GDP for the year, in place of the planned structural withdrawal of 0.3 percent of GDP.

On April 3, 2003, the authorities quickly tightened the fiscal stance by restricting capital expenditures, by limiting discretionary spending on goods and services and freezing new hiring in the public sector. These fiscal measures will remain in place until the supplementary budget for 2003 is in place. A draft will be discussed on April 17. This supplementary budget will increase, by about 0.3 percentage points of GDP, the original budget deficit target of 1.2 percent of GDP, and will include savings resulting from revised spending priorities. The 2004 budget will be reviewed next fall in the course of the regular budgetary procedure. By taking early action, the authorities hope to ensure the credibility of Slovenia's path toward ERM-2 and euro zone accession, and to support the disinflation process.

Other

Indexation of wages and social transfers is seen as the main remaining obstacle to successful disinflation. De-indexation began in early April 2003, after a social agreement had been reached on private and public sector wages for the period 2003-2005. This agreement will link wages to the average EU inflation rate, and will be adjusted only for the amount by which Slovenia's actual inflation exceeds targeted inflation. The agreement also provides that wage growth will stay at least 1 percentage point behind productivity growth.

De-indexation of financial contracts began in 2002. The authorities' efforts to accomplish de-indexation are focused on two areas. The formal elimination of indexation began with banks' short-term financial contracts in June 2002, and will be extended to banks' long-term financial contracts. The second area is long-term nominal instruments: the March 2002 fixed-rate three-year government bond issue was complemented in March 2003 by a five- year nominal bond issue. The commercial banks have followed suit by beginning to offer long-term instruments with nominal interest rates.

The nominalization of bonds will be an important boost not only for the de-indexation of the economy, but also to the deepening of the domestic primary and secondary markets. The process will likewise affect the formation of the yield curve and make the cost of borrowing more transparent, and establish a benchmark of progress toward the Maastricht nominal convergence criteria.

Slovenia's banking sector is sound, despite the recent strain which affected only one small bank. Even though foreign exchange lending increased considerably during 2002, the risk portfolio of the banks' balance sheets did not change, since regulatory provisions require the open foreign exchange position to remain low. Increased demand for banks' foreign exchange loans came mostly from exporters seeking to hedge their foreign exchange exposures, which suggests that the banks' and the exporters' risks are well covered.

The authorities have requested an FSAP Update mission to provide a final test of financial system strength before EU entry and complete the Action Plan implemented on the recommendation of the 2000 FSAP mission. The valuable advice of the Fund and the World Bank during that mission was helpful to the process of strengthening the financial market and preparing it for the competitive pressures of the EU. It is expected that the FSAP Update mission will take place in early autumn.

The above steps, and many others not described here, show the strength of the authorities' commitment to keep the forward momentum based on macroeconomic stability, and to carefully navigate the remaining tasks to be completed to reach Slovenia's ambitious goals.