

Chapter 1

Restoring a sustainable growth path within the Monetary Union

Slovenia achieved strong economic growth leading to a marked catch-up with the EU15 during the last decade. This dynamic growth has been interrupted by the global recession, adversely affecting Slovenian exports and banks' refinancing possibilities. Government policies to counter the downturn have been appropriate: most measures to support banks are well-designed and, given the relatively favourable fiscal position, there was room for the discretionary fiscal stimulus adopted by the government. However, the government should ensure that the fiscal stimulus remains temporary and pro-growth oriented. Looking forward, fiscal policy needs to pay greater attention to the monetary conditions (now set at the euro area level) to avoid overheating. As the economy recovers, efforts to achieve real convergence need to be renewed. Labour productivity gains that had been driving growth per capita need to be sustained through higher total factor productivity growth and better labour utilisation. Competitiveness within the euro area should be maintained by ensuring that wage growth does not exceed that of productivity. Overall, the speed of real convergence will largely depend upon implementation of structural policies to promote fiscal sustainability, make employment more attractive and enhance the business environment.

The global economic crisis poses new challenges to economic policy

Slovenia's dynamic growth of the recent years has been abruptly interrupted by the global recession, adversely affecting Slovenian exports and banks' refinancing possibilities. Prior to the economic crisis, Slovenia had achieved steady gross domestic product (GDP) growth, lifting living standards, and adopting the euro as the first of the new member states. Over the period 1997-2007, real GDP grew at 4.4% on average, expanding employment and shrinking unemployment (Figure 1.1). Favourable developments were also seen in the four OECD transition economies of the Czech Republic, Hungary, Poland and the Slovak Republic with rapid GDP growth amid receding inflationary pressures.

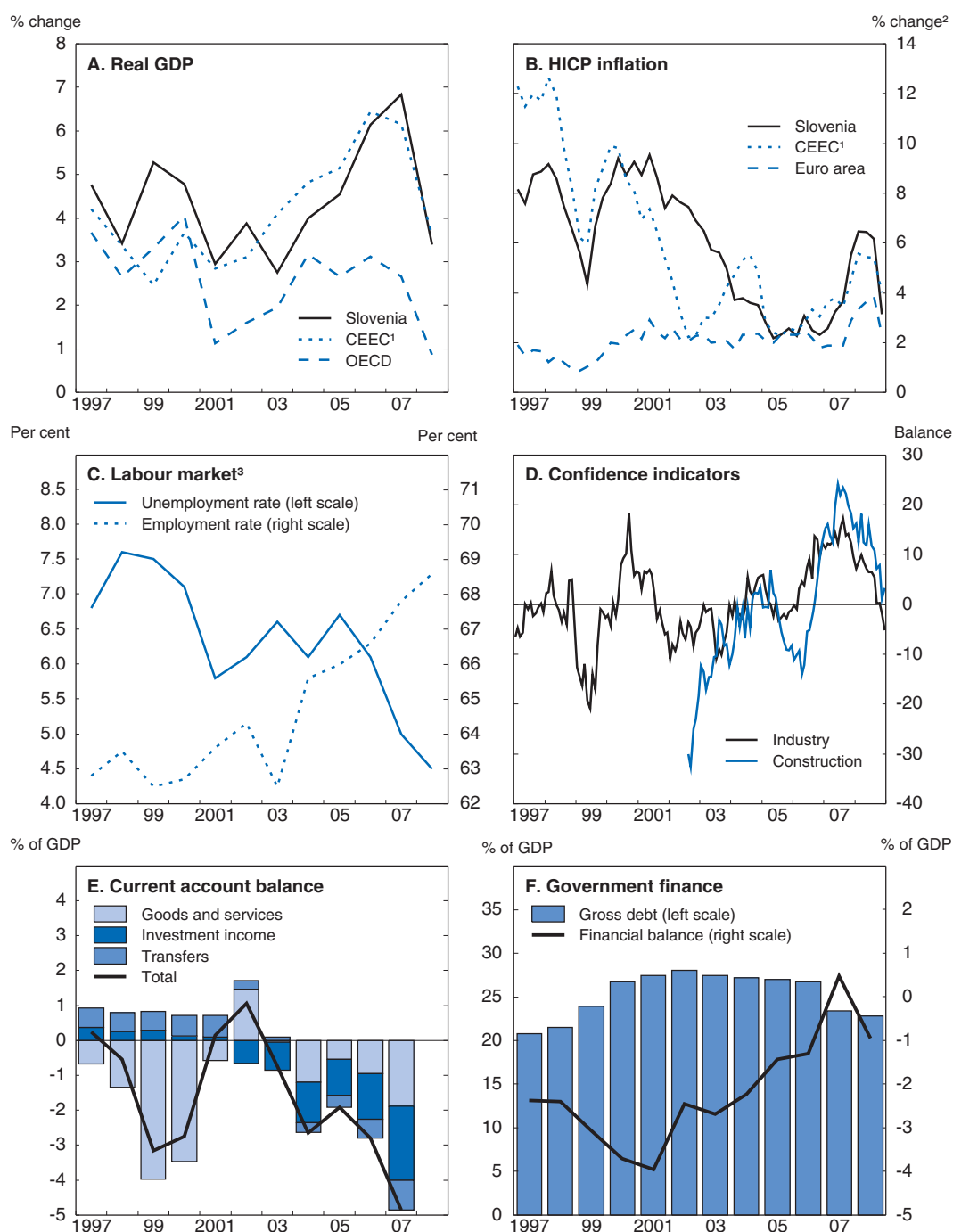
Slovenia had been spared by the financial crisis until the last quarter of 2008 owing to its stable growth, overall prudent macroeconomic policies and the cautious behaviour of its financial institutions towards innovative financial products. Once the crisis became global, however, Slovenia was affected through trade and financial linkages. The impact of the crisis on Slovenia is likely to be severe because of its dependence on foreign financing and exports. Slovenia is heading for recession in 2009 and sluggish growth in 2010 (Box 1.1). As the crisis unfolded, it became clear that the depth and expected length of the slowdown warrant fiscal easing to combat the downturn. To mitigate the impacts of the crisis but at the same time not jeopardise long-term sustainability, the structure of the fiscal stimulus should be carefully designed.

The economy has been severely hit by the global recession

The fall in foreign demand is the main channel through which the economic crisis has affected Slovenia


Collapsing foreign demand triggered a fall in Slovenia's industrial output at end-2008, one of the largest monthly falls of production in the euro area (Figure 1.2). Construction output has also fallen sharply, in contrast to the euro area average, suggesting that this sector was overheated during the past year. The Slovenian economy is not only dependent on exports (over 60% of manufacturing sales) but also on cyclically sensitive industries, such as automobiles, electronics and steel. The car industry was first hit by slackening export demand in late 2008. Revoz (a unit of Renault), the largest exporter in Slovenia with around an 8% share, slashed daily production by almost 17% and its workforce by almost 7% in November 2008, inducing a chain-reaction on companies supplying parts and components. However, subsidies across Europe for scrapping old cars for more environment-friendly new ones have temporarily revived demand for Slovenian car exports and recently prompted Revoz to increase production and employment.¹ Export market diversification has so far provided some cushion against the global downturn, even those markets that had initially been less affected, such as Russia or the Balkan countries, are now also heading for recession. Only the pharmaceutical sector appears to be holding out relatively well, owing partly to the non-cyclical nature of demand.

Figure 1.1. Key economic indicators



1. Unweighted average of data for the Central and East European countries that are OECD members: Czech Republic, Hungary, Poland and Slovak Republic.
2. Year-on-year percentage change.
3. Age group 15-64.

Source: OECD (2009), *National Accounts of OECD Countries – online database*, April and *OECD Economic Outlook: Interim Forecast*, March; Eurostat database (2009), *Economy and Finance*, and *Labour Force Survey*, April; IMF (2009), *Balance of Payments and International Investment Statistics*, CDROM, International Monetary Fund, February; and European Commission (2009), *Economic and Financial Affairs, AMECO database*, April.

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Box 1.1. Short-term outlook for Slovenia

Slovenia is experiencing the worst crisis since independence, as GDP is expected to contract by about 6% in 2009. The severe contraction began at the end of 2008 when the collapse of exports triggered a sharp decline in manufacturing production. Construction output has also fallen sharply. Sentiment indicators still deteriorated in May, particularly in the construction sector, suggesting that the economy has not bottomed out yet. The number of unemployed has started increasing. The economic contraction combined with the decline in commodity prices has lowered inflation, which was high before the crisis. A significant decline in investment, particularly in civil engineering projects and housing, due to dearer and scarcer sources of funds and uncertainty about the timing of a global recovery, will drag the economy. Private consumption will be adversely affected by increasing unemployment, further compounded by a potential negative wealth effect related to falling housing prices. Slovenia is an export dependent country with around two-thirds of its manufacturing output destined for foreign markets. With the euro area in deep recession, foreign demand for Slovenian products has collapsed and will not pick up before recovery abroad. In 2010, the economy should gradually recover, driven by stronger exports and a pickup in investment spending.

The government adopted two fiscal packages in December 2008 and in February 2009, and is contemplating a third round of fiscal measures, whose details were not known at the time of publication. The total amount of discretionary measures should reach around 2.2% of 2009 GDP, although some funds will not be disbursed before 2010. The fiscal packages comprise measures to subsidise reduced working hours, provide guarantees for banks to borrow from abroad, recapitalise the state owned export and development bank and mitigate credit risk (state guarantees). The falling output and the crisis-related packages have interrupted the on-going fiscal consolidation process. It is crucial to ensure that the budget is brought back to a sustainable trajectory once the economy picks up; a new pension reform should play a substantial role in achieving this goal (see Chapter 2).

Real GDP is expected to contract sharply in 2009 (-5.8%) and barely return to positive territory in 2010. Inflation (measured by the harmonised index of consumer prices, HICP) will moderate to 0.8% in 2009 and slightly increase in 2010 (see Table 1.1). Risks to this forecast are tilted to the downside, as a prolonged global recession could adversely affect output and unemployment. A sharp increase in non-performing loans, in the wake of excessive credit growth in the recent past, could severely constrain banks' lending ability and hence could constitute a drag on the recovery. Earlier than expected global recovery, on the contrary, could lead to a faster recovery of exports and output.

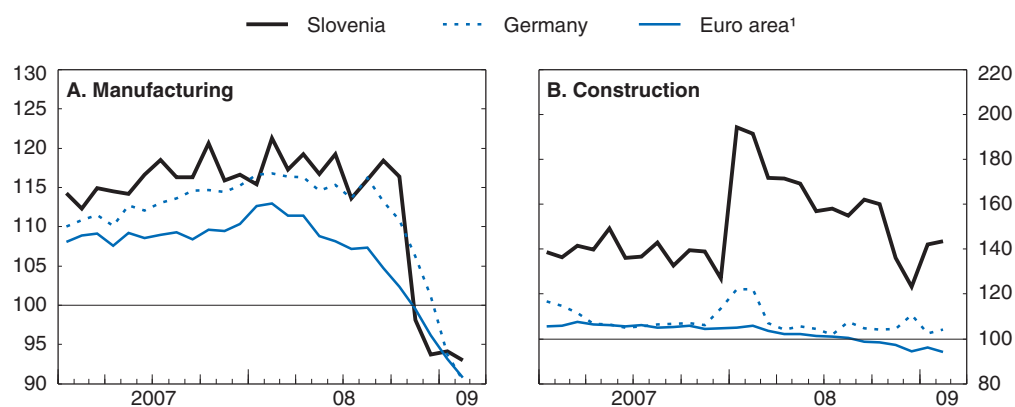
Table 1.1. Short-term projections

	2008	2009	2010
Real GDP growth (%)	3.4	-5.8	0.7
HICP growth (%)	5.5	0.8	1.6
General government financial balance (% of GDP)	-0.9	-5.7	-5.3

Source: OECD (2009), *OECD Economic Outlook*, No. 85.

Figure 1.2. **Production indices**

Seasonally adjusted, 2005 = 100



1. Euro area 15 member countries.

Source: Eurostat database (2009), Industry, Trade and Services, April.

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The second round of economic contraction is on the way as companies slash jobs and hours while the laid off cut consumption. The unemployment rate had fallen below the natural rate in recent years (see Chapter 3), but the crisis has led to the termination of thousands of mainly fixed-term contracts. Uncertainty regarding unemployment will have an adverse impact on consumption, which could be compounded by a potential negative wealth effect related to housing prices, although it is difficult to assess to what extent the housing market has bubbled in recent years. On the other hand, Slovenian households are much less indebted than those in many OECD countries (outstanding household loans equal less than a quarter of GDP compared to over half of GDP in many OECD countries), and they hold a very small share of their assets in securities.² Therefore, the wealth effect related to falling securities prices is expected to be limited and the increase in precautionary savings may be less pronounced than in other countries.

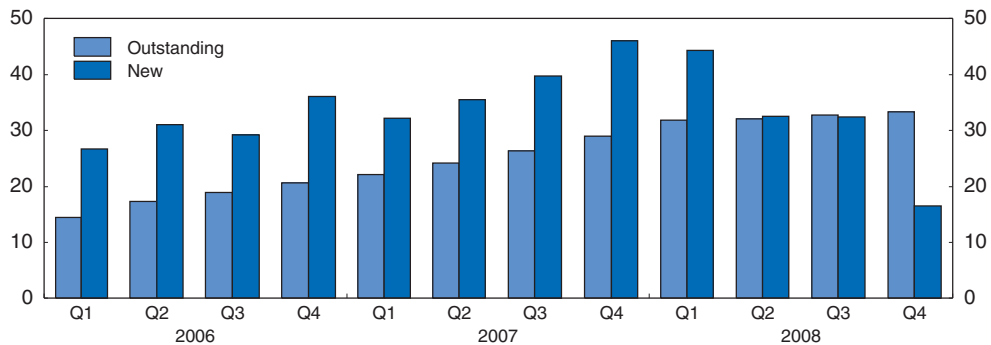
Households have low debt levels, but those with housing or consumption loans are exposed to exchange rate and interest rate risks. The share of housing loans in Swiss francs has reached one-third of total outstanding housing loans (or equivalent to slightly over 3% of GDP) though the share of new housing loans in Swiss francs dropped to below 17% by end-2008 (Figure 1.3). The appreciation of the Swiss franc vis-à-vis the euro of over 10% in 2008 has imposed an additional burden on households' debt financing and has reduced the demand for new loans in that currency. Households are also increasingly exposed to interest rate risk. In 2008, 61% of new housing loans were approved with a variable interest rate, down from 87% in 2007. With monetary easing underway in the euro area, the debt financing burden should ease, bringing support to consumption.

The crisis is compounded by the refinancing difficulties from the banking sector

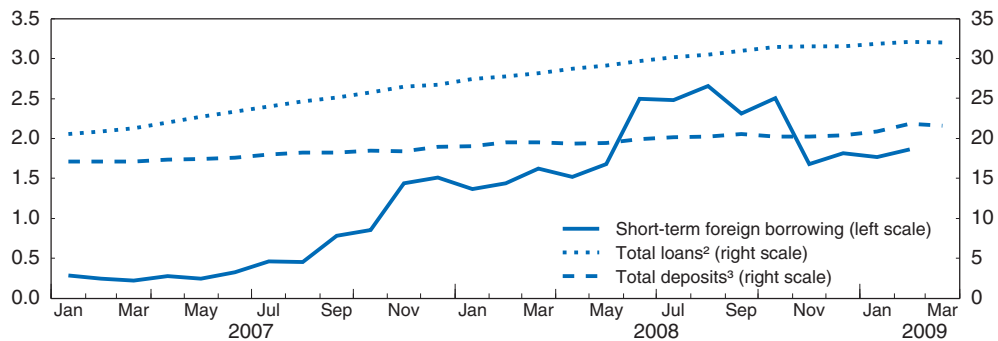
Slovenian banks have been hit particularly hard by the drying up of international refinancing given their increasing reliance on short-term foreign borrowing (Figure 1.4). Foreign funds have financed the savings-investment gap, fuelling the investment boom over the past years. With the financial crisis becoming global, however, foreign financing has become dear and Slovenian banks' low ratings further limited access to and the price of liquidity in international financial markets.

Figure 1.3. **Currency breakdown of housing loans**

Per cent of loans in Swiss francs



Source: Bank of Slovenia.

StatLink <http://dx.doi.org/10.1787/643261457634>Figure 1.4. **Domestic lending and overseas borrowing by commercial banks**Billion euros¹

1. For comparison purposes, the level of GDP in 2007 was EUR 34.7 billion.

2. Claims on non-financial institutions in the balance sheet of other monetary financial institutions.

3. Sum of deposits in domestic and foreign currencies in the balance sheet of other monetary financial institutions.

Source: Bank of Slovenia (2009), *Monthly Bulletin*, Vol. 18, No. 4, April.StatLink <http://dx.doi.org/10.1787/64327765518>

Slovenia's banking sector is also vulnerable to the financial crisis because the strong and probably excessive credit growth in the past (e.g. 40% bank lending growth in 2007 only) is likely to create an increased amount of non-performing loans (NPLs), aggravated by weakening firm balance sheets as a result of slackening demand. Therefore, the build up of NPLs needs to be addressed to allow banks to resume lending.

Slovenian banks also need to cope with a growing maturity mismatch between their assets and liabilities and, to a lesser extent, with a currency mismatch. While banks provide both short-term and long-term financing, most of their liabilities, deposits in particular, are short term. With moderate growth of deposits, the credit boom was mainly financed by short-term foreign borrowing, thereby exacerbating the maturity mismatch. Maturities of foreign loans have further shortened with the unfolding of the global financial crisis in 2008. Issuing bonds and therefore reducing the maturity mismatch had been hampered by the 15% withholding tax on interest from bond issues, until it was abolished in mid-2008, prompting the largest bank to tap international markets for fresh funds.³

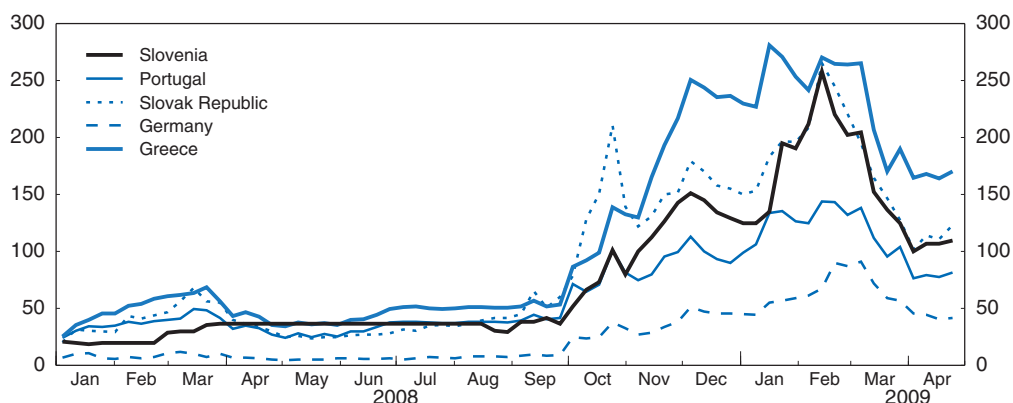
The deterioration of asset portfolios as a result of plummeting global asset prices is expected to be limited for the banking sector as a whole, but is likely to affect some banks more severely, in particular smaller ones that switched to holding equities once the sterilisation bonds were bought back by the central bank in 2007. A low degree of exposure of bank portfolios to structured financial instruments turned out to be an advantage, as they are now less exposed to toxic assets than banks in many other countries.⁴

In addition to these challenges, Slovenian banks appear to be less cost-efficient than their regional peers. Slovenian banks lag behind euro area counterparts and even some Central European OECD countries, based on either accounting ratios or X-efficiency scores (Bems and Sorsa, 2008; Holló and Nagy, 2006).⁵ This may be due to the concentrated market structure and widespread state ownership in the banking sector. While there are over 20 banks operating in Slovenia, the largest one commands a market share of over 30% in terms of assets and the second one nearly 10%. Both are state-owned, directly and indirectly through public funds and financial and non-financial state-owned enterprises. There is also non-negligible cross-shareholding among banks. Market concentration and government ownership, in particular of the largest players, may imply less competitive pressure in the Slovenian banking market. Strengthening competition is therefore crucial to reduce X-inefficiency through, for instance, stimulating managerial efforts by providing more firms to serve as a reference for comparison (Nickell, 1996). New entry may not be the most likely source of stronger competition in this small market, which already has a large number of players; thus, it will be important to encourage competition among the incumbents, particularly among the major players, to boost efficiency and enhance the sector's ability to cope with future crises. Once financial market conditions return to normal, a possible way to boost competition could be through the privatisation of the second largest bank, which is sufficiently large to eventually challenge the dominant position of the largest one.

Refinancing difficulties of Slovenian banks imply harsh credit conditions for companies. Spreads for five-year Slovenian credit default swaps (CDS) have widened since the third quarter of 2008, following a gradual increase starting at the outbreak of the subprime crisis in the United States in mid-2007 (Figure 1.5). These spreads have widened markedly since late 2008 – peaking in February 2009 and receding toward end-2008 levels


Figure 1.5. **Five-year credit default swap rates**¹

Basis points



1. Mid-rate spread between the entity and the relevant benchmark curve.

Source: Datastream.

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thereafter – *vis-à-vis* those for German CDS as a result of higher *premia* attached to emerging markets. Domestic credit supply is unlikely to recover before international liquidity conditions ease. A more cautious approach to lending by global banks – to a large extent attributable to risk assessment difficulties – contributes to a vicious cycle, where even companies with healthy balance sheets have seen access to credit limited.

Measures to support the financial sector have not yet resulted in a pick-up in bank lending

The Slovenian government acted promptly in the third quarter of 2008 to help restore banks' refinancing channels and to enhance stability of the banking system. As part of cross-European efforts to enhance stability of the financial system, the Slovenian government strengthened deposit guarantees in late 2008. The ceiling of the deposit guarantee at local banks was removed (from the earlier EUR 22 000) for private persons and small businesses. This improved cover, alongside an expected increase in savings due to economic uncertainty, should help the banks to expand their customer deposit base and hence ease the constraint of access to foreign funds.

The timely elimination of the capital buffer (an additional capital adequacy requirement of about 0.8 percentage point) also provided some relief for the banking sector in the last quarter of 2008. This buffer was introduced in 2006 to counteract the pro-cyclical effects of the newly introduced less stringent International Financial Reporting Standards (IFRS), but its effectiveness in restraining credit appears to have been limited, maybe because of its small size.

To ease credit constraints brought about by the EU-wide crisis, the European Central Bank (ECB) extended facilities in the form of maximum six-month renewable loans in autumn 2008. Since then, Slovenian banks, domestic and foreign, have been using it widely. This facility, however, falls short of the needs of Slovenian banks as it is confined to short-term refinancing. Furthermore, collateral requirements may be constraining a few banks, although the size of loans is not limited.

To supplement the ECB facility, in November 2008 the Slovenian government made state guarantees for refinancing operations available to the banking sector (see Box 1.2 for details of measures to support bank lending). This measure was made possible by the amendment of the public finance law to allow the government to extend guarantees up to EUR 12 billion. The largest bank, Nova Ljubljanska Banka has applied for the government guarantee, and two other banks are also considering doing so.

However, the measures adopted end-2008 fall short of the need to provide sufficient liquidity to the banking sector, as evidenced by the recently reported predatory bank competition for deposits. Amid dried up international funding, some banks started offering unsustainably high interest rates on deposits at end-2008. To avoid further destabilisation of the banking sector, the central bank considered a measure to penalise banks with large sight deposits.⁶ This warning, alongside decreasing interbank interest rates (Euribor), has dampened predatory competition somewhat. Government guarantees help make foreign borrowing accessible, but given that their cost is linked to a bank's credit rating, they remain confined to larger banks. Government guarantees may also imply restrictions on executive pay or dividends. Measures taken end-2008 also fell short of channelling needed funds to the corporate sector.

Box 1.2. Measures adopted to help banks resume lending

In addition to enhancing financial stability by removing the ceiling on the insurance for private deposit holders and boosting liquidity by releasing the previously accumulated capital buffer, the Slovenian government has adopted several measures to encourage banks to resume lending. The unexpected severity of the crisis has made additional reform packages necessary after the first one in the last quarter of 2008.

The financial measures of the first crisis package aimed at ensuring access to foreign borrowing by Slovenian banks hard hit by the drying up of international liquidity. The most important measure in this respect is the government guarantee facility of bank borrowing up to EUR 12 billion. These guarantees have, however, been under-utilised as so far only one bank has applied and received approval. This will enable it to obtain guarantees and tap international bond markets for fresh funds. In addition, to assist other banks, the government adopted further measures in the second crisis package including an issue of EUR 1 billion to be deposited mainly at banks and the decision to recapitalise the export and development bank and use it as a vehicle to extend loans to the banking and corporate sectors. The government is also providing interest rate subsidies to small and medium-sized enterprises through the Public Entrepreneurship Fund, costing EUR 1.1 million. Further, to mitigate credit risk, the SID bank is providing guarantees to banks up to EUR 1 billion, where banks are required to assume at least 20% of the risk, and to firms borrowing directly in financial markets up to EUR 500 million.

As a consequence, the government put in place a second package at the beginning of 2009. In addition to encouraging banks to borrow with government guarantees, the government raised about EUR 1 billion directly through a bond issue and deposited most of it with the banks. As an alternative, a cheaper source of financing, mainly for smaller banks, was made available by recapitalising the state-owned export and development bank, the SID. The SID is now ready to extend loans to both the banking and the corporate sectors. As its bonds are eligible as ECB collateral, it also helps ease the collateral requirements by ECB. Finally, the government is ready to directly lend to the corporate sector in case the guarantee scheme or the depositing of the proceeds from government bond issues with banks appears insufficient to provide liquidity for the corporate sector. If this measure were to prove inadequate, the government could purchase assets from the banking sector or ultimately provide capital injections.

To ensure uninterrupted operation of enterprises, it is crucial that they obtain the necessary financing. Credit risk has made banks cautious in their lending decisions, and its reduction is therefore the major objective of the second package to combat the crisis. Guarantees are now provided in the amount of up to EUR 1 billion to banks through the SID bank. Under this scheme, firms can borrow from a single bank with amounts determined by their revenue and size of capital for a period between six months and five years. In addition to this scheme, guarantees for the maximum amount of EUR 500 million are provided directly to enterprises that borrow in financial markets. These measures should eventually ease firms' financing constraints, but bank lending to firms has not picked up yet. The government should, however, ensure that measures to encourage lending to firms (credit lines through SID, state guarantees) are transparent in order to mitigate banks' moral hazard.

In this context, there is room for a fiscal stimulus provided it remains temporary and pro-growth

Given the size of the downturn and the relative ineffectiveness of monetary policy, as long as banks face refinancing difficulties, discretionary fiscal measures are justified, in addition to the automatic stabilisers. In the case of Slovenia, fiscal stabilisers alone should be relatively strong (high share of tax and expenditure to GDP), but the low debt-level (around 24% of GDP in 2008) and the fact that the general government budget is broadly in balance give room for temporary discretionary fiscal policy along the lines of the EU coordinated strategy. But, Slovenia should prioritise measures that help foster its potential growth in the following years (e.g. public investment or expenditure on human capital; research and development, etc.). Also, the measures should be withdrawn as activity picks up to ensure a sound underlying fiscal position (Chapter 2).

To counter the downturn, the government's revised budget submitted to Parliament end-February 2009 incorporates a new fiscal stimulus amounting to 1.2% of GDP. Another measure that is not included in the fiscal package, but which may support consumption, is the planned increase in public wages over 2008-10 (about 1% of GDP). The revised budget encompasses both discretionary measures that will bring a positive impact on long-term growth and others that the government will need to remove as soon as possible (see Box 2.2 in Chapter 2).

On the positive side, the fiscal package includes a recapitalisation (EUR 160 million) of the state-owned export and development bank to support lending as well as diverse tax measures to support investment (about EUR 100 million) such as a reduction of tax obligations for the self-employed by 30% on investment in equipment and intangible fixed assets. The latter may make self-employment more attractive and absorb some of the laid-off. Finally, to speed up disbursement of EU funds, the government is giving priority to ministries whose projects are closer to implementation, which is a positive decision.

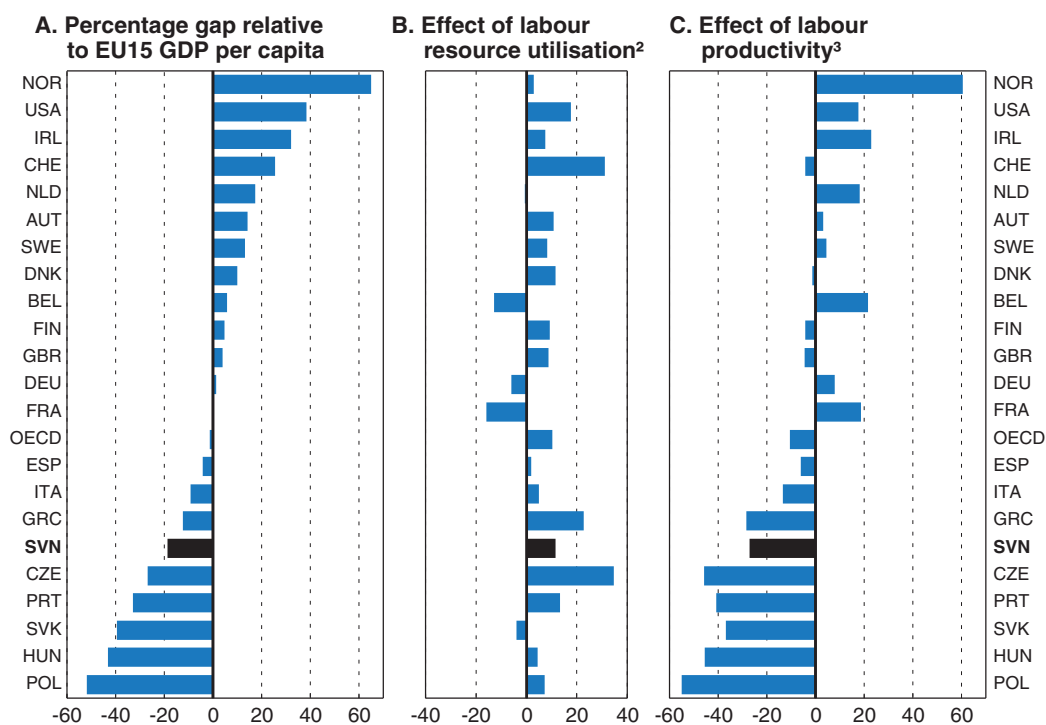
On the other hand, other measures need to be reconsidered. The main government fiscal measure (EUR 230 million) is subsidies for reduced working hours (from 40 to 36 or 32 hours per week) to maintain employment. This measure needs to be clearly time-limited. While it enables firms facing a strong fall in demand to retain human capital within the company and to help uphold private spending, there is a risk that a sustained implementation of this measure or a lack of strict criteria for its application (e.g. only companies facing economic difficulties) may lead to a permanent reduction in working hours. The government should also carefully consider its design. In other countries, such as Germany, such programmes are structured to be unattractive to firms unless they are in cyclical difficulty (Chapter 3). Another measure, although not crisis-related, to be reconsidered is the planned increase in public wages, which may support consumption, but at the expense of long-term fiscal sustainability as this measure has a permanent impact.

Beyond the crisis, maintain a steady economic catch-up without macroeconomic imbalances

Slovenia has enjoyed a steady growth leading to a rapid catch-up in GDP per capita

Slovenia's strong economic performance has led to a marked catch-up in GDP per capita over the last decade, reaching 81% of the EU15 average in 2007 (in current purchasing power parity terms) from 67% in 1997. The current GDP per capita is significantly higher than that of Portugal and close to that of Greece (Figure 1.6). Slovenia's GDP per capita has continuously exceeded that of the four other OECD transition economies over the period (Figure 1.7).

Figure 1.6. **Sources of real income differences**
Percentage point differences in GDP per capita with respect to the EU15, 2007¹



1. GDP in US dollars at current prices and purchasing power parities.
2. Measured as total number of hours worked per capita.
3. Percentage gap with respect to EU15 GDP per hour worked.

Source: OECD (2008), *Productivity database*, September, www.oecd.org/statistics/productivity; OECD (2009), *National Accounts of OECD Countries – online database*, February; and Eurostat database (2009), *Economy and Finance*, February.


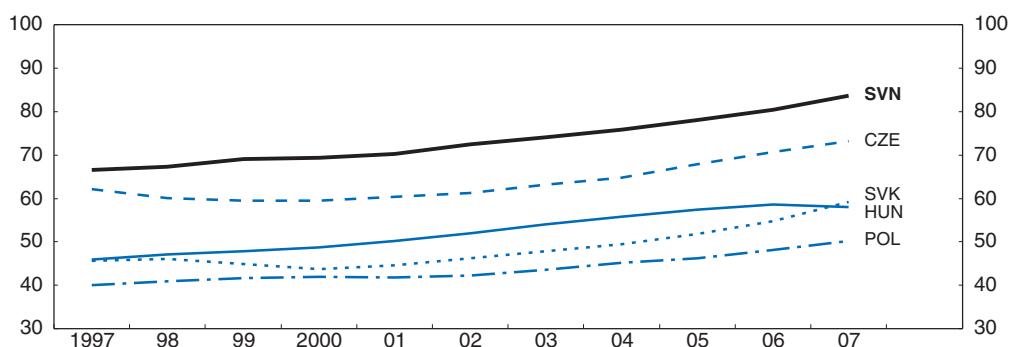

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Figure 1.7. **Convergence of real per capita income**

Real GDP per capita in USD at constant prices and constant purchasing power parities, EU15 = 100



Source: OECD (2008), *Productivity database*, September, www.oecd.org/statistics/productivity; and OECD (2009), *National Accounts of OECD Countries – online database*, February.

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During 1997-2007, labour productivity gain was the major driver of per capita GDP growth⁷ in Slovenia (Table 1.2). The rise in labour productivity stemmed from capital deepening and total factor productivity (TFP) growth, with a slightly larger contribution

from the latter. TFP growth was driven by absorption of advanced countries' production and organisation techniques, helped by deepening integration into the global economy. The contribution of labour productivity to GDP per capita growth compared favourably to that of the Czech Republic or Hungary, but was less than that of Poland or the Slovak Republic during 1997-2007. Regarding the contribution of labour utilisation to GDP per capita growth, Slovenia outperformed all the other OECD transition economies but Hungary, owing to increasing employment rates.

Table 1.2. Real GDP growth per capita compared to other Central and East European countries

Per cent, annual average 1997-2007¹

	Slovenia	Czech Republic	Hungary	Slovak Republic	Poland ²
Real GDP per capita	4.2	3.1	4.3	4.7	4.2
Labour utilisation	0.2	-0.3	0.7	0.0	-0.3
Working time ³	-0.3	-0.4	-0.2	-0.5	-0.3
Employment participation	0.5	0.1	1.0	0.5	0.0
Demographic structure ⁴	0.0	0.4	0.1	0.7	0.5
Employment rate	0.5	-0.3	0.8	-0.2	-0.5
Labour productivity⁵	4.0	3.4	3.5	5.1	4.5
Capital intensity of labour	1.9	2.4	2.0	2.8	1.4
Total-factor productivity ⁶	2.2	1.1	1.5	2.3	3.1
Employment ratio ⁷	0.0	-0.1	0.0	-0.4	..

1. 1997-2006 for Poland.

2. To avoid issues arising from a break in series, Polish employment data prior to 2003 are estimated, see Iradian (2007).

3. Hours worked per person employed.

4. Ratio of working age to total population.

5. Real GDP per hour worked.

6. Calculated as a residual.

7. Employment domestic concept relative to employment national concept.

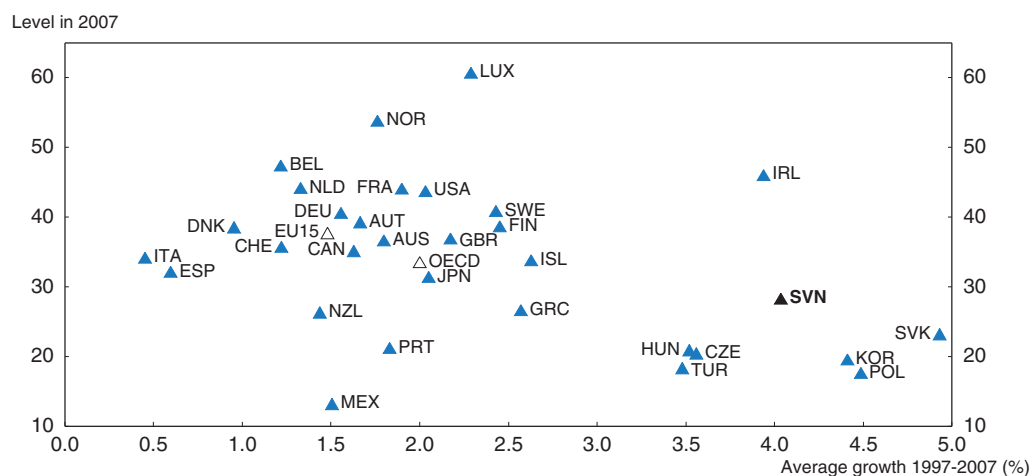
Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; Eurostat database (2009), *Economy and Finance*, February; OECD (2008), *Productivity database*, September; and G. Iradian (2007), "Rapid Growth in Transition Economies: Panel Regression Approach", *IMF Working Paper*, No. 07/170, International Monetary Fund.

Looking ahead, GDP per capita in Slovenia will converge to that of the EU15 by 2015 if both Slovenia and the EU15 keep growing at the same pace as during the last decade. To achieve this goal, the challenge for the Slovenian economy is to keep productivity growth high through an increased contribution of TFP, while maintaining a positive contribution of labour utilisation.

Further catch-up will require maintaining high labour productivity growth...


Despite the past strong growth in labour productivity, the level in Slovenia is still low compared to most EU15 countries (Figure 1.8), implying scope for further gains. Improved human capital should help sustain productivity growth; Slovenia seems to have already performed well compared to other transition economies in this respect based on the average years of schooling as a proxy for human capital (Box 1.3). Nonetheless, average years of schooling is only a rough measure of human capital, and the length of schooling in Slovenia seems to be partly linked to extensive part-time student work (Chapter 3). In general, there is scope for further improving human capital by making the education system more efficient and encouraging lifelong learning (Chapter 3). Capital deepening also should continue to drive labour productivity growth for the coming years, not least due to upcoming projects to improve public infrastructure. However, TFP should play a more important role in the longer

Figure 1.8. Labour productivity
Measured by GDP per hour worked¹



1. In US dollars at constant prices and purchasing power parities.

Source: OECD (2008), *Productivity database*, September, www.oecd.org/statistics/productivity; OECD (2009), *National Accounts of OECD Countries – online database*, February; and Eurostat database (2009), *Economy and Finance*, February.

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Box 1.3. Accounting for growth in Slovenia

The growth accounting exercise¹ reveals that Slovenia's spectacular growth performance during the past decade is mainly attributable to accumulation of physical capital and total factor productivity (TFP) growth, largely in manufacturing industries (van Ark et al., 2007).² However, TFP gained importance over time: it contributed 1.4 percentage points to GDP growth in the first half of the period of 1997-2007 and 2.1 percentage points in the second half of that period (Table 1.3). Human capital – measured by average years of schooling of the working population – has a non-negligible contribution to growth, higher than labour, but lower than capital and TFP.³

Table 1.3. Real GDP growth compared to other Central and East European countries

Per cent, annual average

	Slovenia			1997-2007 ¹			
	1997-2002	2003-07	1997-2007	Czech Republic	Hungary	Slovak Republic	Poland ²
Real GDP	4.1	4.7	4.4	3.1	4.0	4.7	4.2
Inputs							
Labour	0.2	0.3	0.2	-0.2	0.3	-0.3	-0.2
Human capital	0.5	0.5	0.5	0.1	0.4	0.2	0.1
Physical capital	2.1	1.9	2.0	2.3	2.2	2.7	1.3
Total-factor productivity ³	1.4	2.1	1.7	0.9	1.1	2.1	2.9

1. 1997-2006 for Poland.

2. To avoid issues arising from a break in series, Polish employment data prior to 2003 are estimated, see Irdian (2007).

3. Calculated as a residual.

Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; Eurostat database (2009), *Economy and Finance*, February; OECD (2008), *Productivity database*, September; and G. Irdian (2007), "Rapid Growth in Transition Economies: Panel Regression Approach", *IMF Working Paper*, No. 07/170, International Monetary Fund.

Box 1.3. Accounting for growth in Slovenia (cont.)

In three of the other countries examined, capital deepening plays a more vital role with capital accumulation contributions to GDP growth ranging from 55% in Hungary to 73% in the Czech Republic, reflecting huge inflows of foreign direct investment. TFP contributions in the Slovak Republic reach almost the same share as in Slovenia in the period examined. Notably, the use of labour has a minor part in explaining GDP growth in all countries. A closer look at the data reveals that labour contributions are affected by economic downturn and rising unemployment in the first half of the period, and giving a positive contribution to growth on the back of economic upswing and improved labour market conditions in the second period.

The main finding of the growth accounting exercise that physical capital and TFP are the most important sources of growth in Slovenia seems robust to different assumptions. In the baseline scenario, a capital/GDP ratio of 1.7 in 1996 and a constant depreciation rate of 7.5% are assumed when constructing capital stock data. The average labour income share is estimated at 0.7 over 1997-2007 (see Annex 1.A1 for further details and comparison with other countries). Sensitivity analysis with changing parameters for the depreciation rate, initial capital stock and labour income share has been carried out. In the baseline scenario, physical capital and TFP contributed to output growth with 2.0% and 1.7% over the period. Shifting assumptions in favour of physical capital (lower depreciation rate, lower initial capital stock or lower labour income share) increases physical capital contribution to growth at the expense of that of TFP as shown in Table 1.4, but does not alter significantly the results. The economic cycle may also impact the results of growth accounting. Mourre (2009)⁴ estimates the cyclical component of capital, labour, human capital and TFP in the period 2001-07 and found only marginal impacts for Slovenia. The period 1996-2007 is assumed to cover a whole business cycle.

Table 1.4. **Factor contribution to growth**

Different parameters, 1997-2007

Value of parameter	Depreciation rate (%)		Initial capital stock		Labour income share		Depreciation rate 5.0% and initial capital stock 2.0
	5.5	9.5	1.5	1.9	0.65	0.75	
Labour	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Human capital	0.5	0.5	0.5	0.5	0.4	0.5	0.5
Physical capital	2.3	1.7	2.3	1.7	2.2	1.6	2.0
Total factor productivity	1.4	2.0	1.4	1.9	1.5	2.0	1.6

Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; Eurostat database (2009), *Economy and Finance*, February; OECD (2008), *Productivity database*, September.

1. Growth accounting seeks to explain main drivers of economic growth. According to standard growth accounting, economic growth is only partly explained by labour and capital input. The unexplained part of economic growth appears as the residual total factor productivity (TFP). TFP encompasses all growth-enhancing factors other than factor inputs, such as better quality of labour and capital equipment, changes in technology and moving resources from low to high productive sectors. It is assumed that output performance in Slovenia can be expressed using the Cobb-Douglas production function including an instrument for human capital.
2. Ark, B. van, M. O'Mahoney and G. Ypma (eds.), "The EU Klems Productivity Report", No. 1, available at www.euklems.net.
3. Weak correlation between education and GDP growth could be explained by a high initial level of education of the working force and small variation in education series over time. This instrument does not take into account working experience.
4. Mourre, G. (2009), "What Explains the Differences in Income and Labour Utilisation and Drives Labour and Economic Growth in Europe? A GDP Accounting Perspective", *Economic Papers*, No. 354, *European Economy*, European Commission.

run as the income gap narrows with more developed economies. Foreign direct investment (FDI) helps increase TFP through knowledge transfer from advanced economies (Chapter 4). In fact, the level of FDI in Slovenia is still relatively low compared to that of Central and East European countries (CEECs). Moreover, flexible product markets, reduced barriers to entrepreneurship, higher private research and development, and enhanced competition in key service sectors could foster TFP growth (Chapter 4).

Productivity growth should mainly arise from improvement in productivity within sectors

As Slovenia's economy moves toward a full-fledged modern economy, "within-sector" productivity should outweigh productivity gains resulting from movement of labour between sectors ("shift effect"), which results from changes in the structure of the economy, as experienced during the transition process toward a market economy. The shift-share analysis confirms that productivity growth arising from within-sector productivity has played a more important role since 2003 than during the five preceding years (Table 1.5). However, productivity gains resulting from within-sector effects have been smaller than those of other OECD transition economies like Poland or the Slovak Republic over the last decade, pointing to a need to implement measures favouring within-sector productivity growth (Chapter 4). Conversely, the shift effect in Slovenia was more important than other transition economies during the period (except Poland), which may have been caused by the gradual process of reforms that prolonged the transition from old to new sectors. During 1997-2007, employment in the textile, food and mining industries kept decreasing whereas it continued increasing in new and profitable industries producing car equipment, metal and electric products and machinery (Figure 1.9).

Table 1.5. Shift-share analysis of labour productivity growth per person¹
Per cent, average

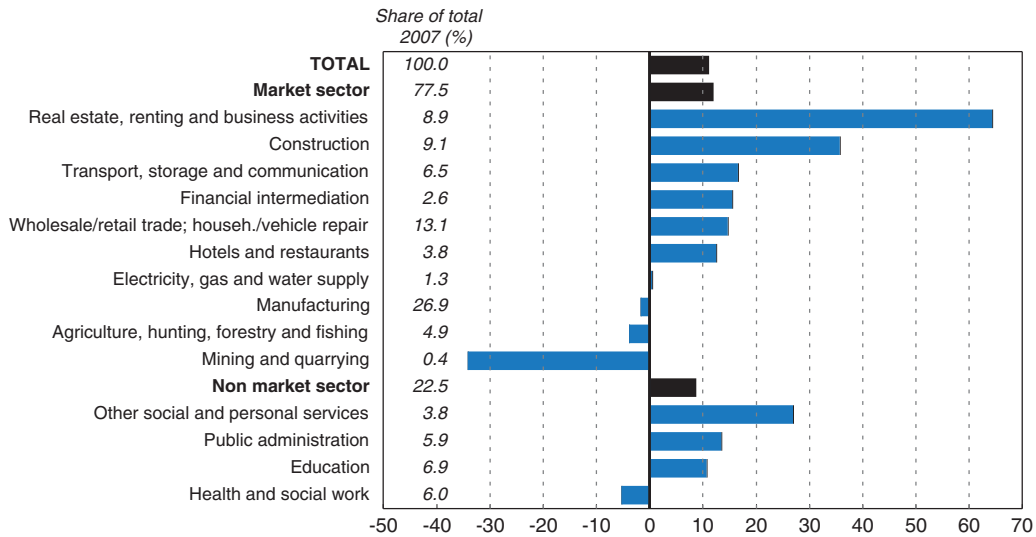
	Slovenia			1997-2007				
	1997-2002	2003-07	1997-2007	Czech Republic	Hungary	Poland	Slovak Republic	EU15 ²
Total market sectors ³	4.4	4.9	4.6	3.9	4.0	5.7	5.0	1.5
Within-sector effect ⁴	3.4	4.5	3.9	3.7	3.3	4.1	5.0	1.2
Shift effect ⁵	1.2	0.5	0.9	0.2	0.9	2.0	0.3	0.3
Interaction effect ⁶	-0.2	0.0	-0.1	0.0	-0.3	-0.4	-0.2	-0.1

1. Measured by value added at constant prices per person employed.
2. Aggregate calculated using USD at constant prices and constant purchasing power parities weighted by employment shares. Includes some estimates where data is unavailable.
3. Excluding public administration and defence; compulsory social security; education; health and social work; other community, social and personal service activities; private households with employed persons; and extra-territorial organisations and bodies.
4. The within-sector effect measures the impact of productivity growth within each sector on total economy productivity growth, assuming that labour shares are unchanged.
5. The shift effect measures the impact on total economy productivity assuming that the level of productivity in each sector is unchanged.
6. The interaction (or cross-term) effect measures the change in both labour share and productivity in each sector and accounts for the impact of labour re-allocation between sectors with varying productivity growth rates.

Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; and OECD (2008), *Structural Analysis (STAN) database*, December.

Figure 1.9. **Employment growth by sector**

Percentage growth, 2000-07

Source: OECD (2009), *OECD Reviews of Labour Market and Social Policies: Slovenia*, forthcoming.StatLink <http://dx.doi.org/10.1787/643377833024>**... and potential gains seem high in the service sector**

During the last decade, manufacturing, wholesale and financial intermediation contributed the most to within-sector productivity growth (Table 1.6), as in other transition OECD countries. The substantial contribution of these sectors reflects their high labour productivity growth (Figure 1.10). Manufacturing in particular recorded an impressive average productivity growth of over 6% in 1997-2007 in Slovenia.

Table 1.6. **Within-sector contributions to labour productivity growth¹**

Per cent, average 1997-2007

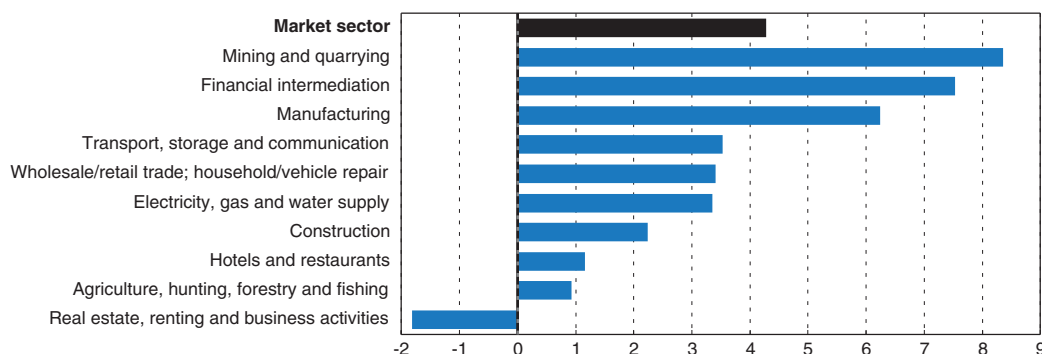
	Slovenia	Czech Republic	Hungary	Poland	Slovak Republic	EU15 ²
Agriculture, hunting, forestry and fishing	0.1	0.2	0.7	0.6	0.8	0.1
Mining and quarrying	0.1	0.0	0.0	0.0	0.1	0.0
Manufacturing	2.2	2.2	1.9	1.7	3.7	0.7
Electricity, gas and water supply	0.1	0.0	0.0	0.1	-0.4	0.1
Construction	0.2	-0.2	0.1	0.2	0.2	0.0
Wholesale and retail trade; repair of motor vehicles and household goods	0.6	1.3	0.5	0.8	0.7	0.2
Hotels and restaurants	0.1	-0.2	0.0	0.0	0.0	0.0
Transport, storage and communication	0.3	0.4	0.5	0.4	-0.1	0.3
Financial intermediation	0.4	0.1	0.3	0.4	-0.1	0.2
Real estate, renting and business activities	-0.2	0.0	-0.8	-0.2	0.1	-0.2
Market sector	3.9	3.7	3.3	4.1	5.0	1.2

1. Measured by value added at constant prices per person employed.

2. Aggregate calculated using US dollars at constant prices and constant purchasing power parities weighted by employment shares. Includes some estimates where data is unavailable.

Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; and OECD (2008), *Structural Analysis (STAN) database*, December.

Figure 1.10. **Labour productivity growth by sector**¹
Percentage growth, annual rate, 1997-2007



1. Measured by value added in US dollars at constant prices and constant purchasing power parities per person employed.

Source: OECD (2009), *National Accounts of OECD Countries – online database*, February.

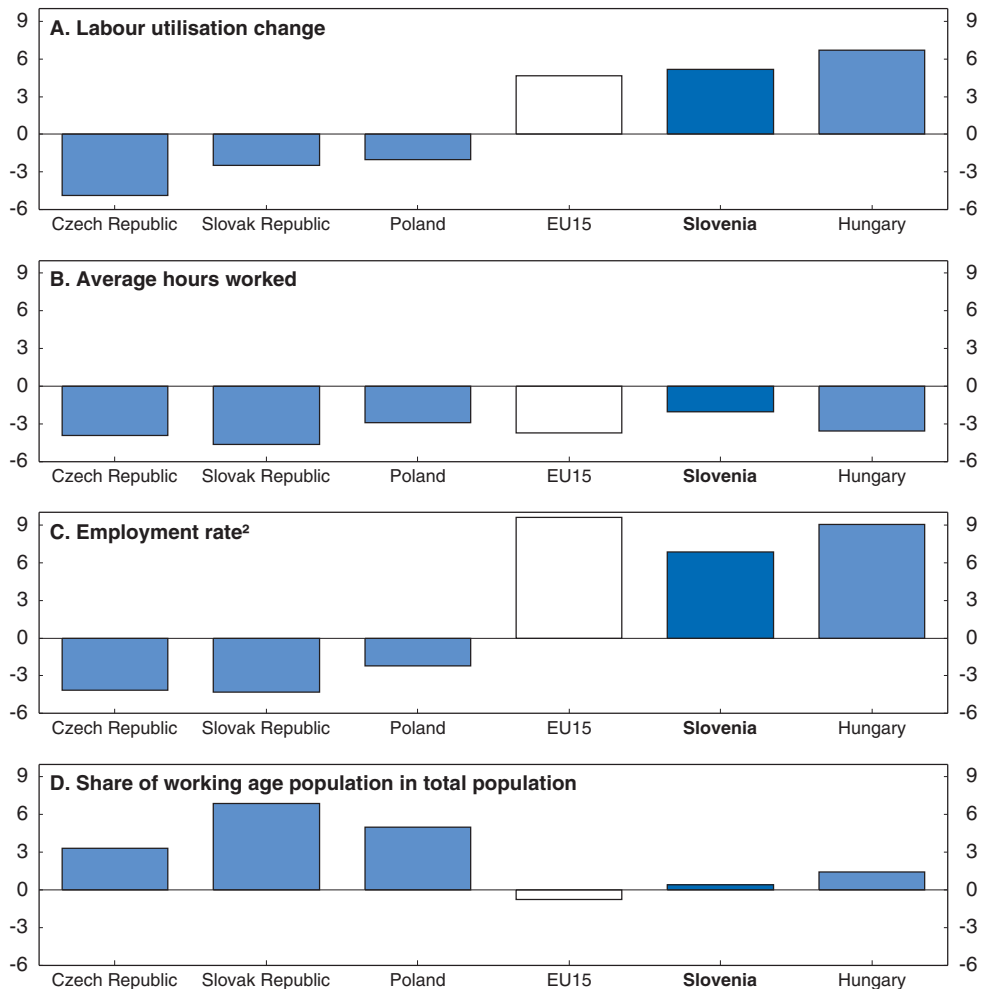
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In the future, within-sector productivity could be further strengthened by efficiency gains in sectors where productivity improvement has been limited in the past decade, notably the service sector. Even in sectors enjoying sizeable productivity growth, like the financial sector, productivity could be further improved by tackling input inefficiencies, as demonstrated by several studies (Chapter 4). Since the service sector accounts for an increasingly larger share of employment in the economy, enhanced competition and efficiency in this sector will be important to maintain high productivity growth in Slovenia.

Increasing labour utilisation remains a challenge for the future

Slovenia's convergence in terms of GDP per capita has benefited from increased labour utilisation (Table 1.2). This contrasts with the negative labour utilisation developments in the Czech Republic, Poland and the Slovak Republic, where favourable changes in the demographic structure were not sufficient to offset the negative impact of fewer hours worked and decreasing employment rates (Figure 1.11, panel D). As in the EU15 (and Hungary), the increased labour utilisation in Slovenia was almost entirely due to the higher employment rate, arising from strong growth as well as policies favouring labour participation, such as the pension reform in 1999 (Chapter 3). For the future, maintaining a positive contribution of labour utilisation to GDP per capita growth will remain a challenge for Slovenia. Given its rapidly aging population, Slovenia is unlikely to experience positive changes in the demographic structure in the near future. Regarding total hours worked, Slovenia's average number of hours worked per capita (821 in 2007) was already well above that of the EU15 (737) and most CEECs, except the Czech Republic (993). If Slovenia follows its peers and the number of hours worked falls, a positive contribution of labour utilisation to growth will require increased labour participation, especially of the older and younger cohorts (Chapter 3), or increased immigration.


Figure 1.11. **Decomposition of labour utilisation¹**
Per cent change, 1997-2007



1. Labour utilisation is measured by the number of hours worked per person.

2. To avoid issues arising from a break in series, Polish employment data prior to 2003 are estimated, see Iradian (2007).

Source: OECD (2008), *Productivity database*, September, www.oecd.org/statistics/productivity; OECD (2009), *National Accounts of OECD Countries – online database*, February; Eurostat database (2009), *Economy and Finance, and Population and Social Conditions*, February; and G. Iradian (2007), “Rapid Growth in Transition Economies: Panel Regression Approach”, *IMF Working Paper*, No. 07/170, International Monetary Fund.

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To achieve sustainable growth within the euro area, well-directed policies are needed

Slovenia adopted the euro in 2007, only three years after entering the European Union. As a result, its vulnerability to external shocks has been sharply reduced as the probability of a currency crisis has become almost nil. Indeed, euro area membership has played an important role in protecting Slovenia during the current global crisis. In the long run, being part of the euro area will bring static and dynamic gains, through lower transaction costs and increased competition, which will help boost potential GDP. Overall, euro membership should provide a sound macroeconomic framework (moderate inflation, disciplinary

mechanisms to ensure prudent fiscal policy) that is conducive to growth. Reaping the benefits of being a member of the euro area is, however, demanding. The loss of monetary policy independence and exchange rate flexibility requires a more flexible economy, so that Slovenia remains resilient to shocks, especially asymmetric shocks. Structural reforms need to create flexible product and labour markets so that prices and wages can adjust quickly if needed. The loss of monetary policy independence also requires that fiscal policy plays a bigger role in influencing aggregate demand and ensuring that inflation remains close to the euro area objective.

Fiscal policy will need to pay greater attention to the appropriate policy mix

Rapid convergence was helped by overall prudent macroeconomic policies over the last decade

Monetary policy was very successful in bringing inflation down to average euro area levels, paving the way for Slovenia to be the first transition country to enter the euro area. Adherence to a tight money-based stabilisation programme – supported intermittently by nominal exchange rate and core inflation targets – helped bring inflation down to single digits by 1996 (Ross, 1998). With capital account liberalisation and hence less control over broad money, the Bank of Slovenia successfully adopted a new policy framework closer to inflation targeting⁸ in 2002 and followed a gradual approach to disinflation based on declining currency depreciation (International Monetary Fund [IMF], Article IV, 2002). This helped the entry to the exchange rate mechanism agreement ERM II in mid-2004 at a euro/tolar parity that did not change until euro adoption in 2007. However, as a surge of capital inflows exerted upward pressure on the exchange rate, the Bank of Slovenia was first forced to intervene in the exchange market – with sterilisation operations – and then to converge faster than expected toward euro area interest rates. Sterilisation operations and lower interest rates helped fuel a subsequent credit boom (see below).

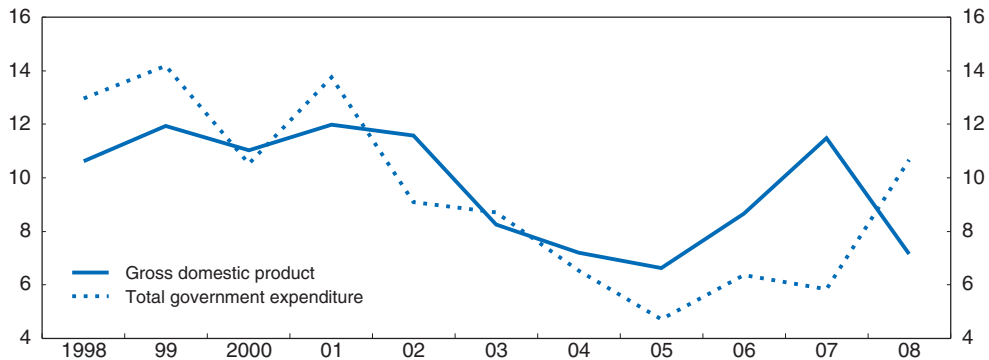
Prudent fiscal policy was also important. The fiscal deficit improved from a peak of 4% of GDP in 2001 to a small surplus in 2007. The adoption of rolling two-year budgeting in 1998, which was implemented from 1999-2000, was an effective tool to contain the growth in expenditure. Since 2002, a two-year budget had been formulated to be consistent with Slovenia's medium-term goal of attaining close to structural balance before adopting the euro. Consequently, nominal expenditure growth was more moderate than that of nominal GDP from 2002 to 2007 (Figure 1.12), leading to a decrease in the expenditure-to-GDP ratio to 42.4% in 2007 from 47.6% in 2001. However, part of this achievement was due to delayed public sector wage increases, which may now pose a risk to the fiscal position as a catch-up of public wage started in 2008 (see below and Chapter 2).

However, euro area monetary policy is likely to be too loose for Slovenia


Slovenia entered the euro area at a time when its economy started to boom. Despite monetary tightening by the ECB, financial conditions remained loose for Slovenia during its two first years of euro membership (2007 and 2008). The credit expansion in recent years has been further boosted by pro-cyclical events. In 2006, the introduction of International Financial Reporting Standards (IFRS) expanded banks' capacity to lend, since these IFRS are less stringent than previously existing Slovenian provisioning requirements. The most significant one-off boost came in spring 2007 when the Bank of Slovenia ceded all its instruments of quasi-money creation, as required by European Monetary Union (EMU) rules. This led to a repayment to banks of all bills issued as part of sterilisation

Figure 1.12. **Government expenditure and GDP**

In current prices, per cent growth



Source: OECD (2009), National Accounts of OECD Countries – online database, April.

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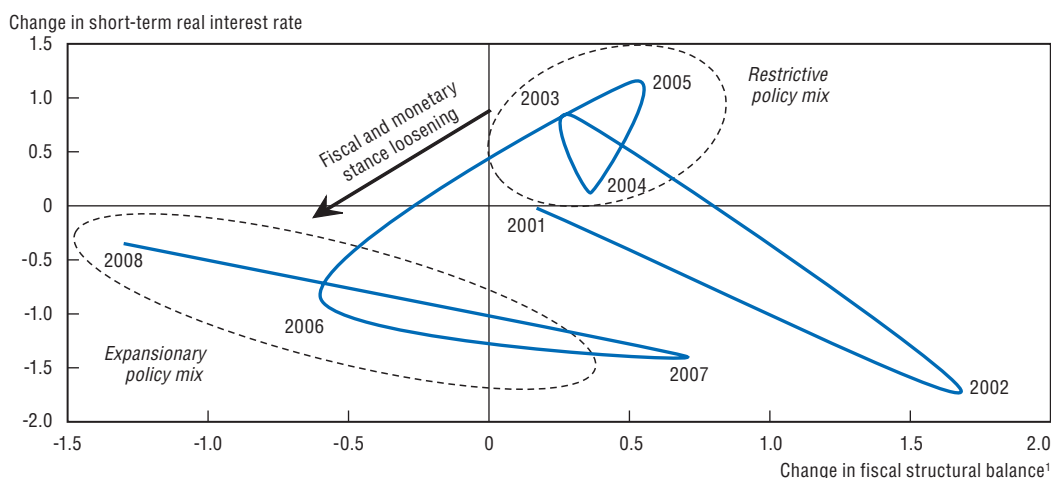
operations during the ERM II period, whose total amount equalled EUR 3½ billion, about one tenth of total bank assets. This operation alone explained about 40% of the credit growth in 2007 as part of this amount was used for lending purposes (and the rest was invested in secondary liquidity instruments on the money market). This excess in credit during recent years may have led to a build-up of risky loans, which could turn out to be non-performing given the current economic slowdown, weakening banks' balance sheets.

Slovenia being a small country at the periphery of the euro area, the likelihood of a misalignment of the common monetary stance to Slovenia's business conditions will remain high in the coming years; ECB monetary policy is likely to be too loose for Slovenia's catching-up economy. The Balassa-Samuelson effect is estimated at around 1-3% per year (Mihaljek and Klau, 2008). Such misalignment could be exacerbated by the pro-cyclical impact of mark-to-market valuation, as actually happened in 2007.

To avoid an excessive credit expansion in the future, the Bank of Slovenia should try to use all the instruments under its control to limit credit. Such options have already been explored by the Bank of Slovenia when it tried to limit the *de facto* boosting of the solvency ratio following the introduction of the IFRS norms by imposing an additional buffer (roughly 0.8 percentage points in excess of the capital adequacy ratio) until mid-2008. In case the economy starts overheating in the future, the central bank should consider again the use of additional capital requirements or other instruments that could mitigate the procyclicality of fair value accounting (Novoa et al., 2009).


Consequently, fiscal policy needs to be tighter in good times in contrast to what happened upon entrance to the euro area

In the absence of a monetary policy instrument, the main responsibility to ensure an appropriate level of aggregate demand will fall on fiscal policy. In this sense, fiscal policy should have been tighter after euro area accession. Although the fiscal balance was in surplus in 2007 (0.5% of GDP), a more restrictive fiscal policy would have been desirable to compensate for the relatively loose ECB monetary stance *vis-à-vis* Slovenia's cyclical position. Figure 1.13 shows that both fiscal and monetary policy stances were tightening during the period of qualification for the euro area (2003, 2004 and 2005). Conversely, in 2006 – the year immediately preceding euro area entry, when the Bank of Slovenia policy was *de facto* aligned to that of the ECB and its stance already easing – as well as in 2008,

Figure 1.13. **Fiscal-monetary policy mix**

1. In per cent of GDP.

Source: European Commission (2009), *Economic and Financial Affairs*, AMECO database, April.

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fiscal policy was too expansionary. Moreover, the apparent tightening of fiscal policy in 2007 was quite limited. In fact, the improvement in the structural balance owed much to the build up of likely contingent liabilities (arising from the construction company DARS) and exceptionally high tax elasticities that were compensating for the tax reforms (see Chapter 2). Correcting for these factors, the fiscal stance was expansionary in 2007.

Insufficiently tight fiscal policy was compounded by the government decision to restructure its debt in 2007 in a way that helped boost domestic credit when it was already booming. The government issued its first euro-bond of EUR 1 billion in 2007 and used three-quarters of it to repay, earlier than scheduled, debt owed to domestic banks, thereby increasing the liquidity available for banks at a time when liquidity was already expanding fast because of the repayment by the Bank of Slovenia of bonds purchased during the ERM II period. On the positive side, this borrowing, connected to EMU entry, facilitated access to the euro market during the current crisis.

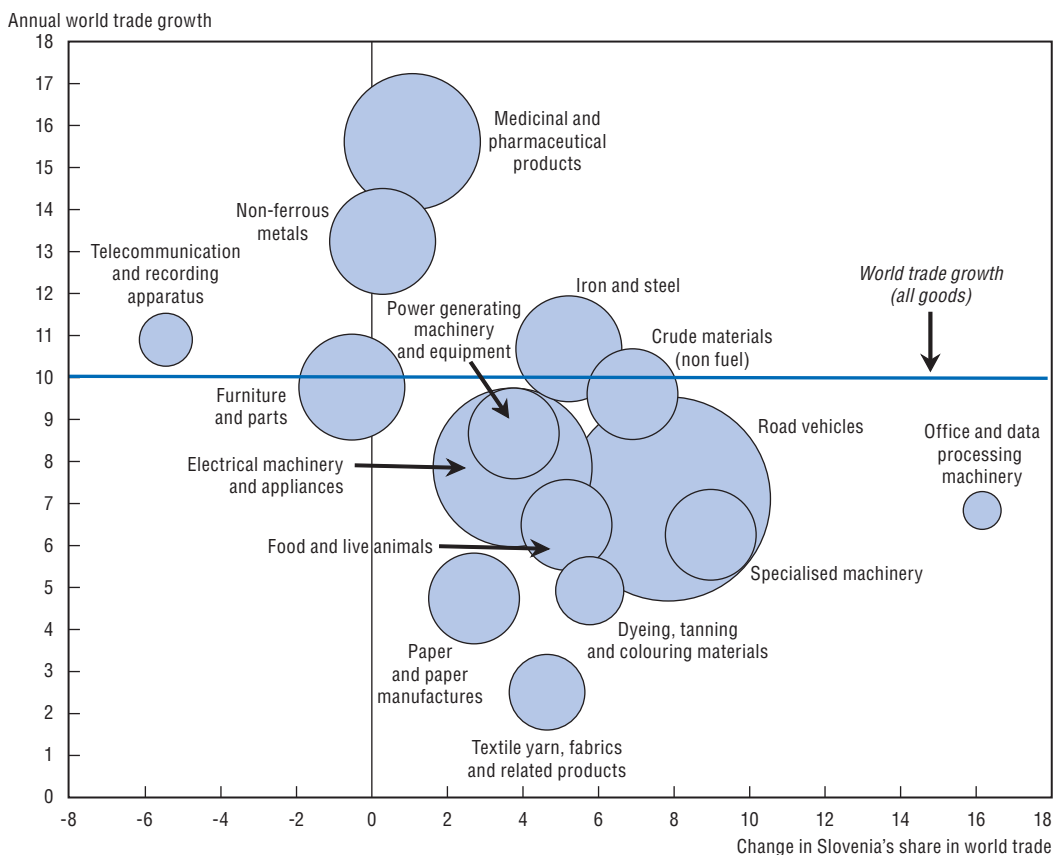
One way to help guide fiscal policy in the future could be to put in place a fiscal council. The rationale of a fiscal council is that it mitigates the information asymmetry problem between the government and its electorate and hence it helps the electorate to judge the government's fiscal decisions. This council should provide independent assessments of Slovenia's fiscal stance and its long term fiscal sustainability. Such a fiscal council could also be a useful instrument to encourage timely withdrawal of fiscal impulse as economic prospects improve, thereby preventing fiscal policy from becoming procyclical. Finally, a fiscal council could play a useful role in assessing the government's medium-term objectives. For such a fiscal council to effectively perform its task as a fiscal "watchdog", it is indispensable that it be unbiased, technically capable and highly visible (Stéclébout-Orseau and Hallerberg, 2006). As country experiences show, fiscal councils can be a useful tool in guarding fiscal sustainability. The discipline imposed by, for instance, the High Council of Finance in Belgium has contributed to the improvement of public finances over the past decade. The High Council of Finance has helped to reduce spending pressures, define medium-term budgetary objectives and incorporate age-related spending into the budgetary strategy (Lebrun, 2006).

To maintain competitiveness, real wage growth should not exceed productivity growth

Despite limited current account deficits until recently, Slovenia's competitiveness performance is mixed


Slovenian exporters managed to increase their share in world trade in most major export products during 1997-2007 (Figure 1.14). The most remarkable gain was in medicinal and pharmaceutical products, where Slovenia's market share increased amid double-digit growth in world trade. Similarly, good performance was achieved in the metals sector (iron and steel and non-ferrous metals). In road vehicles, Slovenia's most important export product, exporters boosted their share in world markets by 8% during 1997-2007. Slovenia's comparative advantage in road vehicles – measured by the revealed comparative advantage index (Figure 1.15, panel A) – increased markedly after EU entry to a level close to that of Germany (but still far from that of Japan).

Figure 1.14. **Slovenia's export performance in selected commodities**¹
Per cent, 1997-2007

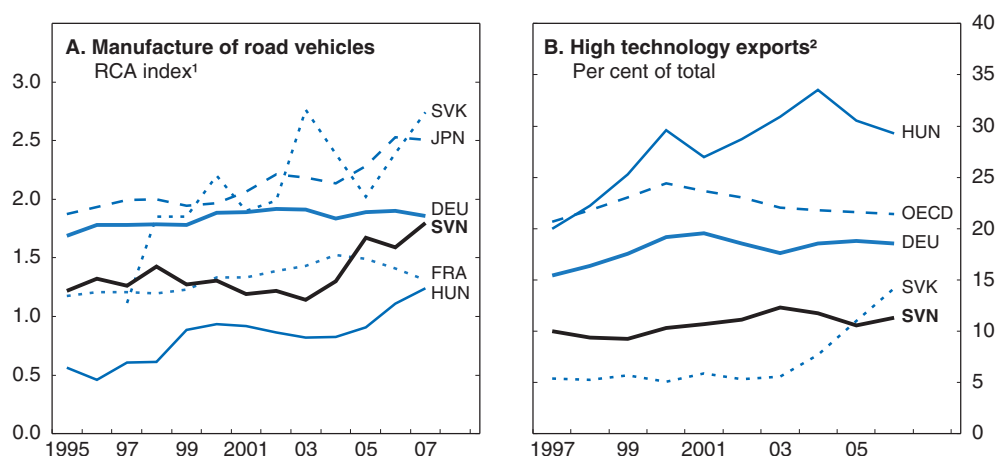


1. Commodities based on SITC Rev.3 classification; those shown represent 64% of total exports in 2007. The size of the bubble indicates the share of the sector in total exports in 2007.

Source: OECD (2009), *International Trade by Commodity Statistics*, ITCS online database, January.


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Despite this outstanding export performance in some products, the technology-intensity level of Slovenian export products remains relatively low. Measured by the share of high-technology exports in total exports, Slovenia lags behind the OECD average and

Figure 1.15. **Export performance**

1. Commodity 78: Road vehicles, based on SITC Rev.3 classification. The revealed comparative advantage (RCA) index of a country i for product j is calculated as: $RCA_{ij} = (x_{ij}/X_{it}) / (x_{wj}/X_{wt})$, where x_{ij} and x_{wj} are the values of country i 's exports of product j and where X_{it} and X_{wt} refer to the country's total exports and world total exports.
2. Based on ISIC Rev.3 classification the high technology sector includes codes 30, 32, 33, 353, 2423 pursuant to the OECD high technology definition.

Source: OECD (2009), *International Trade by Commodity Statistics*, ITCS online database, January.

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some dynamic exporters in the region, such as Hungary (Figure 1.15, panel B). Slovenia's FDI inflows are also remarkably small compared to other CEECs (Chapter 4). These points suggest a less rosy picture of Slovenia's export performance. In fact, the relatively small current account deficits until the last three years were hiding large deficits in goods trade that were mostly balanced by surpluses in the services account.

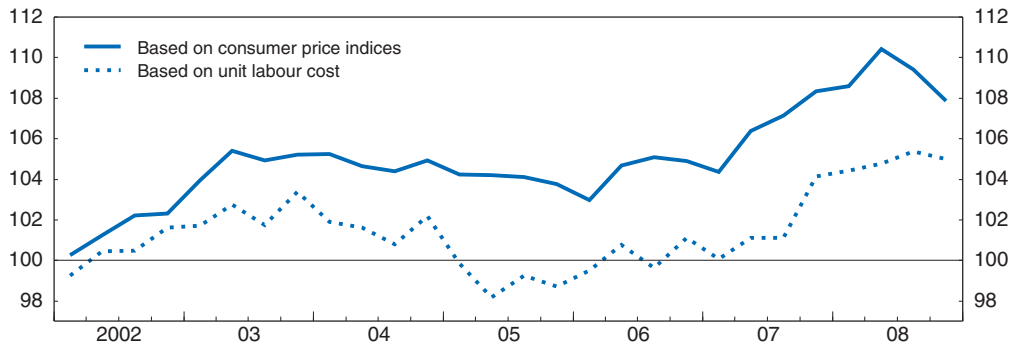
The current account deficit has risen significantly in recent years (Figure 1.1), but this does not stem from deterioration in competitiveness. Rather, as a result of the recent commodity price boom, negative terms of trade shocks contributed to a faster increase in imports than exports in value terms, boosting the deficit in goods trade. Imports were also booming because of the overheated economy, before the global crisis hit Slovenia. Finally, the current account deficit was driven by the rise in payment on the income account largely as a result of: i) an increased share of domestic commercial banks' borrowing abroad; and ii) a rise in interest rate during the period, leading to a larger than usual deficit in the current account. Nevertheless, price competitiveness, measured by the real effective exchange rate, has been deteriorating on account of high inflation, increases in labour costs and the strong appreciation of the euro since 2005-06 (Figure 1.16).

Renewed agreement that wage growth should not exceed that of productivity is key to maintaining competitiveness in the future


Recent experience highlighted the risk of a loss in competitiveness arising from excessive price or wage dynamics. Headline inflation picked up with the increase in oil and food prices in 2007 (Figure 1.1), and inflation reached the highest level in the euro area by mid-2008. The sensitivity of Slovenia's inflation to food prices is not easy to explain (Dalsgaard, 2008) and may indicate less competition in the food manufacturing and retail sectors, as shown by the high mark-ups in these sectors. The magnitude and stickiness of core inflation in 2007 and 2008 was also a puzzle and raised concerns of second-round

Figure 1.16. **Real effective exchange rate trends in Slovenia**

Index, 2001 = 100



Source: Institute of Macroeconomic Analysis and Development.

StatLink  <http://dx.doi.org/10.1787/643643627712>

effects as labour shortages and higher wage demands were prevalent at the time. Despite the current slack, wage growth is expected to exceed that of productivity in the near future for the first time since 2001, with significant planned wage increases of more than 25% over three years, of which 14.5% is a consequence of the policy of public wage catch-up that started in 2008.

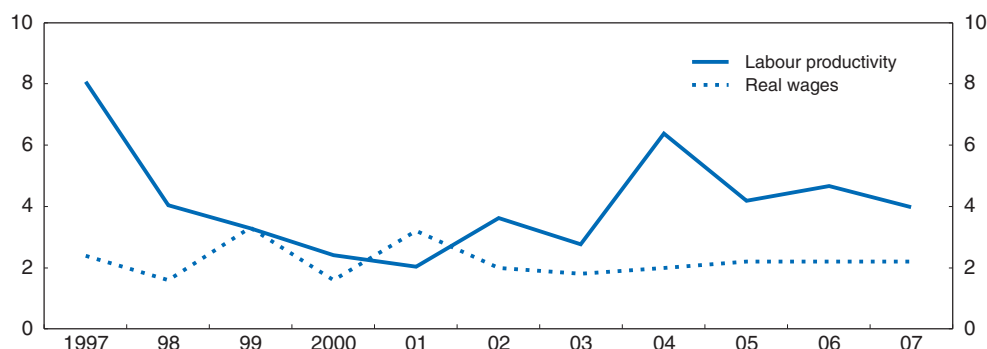
The financial crisis and the ensuing slack in the labour market have certainly reduced the risk of a wage-price spiral in the coming years. However, it remains important that wage growth does not exceed that of productivity, as had been the case since 2002, following a political agreement in 2001 between the State, employees and employers to end the backward-looking indexation of wages to inflation and to aim to keep wage growth below that of productivity (Figure 1.17). The agreement became particularly constraining for public employees as wage indexation was held to only 50% of inflation forecasts from 2004 to 2007 in order to facilitate euro area entry. Private sector wages were more dynamic, but still remained below or roughly in line with productivity growth. The new wage bargaining setting after 2001 helped to reduce inflation by lowering cost-push factors that had been largely driving inflation in Slovenia (Surti, 2008). The possibility that public wage increases could eventually add to wage pressures when the crisis subsides, damaging employment and competitiveness, is a key reason why the government should reconsider them.

Structural reforms need to be less gradual and broaden

Since independence, Slovenia has made steady progress in implementing major structural reforms in the trade and financial sectors, tax system, product and labour markets. Slovenia's catch-up and acceleration of structural reforms were not accompanied by widening income inequalities. In contrast to most other transition economies, Slovenia has succeeded so far in maintaining a very low level of inequality: the Gini coefficient in Slovenia was around 0.25 in 2005 (Medgyesi and Hegedüs, 2007), close to those of Scandinavian countries and below the EU average (0.3), and far below EU countries with similar income levels, like Portugal (0.4). Low income inequalities in Slovenia are largely attributable to strong preference for social and economic fairness, with the constitutional obligation of the State to provide employment opportunities and a healthy living environment for its citizens.


Figure 1.17. **Wages and labour productivity growth**¹

Per cent



1. Labour productivity measured by GDP in constant prices per hour worked; wages measured by the growth of real gross wages per employee.

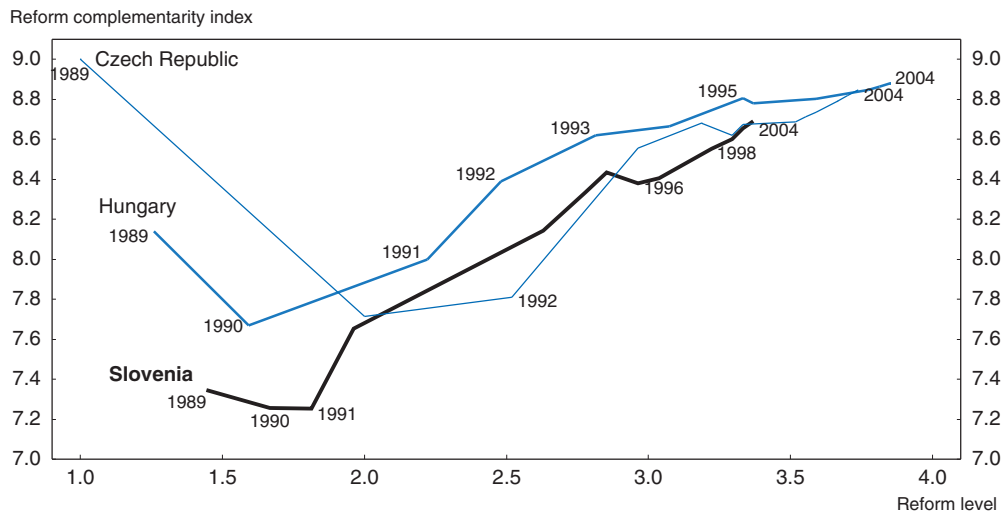
Source: OECD (2009), *National Accounts of OECD Countries – online database*, February; Eurostat database (2009), *Economy and Finance*, February; IMAD (2008), *Development Report 2008*, Institute of Macroeconomic Analysis and Development.

StatLink  <http://dx.doi.org/10.1787/643643702513>


However, the reform process has been quite gradual. For most of the 1990s, state banks were protected from competition by a ban on foreign branch banking and deposit rate ceilings; capital controls and labour market regulation were extensive; and enterprise privatisation took place mostly through a voucher scheme or internal buyouts raising governance issues. The prominent role of the Economic and Social Council, the forum for tripartite dialogue, in adopting policy reforms and its working principle of consensus building may have enhanced public support for the reforms adopted, but may also have reduced the speed and the scope of reforms. The pace of structural reforms accelerated only after a critical report by the EU Commission in 1998. EU accession (2004) and euro entry (2007) put pressure on the government to implement the remaining major structural reforms within a few years.

Reform gradualism may have slowed down the catch-up process of Slovenia. But the sequencing of structural reforms is also important as it affects the political acceptance of continuing with reforms (IMF, 2004) and reforms can also breed their own momentum. For example, there is empirical evidence that product market reforms help implement labour market reforms (Nicoletti and Scarpetta, 2003; OECD, 2002 and Fiori *et al.*, 2008). In the case of Slovenia, the timing of reforms was only partially satisfactory (see Annex 1.A3). Major trade reforms and financial liberalisation were implemented quite late (late 1990s and early 2000s) and, as a consequence, the associated benefits could not be reaped early to help implement other structural reforms. Product market reforms were implemented more slowly, with delays in privatising, setting-up efficient competition regulators, and opening up to competition of network industries (see Chapter 4). This relatively slow pace in product market reforms may explain why labour market reforms have been quite limited so far and tax reforms aiming at improving the labour market efficiency only partial and recent (see Chapters 2 and 3). Overall, progress has been made in reform level, but as shown by a recent study, the pace of reform achievement was slower compared to other countries in the region like the Czech Republic or Hungary (Figure 1.18) and, until EU accession, the complementarity of reforms was less satisfactory (de Macedo and Oliveira Martins, 2008).

Figure 1.18. **Reform achievement**
Index based on EBRD structural indicators



Source: De Macedo, J.B. and J. Oliveira Martins (2008), "Growth, Reform Indicators and Policy Complementarities", *The Economics of Transition*, Vol. 16, No. 2, European Bank for Reconstruction and Development, Blackwell Publishing.

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Challenges ahead: restore and maintain a sustainable growth within the Monetary Union

Looking ahead, the challenges for economic policy are set to intensify. Being a high-wage-cost country among emerging markets, Slovenia faces growing pressure to preserve its competitiveness. Moreover, maintaining the rapid pace of real income convergence requires stronger TFP gains and better labour utilisation than during the last decade. Box 1.4 summarises the main policy recommendations to restore and maintain a sustainable growth within the Monetary Union.

The prospects for stronger productivity and better labour utilisation hinge upon implementation of structural policies capable of promoting fiscal sustainability, making employment more attractive and enhancing the business environment. The following three chapters are devoted to these issues.

- *Keeping public finances on a sustainable path and improving its efficiency.* Slovenia's fiscal policy needs to be sufficiently counter-cyclical, particularly during good times. In addition to sticking to ambitious medium-term objectives, the introduction of an expenditure rule would be a useful device to achieve this goal. Furthermore, long-term sustainability requires taking into account upcoming ageing costs. The most important reform to implement in that respect is a pension reform, which will have the side benefit of increasing labour participation. A reform of the tax structure with a lower labour tax wedge and more consumption taxes will also foster employment and growth.
- *Labour policies: making employment more attractive.* In the medium term, labour policy measures should aim at correcting the low participation of old and young workers, and the rising duality of the labour market. Regarding the elderly; the pension system needs to be reformed to provide sufficient incentives for staying active. As for young workers, an improvement in the education system should help raise incentives for rapid graduation. To avoid a persistent dual market, an easing of employment regulation should be considered once the crisis subsides.

- *Enhancing the business environment to foster productivity growth.* While the overall state of the business environment is good, the play of competitive forces is hampered by pervasive state involvement, notably in finance, energy and telecommunications. Subdued prospects for privatisation have reinforced the need for better managing, for example through upgrading managerial skills, of state-owned enterprises as well as in firms where the government and special state funds exercise strong control. Market forces have also been hindered by strong market concentration inducing anti-competitive practices in key service sectors (retail food, banking, insurance, energy and telecommunications). Effectively tackling abuses of market power requires truly independent institutions of competition protection and market regulation.

Box 1.4. **Policy recommendations for restoring a sustainable growth path within the Monetary Union**

Conducting appropriate policy-mix

- Fiscal policy should pay greater attention to providing an appropriate policy-mix particularly when the euro area monetary stance is not consistent with Slovenia's business cycle as was the case during the past cyclical upturn. A fiscal council would be a useful device to help shape the political and public awareness on the appropriate policy-mix and fiscal sustainability.

Maintaining competitiveness

- Renew the social agreements ensuring that real wage growth is not higher than that of productivity as in the past.

Fostering the banking system

- Create a competitive banking sector that more efficiently intermediates funds. The efficiency of the banking sector could be enhanced by privatising the second largest bank once global financial markets recover.

Notes

1. Given the uncertainty about how long this revived demand for cars will last, the newly employed at Revoz are on fixed-term contracts.
2. Less than 1% of household income was capital income, one of the lowest shares in the EU according to the 2005 EU SILC survey (Medgyesi and Hegedüs, 2007).
3. An amendment to the Corporate Income Tax Act in 2008 implies that legal persons (either domestic or foreign) are exempt from the 15% withholding tax on interest received from banks (i.e. interest paid by banks) as long as their actual management is not located in a non-EU country where the general nominal corporate tax rate is lower than 12.5%.
4. The exposure of the financial system to contaminated assets is estimated to be limited to EUR 25 million (Bank of Slovenia).
5. X-inefficiency, which measures the slack in the use of production inputs, is derived from the stochastic frontier approach. According to Bems and Sorsa (2008) Slovenia appears among the furthest from the efficiency frontier irrespective of the underlying time period (1995-2007, 2000-07 and 2005-07). Holló and Nagy (2006) confirm that Slovenian banks had been relatively far from the efficiency frontier 1999-2003.
6. The Bank of Slovenia announced that it would increase the share of sight deposits (from the present 45%) that need to be matched by short-term investments under the liquidity ladder regulation. This measure was not adopted as competition for deposits has become less fierce.

7. GDP per capita (in purchasing power parities) is decomposed into the share of working age population (age 15-64) in the total population, the employment rate, hours worked per person employed, and labour productivity (per hour worked):

$$\frac{\text{GDP}}{\text{Total population}} = \frac{\text{Working age population}}{\text{Total population}} \times \frac{\text{Persons employed}}{\text{Working age population}} \times \frac{\text{Hours worked}}{\text{Persons employed}} \times \frac{\text{GDP}}{\text{Hours worked}}$$

8. Instead of targeting a specific inflation rate, the Bank of Slovenia announced a medium-term objective of 3-4% by 2005, and specific end-year forecasts for end-2002 (5.8%) and end-2003 (4.1%) consistent with this goal.

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ANNEX 1.A1

Growth accounting framework

Following the standard growth accounting framework, output performance in Slovenia can be expressed using the Cobb-Douglas production function:

$$Y_t = A_t K_t^\alpha (q_t L_t)^{1-\alpha}$$

where Y is real GDP, K is the physical capital, L is labour input, q is a human capital index (measured by education), and A is total factor productivity (TFP), which can be interpreted as containing any growth enhancing factor other than the inputs mentioned.

The path of the physical capital is calculated from:

$$K_{t+1} = I_t + (1 - \delta)K_t$$

where I denotes the real investment and δ is the rate of depreciation of the existing capital. Time series for real GDP, employment and human capital are obtained from the OECD National Accounts database. Employment data for Poland are from Iradian (2007) and education data for Slovenia from the Institute for Macroeconomic Analysis and Development (IMAD).

There exists no official capital stock for Slovenia. Capital stock series are constructed assuming a capital/GDP ratio of 1.7 in 1996 and a constant depreciation rate of 7.5%, following assumptions in Jongen (2004). For the Czech Republic, Hungary and the Slovak Republic, capital stock series are derived by assuming a capital/GDP ratio of 2.0 in 1996 and a constant depreciation rate of 5%, following Mourre (2009) whereas capital stock series for Poland are taken from national accounts. The stock of human capital is approximated using average years of schooling of the population of working ages 25-64 and is on average at 11.6 years in Slovenia, 13 years in the Czech Republic, 11.5 years in Hungary, 12.8 years in the Slovak Republic and 11.5 years in Poland in 1997-2007. Slovenian data come from IMAD. Labour contribution is measured by total hours worked by all persons in employment.

Gollin (2002) argues that labour income shares $(1 - \alpha)$ should be adjusted for self-employment in emerging economies, which means including a share of national mixed income. Assuming labour has the same share of mixed income as compensation of employees has in GDP, labour income shares are calculated each year. Average labour income shares over the period 1997-2007 are estimated at 0.70 in Slovenia, 0.64 in the Czech Republic, 0.68 in Hungary, 0.60 in the Slovak Republic and 0.58 in Poland.

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ANNEX 1.A2

Shift-share analysis of labour productivity growth

The productivity-decomposition analysis used in Chapter 1 is based on the shift-share analysis described in European Commission (2003), which decomposes aggregate changes in labour productivity into an intra-industry, a shift and an interaction effect. The “within-industry effect” measures productivity growth within each sector. The “shift effect” measures the effect on total economy productivity of the displacement of resources between industries of varying productivity levels. Finally, the “interaction effect” accounts for labour re-allocation effects between industries with varying productivity growth rates.

For each individual industry i labour productivity is defined as output Y divided by labour input L :

$$LP_{it} = \frac{Y_{it}}{L_{it}}$$

$$LP_t = \frac{Y_t}{L_t} = \sum_i Y_{it} / \sum_i L_{it}$$

When expressed in nominal terms, labour productivity can be written as a weighted sum of the within-industry productivity values:

$$LP_t = \sum_t LP_{it} \frac{L_{it}}{L_t}$$

This gives, in difference terms:

$$\Delta LP = \sum_i \Delta(LP_i) \frac{L_{it-1}}{L_{t-1}} + \sum_i LP_{it-1} \Delta\left(\frac{L_i}{L}\right) + \sum_i \Delta(LP_i) \Delta\left(\frac{L_i}{L}\right)$$

Dividing by LP_{t-1} to get the growth (percentage change) and rearranging the terms:

$$\frac{\Delta LP}{LP_{t-1}} = \sum_i \frac{\Delta LP_i}{LP_{it-1}} \frac{Y_{it-1}}{Y_{t-1}} + \sum_i \frac{LP_{it-1}}{LP_{t-1}} \left(\frac{L_{it}}{L_t} - \frac{L_{it-1}}{L_{t-1}} \right) + \sum_i \frac{1}{LP_{t-1}} (\Delta LP_i) \Delta\left(\frac{L_i}{L}\right)$$

- The first component is the within-industry effect, i.e. the sum of industry productivity growth rates, weighted by the initial (nominal) output shares.
- The second component is the shift effect, i.e. the sum of changes in input shares, weighted by the relative productivity level (i.e. the ratio of industry productivity to average productivity). This effect could also be written and decomposed as the sum of industry labour input growth rates, weighted by initial output shares, minus total labour input growth.

- The sign of the residual (interaction) component is usually negative (in the economy there is a majority of industries where the productivity change and the labour input change have opposite signs). It may, however, be positive when beneficial restructuring of the economy occurs (in this case, most of the industries enjoying productivity growth are at the same time attracting more resources).

The decomposition described above would strictly hold only in the case of (discrete) percentage changes. The logarithmic approximation (used throughout the study) entails an error of magnitude often comparable to the interaction effect. We have, however, defined the within-industry effect and the shift effect analogously to the discrete case. A corresponding decomposition for the continuous time assumption can be found in Nordhaus (2002), who has also shown that when “old-fashioned” price index methods are used (i.e. not the Törnqvist method), one should add to the decomposition an additional term accounting for the drift in prices.

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ANNEX 1.A3

Main structural reforms in Slovenia

Main objectives	Achieved so far	More progress needed
Trade sector		
Lower barriers to imports	Common external EU tariff since 2004	None at Slovenian level (EU-wide policy)
No barriers for exports	No export restrictions	None
Financial sector		
Less restrictions on international financial transactions	Liberalisation started in 1999; full application of EU directives since 2004	None at Slovenian level (EU-wide policy)
Less credit controls	Application of European Monetary Union (EMU) rules	None at Slovenian level (EMU-wide policy)
Less state regulation of interest rate	Recommended maximum deposit interest rates abolished in 2000	None at Slovenian level (EMU-wide policy)
Product markets		
Lower public ownership	Privatisation of majority of public firms since 1991	Privatise remaining state shares (banks, insurance)
Lower barriers to entry	One-stop shop for companies (2007)	Reduce market share of incumbent in many sectors (retail, bank insurance)
Improve market structure (less concentration)	Competition agency strengthened recently	Increase powers for the competition agency
Avoid price controls	..	Further liberate price setting for petroleum products
Liberalise network industries	Full or partial liberalisation for road, air, telecommunications, gas (2003) and electricity but incumbent share still high	Reduce further the incumbent share for telecommunications and electricity; open to competition rail and postal services
Labour market		
Reduce excessive employment protection (EPL)	Reduction in EPL, though mainly on temporary contracts	Further reduction in EPL on regular work contracts
Raising the employment rates of the youth and the elderly	Tightening of eligibility criteria for unemployment benefits	Further pension reform to raise work incentives of the elderly
	Simplification and reduction of labour taxes	Reform study support system and student work to raise incentives for rapid graduation
	Alignment of education system with Bologna requirements	Further reduction in minimum wage relative to average wage
Taxation		
Reduce marginal tax rate and broaden tax bases	Reform of personal and corporate income tax (2005)	Avoid further deduction for corporate tax base
Avoid excessive taxation on mobile input factor (capital, qualified labour)	Labour tax wedges have been slightly reduced since 2003	More reduction in labour tax wedge needed
Appropriate level of consumption taxes compared to labour taxes	VAT introduced in 1999 Environmental taxes have been increased	Change tax mix more towards real estate tax and indirect taxes

Glossary

ALMP	Active labour market policies
AWG	Ageing working group
CDS	Credit default swap
CEECs	Central and East European countries
CPO	Competition Protection Office
ECB	European Central Bank
EIUA	Employment and Insurance against Unemployment Act
EMU	European Monetary Union
EPL	Employment protection legislation
ERA	Employment Relationships Act
ERM	Exchange rate mechanism
EU	European Union
EU15	EU members before enlargement in May 2004
EU27	EU members as from 2007
EUR	Euro
FDI	Foreign direct investment
GDP	Gross domestic product
HSE	Slovenian Power Holding Limited
ICT	Information and communication technology
IFRS	International financial reporting standards
IMAD	Institute for Macroeconomic Analysis and Development
IMF	International Monetary Fund
KAD	Capital Fund
MBO	Management buyouts
NAIRU	Non-accelerating inflation rate of unemployment
NDC	Notional defined contribution
NKBM	Nova Kreditna Banka Maribor
NLB	Nova Ljubljanska Banka
NMS	New member states
NPL	Non-performing loan
NRDP	National Research and Development Programme
PAEFI	Public Agency for Entrepreneurship and Foreign Investment
PDIA	Pension and Disability Insurance Act
PLYA	Project learning for young adults
PMR	Product market regulation
R&D	Research and Development
SID	Export and development bank
SME	Small and medium-sized enterprises

SOD	Compensation of Restitution Fund
TIA	Slovenian Technology Agency
TFP	Total factor productivity
USD	United States dollar
VAT	Value added tax
ZPIZ	Institute of Pension and Invalidity Insurance

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On 16 May 2007, the OECD Council decided to open discussions with Slovenia on accession to the Organisation and, on 30 November 2007, an Accession Roadmap, setting out the terms, conditions and process for accession was adopted [C(2007)104/FINAL].

In the Roadmap, the OECD Council requested a number of OECD Committees to provide it with a formal opinion. The Economic and Development Review Committee was requested to review Slovenia's overall economic policies in order to provide a formal opinion on the degree of coherence of Slovenia's policies with those of OECD member countries. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council will decide whether to invite Slovenia to become a member of the Organisation.

The present Economic Survey of Slovenia was prepared for the purposes of the accession review of Slovenia and was discussed by the Economic and Development Review Committee on 16 April 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 May 2009.

The Secretariat's draft report was prepared for the Committee by Colin Forthun, Isabell Koske, Willi Leibfritz, Axel Mittelstadt and Margit Molnar under the supervision of Pierre Beynet. Research assistance was provided by Desney Erb.

The previous Survey of Slovenia was issued in May 1997. This Survey is published on the responsibility of the Secretary-General of the OECD.

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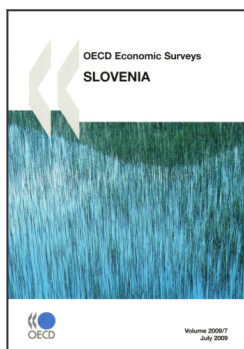


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