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INSTITUTE OF MACROECONOMIC ANALYSIS AND DEVELOPMENT

Autumn Forecast of Economic Trends 2007

(forecasts of economic trends for 2007-2009 with an analysis of current trends in 2007)

September 2007

Autumn Forecast of Economic Trends 2007

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Summary

Strong economic growth has continued in 2007. Its structure has remained favourable in terms of development since it has been driven by exports and investment. Economic growth in Slovenia has remained robust for the second consecutive year. The forecast of real GDP for 2007 totals 5.8%, 0.1 p.p. more than in 2006 and 1.1 p.p. more than projected in the spring of this year. The two main factors that contributed to the continued strong GDP growth and the raising of forecasts are better economic conditions in the international environment than expected in the spring and significantly higher investment activity. In addition to economic developments, GDP growth has also been supported by the effects of the adopted reforms, particularly in the field of taxation, along with the positive effects of EU membership, which has especially benefited external trade. The expansion of exports has sped up further this year in comparison with 2006 amid the continued vigorous growth of foreign demand, which did not moderate as projected in the spring. Since May, exports have been additionally propelled by the increased production and exports of vehicles. Apart from the faster realisation of motorway construction than projected in the spring, the higher gain in gross fixed capital formation was partly underpinned by a greater volume of other construction and stronger investment in machinery and equipment. The high capacity utilisation in manufacturing, driven by high domestic and foreign orders, was the main engine of private investment growth, which received an additional boost from the higher purchases of transport equipment in May. According to preliminary estimates, the real growth of private consumption has remained moderate this year; current indicators suggest a slight acceleration in comparison with 2006, mainly underpinned by the favourable trends in the labour market and partly by the effect of the smaller tax burden on the growth of net wages based on the new tax legislation. The growth of government consumption has also remained moderate. The structure of growth on the supply side shows that the production of manufacturing industries, particularly the chemical, machinery, and electro industries, and construction have been the main contributors to the increase in value added this year; apart from these, market services have also preserved strong growth of value added.

This year's economic boom has had a favourable effect on developments in the labour market, where employment has risen sharply (forecast for 2007: 2.3%) while unemployment has declined. This is evidenced by the decreases in the survey and registered unemployment rates, which have dipped to their lowest levels since Slovenia's independence (forecasts for 2007 total 5.0% and 7.7%, respectively). Roughly a quarter of this year's surge in formal employment is attributable to the vigorous construction activity, where

increased demand for labour has been partly met by hiring foreign workers. Employment has also risen appreciably in business services, where a significant share of workers found employment through job agencies and were also hired by other industries, and in manufacturing, particularly the metal and car industries, where the increase is linked to high orders and favourable business expectations regarding sales abroad as well as in the domestic market. The stronger demand for labour is also indicated by the results of surveys conducted in companies this year. Shortages of skilled labour have been the most frequently reported limiting factor to production, while insufficient demand for goods and services has become a relatively less prominent limiting factor. The high demand and the imbalances in the labour market are also reflected in the high rate of available vacancies.

The macroeconomic environment has remained fairly stable this year, especially as regards public finances and wage developments. Slovenia's general government position will improve this year, partly due to the cyclical effect of strong economic growth and partly as a result of the decrease in general government expenditure as a share of GDP, which will be higher than the drop in general government revenues resulting from new tax legislation. These trends are also expected to contribute to a slight decrease in the structural deficit this year, which will, however, still fall short of the medium-term objective set by the Stability and Growth Pact. Wage rises have also remained within the limits of productivity growth this year and have supported the improvement in cost competitiveness, particularly in the tradable sector. On the downside, the current account deficit will be higher than last year, chiefly as a result of the accelerated imports driven by the surge in domestic consumption, and partly due to the deteriorated terms of trade.

The increase in consumer price rises witnessed this year is largely attributable to external factors, which have a relatively stronger effect in Slovenia than in other euro area countries. The relatively faster price growth in Slovenia in comparison with the euro area average observed over the last few years primarily reflects the effects of the process of real convergence in the Slovenian economy. The additional acceleration in consumer price rises seen in the last four months appears to be related predominantly to external factors – higher prices of food and oil – which have had a stronger effect in Slovenia compared with euro area countries due to the specific structure of consumption and the relatively more rigid market in Slovenia. The autumn forecast of annual inflation for 2007 thus totals 4.3%, while average inflation is projected to be 3.4%, slightly more than the revised average inflation forecast from July 2007 (3.0%).

In 2008 economic growth will moderate but it will remain above the long-term average. The relatively lower real GDP growth (4.6%) in comparison with 2007 will partly reflect the expected easing in the growth of export demand and partly the more subdued

growth rate of gross fixed capital formation. The volume of infrastructural investment will continue to grow, chiefly in motorway construction, as will the volume of investment in residential construction and in machinery and equipment. The robust investment activity will thus expand further and add sizeably to GDP growth. However, given the already achieved high levels, in 2008 we cannot expect an increase on a par with this year. The growth of private consumption will remain at a similar level as in 2007. While private consumption has been mainly driven by employment growth and the positive effects of tax legislation changes this year, its expansion in 2008 will be mainly underpinned by stronger wage growth. Employment growth will moderate to below 1% in 2008, while the stronger wage growth (3.7% in real terms; this year 2.4%) will be underpinned relatively more than in recent years by pay rises in the public sector due to the elimination of wage disparities in the public sector negotiated in the Collective Agreement for the Public Sector, which was initialled in July 2007. Nevertheless, the overall wage growth in 2008 will not exceed productivity growth.

Foreign demand will ease off further in 2009, and the growth of investment and private consumption will also be lower. Economic growth will thus cyclically moderate to 4.1%. In line with the forecasts of economic trends in the international environment, export growth is projected to slow down to below 10% in 2009. As in 2007 and 2008, the growth of gross fixed capital formation will be under strong influence of the planned realisation of infrastructural projects, where investments in railway infrastructure will gain relatively greater weight, while the volume of motorway construction will gradually taper off. Given the anticipated trends in employment and the moderation of the real growth of gross wages per

employee to below 3%, the increase in private consumption will also be smaller (3.4%), returning to a level close to its long-term average.

In view of the expected continued high GDP growth rates in the next few years, the stabilising role of macroeconomic policies remains a key priority.

Following the entry to the euro area, when monetary policy became subject to the common interest of the euro area countries, the stabilising role in cushioning the shocks that have a greater effect in Slovenia has largely been transferred to fiscal and income policies. In order to prevent the higher price rises in some groups from spilling over to other prices and to curb inflationary expectations, it is vital that co-ordinated application of macroeconomic policies provides a stable macroeconomic framework that will ensure the adjustment of relative prices rather than an overall increase in inflation. The main task in the area of fiscal policy is to further reduce the shares of public spending and the structural deficit to the levels set by the medium-term objective, which will create greater leeway for fiscal policy to operate counter-cyclically in compliance with the provisions of the Stability and Growth Pact. In line with the adopted agreements, earnings in the public sector will increase faster in 2008. In order to preserve macroeconomic stability, wage policy must therefore ensure that the upswing in prices is not fully transferred to pay rises. Price policy should additionally support the counter-inflationary measures of fiscal and income policies by preserving the current guidelines on administered prices policy. This will allow inflation to return to its equilibrium level of 2.5%-3% already next year, which will also be crucial to maintaining the price and cost competitiveness of the Slovenian economy in the medium term.

Autumn forecasts of the main macroeconomic aggregates and a comparison with spring forecasts

real growth rates in % (unless otherwise indicated)

| | 2006 | 2007 | | 2008 | | 2009 | |
|---|--------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| GROSS DOMESTIC PRODUCT | 5.7 | 4.7 | 5.8 | 4.4 | 4.6 | 4.1 | 4.1 |
| GDP in EUR m (current prices and current exchange rate) | 30,453 | 31,918 | 33,177 | 34,444 | 35,953 | 36,783 | 38,482 |
| INFLATION (Dec/Dec of the previous year, %) | 2.8 | 2.5 | 4.3 | 2.5 | 2.9 | 2.4 | 2.7 |
| INFLATION (Jan-Dec/Jan-Dec annual average, %) | 2.5 | 2.2 | 3.4 | 2.5 | 3.5 | 2.5 | 2.8 |
| GDP deflator (%) | 2.0 | 2.5 | 3.0 | 3.4 | 3.6 | 2.5 | 2.9 |
| EUR/USD exchange rate | 1.254 | 1.294 | 1.343 | 1.292 | 1.350 | 1.292 | 1.350 |
| EMPLOYMENT according to the SNA (growth in %) | 1.2 | 0.9 | 2.3 | 0.8 | 0.9 | 0.7 | 0.6 |
| REGISTERED UNEMPLOYMENT RATE (%) | 9.4 | 8.2 | 7.7 | 7.8 | 7.4 | 7.4 | 7.1 |
| ILO UNEMPLOYMENT RATE (%) | 6.0 | 5.7 | 5.0 | 5.4 | 4.9 | 5.4 | 4.8 |
| PRODUCTIVITY (GDP per employee), growth in % | 4.5 | 3.8 | 3.4 | 3.6 | 3.7 | 3.4 | 3.5 |
| GROSS WAGE PER EMPLOYEE | 2.2 | 2.9 | 2.4 | 2.9 | 3.7 | 2.8 | 2.8 |
| EXPORTS OF GOODS AND SERVICES | 12.3 | 9.7 | 13.4 | 9.2 | 10.3 | 8.8 | 9.7 |
| - exports of goods | 13.4 | 10.1 | 13.1 | 9.4 | 10.6 | 9.1 | 10.1 |
| - exports of services | 7.3 | 7.6 | 15.0 | 8.0 | 9.1 | 7.2 | 7.9 |
| IMPORTS OF GOODS AND SERVICES | 12.2 | 8.7 | 14.2 | 8.6 | 10.1 | 7.9 | 8.2 |
| - imports of goods | 12.7 | 8.8 | 14.3 | 8.6 | 10.1 | 8.0 | 8.2 |
| - imports of services | 8.9 | 7.8 | 13.1 | 8.4 | 10.0 | 7.4 | 8.5 |
| CURRENT ACCOUNT BALANCE (EUR m) | -857 | -629 | -1,165 | -273 | -1,118 | -64 | -770 |
| - as % of GDP | -2.8 | -2.0 | -3.5 | -0.8 | -3.1 | -0.2 | -2.0 |
| GROSS FIXED CAPITAL FORMATION | 8.4 | 5.9 | 14.5 | 6.6 | 6.2 | 4.4 | 2.6 |
| - as % of GDP | 26.1 | 26.2 | 28.2 | 26.7 | 28.2 | 26.6 | 27.6 |
| PRIVATE CONSUMPTION | 4.0 | 3.8 | 4.2 | 3.5 | 4.0 | 3.4 | 3.4 |
| - as % of GDP | 53.4 | 53.4 | 52.8 | 52.5 | 52.5 | 52.1 | 52.1 |
| GOVERNMENT CONSUMPTION | 4.4 | 3.1 | 2.6 | 2.9 | 3.2 | 2.3 | 2.6 |
| - as % of GDP | 19.2 | 19.1 | 18.8 | 18.9 | 18.9 | 18.8 | 18.9 |

Sources of data: SORS, BS; forecasts by IMAD

***Background documents and data for the Spring Forecast of Economic Trends
2007-2009***

The Autumn Forecast is based on the implemented or adopted economic policy measures. The forecast of the general government current and investment consumption in 2007 takes into account the estimated realisation of general government expenditure, while the forecasts for 2008 and 2009 are based on the starting positions for proposed changes to the national budget for 2008 and for the draft budget for 2009. The forecast takes into account the enacted changes in the personal income tax, payroll tax, and corporate income tax, while it does not factor in any rises in excise duties, since this issue has yet to be decided.

The Autumn Forecast of economic trends is based on the IMAD's model and expert estimates using the following source data: (i) revised data on gross domestic product, the main national accounts aggregates, and employment for the period 2000-2006; (ii) quarterly national accounts data on gross domestic product and employment in the first and second quarters of 2007; (iii) forecasts of international institutions regarding economic trends in Slovenia's main trading partners, published by 14 September 2007; (iv) prevailing expectations of international forecasters regarding the price dynamics of oil and other commodities; (v) data on the structure of consumer price developments in the first eight months of 2007; (vi) results of the dynamic factor model and other econometric models used in forecasting; and (vii) consultations with other organisations that prepare forecasts for Slovenia.

Forecasts of economic trends for 2007-2009

Assumptions of the Autumn Forecast

Despite a slight deceleration, global economic growth will remain strong this and next year. In July the International Monetary Fund revised its forecasts of global economic growth upwards, largely due to the rapidly growing developing economies (China, India, Russia). GDP growth in Europe and Japan is also expected to be higher this year than projected in the spring, while the slowdown in the USA will be more pronounced than originally expected.

Autumn forecasts of GDP growth in Slovenia's main trading partners within the euro area for 2007 and 2008 are more favourable than they were in the spring, but a gradual softening is still expected in both years (see Table 1). Investment and exports have been the main factors of this year's economic expansion in this group of countries. Although investment growth began to ease in the second quarter in most countries, which also slowed GDP growth in all the main trading partners of Slovenia (except Austria), investment will remain the primary engine of GDP growth in euro area countries until the end of this year, chiefly due to the high capacity utilisation. Exports will also make a significant contribution, although they started to moderate already in the first half of the year, notably in Italy and France, reflecting the slightly weaker growth of global trade, coupled with the strong euro. Private consumption rose modestly this year, particularly in Germany and Austria, but is expected to strengthen gradually on the back of the overall improvement in the labour market. In 2008 private consumption is therefore expected to be the main engine of GDP growth in most euro area countries.

The strong economic growth in the ten new member states accelerated further after they joined the EU; according to the latest forecasts, it will also enable stable foreign demand for the next few years. Data show that the gap between the average GDP growth rate of the new member states and that of the old ones widened considerably after the ten countries joined the EU. In 2001-2003, the difference totalled 1.7 p.p.; in 2004-2006 it widened to 3.1 p.p. Except for Hungary, the forecasts for other main trading partners from this group (Poland, the Czech Republic) indicate that such trends will continue in 2007-2009. In Poland and the Czech Republic the vigorous GDP growth from 2006 continued in the first half of 2007; the annual figure will therefore exceed our spring expectations. Following the cooling in the international environment, GDP growth will gradually moderate but will nevertheless remain strong (see Table 1). In Hungary, the negative effects of the fiscal stabilisation programme are already noticeable:

the growth of domestic demand came to a complete halt in the first half of the year, and GDP growth has been propelled by exports instead. The structure of growth in Hungary is not expected to change significantly until the end of 2008.

In the countries of former Yugoslavia GDP growth will accelerate this year and will also exceed the spring assumptions in the next two years. In all of these countries, GDP growth surprised on the positive side in the first quarter, which also resulted in higher estimates of growth in the future. In all countries, domestic demand will be the main engine of economic expansion this year and in the next two years. In Croatia, private consumption is set to gather momentum on the back of the vigorous growth of loans, while the growth of investment is expected to moderate slightly due to fewer large infrastructural projects. In Serbia, BiH, and Macedonia, on the other hand, the strong investment growth witnessed at the beginning of 2007 is projected to accelerate further. Particularly encouraging are data on the high growth rates of investment in machinery and equipment. Coupled with the realisation of major infrastructural projects, they are set to boost the potential growth of these economies. On the whole, economic growth is expected to record just a slight moderation over the next two years, largely due to the international economic slowdown.

The potential consequences of the financial crisis in the USA are the predominant risk to the economic outlook. The onset of the financial crisis at the beginning of August that followed the collapse of the subprime mortgage market significantly heightened the uncertainty regarding economic developments in the USA. Other potential risks include the possibility of further rises in the prices of oil and other commodities, as well as food. The main upside risk refers to the possibility that the growth of private consumption in Europe will speed up more than assumed in the current projections as a result of a substantial improvement in the labour market.

The potential channels for the transfer of the negative effects of a possibly stronger slowdown in the USA to European economies are trade, financial markets, exchange rates, psychological factors, and real estate markets. The *trade* channel refers to the direct effect on European exports to the USA, which in 2006 accounted for 14.4% of the EMU's exports (excluding trade within the EMU), and the indirect effect on the European exports to other non-EMU countries. Given the nature of the current financial crisis, the *financial* channel is even more significant. Its impact depends on two factors: the actual scope of European lenders' losses, and the effect of changed risk estimates on the tightening of lending terms in Europe. The financial channel also involves the impact of slower growth in the USA on the business performance of European firms' local branches in the USA. The *exchange rate*

channel is closely linked with the two previously mentioned channels. The high value of the euro is affecting the competitiveness of European exporters, while the low value of the dollar is eroding the profitability of European firms operating in the USA. The fourth channel is *psychological*: a sudden deterioration in firms' business climate may directly affect their investment decisions, whereas consumers may become more cautious in how they spend their money. The latter is relevant with regard to the expectations that private consumption will assume the role of the main engine of economic growth in the EMU. The last channel of transfer is *real estate*: the surging prices of housing in both the USA and a number of European countries were caused by similar factors. Excess supply and the raising of interest rates

that resulted in price corrections in the USA have also been observed in Europe.

In December 2006 the European Commission estimated the impact of an economic slowdown in the USA on economic developments in the euro area. According to a scenario that assumes a 20.0% drop in housing prices in the USA and a decline in residential investment similar to the one of 1991, and which takes into account the effects transferred through the trade, financial, and psychological channels assuming a 10.0% depreciation of the dollar against the euro, GDP growth in the euro area would decelerate by 0.5 p.p. in the first year and by 0.3 p.p. in the second year following the crisis. Based on the current assumptions, this would cause GDP growth in the euro area to remain slightly below 2.0% for two years.

Table 1: IMAD's assumptions of economic growth in Slovenia's main trading partners, 2007-2009

| | 2006 | 2007 | | 2008 | | 2009 | |
|----------------------|------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| EU | 3.0 | 2.5 | 2.8 | 2.4 | 2.5 | 2.2 | 2.2 |
| Euro area | 2.8 | 2.4 | 2.6 | 2.2 | 2.3 | 2.0 | 2.0 |
| Germany | 2.9 | 1.9 | 2.6 | 2.0 | 2.3 | 1.8 | 1.9 |
| Italy | 1.9 | 1.8 | 1.9 | 1.5 | 1.5 | 1.5 | 1.6 |
| Austria | 3.3 | 2.5 | 3.1 | 2.3 | 2.4 | 2.1 | 2.1 |
| France | 2.0 | 2.0 | 1.9 | 2.0 | 2.0 | 2.0 | 2.2 |
| UK | 2.8 | 2.6 | 2.8 | 2.4 | 2.1 | 2.2 | 2.3 |
| Czech Republic | 6.4 | 5.0 | 5.5 | 5.0 | 5.0 | 4.5 | 5.0 |
| Hungary | 3.9 | 2.7 | 2.2 | 3.0 | 2.8 | 3.5 | 3.5 |
| Poland | 6.1 | 5.5 | 6.5 | 5.0 | 5.5 | 4.8 | 5.0 |
| Croatia | 4.8 | 4.5 | 5.3 | 4.3 | 5.0 | 4.0 | 4.8 |
| Bosnia & Herzegovina | 6.2 | 5.5 | 6.0 | 5.5 | 6.0 | 5.5 | 5.5 |
| Serbia | 5.7 | 5.2 | 6.0 | 5.2 | 5.8 | 5.2 | 5.5 |
| Macedonia | 3.1 | 4.0 | 4.0 | 4.0 | 4.2 | 4.0 | 4.2 |
| USA | 2.9 | 2.4 | 1.8 | 3.0 | 2.3 | 3.0 | 3.0 |
| Russia | 6.7 | 5.6 | 7.0 | 5.2 | 6.5 | 5.2 | 6.0 |

Sources of data: Eurostat; Consensus Forecasts, July 2007, August 2007, September 2007; European Commission, DG Ecfm – Interim Forecast, September 2007; European Commission, DG Ecfm – Economic Forecasts, Spring 2007, Economist Intelligence Unit Country Reports (for Bosnia, Serbia, and Macedonia), August 2007, September 2007; OECD Economic Outlook, May 2007; WIIW Research Report, July 2007; IMAD estimates.

The autumn forecasts assume higher oil prices than the spring forecasts. After the price of Brent crude averaged USD 58.1/barrel in the first quarter of 2007, it rose in the second quarter (averaging USD 68.7/barrel). Prices persisted at a high level in July and August, when the price of Brent crude rose to USD 74.0/barrel. The assumed price for this and the next two years was therefore raised. The Autumn Forecast is based on the assumption that oil prices will, on balance, remain at the level from the beginning of September until the end of 2007, which translates into an average price of USD 67.0/barrel for 2007 and USD 68.5/barrel for 2008 and 2009.

Assumptions on the demand side take into account the effect of the economic slowdown in the USA and the lower demand for oil, while assumptions on the supply side factor in OPEC's announcement that it will raise oil production by half a million barrels a day.

The autumn forecasts are also based on a higher technical assumption of the euro/dollar exchange rate than that used in the spring. Based on developments in the six months from March to August 2007, the new assumed exchange rate for the next two years totals USD 1.350 to EUR 1, up from USD 1.292 to EUR 1 assumed in the spring.

Table 2: Autumn Forecast assumptions of Brent crude prices, USD/barrel

| | 2006 | 2007 | | 2008 | | 2009 | |
|-------------------|------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| Average oil price | 65.4 | 62.5 | 67.0 | 64.0 | 68.5 | 64.0 | 68.5 |

Source of data: World Bank; assumptions for 2007-2009 by IMAD.

Revision of the main national accounts aggregates used in the Autumn Forecast

In September 2007 the national statistical office published a methodological revision of data on gross domestic product, the main national accounts aggregates, and employment for the period 2000-2006. GDP figures were revised upwards by an average of 1.8%-1.9% in 2001-2004 and by 2.2%-2.4% in 2005

and 2006. According to a preliminary annual estimate, the revised value of GDP for 2006 is SIT 7,296,627 m, which is 2.4% more in nominal terms than the estimate based on quarterly accounts made prior to the methodological revision (SIT 7,126,012 m). The revised estimates of real GDP growth do not differ significantly from the hitherto published figures (see Table 3). The only exceptions are the years 2001 and 2006, where the new estimates of GDP growth rates are a respective 0.4 p.p. (3.1%) and 0.5 p.p. (5.7%) higher.

Table 3: Effects of the methodological revision for the period 2000-2006 as a % of GDP

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|--|------|------|------|------|------|------|------|
| 1. Nominal increase in GDP level relative to previous data release | 1.5 | 1.8 | 1.8 | 1.9 | 1.9 | 2.2 | 2.4 |
| 2. GDP growth rates after the last revision | - | 3.1 | 3.7 | 2.8 | 4.4 | 4.1 | 5.7 |
| 3. GDP growth rates before the last revision | - | 2.7 | 3.5 | 2.7 | 4.4 | 4.0 | 5.2 |
| 4. Differences in GDP growth rates (4=2-3) | - | 0.4 | 0.2 | 0.1 | 0.0 | 0.1 | 0.5 |

Source of data: SORS.

Although the revised GDP growth rates do not diverge significantly from the previously published figures, the differences between the old and new estimates of value added growth in some industries are more pronounced. With the methodological revision, the following activities have been included in GDP estimates: illegal activities (drugs and prostitution), intentionally non-registered activities (alternative medicine, private lessons, and other home services) and the estimated own-account software production. In addition, further corrections were made in order to check and improve the existing estimates by using new data sources and new assessment methods. Based on a statistical survey on profit rentals for 2003 and the 2002 Population Census, revised estimates were prepared for the housing rental market and the rentals imputed to home owners. The latter estimate was revised upwards, mainly because the number of home owners was harmonised with the Census and survey data. In the entire period, new data sources resulted in significant upward corrections to the value

of output for student work and, to a lesser degree, to the value of intermediate consumption for cash reimbursement for business trip costs in small enterprises. From 2002 onwards, the estimated output for contract-based payments was also revised upwards. A negative revision of output (value added) for subsidies and transfers in kind was only calculated until 2003; this correction was necessary to balance the figure with the 2004 estimate. Other corrections, including the routine revisions for 2004 and 2005, include the corrections that were necessary in all sectors due to the new estimates of insurance services by activity and by sector. Based on a sample survey of own-account construction of individual houses by households in 2004, new estimates of this household activity were prepared. For the entire period, the estimated production activities of households and sole proprietors were revised using new data sources. In addition to the described changes, the introduction of the double-deflation method also had an impact on the calculation of real value added by activity.

Table 4: Gross domestic product, main revision – corrections by type and by production method

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--|------|------|------|------|------|------|
| INCREASE IN GDP, total | 1.5 | 1.8 | 1.8 | 1.9 | 1.9 | 2.2 |
| 1. Illegal activities | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 | 0.3 |
| 2. Intentionally non-registered activities | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| 3. Own-account software production | 0.3 | 0.4 | 0.4 | 0.3 | 0.3 | 0.4 |
| 4. Housing activities of households | 0.0 | 0.2 | 0.3 | 0.1 | 0.1 | 0.2 |
| 5. Student work | 0.7 | 0.7 | 0.8 | 0.8 | 0.8 | 0.5 |
| 6. Cash reimbursements for business trips | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 |
| 7. Contract-based payments | - | - | 0.2 | 0.2 | 0.2 | 0.2 |
| 8. Subsidies and transfers in kind | -0.1 | -0.1 | -0.3 | -0.2 | - | - |
| 9. Other and routine revision, 2004-2005 | -0.1 | 0.0 | -0.2 | -0.1 | -0.1 | 0.4 |

Source of data: SORS.

On the expenditure side of GDP, the methodological revision required most adjustments in household final consumption expenditure and expenditure on gross fixed capital formation. Illegal and intentionally non-registered activities are fully paid by households; after the revision, these services therefore account for 1.2%-1.5% of households' total expenditure. In revising the housing activities of households, the costs of home maintenance were newly divided into the costs of current maintenance (intermediate consumption of housing activities) and the costs of major repairs of an investment nature. Thus, the total rental or output of these activities is now lower, while the investments of households in residential construction have increased accordingly. The revision included the estimated imports of illegal drugs (on average just above 0.1% of

GDP) into imports of goods. In addition, the estimated imports and exports of insurance services have been revised on the basis of data reported by insurance companies.

As a result of the methodological revision, the estimated employment also required a correction. The estimated illegal and intentionally non-registered activities were included in employment estimates, as were the improved employment estimates based on student work and contract-based work data. The new estimates of employment according to the national accounts have been revised upwards by slightly less than 1%.

Economic growth

Evolution of the main demand aggregates

GDP growth in the first half of 2007 reached 6.5%, considerably exceeding last year's average, which totalled 5.7% according to revised data (see also 'Revision'). After its exceptional pace of 7.2% in the first quarter, economic growth moderated somewhat in the second quarter but remained strong at 5.9%. The structure of growth was favourable as well. The booming investment activity (up 21.6%) and the strong real growth of exports (13.9%) were the main drivers of economic growth, while private and government consumption recorded modest mid-year real increases (3.2% and 0.2%, respectively).

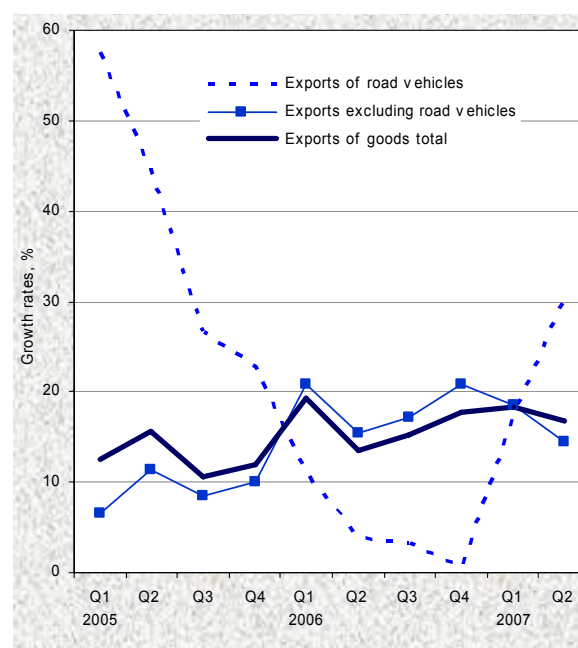
Looking at investment, this year has seen the fastest growth in investment in buildings and constructions.

This segment recorded a 26.5% increase in the first half of the year, partly due to the favourable weather conditions particularly at the beginning of the year. Residential investment rose by 17.1%, while investment in other buildings and constructions surged by 30.1%. The first quarter saw a boom in investment in civil engineering (notably motorway construction), while the second quarter was characterised by buoyant investment in non-residential buildings. According to our estimates, investment growth was brisk in both the public and the private sector.¹ Investment in machinery and equipment rose by 17.0%; particularly high was the increase in investment in transport equipment in the second quarter (48.6%), which was partly due to the one-off effect of the transport equipment purchase in May. Apart from that, the booming investment activity in machinery and equipment has also been underpinned by favourable international economic trends.²

Slovenia has recorded strong real growth of exports for the fourth year since joining the EU. Since Slovenia joined the EU, the average annual increase in Slovenian goods exports has totalled 12.4% in real terms. Exports to EU countries have been rising faster than exports to non-EU countries – in the first half of 2007 approximately twice as fast (by around 20% in nominal terms.) In terms of export structure according to the SITC, the exports of road vehicles, iron and

steel, metal products, wood and cork, and feeding stuff for animals have contributed the largest shares to the nominal increase in goods exports in the first half of the year (45.4% of the total increase in exports). Exports of services recorded an even stronger gain than exports of goods in the first half of the year (17.8% over 13.2%), largely due to the high exports of some predominantly knowledge-based services in the group of other services, namely merchanting, financial services, and construction services. The smallest increase in this period was recorded in transport services exports.

Figure 1: Nominal gains in exports of road vehicles and other goods



Source of data: SORS; calculations by IMAD.

Imports rose somewhat more than exports in the first half of 2007.

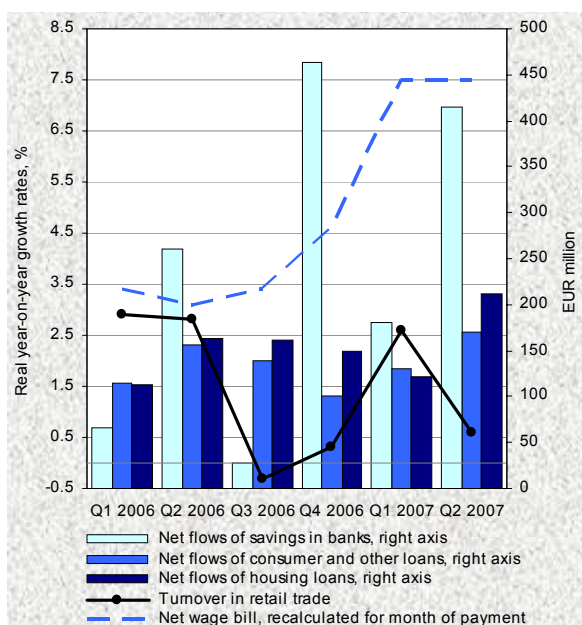
Imports of goods increased by a real 15.4% in the six months to June. Due to the boom in industrial production, imports of intermediate goods recorded the highest increase within total imports of goods (expressed in euros). This points to a strong dependency of imports for subsequent exports, which has even increased over recent years as a result of the growing economic integration and globalisation of Slovenian producers. Individual groups of products that made the largest contributions to the nominal year-on-year increase in imports (46.8% of the total gain) are: road vehicles, iron and steel, electrical machinery and equipment, non-ferrous metals, metal products, and metal ores. The increase in services imports recorded in the first half of the year (18.4% in real terms), which was almost 10 p.p. above the 2006 average, was largely propelled by imports of construction and assembly services and investment works performed by foreigners linked to the strong investment in buildings and constructions.

¹ According to the consolidated general government revenue and expenditure, public expenditure on new construction, reconstruction, and renovation was a nominal 40.6% higher in the first half of 2007 compared with the same period of 2006. Meanwhile the value of non-residential construction put in place increased by 37.6% in real terms.

² The non-financial corporate sector, especially in those manufacturing industries which are strongly export-oriented, generates the highest share of this investment in machinery and equipment. On the other hand, the general government and household sectors exhibit over-proportionate investment in construction. In 2005 their total share accounted for 47.2% of the total investment in buildings and constructions, whereas their share in investment in machinery and equipment was just 22.1%.

In the first half of 2007 household income rose at a faster pace than in the same period of 2006. As a result of the substantial increase in the number of persons employed by legal entities (2.9%) and the lowering of taxes on personal income, the mid-year real increase in the net wage bill was 4.6 p.p. higher than in the comparable period of 2006 (while the increase in the gross wage bill was 2.3 p.p. higher). Compared with the first half of 2006, the purchases of durable and semi-durable goods picked up – the number of new car registrations was over a tenth higher than in the same period of 2006; meanwhile, the brisk growth of turnover in shops selling furniture, household appliances, and construction material continued.

Figure 2: Private consumption indicators and net flows of household loans and savings in banks



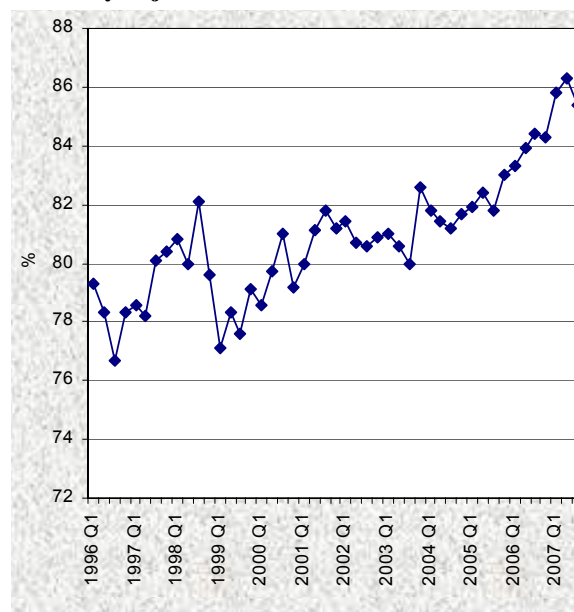
Sources of data: SORS, MF, BS, AJPES; forecast by IMAD.

Government consumption has recorded the smallest increase among consumption aggregates this year. The modest mid-year increase in government consumption (0.2%) can be explained by the weak growth of employment in the general government sector, coupled with a softening in local budgets' expenditure growth on goods and services after its faster growth in 2006 (an election year).

Based on the developments in the first half of 2007 and the favourable business expectations until the end of the year, GDP growth is projected to total 5.8% this year. The sizeable correction of the GDP growth forecast for 2007 is based on better than expected results in exports and investment activity. The moderation of economic growth in EU countries has been slower than we assumed in the spring projections. The business cycle in the countries of former Yugoslavia has also been stronger than expected.

Furthermore, the production and exports of road vehicles have been rising at a faster pace than last year (see Figure 1) and are currently expected to contribute slightly more to the total exports of goods than assumed in the spring. Thus, the real annual increase in goods exports will exceed the spring forecast by 3 p.p. and total 13.1%, a similar rate as in 2006. An even stronger acceleration relative to the spring forecast and relative to last year is expected in exports of services whose gain will strengthen to 15% in real terms, largely on the back of the structurally favourable increase in the share of predominantly knowledge-based services. The high business expectations linked to the developments in the international environment, and even more the boom in construction investment, have underlain the significant revision of the forecast for gross fixed capital formation, which is projected to increase by a real 14.5% this year. This forecast anticipates that growth will ease off in the second half of the year due to the expected moderation in construction investment, which is already showing in some current data.³ We estimate that the vigorous investment in machinery and equipment witnessed over the last two years will lessen the pressure on capacity utilisation, which is already evidenced in data for the third quarter (see Figure 3), which will result in a gradual slowdown of this investment. The softening in the international environment and the somewhat tighter financing conditions (higher interest rates) will additionally contribute to the slowdown.

Figure 3: Capacity utilisation in manufacturing, seasonally adjusted



Source of data: SORS.

³ Construction activity is already showing signs of moderation. The value of construction put in place in the first five months of the year was 37.8% higher than in the same period of 2006; in the next two months the gap narrowed to "just" 18.5%.

The current indicators of household income and expenditure show that the real growth of private consumption will edge up to 4.2% from last year's 4%. This increase will be largely underpinned by the higher rise in the net wage bill resulting from the accelerated growth of both employment and the net wage per employee; the latter has accelerated due to the lower tax wedge enacted by new tax legislation. However, since the tax cuts mainly pertain to higher income brackets where the propensity to save is stronger, part of the funds is being transferred to savings in banks and to mutual funds.⁴ The real growth of private consumption will therefore remain below the real growth of disposable income (5%) this year.

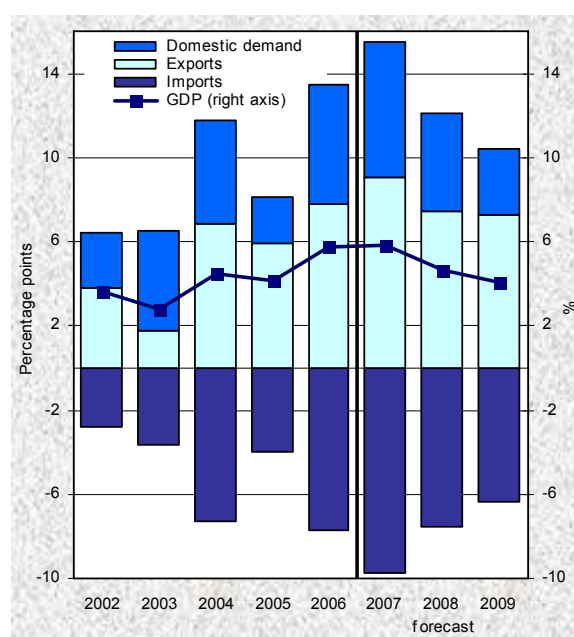
The growth of government consumption has moderated this year (2.6%) from its pace of 2006 (4.4%). The volume of government consumption is based on the estimated realisation of general government budget. The modest increase in employment in the general government sector appears to be a significant factor of the slowdown in government consumption. On the other hand, the expenditure that has risen more rapidly this year includes the costs related to Slovenia's Presidency of the EU (transport costs and services, travel costs, current maintenance of buildings, and other operating costs), the cost of special materials and services for the national armed forces, and the cost of setting up the Schengen border.

The stronger growth of domestic consumption will be matched by a high real increase in the imports of goods and services this year. Imports of goods are estimated to rise by a real 14.3%, which is over 5 p.p. more than projected in the spring and largely reflects the correction in this year's estimated gross fixed capital formation, which includes several major one-off purchases of transport equipment (in May). Imports of services are projected to increase by a real 13.1% this year, with above-average gains of the group of other services.⁵

Economic growth in 2008 will slow down by a good percentage point from this year's pace to total 4.6%. Weaker growth of foreign demand and investment activity will be the main factors of the anticipated moderation. The growth of road vehicles exports is expected to partly compensate for the projected slowdown in the international environment already in the second half of 2007 as well as in 2008; exports of

goods are therefore forecast to rise by 10.6% in real terms next year. Exports of services will slow down to a pace of 9.1% under the influence of the projected softening in exports of other services and transport services. As the construction of the national motorway network is expected to be finalised earlier than originally planned, we can expect a further increase in motorway investment in 2008. Investment of the private sector will be boosted by the phased abolition of the payroll tax for companies and lowering of the corporate income tax. However, the international economic slowdown, the tighter financing conditions, and the increase in production capacity realised over the last two years are bound to dampen business investment. Therefore, investment in machinery and equipment is expected to rise only slightly in 2008. On the other hand, the real growth of private consumption will not decline significantly (to 4%) and will remain broadly consistent with the estimated increase in disposable income in that year. Within the latter, the growth of the number of wage recipients will be slowing, while the growth of the gross wage per employee will accelerate due to the release of funds earmarked for the elimination of wage disparities in the public sector (see also 'Labour market'). The real growth of government consumption will pick up to total 3.2%. The projections take into account the starting positions for the proposed changes to the national budget for 2008, according to which the growth of employment in the general government sector is planned to strengthen somewhat (to 1.4%, up 1 p.p. from 2007), as is the increase in the earnings of employees in this sector (see also 'Earnings'). Expenditure related to the EU Presidency and expenditure on medicines and on goods and services in health care will record above-average increases in 2008.

Figure 4: Contributions of export demand and domestic demand to GDP growth, 2002-2009



Source of data: SORS; forecast by IMAD.

⁴ In the seven months to July, the net flows of household savings in banks amounted to EUR 727.3 m, more than double the volume of the net inflows from the same period of 2006. Meanwhile, the net payments into mutual funds recorded in the first six months of the year totalled EUR 287.1 m, which was 4.2-times more than in the comparable period of 2006.

⁵ Other services include: communication, construction, insurance, financial, computer and IT services, cultural and recreational services, other business services (merchandising), licences, patents and copyrights, and government services.

In 2009 economic growth will slow to 4.1%. In addition to the somewhat lower growth of exports (9.7%), due to the expected further softening in the international environment, the increase in domestic consumption will also be lower in 2009 (3.1%). Investment in gross fixed capital formation will slow down in particular due to the planned completion of motorway construction, despite the expected stronger investment in other infrastructural projects relative to previous years. After hovering around 4% for three years, the pace of private consumption growth will ease off to 3.4% in 2009, which is in line with the projected slowdown in household disposable income for that year.

Any faster cooling of economic growth in the USA in 2008 would have a relatively small impact on the materialisation of the autumn forecast. Among the downside risks to the autumn forecast we estimated the consequences of a quicker than expected slowdown of

US economic growth in the next two years that would follow the sharp drop in real estate prices and housing investment. If GDP growth in the USA were 1.25 p.p. lower than projected in the baseline scenario in both years, it would directly translate into weaker growth of Slovenian exports to the US market. Indirectly, it would also affect Slovenia's exports to countries that would be most affected by the slowdown in the American economy as their GDP growth would consequently slacken as well (see also 'Assumptions of the Autumn Forecast'). To a much lesser extent, the international downturn would also affect investment, especially in machinery and equipment, which is characterised by the greatest dependence on the business cycle. The overall impact of the indirect and direct effects of the slower economic growth in the USA would reduce Slovenia's GDP growth by a maximum of 0.2 p.p. The effect would be more pronounced in the first year.

Table 5: Autumn forecasts of GDP growth and consumption aggregates and a comparison with the spring forecasts

| | Real growth rates, % | | | | | | |
|-------------------------------|----------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| | 2006 | 2007 | | 2008 | | 2009 | |
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| GROSS DOMESTIC PRODUCT | 5.7 | 4.7 | 5.8 | 4.4 | 4.6 | 4.1 | 4.1 |
| Exports of goods and services | 12.3 | 9.7 | 13.4 | 9.2 | 10.3 | 8.8 | 9.7 |
| Imports of goods and services | 12.2 | 8.7 | 14.2 | 8.6 | 10.1 | 7.9 | 8.2 |
| Private consumption | 4.0 | 3.8 | 4.2 | 3.5 | 4.0 | 3.4 | 3.4 |
| Government consumption | 4.4 | 3.1 | 2.6 | 2.9 | 3.2 | 2.3 | 2.6 |
| Gross fixed capital formation | 8.4 | 5.9 | 14.5 | 6.6 | 6.2 | 4.4 | 2.6 |

Source of data: SORS; forecasts by IMAD.

Dynamics of value added by activity

In the first half of 2007 the year-on-year growth of value added sped up to 6.8% and was 0.8 p.p. higher than in 2006; it was also higher than in the second half of 2006, when it began to accelerate noticeably.

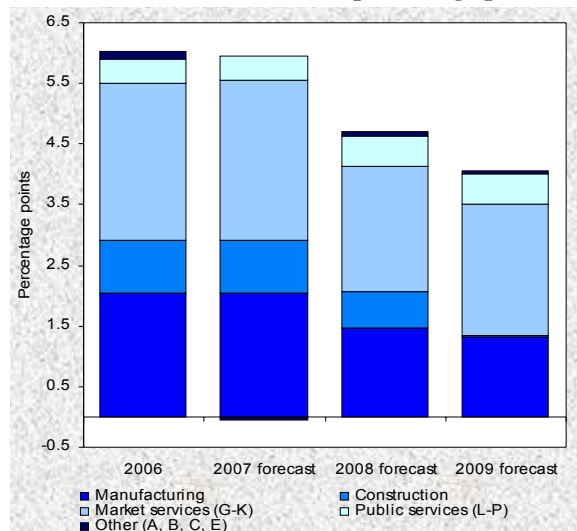
As in the previous six months, the further acceleration was largely propelled by manufacturing, construction, and market services. The 10% year-on-year growth of manufacturing's value added was driven by the rising demand in Slovenia's trading partners, coupled with a sizeable rise in domestic-market sales linked to the construction boom. Above-average growth rates of industrial production were recorded in most mainly export-oriented industries (the chemical, machinery, and electro industries) as well as in industries that are closely linked to construction (the manufacture of other non-metal mineral products, the metal industry, and the wood-processing industry). The 27.3% year-on-year surge in value added in construction was propelled by the construction of motorways, as well as residential and non-residential buildings; in the winter months it was additionally supported by the mild weather conditions. Meanwhile, developments in most market services continued to be favourable; the highest growth rates were recorded in branches that are closely linked to manufacturing and construction: wholesale trade,⁶ the sale of non-food products,⁷ freight transport, business services (particularly consultancy and information services, engineering, and job brokering). The sale of motor vehicles has also risen this year. In financial intermediation the relatively high increase in value added recorded in the first half of 2007 was again largely underpinned by banks' lending activity, which is still expanding on the back of the strong business cycle despite the gradual raising of interest rates.⁸ Within public services the slowdown in the pace of value added growth observed in 2006 has continued this year and was accompanied by a drop in the number of employees in the armed forces, the police force, and in secondary education, along with modest increases in primary education, health care, and social care. As in 2006, favourable trends were observed in tertiary education; in addition, other community, social, and personal services also recorded brisker growth than a year ago.

⁶ The nominal turnover in wholesale trade rose by almost 20% in the six months to June, year on year, marking the highest increase since 2002.

⁷ The turnover in specialised shops selling furniture, household equipment, and construction material rose by a real 21.2%, year on year.

⁸ Thus far, the gradual raising of interest rates has not had a strong dampening effect on the borrowing of the Slovenian non-banking sector from domestic banks. In the first half of 2007, the non-banking sector recorded net borrowing from domestic banks amounting to EUR 3,282.5 m, over 60% more than in the comparable period of 2006.

Figure 5: Contributions of individual activities to the increase in value added, in percentage points



Source: SORS; calculations by IMAD.

In 2007 value added will remain at the 2006 level (5.9%). With the gradual slowdown projected for the second half of the year, the manufacturing and construction sectors will achieve roughly equal growth rates as in 2006 (8.5% and 14.0%, respectively). Based on GDP growth forecasts for Slovenia's trading partners (see Assumptions of the Autumn Forecast), we expect lower growth rates in the second half of the year particularly in those industries that export extensively to the EU market, except for the manufacture of transport equipment (DM), where the car industry is projected to continue to enjoy strong growth given the realised investment. The positive effect of construction investment on the growth of manufacturing observed in the last four quarters will also wane. However, relatively favourable trends are still expected in high-technology industries, notably the pharmaceutical industry, which is not highly dependent on the EU market. The boom in construction will continue in the second half of the year, but the year-on-year growth rate of construction activity is expected to moderate in the latter part of the year due to the effect of the mild weather at the end of 2006, which is not likely to recur this year. As evidenced by data for the first half of 2007, the favourable trends in primary activities were accompanied by strong growth of value added in market services. Thus, distributive trades (G) and business services (K) will record even higher gains in value added this year than in 2006 (7.5% and 4.8%), while the growth of value added in financial intermediation (J) and in transport, storage, and communications (I) will moderate somewhat after last year's exceptional, almost 10%, gains, but will nevertheless remain fairly strong (at 7.0% and 6.5%, respectively). On the other hand, data for the first half of the year point to significantly lower growth rates in hotels and restaurants (projected to remain at roughly the rate of 2006) and in public services (a moderation from last year's pace).

Table 6: Value added by activity, real growth rates, %

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Forecast | | |
|---|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| | | | | | | | 2007 | 2008 | 2009 |
| A Agriculture, forestry, hunting | 0.1 | 12.1 | -15.8 | 15.1 | -4.4 | -3.8 | 1.0 | 1.5 | 1.5 |
| B Fishing | 16.4 | 1.3 | 4.9 | -7.0 | 20.4 | 1.5 | 0.0 | 1.0 | 1.0 |
| C Mining | -4.3 | -0.6 | 11.3 | 6.8 | 0.4 | 7.5 | 1.0 | -0.5 | -0.5 |
| D Manufacturing | 4.2 | 5.0 | 5.3 | 3.7 | 3.6 | 8.5 | 8.5 | 6.0 | 5.3 |
| E Electricity, gas, steam, and water supply | -0.1 | 5.6 | 0.2 | 6.8 | 5.7 | 5.7 | -3.0 | 1.5 | 0.5 |
| F Construction | -0.6 | 3.9 | 3.1 | 0.0 | 4.9 | 15.2 | 14.0 | 9.0 | 0.5 |
| G Distributive trades, motor vehicle repair | 5.9 | 5.4 | 2.8 | 4.2 | 4.5 | 6.1 | 7.5 | 4.3 | 3.8 |
| H Hotels and restaurants | 6.7 | 3.3 | 2.1 | -1.1 | 1.2 | 2.9 | 3.0 | 5.0 | 4.5 |
| I Transport, storage, and communications | 3.7 | -0.6 | 4.7 | 5.3 | 6.1 | 9.4 | 6.5 | 5.5 | 6.5 |
| J Financial intermediation | 5.9 | 7.0 | 3.8 | 17.1 | 10.5 | 9.8 | 7.0 | 6.0 | 6.5 |
| K Real estate, renting, and business activities | 4.7 | 2.8 | 2.3 | 2.8 | 3.5 | 3.7 | 4.8 | 4.3 | 4.5 |
| L Public administration, defence, and social sec. | 5.4 | 3.4 | 5.6 | 4.8 | 2.9 | 2.9 | 1.2 | 2.0 | 2.0 |
| M Education | 2.5 | 3.1 | 2.1 | 2.3 | 3.3 | 1.7 | 1.8 | 1.8 | 1.8 |
| N Health care and social work | 0.3 | 5.5 | 2.3 | 5.6 | 5.2 | 1.6 | 1.7 | 3.0 | 3.0 |
| O Other community, social, and personal services | 3.3 | -0.2 | 1.3 | 2.8 | 3.3 | 1.2 | 3.5 | 4.0 | 4.0 |
| P Private households with employed staff | 12.3 | -10.0 | -34.1 | -8.1 | 5.9 | -3.5 | -4.1 | 0.0 | 0.0 |
| VALUE ADDED | 3.7 | 4.1 | 3.0 | 4.4 | 4.0 | 6.0 | 5.9 | 4.7 | 4.1 |

Source: SORS; forecast by IMAD.

In the next two years the growth of value added will gradually moderate, to 4.7% in 2008 and to 4.1% in 2009. The biggest changes are expected in the construction sector. In 2008 the growth of value added will remain relatively strong at 9%⁹ due to the projected further expansion of motorway construction, only to slow down to 0.5% in 2009. Manufacturing will also experience a progressive moderation, to 6.0% in 2008 and 5.3% in 2009. The main factors underlying this slowdown include the gradual softening of the international environment and the weaker growth of construction investment (particularly in 2009). Especially in 2008, the downturn in manufacturing will be somewhat cushioned by the continued favourable trends in some technologically more intensive industries (the car industry and pharmaceutical industry). With regard to services, the value added of market services will record a slightly lower yet still strong growth, while the value added in public services will rise at a slightly faster pace than this year, albeit still below-average. Within market services, distributive trades will witness the sharpest drop in value added growth, which will stabilise at around 4% in the next two years due to the slowdown in the sales of motor vehicles and sales linked to construction activity (particularly in 2009). On the other hand, the projected increase in value added in hotels and restaurants is much higher than in recent years as a result of the increased investment since 2004 and the Slovenian Presidency of the EU (in 2008). In transport, storage, and communications, financial intermediation, and business services, growth will remain fairly strong, although it will be somewhat lower than in the last two years, when it was additionally propelled by the strong domestic business cycle. Knowledge-based services such as information and communication activities and the development and expansion of new financial and

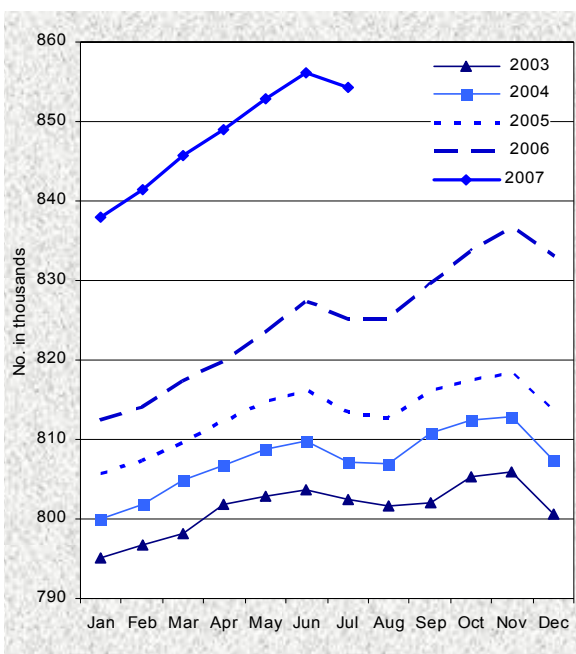
business services will be the main engines of growth. Faster growth of value added in public services will be underpinned by the increased volume of public administration activities related to Slovenia holding the Presidency of the EU in the first half of 2008, the further extension of the social and health care network, and the expansion of higher and adult education. On the other hand, low growth rates are again projected in primary and secondary education, largely due to the shrinking generations of pupils.

⁹ In the first quarter of 2008, the year-on-year pace of value added will slow down additionally due to the effect of the favourable weather conditions in the first three months of 2007, which are assumed not to recur next year.

Employment and unemployment

The growth of employment accelerated strongly in the first half of 2007. The number of the employed and self-employed (particularly farmers) increased much more than we anticipated in the spring. Moreover, the number of formally employed foreign workers also rose sharply. On the other hand, informal employment¹⁰ declined, partly on account of the higher number of sole proprietors (see Table 7). In comparison with the same period of 2006, the number of employed persons rose by 1.9% according to the labour force survey, by 3.4% according to the monthly statistics on formal employment, and by 2.5% according to the preliminary estimates of the quarterly national accounts.

Figure 6: Number of persons in formal employment by month; January 2003-July 2007



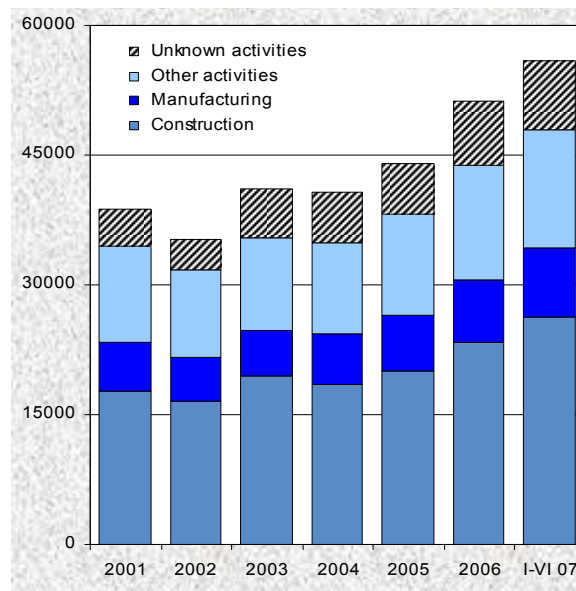
Source of data: SORS.

In the first half of 2007 employment rose most strongly in construction and business services, while formal employment also rose substantially in agriculture. In comparison with the first half of 2006, the number of formally employed workers rose by 11.1% in the construction sector, by 8.7% in business services, and by 8.3% in agriculture. The increase in the construction sector, underpinned by the higher residential and motorway construction and partly enabled by a bigger inflow of foreign workers (see Figure 7), accounted for over a quarter of the total increase in formal employment. The increase in

¹⁰ I.e. the number of people who work either as unpaid family workers, on a contractual basis, or in the grey market. In simplified terms, it is estimated as the difference between the number of employed persons according to the survey and the number of formally employed, i.e. persons in paid employment and licensed self-employed workers.

business services¹¹ represented a good fifth of the total rise, while agriculture contributed a tenth to the overall increase in employment.

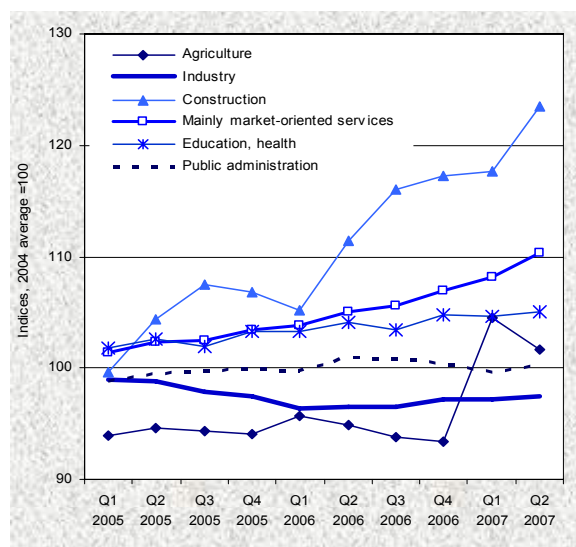
Figure 7: Number of work permits for foreign workers



Source of data: Employment Service of Slovenia; calculations by IMAD.

After the declining trend that lasted for five years, the number of workers employed in manufacturing also began to climb in the middle of 2006. In the first six months of 2007, it rose by 1.0%, year on year, with the highest rises being observed in the manufacture of metals and metal products and the manufacture of transport equipment.

Figure 8: Quarterly gains in the number of employees by sector, Q1 2005-Q2 2007



Source of data: SORS.

¹¹ Over a quarter of the increase in employment recorded in business services was due to the higher number of staff employed in job brokering agencies.

Table 7: Indicators of employment growth and unemployment rates in 2006-2009

| | 2006 | I-VI 2007 I-VI 2006 | 2007 | 2008 | 2009 |
|---|------|------------------------|----------|------|------|
| | | | Forecast | | |
| Employment according to the national accounts methodology | 1.2 | 2.5 | 2.3 | 0.9 | 0.6 |
| Employment according to the labour force survey | 1.3 | 1.9 | 1.9 | 0.5 | 0.2 |
| Formal employment according to the Statistical Register of Employment | 1.4 | 3.4 | 3.0 | 0.9 | 0.6 |
| Formal employment | 1.4 | 3.1 | 2.8 | 0.9 | 0.6 |
| – in enterprises and organisations | 1.3 | 2.9 | 2.7 | 0.9 | 0.6 |
| – activities A–K | 1.3 | 3.8 | 3.3 | 0.8 | 0.4 |
| – activities L–O | 1.5 | 0.9 | 0.8 | 1.2 | 1.2 |
| – by individuals | 1.7 | 5.1 | 4.4 | 1.5 | 0.5 |
| Formal self-employment | 2.1 | 6.4 | 4.8 | 0.3 | 0.1 |
| – sole proprietors | 2.9 | 3.7 | 3.6 | 1.9 | 1.3 |
| – own-account workers | 1.6 | 1.9 | 1.6 | 1.9 | 1.7 |
| – farmers | 1.2 | 11.0 | 7.1 | -2.2 | -1.9 |
| Informal employment (estimate) | 1.7 | -3.1 | -0.3 | 1.4 | -0.2 |
| Foreigners with work permits | 16.1 | 21.3 | 22.7 | 9.4 | 4.6 |
| Registered unemployment rate | 9.4 | 8.0 | 7.7 | 7.4 | 7.1 |
| Survey unemployment rate | 6.0 | 5.2 | 5.0 | 4.9 | 4.8 |

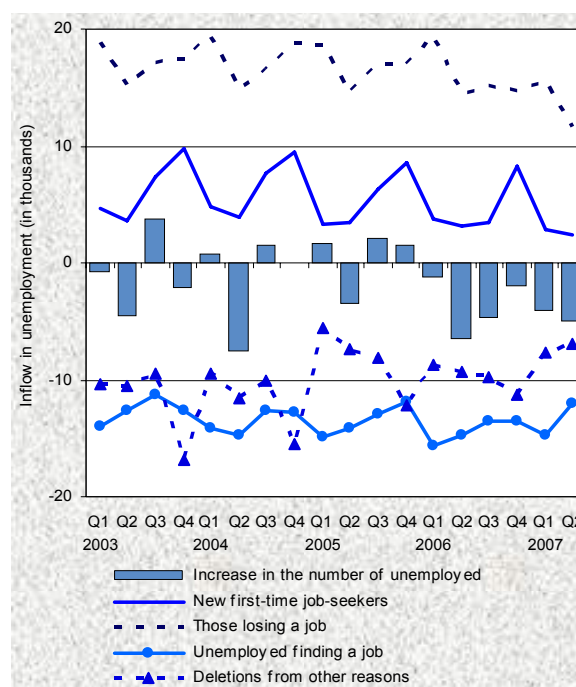
Source: SORS; calculations, estimates, and forecasts by IMAD.

Indicators of unemployment have dipped to their historically low levels this year; male unemployment has been declining at a much faster pace than female unemployment. In the six months to June, the number of registered unemployed was 18.1% lower than in the same period of 2006, while the number of unemployed according to the survey was 19.3% lower. Unemployment rates also declined: by June, the registered unemployment rate fell to its lowest level (7.5%) since April 1991, while the survey unemployment rate plunged to its historical low in the second quarter of 2007 (4.6%). This year's seasonal decline in registered unemployment was bigger than in previous years, mainly due to the smaller inflow to unemployment (see Figure 9), which was lower by a fifth in the first half of 2007 compared with the same period of 2006. At the same time, outflows from unemployment were lower as well, particularly as regards the number of persons struck off unemployment registers for neglecting their duties. Unemployment rose somewhat in July due to the layoffs of temporary workers before the summer holidays, but it fell again in August.¹² The registered and survey unemployment rates for women (in the six months to June they averaged 9.9% and 5.3%, respectively) remain considerably higher than the corresponding rates for men (6.5% and 4.2%).

Although employment is expected to grow slightly less rapidly in the second half of the year, the high growth rates measured hitherto in most activities have exceeded expectations and call for a substantial upward revision of the spring forecast. Based on the usual seasonal dynamics and projected economic

growth, employment is expected to increase by approximately 2.2% in the second half of the year and by 2.3% in the year as a whole. The spring forecast has been revised upwards mainly due to the increased demand for labour in the construction sector, as well as in industry and in the predominantly market-oriented services. These activities have also continued to record above-average gains in productivity: approximately 8% in manufacturing, about 5% in construction, and about 4% in some market services.

Figure 9: Components of the increase in registered unemployment by quarter; Q1 2003-Q2 2007



Source: Employment Service of Slovenia; calculations by IMAD.

¹² The registered unemployment rate rose to 7.6% in July, but was (as in June) still 1.8 p.p. lower than a year ago. The number of registered unemployed dropped to 68,539 in August, hitting its lowest level since April 1991.

At the same time, the number of the unemployed and the unemployment rates will be lower this year than we projected in the spring. Given the projected usual seasonal dynamics of inflows and outflows in the autumn, the number of registered unemployed is expected to drop to approximately 67,500 by the end of the year, while the registered unemployment rate will decline to 7.3%, which is 1.3 p.p. lower than projected in the spring. The average annual number of registered unemployed will total around 71,400 this year (down 16.8% from last year), while the average annual registered unemployment rate will be 7.7%. Based on the higher number of employed persons and the lower number of the unemployed, the survey unemployment rate will also be lower than projected in the spring. It will total 5.0%, which is 1.0 p.p. less than last year and 0.2 p.p. less than forecast in the spring.

In line with the projected economic trends, the growth of employment will gradually moderate in 2008-2009. In 2008 we expect an increase in employment of around 0.9% as a result of the further strong growth of employment in construction and business services, coupled with lower growth rates than in 2007 in most other services and a decline in employment in agriculture and industry. The latter is projected to continue in 2009, when the growth of employment will moderate to 0.6% due to the contraction of the number of employed in the construction sector. Given that in 2007 and the next two years employment will be higher than we projected in the spring, we also expect the unemployment rates to decline at a faster pace in the next two years: the registered unemployment rate to 7.4% and 7.1%, respectively, and the survey unemployment rate to 4.9% and 4.8%.

Earnings

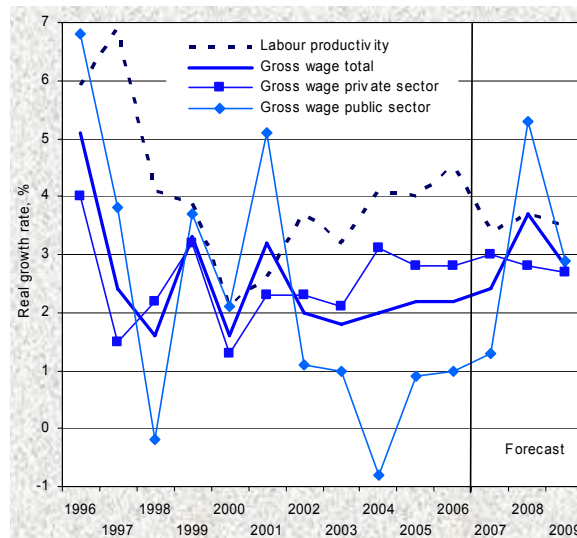
Based on the developments in the first six months and the forecasts until the end of the year, the gross wage per employee will increase by 5.9% in nominal and by 2.4% in real terms in 2007. The autumn forecast of the nominal increase in gross wages is 0.7 p.p. higher than the spring forecast due to the higher gross pay rises in the private sector, while earnings in the public sector will rise at a slower pace due to delays in the negotiations on the Collective Agreement for the Public Sector, which means that gross salaries will not begin to be disbursed according to the new system in September as we assumed in the spring.

In 2007 the average wage in the private sector will increase by 6.6% in nominal terms and by 3% in real terms. Earnings in the private sector increased by a nominal 6.3% in the first half of 2007, exceeding the spring forecast. A sizeable rise was observed in March, when most companies evaluate their performance in the previous year. Apart from that, the somewhat higher mid-year growth of wages is also attributable to the continued favourable economic trends observed this year. In the second half of 2007 the year-on-year increase in the gross wage per employee is expected to be even higher than in the first half, at 6.8%. This forecast takes into account the adjustment by a minimum of 2% in August and an additional adjustment by 0.5% to compensate for inflation exceeding 2.3% in 2006, in compliance with the *Collective Agreement on the Wage Adjustment Mechanism, Reimbursement of Work-related Costs, and Holiday Allowances*. At the sectoral level there have been no major divergences from the minimum standards negotiated in the Collective Agreement. The forecast also factors in the payments of 13th month's pay at the end of the year.

The gross wage per employee in the public sector has continued to rise at a slower pace in 2007 and is projected to achieve a 4.7% nominal and a 1.3% real increase this year. Pursuant to the *Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities 2007-2009* (hereinafter *the Agreement*), starting-level wages were raised by 1.3% in July, whereas the rest of the adjustment percentage (0.8%) was earmarked for the elimination of wage disparities in the public sector. In addition, starting-level wages were raised by a further 0.45% in July to compensate for inflation exceeding 2.35% in 2006. Further, the inflation adjustment from January onwards was also included in July's rise, which corresponded to a 2.7% increase in gross wages in July and an equal decrease in August. The forecast until the end of the year also takes into account the expenditure on regular promotions, rewards for outstanding performance, the increased workload in public administration in

preparation for the Slovenian Presidency of the EU, and the increased caseload of judges and prosecutors due to the Lukenda project (reduction of court backlogs).

Figure 10: Real growth of gross wage per employee and overall labour productivity, 1996-2009



Source: SORS; calculations for labour productivity and forecasts by IMAD.

To a greater extent than in the last few years, wage increases in 2008-2009 will be determined by wage growth in the public sector due to the elimination of wage disparities in this sector. The framework of the future wage policy is defined in the initialled Social Agreement 2007-2009, which allows the social partners to bargain, by way of collective agreements at all three levels, such wage adjustment mechanisms which take into account both inflation and labour productivity. The adjustment mechanism for 2008 and 2009 was only negotiated for the public sector in the *Agreement*, initialled in June 2006, in which the social partners agreed on an adjustment mechanism and a financial mechanism for the elimination of wage disparities in the public sector. Based on the *Collective Agreement for the Public Sector*, initialled in July 2007, indicative jobs were defined as target points around which jobs in sectoral collective agreements will be classified. Further, a performance bonus mechanism was specified, and pay supplements, the promotion system, and the time frame for the phased elimination of wage disparities in the public sector by quarters (in January 2008, September 2008, September 2009, and March 2010) were defined uniformly. Thus, these documents laid down the adjustment mechanism and the mechanism for the elimination of gross wage disparities in the public sector. In order for gross wages to be disbursed according to the new pay system in the public sector already in January 2008, the social partners must conclude sectoral collective agreements. In the private sector, negotiations on the pay policy have only just started.

In 2008 the gross wage per employee is projected to increase by 7.3% in nominal terms and by 3.7% in real terms. The forecast for the *private sector* takes into account the expected softening in the economic environment. However, the three working days more than in 2007 will result in higher year-on-year wage growth in the second half (6.7%) compared with the first half of the year (6.1%). In the entire year, the gross wage per employee in the private sector will rise by 6.4% in nominal and by 2.8% in real terms. The forecast of the nominal increase in gross wages for the *public sector* has been revised upwards from the spring due to the fact that the new wage system will not be introduced until 2008 and that wages will be raised by two quarters of the funds earmarked for the elimination of wage disparities rather than by one third, as assumed in the spring forecast, and due to the greater difference between the projected and actual inflation in 2007. In line with the adopted adjustment mechanism and the time frame for the elimination of wage disparities, the gross wage will be raised by 2.4% in January 2008, i.e. by a quarter of the funds intended for the elimination of disparities; in July 2008, based on the autumn inflation forecast (2.9%), it will be adjusted by half of this figure (1.45%), while in September it will be adjusted by the second quarter of the funds earmarked for the elimination of disparities. The forecast also takes into account that gross wages in public administration will decrease at the end of Slovenia's EU presidency proportionally with the smaller workload. Based on these assumptions and taking into account the regular funds for promotions and performance bonuses, the gross wage per employee in the public sector is projected to increase by a nominal 6.8% in 2008. Due

to the higher than projected inflation this year, gross wages will be raised by an additional 2.2% in January, i.e. by the difference between the autumn inflation forecast for 2007 and the inflation forecast used when the *Agreement* was initialled. Thus, the gross wage in the public sector will rise by a nominal 9% and by a real 5.3% in 2008.

In 2009 the gross wage per employee in the private and public sectors will increase almost evenly. The gross wage per employee is projected to rise by 5.7% in nominal and by 2.8% in real terms. The forecast of wage dynamics in the *private sector* takes into account the projected slowdown in economic activity, as well as the three working days more than in 2008. According to the forecast, the gross wage per employee will grow by a nominal 5.6% and by a real 2.7%. In the *public sector*, the projected nominal increase in gross wages takes into account the adjustment mechanism from the *Agreement* and the September wage adjustment by the third quarter of the funds earmarked for the elimination of wage disparities in the public sector. Based on these assumptions and by incorporating the regular promotions and performance bonuses, the gross wage in the public sector is projected to increase by a nominal 5.8% and by a real 2.9%.

In 2007 and 2008, the nominal growth of the gross wage per employee will lag behind the nominal growth of labour productivity, while the two will be roughly even in 2008 (see Table 8).

Table 8: Autumn forecasts of increases in wages and productivity, and a comparison with the spring forecasts for 2007-2009

| | 2006 | 2007 | | 2008 | | 2009 | |
|--|------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| Gross wage per employee (nominal growth in %) | 4.8 | 5.2 | 5.9 | 5.5 | 7.3 | 5.4 | 5.7 |
| - private sector | 5.4 | 5.2 | 6.6 | 5.4 | 6.4 | 5.4 | 5.6 |
| - public sector | 3.5 | 5.1 | 4.7 | 5.9 | 9.0 | 5.2 | 5.8 |
| Gross wage per employee (real growth in %) | 2.2 | 2.9 | 2.4 | 2.9 | 3.7 | 2.8 | 2.8 |
| Nominal growth of productivity in % | 6.5 | 6.4 | 6.5 | 7.1 | 7.4 | 6.0 | 6.4 |
| Real growth of productivity in % | 4.5 | 3.8 | 3.4 | 3.6 | 3.7 | 3.4 | 3.5 |

Source of data: SORS; forecasts by IMAD.

Note: Labour productivity is measured as GDP/employee according to the national accounts.

Since faster wage growth will be limited chiefly to the public sector next year, the cost competitiveness of Slovenian manufacturing will continue to improve amid its further strong productivity growth. The improvement of manufacturing's cost competitiveness, measured by the real effective exchange rate deflated by the relative unit labour costs in manufacturing, will be somewhat slower in 2007 and 2008 relative to the respective previous year (1.9% in 2006, 0.7% in 2007,

and 0.6% in 2008) due to the moderation in productivity growth, which will nevertheless remain strong (10.4%, 8.1%, 7.2%).

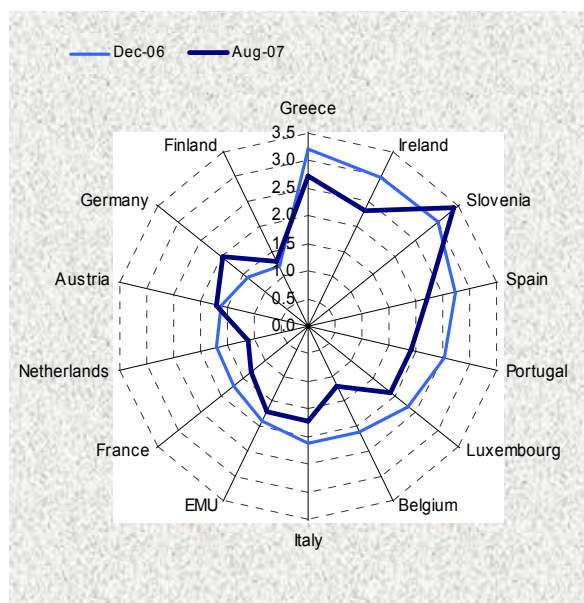
However, the cost competitiveness of the whole economy will deteriorate after two years of relatively favourable trends. The real appreciation of the effective exchange rate deflated by the relative unit labour costs of the economy is estimated at 1.9% for

2007 and 1.8% for 2008, after it totalled an estimated 0.1% in 2006. This year's deterioration is mainly attributable to the decelerated growth of labour productivity (from 4.5% in 2006 to 3.4%), since the strong GDP growth will also be accompanied by a sizeable increase in employment. The deterioration in 2008 will primarily reflect faster growth of the compensation of employees per employee resulting from the quicker growth of wages in the public sector due to the elimination of wage disparities in this sector.

Inflation

At the beginning of 2007, when Slovenia adopted the euro, its inflation rate was among the highest in the euro area. Slovenia's higher inflation is largely attributable to its higher economic growth, which has exceeded the euro area's average more than twofold in the last two years and has been closely linked to the process of Slovenia's convergence with the more developed countries, which has translated into higher price rises through the Balassa Samuelson effect. Similar developments have been observed in other euro area countries with GDP per capita and price levels roughly comparable to those in Slovenia. In the past four months, the inflation rate recorded an additional increase, which appears to be largely related to the higher prices of food, package holidays, and oil; the latter has a relatively higher share in the Slovenian price index than in the other EMU countries.

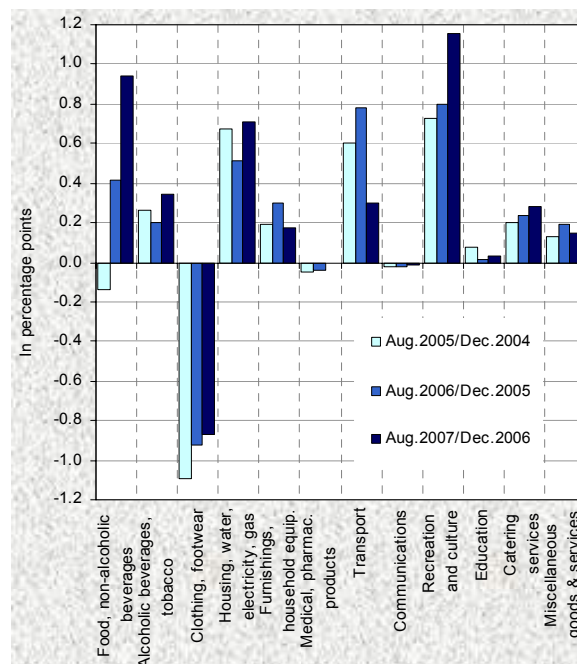
Figure 11: Year-on-year consumer price rise (HICP) in Slovenia and the euro area, December 2006 and August 2007



Source: Eurostat.

Data for the eight months of 2007 indicate that the factors underlying this year's higher inflation, which necessitated the upward revision of the inflation forecast at the end of June, also persisted in the summer months. In the eight months to August, consumer prices rose by 3.2%, 0.7 p.p. more than in the same period of 2006. A comparison of the individual contributions of price groups to inflation in the first eight months of both years shows that the prices of food and package holidays were the main reasons for this year's higher inflation (see Figure 12). These two groups, in addition to the prices of liquid fuels for transport and heating, were already identified in June's inflation forecast update as showing divergence from the trends projected in the spring forecast.

Figure 12: Contributions of individual price index groups to inflation in the first eight months of the year in the period 2005-2007



Source: SORS; calculations by IMAD.

Note: package holidays belong to the 'recreation and culture' group.

This year the contribution of food prices to inflation will be larger than we assumed in the inflation forecast update. Instead of the expected moderation in food price rises in the second half of the year, some food products have continued to record further price rises in the autumn due to the soaring prices of raw products in the world markets (especially maize and wheat, as well as meat and milk products due to the rises in the prices of feedstuffs). Therefore, the autumn forecast assumes an additional increase in food prices until the end of the year of 4.7%. Since the market in Slovenia is relatively more rigid, the price hikes observed in raw products have had a stronger impact than in other euro area countries (see also below Box: Food Price Developments).

The average oil price in August was over 13% higher than in December 2006. The price of oil, which totalled around USD 55/barrel at the beginning of the year, surged to almost USD 80/barrel during the preparation of the Autumn Forecast. Coupled with the depreciation of the dollar against the euro, the oil price hike has contributed 0.6 p.p. to domestic inflation this year. Its contribution at the end of the year is projected to remain at this level, while July's forecasts assumed that the annual contribution of oil prices to inflation will not exceed 0.3 p.p.

Table 9: Autumn forecasts of inflation and a comparison with the updated spring inflation forecasts

| | 2006 | 2007 | | 2008 | | 2009 |
|-------------------------------|------|------------------------------------|------------------------------|------------------------------------|------------------------------|------------------------------|
| | | Spring Forecast Update (July 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast Update (July 2007) | Autumn Forecast (Sept. 2007) | Autumn Forecast (Sept. 2007) |
| Inflation (annual average, %) | 2.5 | 3.0 | 3.4 | 2.7 | 3.5 | 2.8 |
| Inflation (Dec/Dec, %) | 2.8 | 3.2 | 4.3 | 2.6 | 2.9 | 2.7 |

Source of data: SORS; forecasts by IMAD.

On the other hand, the contributions of fiscal changes to inflation in the eight months to August will be lower than projected in the spring forecast update.

The raising of excise duties on alcohol, assumed in the spring forecast update, will not be carried out this year. In addition, in September the Government reduced the excise duties on liquid fuels for transport and heating to the lowest level allowed by EU regulations, pursuing the policy of counter-cyclical adjustment of excise duties on these fuels. Thus, the effect of fiscal impacts on inflation will total 0.3 p.p. this year.

This year the rises in administered prices, excluding the prices of liquid fuels for transport and heating, have again been lagging behind the market-determined price rises.

In the eight months to August, administered prices, less the impact of the price rises in liquid fuels for transport and heating, rose by 2.4%,¹³ while market-determined prices increased by 2.7%. Meanwhile, the prices of liquid fuels for transport and heating rose by 8.1% in this period, and the overall increase in the prices that are under various regimes of regulation therefore totalled 6%. Since September, consent to any changes in administered prices must be given by the Government (previously by the Ministry of the Economy), which has tightened control over these prices.

The autumn forecast of annual inflation for 2007 is 4.3%, while average inflation is projected to total 3.4%.

Since significant upward divergences have only occurred in two out of the twelve price index groups, we estimate that the orientation of economic policies has not been a contributing factor to higher inflation. The current increase in inflation is largely attributable to external factors and therefore transitory (see also Box: Food Price Developments). In order to prevent the higher price rises in some groups from spilling over to other prices and to curb inflationary expectations, it is vital that co-ordinated application of macroeconomic policies provides a stable macroeconomic framework that will ensure the adjustment of relative prices, rather than an overall increase in prices. The main task in the area of fiscal policy is to further cut the shares of public spending and the structural deficit to the levels set by the medium-term objective, which will create greater leeway for fiscal policy to operate counter-

cyclically in compliance with the provisions of the Stability and Growth Pact. In the area of wage policy, earnings in the private sector will increase at a faster pace in 2008, in line with the adopted agreements. In order to preserve macroeconomic stability, wage policy must therefore ensure that the upswing in prices is not fully transferred to pay rises. Price policy should additionally support the counter-inflationary measures of fiscal and income policies by preserving the current administered prices policy. This will allow inflation to return to its equilibrium level between 2.5% and 3% already next year, which will be crucial to maintaining or improving the price and cost competitiveness of the tradable sector.

Annual inflation will moderate to 2.9% in 2008 and to 2.7% in 2009.

In line with the forecasts of international institutions,¹⁴ which project a slowdown in global food price rises, domestic food price rises are also expected to moderate in the next two years. The soaring prices of raw products observed this year, which have been partly linked to the growing global demand,¹⁵ have prompted proposals by agricultural policy-makers both in Slovenia and the EU aimed at increasing agricultural areas available for cultivation and adopting some other measures in order to increase the supply of products, and thus mitigate the pressures on prices. Taxation and excise duties are also not expected to exert any upward pressures on inflation in 2008 and 2009. The estimated movements of the prices of liquid fuels for transport and heating are based on the assumption that the price of Brent crude will average USD 68.5/barrel in 2008 and 2009, which will contribute 0.2 p.p. to the projected inflation in 2008. The dynamics of administered prices in the next two years are expected to remain consistent with the existing guidelines.

Given that consumer price rises in Slovenia's trading partners are projected to moderate slightly, the accelerated growth of these prices in Slovenia will cause its cost competitiveness to deteriorate in 2007 and 2008. After three years of relative stability, the Slovenian real effective exchange rate deflated by relative consumer prices will appreciate by 2.2% in 2007 and by 1.7% in 2008.

¹³ The calculation includes the price of electricity, which rose by 4.9% in April, in accordance with a Government decision. Since 1 July 2007, the prices of electricity have been determined by the market.

¹⁴ OECD – FAO Agricultural Outlook 2007-2016, July 2007.

¹⁵ For a more detailed discussion see Box 1, Economic Issues 2007, IMAD. <http://www.umar.gov.si/public/izzivi/izzivi07.php>

Box: Food price developments¹⁶

The prices of agricultural commodities have soared in 2007 as a result of the weather-induced output drops in the world's major grain producers, coupled with structural changes. In Canada the production of grains suitable for bread-making and animal feeding dropped by a fifth in the 2006/07 season; in Australia it plummeted by 50%. In addition to the short-term seasonal swings in grain production, the global market is also experiencing structural changes. The increased demand for food and the changes in the structure of consumption, particularly in the developing Asian markets, which are linked to the growing populations and their incomes, have been an important element of global price projections for some time. In addition, the effect of the use of grains for biofuels production in North America and Europe has thus far been underestimated. The use of renewable energy sources is a top political priority in most countries. However, estimates of its effect on food markets have mostly been approximate and limited to individual economies. The increased use of agricultural commodities for biofuels production, coupled with a concurrent shock on the supply side, has certainly contributed to the price pressures in the global market this year. Direct effects have been observed primarily in the markets of raw materials for animal feedstuffs (maize and soy). Due to the changes in the sowing structure of major producers, indirect effects were also felt in the supply of bread grains.

Another element that has affected the global commodity market and will continue to do so has been the process of liberalising the agricultural policies of the most developed countries. Largely under the auspices of the WTO, a process was launched to abolish the agrarian policies which have been causing major distortions, but which co-laterally stabilised prices and maintained the volume of supply (by placing excess supplies on the global market).

The combination of the reduced output, the growing demand, and the extremely low global grain reserves has led to enormous price rises. According to projections for 2007, the reference global grain price will this year achieve a historically record-high level on a par to that of 1995, exceeding the average price in 2000-2005 by almost two quarters. Global grain production will fall short of consumption for the seventh time in the last eight years, which will cause grain reserves to plunge to the lowest level in thirty years. However, while most imbalances were previously caused by supply shocks, the structural shock on the demand side is currently an important systemic factor. The present situation bears some resemblance to the developments in oil markets in the last four years, which have led to an almost consensual setting of oil prices at a relatively high level.

Grain consumption in Slovenia, totalling between 0.9 and 1 million tonnes in recent years, has exceeded grain production for several years. Within that, close to a third has been intended for direct human food, while the rest has been used for animal feed, where maize predominates with a share of over 70%. In recent years Slovenia has reached a 50% self-supply rate in grains, noting that this rate is lower for bread grains.

Preliminary estimates for 2007 show that the production of the main agricultural products in Slovenia will be slightly higher than in 2006. Despite the drought, the yield of wheat is projected to exceed last year's levels by 18%, the production of barley is expected to rise by 30%, while the yield of grain maize will be almost a tenth higher than in 2006. These good results are attributable to the high average yields per hectare, as well as the increase in the area sown. Therefore, preliminary estimates do not indicate low grain crops this year, but that will not have a significant impact on the price levels, since the Slovenian grain market has been strongly influenced by international developments ever since its liberalisation upon Slovenia's entry to the CEFTA.

From January 2003 to January 2007, the average price rise in the food and non-alcoholic beverages group was lower than the average consumer price rise. Among the major sub-groups, this was particularly true of milk, milk products, and eggs, and meat and meat products. Such trends are partly attributable to the liberalisation of foreign trade, which had already started before Slovenia joined the EU, but the main reason was the consolidation of the retail food sales sector, which also resulted in the lowering of retail food prices. However, the increased concentration in the retail food sales sector has led to some other negative distortions arising from the domination in the supply chain.

Therefore, the changes in the international agricultural commodity market, albeit significant, cannot fully explain the acceleration of food prices in Slovenia observed over the last year. Economies with a high proportion of imports in the composite supply in the domestic market are most strongly affected by the developments in the global grains market. The price rise in bread grains may already be partly applied to the changes in the prices of bread and other cereals in August; however, the bulk of its contribution is expected to show in September's inflation, when the effect of the announced price rises will become fully visible. Data on the import prices of bread grains for the first half of the year also reflect the developments in the global market and their impact on Slovenian importers. Nevertheless, we should highlight that the expected direct effect of the changes in agricultural commodity prices is limited, since raw products usually account for just a fraction of the final price of products. However, this is conditional on flexible markets and competitive conditions at all levels of the supply chain.

¹⁶ The text was written by Dr. Aleš Kuhar, Biotechnical Faculty, University of Ljubljana.

Current account of the balance of payments

This year, the current account deficit will widen to 3.5% of GDP. As in previous years, the deficit will mostly arise from *trade in goods*, where the deficit (EUR 1,668 m) will rise further in comparison with last year due to the slower real growth of goods exports in comparison with the their imports; in addition, the deterioration in the terms of trade will also significantly affect the trade balance. Furthermore, the deficit in *factor incomes* (EUR 497 m) will be higher than in 2006. Although we expect receipts to record an increase due to higher interest obtained from the banking sector's stronger lending to the rest of the world and from capital exports via investment in debt securities, capital expenditure will witness an even larger increase due to higher payments of interest on external debt. The deficit in *current transfers* will be modest this year (EUR 96 m), narrowing from last year's level. This expected improvement will be the result of a higher surplus in the national budget against the EU budget, where current data indicate higher inflows of funds for the implementation of the common agricultural policy and internal policies. The substantial increase in the *services* trade surplus (EUR 1,095 m),

which will be underpinned by the higher surpluses in tourism and transport services, will again cushion the deficits in other current account sub-balances.

The current account deficit will decline to 3.1% of GDP in 2008 and to 2.0% of GDP in 2009. In 2008 the total deficit will amount to EUR 1,118 m; the narrowing will be based on the lower deficits in factor incomes and current transfers, coupled with a higher surplus in services trade. The latter will not be as pronounced as this year, but it will remain favourable in terms of structure, since a further decline is projected in the deficit of the predominantly knowledge-based group of services. On the other hand, the trade deficit will widen slightly further in comparison with the previous year, although exports of goods are projected to record faster real growth than imports of goods and terms of trade will improve slightly. This is due to the higher nominal level of imports than exports in the previous year. The further narrowing of the current account deficit in 2009 (to EUR 770 m) will be primarily underpinned by the lowering of the deficit in goods trade, since the real growth of imports is projected to slow down more than the growth of exports, given the projected trends in domestic consumption.

Table 10: Autumn forecast of the current account and a comparison with the spring forecast

| | 2006 | 2007 | | 2008 | | 2009 | |
|--|------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| | | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) | Spring Forecast (March 2007) | Autumn Forecast (Sept. 2007) |
| Current account of the balance of payments, EUR m | -857 | -629 | -1,165 | -273 | -1,118 | -64 | -770 |
| Current account of the balance of payments, % of GDP | -2.8 | -2.0 | -3.5 | -0.8 | -3.1 | -0.2 | -2.0 |

Source of data: Bank of Slovenia; forecasts by IMAD.