



GOVERNMENT OF THE REPUBLIC OF SLOVENIA

INSTITUTE OF MACROECONOMIC ANALYSIS AND DEVELOPMENT

***S*pring Forecast of Economic Trends 2007**

(with an overview of developments in 2006 and an analysis of forecasts for 2007-2009)

April 2007

Spring Forecast of Economic Trends 2007

Institute of Macroeconomic Analysis and
Development

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Summary

The structure of the strong economic growth in 2006, which exceeded expectations, was favourable in terms of development preferences. GDP growth in 2006 totalled 5.2%, 1.2 p.p. more than in 2005 and 0.5 p.p. above the IMAD's autumn forecast. The pick-up in the international environment had a positive effect on the growth of exports, which remained at the high 2005 level despite the much slower growth of vehicle exports and the slackened growth of services exports. Within the structure of manufacturing's industrial production, the contribution of technologically more intensive industries to growth increased. The acceleration of GDP growth seen in 2006 primarily reflected the growth of gross fixed capital formation, which picked up strongly over the year before and exceeded the autumn forecasts. A substantial increase was recorded particularly in investment in motorway construction. The investment in residential construction, additionally supported by the favourable weather conditions in the latter part of the year, also continued to grow robustly. The growth of investment in machinery and equipment was also higher, which in addition to the strong business cycle also appears to be linked to changes in taxation, especially the gradual abolition of payroll tax and the claims for general investment tax relief prior to the abolition of such relief as of 1 January 2007.

The rebound in economic activity was also reflected in developments in the labour market. Despite the favourable overall trends, however, unemployment in some population groups is on the rise. The growth of employment topped 1% in 2006, reaching the highest growth rate since 1999. Around 80% of the total increase in employment was generated by construction and real estate, renting, and business services, which also recorded the biggest increase in the number of companies. In addition to the buoyant economy, this development is also estimated to have been linked to the adopted measures aimed at promoting entrepreneurial activity, particularly the simplification of the business environment. Employment also rose considerably in export-oriented manufacturing industries, which enjoyed the biggest increase in the volume of production on the back of stronger foreign demand. The number of unemployed and both unemployment rates fell to their lowest levels since 1991. However, the structure of unemployment deteriorated in terms of development preferences as the number of highly educated unemployed people climbed.

The supportive economic environment, which had the strongest impact on GDP growth and employment, was complemented by the effects of changes in taxation, on one hand, and by economic policy measures primarily aimed at the fulfilment of the euro adoption criteria, on the other. The economic policy mix aimed at a

sustainable fulfilment of the criteria for euro adoption helped maintain stable macroeconomic conditions. Despite the brisk economic growth, there was no escalation in inflationary pressures on the demand side, which was significantly underpinned by the moderate wage growth that also had a favourable effect on the increase in labour costs. The vigorous lending activity similarly had no significant effect on the growth of final consumption and prices. As in previous years, it was largely based on the growth of housing loans and loans intended for firms' investments. At the macroeconomic level, this mainly translated into the further growth of banks' and firms' borrowing abroad. At the level of activities, the stable macroeconomic conditions coupled with low interest rates had a stimulative effect, especially on the further development of the financial sector, where Slovenia still lags considerably behind the more developed countries.

Average inflation in 2006 remained at the level of the previous year, whereas the structure and dynamics of price rises underwent some changes. As the key macroeconomic policy objectives remained unchanged and competition rose, long-term inflation indicators remained stable in 2006 while the structure of price rises changed. In comparison with 2005, the effect of external factors waned whereas the growth of market-determined prices increased as a result of price increases in food, clothing and footwear, and services. We estimate that rather than signalling a negative reversal in the trend of market-determined price rises, inflation of these prices thus returned to its long-term equilibrium level after the modest price increases seen in previous years that were partly the result of one-off factors of EU accession.

Price developments in December 2006 and the first two months of 2007 show that the introduction of the euro did not cause a general increase in prices, which was primarily enabled by the coherent operation of the macroeconomic policy mix and the adopted measures regarding dual pricing, the informal price watch and informing of consumers about possible risks in the currency changeover process. The total effect of the euro adoption on prices in Slovenia is estimated to have totalled 0.24 p.p., which is consistent with Eurostat's estimate (around 0.3 p.p.) and was one of the lowest in comparison with other countries in the euro area. Price increases attributable to the euro changeover were mainly observed in services, especially hotels and restaurants, which was expected based on the experience of other countries.

Favourable economic developments are expected to continue in 2007 against the background of a stable macroeconomic environment. GDP growth will ease off somewhat in 2007, but will nevertheless be higher than projected in the autumn. Macroeconomic policy measures will continue to ensure a stable business environment and thus prevent any increased fiscal

pressures or rising labour costs that could be macroeconomically unsustainable.

In addition to the strong growth of foreign demand, GDP growth in 2007 will also be underpinned by the effects of the changed tax legislation that entered into force on 1 January 2007, whereas higher interest rates will cause a slackening in lending activity and domestic consumption growth. Amid the still buoyant external environment and an acceleration of private consumption, real GDP growth will slow down by 0.5 p.p. (to 4.7%), mainly due to the lower growth of investment in motorway construction and partly due to the somewhat slower growth of business investment resulting from tax changes¹ and higher levels of interest rates. Investment activity will continue to be underpinned by the gradual abolition of the payroll tax, which is due to be fully abolished in 2009. The upward revisions to forecasts of economic trends in the external environment project a relatively minor slowdown of economic growth this year in comparison with 2006. The downward effect of this slowdown on export growth will be additionally lessened by the expected rebound in the production and exports of vehicles from Slovenia in the second half of the year. The available data on the business expectations of the business sector and the high consumer optimism also suggest a short-term continuation of favourable trends. The growth of private consumption will pick up due to the lower personal income tax rates, coupled with the continued favourable trends in the labour market. On the other hand, the increase in the volume of household loans, among which housing loans will continue to predominate, is projected to ease off as a result of the higher interest rates.

Employment growth is expected to soften somewhat in 2007, while the real growth of the gross wage per employee will be higher than last year. Following the projected slowdown of the economy, the growth of employment will ease off slightly, primarily due to a decline in informal employment. The further phasing out of the payroll tax will continue to have a positive effect on employment as well, since it is opening up new possibilities for increased hiring of highly educated labour in the business sector. Wage growth will strengthen in comparison with 2006, largely on the back of the wage growth in the public sector, where wage disparities will begin to be eliminated and the workload will increase due to Slovenia holding the presidency of the EU and the reduction in court backlogs. In the private sector, wage growth will remain at a similar level as in 2006.

The applied macroeconomic policy mix will continue to ensure stable price growth this year. Inflation is expected to remain stable in 2007. The lower projected average inflation (2.2%; 2006: 2.5%) is transitory and mostly technical in nature (resulting from the effect of the monthly deflations in Q4 of 2006 and the first two months of 2007). The contributions of the fiscal policy measures and administered prices will be similar as in 2006. The projected increase in private consumption resulting from the reduced personal income tax rates and wage increases in 2007 is not expected to cause any inflationary pressures. The lowering of personal income tax rates will reduce the tax burden especially in the higher income brackets where the propensity to save is higher. Therefore, the total increase in disposable income resulting from the lower tax burden will not translate into consumption. The acceleration of private consumption growth will therefore be macroeconomically sustainable.

Economic growth in the next few years will largely depend on further implementation of reform measures and planned infrastructural projects. Given the adopted macroeconomic policy measures and the projected slowdown in the external environment, GDP growth will stabilise at a level between 4% and 4.5% after 2007. This shows that Slovenia's long-term potential for growth has increased, since the potential growth of the Slovenian economy has hitherto been estimated at between 3.5% and 4%. Business and financial services will continue to grow briskly. The rapid expansion of telecommunications is also set to continue on the back of the growing competition between suppliers, coupled with active government policy in this area. Investment in infrastructural projects will remain an important factor of economic growth. In addition to intensive motorway construction, which is due to be completed in 2008, it will mainly include investment in the modernisation of the railway network. The contribution of GDP growth factors based on investment in knowledge will increase only gradually. In 2008 and 2009, the contribution of technology-intensive industries is expected to grow gradually. This increase will be partly underpinned by the projected higher investment in research and development, stimulated by the already adopted tax relief and the expected changes in the organisation of the research and education sectors. In order to ensure a higher quality of public services it will be essential to introduce new methods of medical treatment and private medical practice, and to continue improving access to social protection services. The expansion of other community and personal services will also be contingent on the realisation of the planned projects in the area of arts, entertainment, and recreation. However, to achieve a more visible increase in potential growth to a level above 5% in the next few years, which was foreseen in strategic documents, the pace of changes would have to be faster than in the previous years, particularly in R&D investment and innovation activities where changes have been relatively modest so far.

¹ The amended Corporate Income Tax, which progressively reduces the tax rate from 25% to 20% by 2010 and raises tax relief for research and development, will not result in significantly higher investment in 2007 due to the abolition of the general investment relief. However, its effects will become more visible in 2008.

Spring forecasts of macroeconomic aggregates and a comparison with autumn forecasts

Real growth rates in % (unless otherwise indicated)

	2006	2007		2008		2009
		Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
GROSS DOMESTIC PRODUCT	5.2	4.3	4.7	4.2	4.4	4.1
GDP in EUR m (current prices)	29,741	31,657	31,918	33,793	34,444	36,783
INFLATION (Dec/Dec of the preceding year, %)	2.8	2.7	2.5	2.2	2.5	2.4
INFLATION (Jan-Dec/Jan-Dec annual average, %)	2.5	2.7	2.2	2.5	2.5	2.5
GDP deflator (%)	2.3	3.1	2.5	2.5	3.4	2.5
EUR/USD exchange rate	1.254	1.265	1.294	1.265	1.292	1.292
EMPLOYMENT according to the SNA (% growth)	1.2	0.8	0.9	0.9	0.8	0.7
REGISTERED UNEMPLOYMENT RATE (%)	9.4	9.5	8.2	9.1	7.8	7.4
ILO UNEMPLOYMENT RATE (%)	6.0	6.4	5.7	6.4	5.4	5.4
PRODUCTIVITY (GDP per employee), % growth	4.0	3.5	3.8	3.2	3.6	3.4
GROSS WAGE PER EMPLOYEE	2.2	2.5	2.9	3.0	2.9	2.8
EXPORTS OF GOODS AND SERVICES	10.0	8.3	9.7	8.5	9.2	8.8
- exports of goods	10.8	8.6	10.1	8.9	9.4	9.1
- exports of services	6.4	6.7	7.6	6.8	8.0	7.2
IMPORTS OF GOODS AND SERVICES	10.4	7.7	8.7	7.7	8.6	7.9
- imports of goods	10.5	7.7	8.8	7.7	8.6	8.0
- imports of services	9.5	7.1	7.8	7.5	8.4	7.4
CURRENT ACCOUNT BALANCE (EUR m)	-773	-503	-629	-410	-273	-64
- as % of GDP	-2.6	-1.6	-2.0	-1.2	-0.8	-0.2
GROSS FIXED CAPITAL FORMATION	11.9	5.5	5.9	4.5	6.6	4.4
- as % of GDP	25.8	25.6	26.2	25.8	26.7	26.6
PRIVATE CONSUMPTION	3.3	3.6	3.8	3.6	3.5	3.4
- as % of GDP	54.0	54.0	53.4	53.7	52.5	52.1
GOVERNMENT CONSUMPTION	3.8	2.5	3.1	2.8	2.9	2.3
- as % of GDP	19.3	19.2	19.1	19.2	18.9	18.8

Sources of data: SORS, BS, forecasts by IMAD.

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

The Spring Forecast of Economic Trends is based on the implemented or adopted economic policy measures, the realisation of the adopted budget for 2006, and for the Government's current and investment consumption forecasts for 2007 and 2008 on the amended budget for 2007 and the budget for 2008. In the area of taxation and general government revenue, the forecast does not take into account any increase in the VAT rates since the decision on this has not yet been made. It does, however, assume that the current policy of the gradual raising of excise duties will continue to be applied and, as did the previous forecasts, it takes into account the already enacted changes in the personal income tax, payroll tax, and corporate income tax.

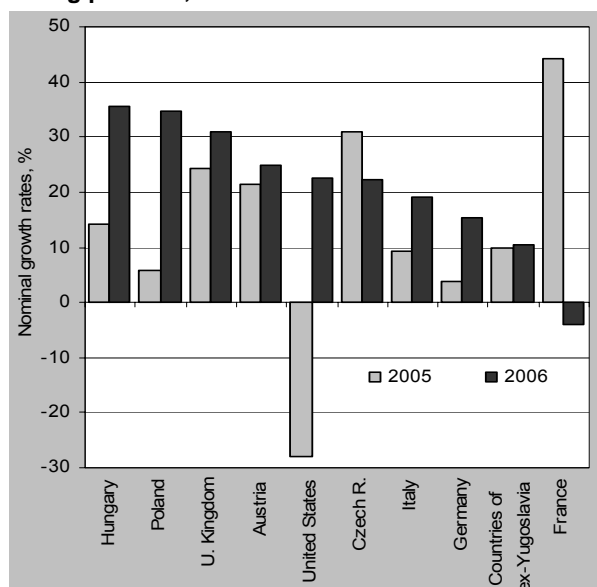
The Spring Forecast of Economic Trends is based on the IMAD's model and expert estimates using the following source data: (i) first statistical release on GDP growth in 2006; (ii) quarterly data on GDP growth until 2005, released in December 2006 and now harmonised with previously published annual estimates; (iii) data on GDP growth in the international environment in 2006 and the published spring forecasts of international institutions; (iv) prevailing expectations of international institutions regarding the dynamics of the prices of oil and other commodities, and of the euro/dollar exchange rate; (v) consultations with other organisations that prepare forecasts for Slovenia; (vi) results of econometric models used in forecasting; (vii) detailed data on the structure of the dynamics of consumer prices in 2006 and the first two months of 2007.

Economic developments in 2006

Economic growth

GDP growth totalled 5.2% in 2006, 1.2 percentage points more than in 2005 and the highest growth since 1999. It was mainly driven by foreign demand and investment activity. While the growth of exports, which reached a high 10% in 2006, moderated slightly in the second half of the year (on average), the growth of gross fixed capital formation picked up strongly in Q3 and Q4. It was spurred by the accelerated investment activity of the government, the construction of roads and motorways, and the robust growth of investment in machinery and equipment. The abolition of the general investment tax relief on 1 January 2007 seems to have provided an additional boost. In the year as a whole, gross fixed capital formation rose by 11.9%, which is over 10 p.p. more than in 2005. The growth of investments exceeded the autumn forecasts and was the main reason for higher than projected GDP growth.

Figure 1: Growth of goods exports to selected trading partners, 2005-2006



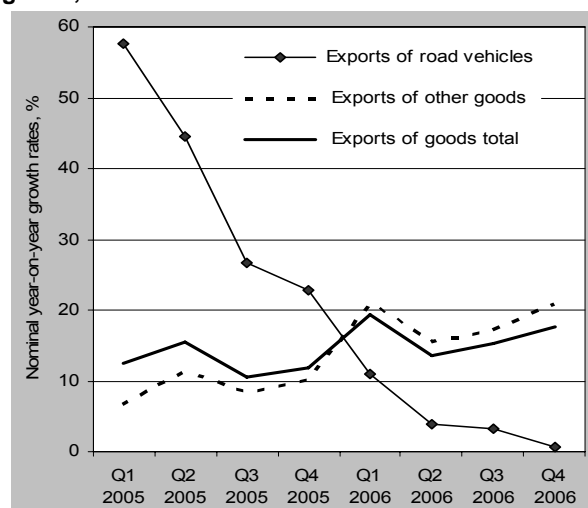
Source of data: SORS; calculations by IMAD.

Exports of goods increased last year to most of Slovenia's trading partners, except France, Bosnia-Herzegovina, and Macedonia. Amid the buoyant international economic activity, the growth of Slovenian exports accelerated to Germany, Italy, the United Kingdom, Hungary, Poland, and Russia, and somewhat less to Austria last year. Goods exports to the USA increased as well, after having declined for two consecutive years (Figure 1). Among the countries of former Yugoslavia, goods exports to Macedonia and Bosnia-Herzegovina continued to decrease last

year. This falling trend has been observed ever since Slovenia joined the EU, which has a less favourable foreign trade regime with these two countries than Slovenia did before accession. Exports to Croatia, whose trade in industrial goods with the EU is already largely liberalised, grew further last year, albeit at a slower pace than the previous year. Exports to Serbia and Montenegro, on the other hand, were up even more than in 2005.

The growth of road vehicle exports slowed sharply last year, while export growth of other goods rose. The growth of road vehicle exports was still a significant driver of export growth to Germany, the United Kingdom, and Croatia. On the other hand, exports of road vehicles to France dropped off sharply last year (after their high increase in 2005), which was the main reason for the decline in the total goods exports to this country.

Figure 2: Exports of road vehicles and other goods, 2005-2006



Source of data: SORS; calculations by IMAD.

The increased domestic activity provided a strong boost to the growth of goods imports last year. Compared with 2005, imports of goods rose by almost four percentage points (10.5%). The increase was mainly underpinned by the acceleration in import growth of investment equipment and machinery, whereas the acceleration in import growth of consumer and intermediate goods was less pronounced. In contrast with exports, which recorded faster growth to the EU member states than to non-members, imports from non-members again rose at a faster pace than imports from the EU last year.

Exports and imports of services rose at a much slower rate than trade in goods. The growth of services exports eased off considerably from the year before, failing to keep pace with the brisk growth of goods exports. A significant factor of the slowdown seen in the export of services was the modest growth of travel services in Slovenia, largely due to the

stagnation of the inflow from casinos and the decline of sales in border shops. The increases in exports and imports of transport services were even and in line with the robust growth of trade in goods. Other services, which comprise a group of predominantly knowledge-based services, achieved even slightly higher growth than transport services in both exports and imports. Within exports, the biggest increase was recorded in merchanting and financial services, whereas licences, patents, and copyrights led imports.

The growth of private consumption remained at a similar level as in the previous year, while the growth of government consumption increased last year.

Household consumption (3.3%) again rose more than disposable income (3.0%) in 2006. We estimate that this development was related to the still relatively strong borrowing, however that was predominantly long-term and intended for the purchase of homes (which represent investment rather than private consumption). The growth of housing loans (43.2%) was again higher than the increase in consumer and other loans (13.2%). Housing loans thus achieved 35.6% in the structure of loans by the end of the year, up 5.2 p.p. from the year before. The higher real growth of government consumption (3.8%), which increased by 1.5 p.p. from 2005 was underpinned by the considerably faster real growth of expenditure on goods and services, especially that coming from local government budgets.

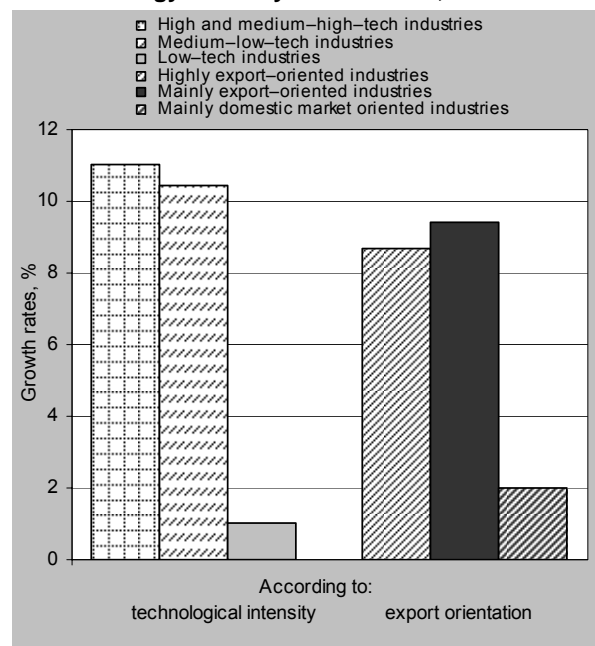
Dynamics of value added by activity

The growth of value added reached its highest level in eleven years in 2006 (5.3%). Primary activities recorded the most favourable trends. Market services were another contributor to the high growth of value added, whereas the growth of value added in public services slowed down considerably in 2006.

Within primary activities (A-F), growth picked up strongly in manufacturing and construction, where it amounted to 6.7%. The acceleration of the real growth of value added in *manufacturing* (to 7.4%) was largely underpinned by the robust growth of industrial production in highly and mainly export-oriented industries (Figure 3), supported by the strong business cycle. The highest growth rates were recorded in the four largest industries: the electro, chemical, metal, and machinery industries. All of them, except for the metal industry, are classified as high- or medium-high technology-intensive industries according to the OECD's definition, which shows that the structure of industrial production growth was favourable last year in terms of the manufacturing industry's restructuring in favour of the more technology-intensive industries. Activity in *construction* was particularly high in the second half of the year, when weather conditions were

favourable. Once again, it was driven by the construction of motorways and housing. In addition, the construction of non-residential buildings (especially hotels and wholesale and retail trade buildings) also strengthened notably. The results in other primary activities were more modest (in *mining and quarrying* and in *electricity, gas, and water supply*), while *agriculture* recorded a drop in value added for the second consecutive year due to the lower crop production.

Figure 3: Real growth of production in manufacturing in terms of the export orientation and technology intensity of industries, 2006



Source of data: SORS; calculations by IMAD. Note: industry classification according to OECD methodology.

The real growth of value added in market services (G-K) increased for the third consecutive year and reached 5.6% in 2006. Good results were recorded in both traditional market services (distributive trades, hotels and restaurants, transport) and knowledge-based services (business and financial services). In *hotels and restaurants*, turnover growth continued to increase in restaurants and bars², whereas in hotels the increase in turnover was approximately the same as last year due to the modest rise in the number of overnight stays. The real growth of value added in *distributive trades* was the highest since 1997 thanks to increased turnover in wholesale trade and the sale of motor vehicles. In retail trade, however, only specialised shops selling furniture, household equipment, and construction material recorded a considerable increase in turnover last year. Within *business services*, data on employment suggest that in some knowledge-based services³ (legal, tax and business consultancy,

² Groups in the standard classification of activities: restaurants, bars, canteens, and catering.

³ Activity K, sections 71-74, according to the OECD definition.

computer services and temporary employment agencies) developments remain favourable. Real estate activities also grew substantially. As in the previous year, the high growth of value added in *financial intermediation* was underpinned by the more stable macroeconomic conditions and the consequently low interest rates⁴, which resulted in an increase in banks' lending activities on one hand, and a brisk expansion of other financial services, matched by a decline in interest in savings in banks, on the other. The growth of value added in *transport, storage, and communications* was still robust, if slightly lower than in 2005. It was driven by the sustained vigorous activity in road freight transport, as well as the strong growth of postal and telecommunication services.

The growth of value added in public services (L-P) achieved 2.4% in 2006, having declined from 2005 in all activities. The low growth of value added recorded in *public administration* reflects the decline in the number of employees in the civil service, which accounts for roughly 70% of the total employment in this sector. The *education* sector saw a sharp slowdown in employment growth last year when the introduction of the nine-year primary school was completed. In addition, activity in primary and secondary schools was probably also partly affected by the shrinking of generations. Employment only rose noticeably in higher education, indicating a structural shift in favour of tertiary education and reflecting last year's increase in the number of higher education institutions and the launching of the reform process and new study programmes. Within *health and social care*, the growth of employment slackened substantially in social care, while it remained at the low level of 2005 in health care. The increase in value added was also more modest than the year before in *other community and personal services*. The highest growth rates were again recorded in the predominantly commercial segment of the activity (casinos, recreational, cultural and sporting activities) and in sewage and refuse disposal, sanitation, and similar activities.

Current account of the balance of payments

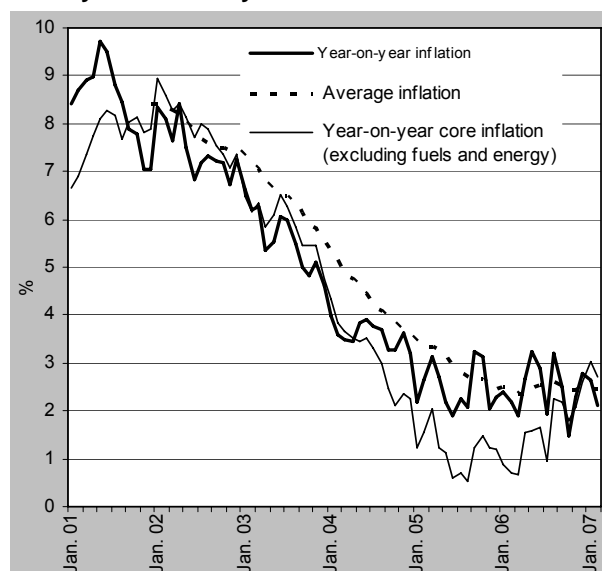
The current account deficit increased last year. It totalled 2.6% of GDP, a good 0.5 p.p. more than the year before. We nevertheless estimate that the deficit level is sustainable in the long run as it does not create any major upward pressures on gross external debt. The current account deficit was created by deficits in all balances except in services, where the surplus remained approximately the same as in the previous year. The improvement in the terms of trade caused a negligible slowdown in the increase of last year's deficit. The increase in export prices topped the increase in import prices by 0.2 p.p. The deficit in factor incomes widened primarily as a result of the higher net payments of interest on external debt and the appreciable increase in the payments of dividends and undistributed profits to foreign investors. The deficit in the current transfers balance rose due to the higher deficit of the private sector, whereas the inflows from the EU budget into the national budget exceeded Slovenia's payments to the EU budget by over EUR 60 m. The absorption of EU funding totalled 78% of the planned amount last year, which was better than in 2005 (63%). Slovenia's payments to the EU, on the other hand, totalled 92% of the planned payments.

⁴ Although interest rates rose somewhat in 2006, they were still considerably lower than in 2005.

Inflation

Inflation remained subdued in 2006; its structure, however, changed. Average inflation in 2006 totalled 2.5%, the same as in 2005. Year-on-year inflation also hovered around this value throughout the year (Figure 4). On the other hand, the structure of price increases changed last year (Figure 5). In contrast with the previous two years, the contribution of oil prices to inflation was negligible since they decreased in the final quarter, which was also the main reason that inflation in 2006 was lower than projected in the autumn forecast. Apart from that, the contribution of administered prices (excluding liquid fuels) to inflation was lower than in 2005. Increases were observed in the fiscal impact and contribution of food prices and market-determined prices of services (the latter occupy a major share within the group 'other' in Figure 5).

Figure 4: Dynamics of average and year-on-year inflation (with and without fuels and energy), January 2001-January 2007



Source of data: SORS.

The restrained inflation was underpinned by the sustained stabilising economic policies of the Bank of Slovenia and the Government. As the tolar's exchange rate stability significantly contributed to the sustainable disinflation over the last three years, the Government continued to apply a restrictive policy of administered price rises. The contained growth of consumer prices was also underpinned by the continued policy of moderate wage growth in both the public and private sectors, which prevented any demand pressures on inflation.

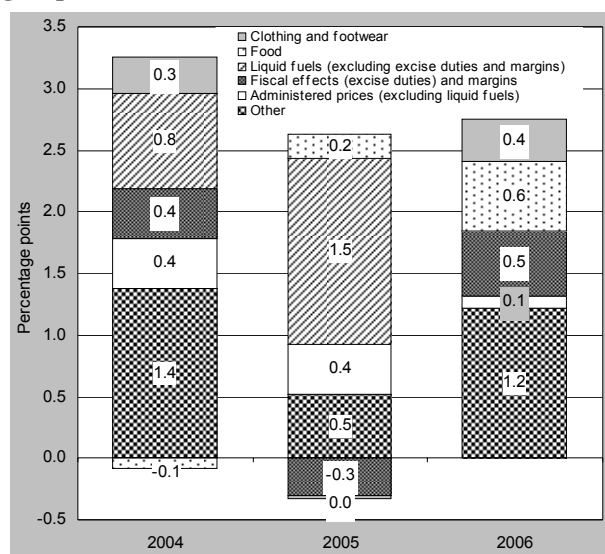
The increases in market-determined prices were the main contributor to last year's consumer price rises. Market-determined prices of services contributed

nearly 1.2 p.p. to inflation, whereas market-determined prices of goods added around 1.3 p.p. due to the increases in the prices of food, clothing and footwear, tobacco (higher excise duties), and products for regular maintenance and repair of homes. The contribution of food price increase was higher than in 2004 and 2005, which is attributable to two factors. First, the one-off effect of Slovenia's entry to the EU, which was the main cause for the price decrease in non-seasonal food, lost its impetus in 2006. As a result, these prices began to increase at a moderate rate again in 2006. Second, the price dynamics of seasonal food were different than in 2005, and the contribution of these price rises to year-on-year inflation was consequently different as well.

In accordance with the Government plan, administered price rises lagged behind market-determined price rises, yet their contribution to inflation was nevertheless slightly higher than planned. Prices under various regimes of regulation rose by 2.1% last year and did not exceed the increase in market-determined prices (3.0%). Furthermore, the rises in individual administered prices were generally not significantly different than the rises in market-determined prices. Administered prices contributed 0.4 p.p. to overall inflation (2.8%), which is 0.2 p.p. more than planned in the Government's administered prices adjustment plan, but less than in 2005, when the contribution of these prices was 0.9 p.p. The plan did not account for the increases in margins and excise duties on liquid fuels for transport, which added a good 0.3 p.p. to inflation. Two further deviations from the Government plan were the 6.6% decrease in utility prices due to changes in their calculation in Ljubljana, and the 12.4% increase in the price of district heating resulting from the oil price hike seen in the first three quarters of 2006⁵.

⁵ The methodology for calculating these prices takes into account the movements of energy prices over a longer period of time and therefore reflects the high oil prices from the first three quarters of the year.

Figure 5: Breakdown of year-on-year inflation (in December) into the contributions of individual sub-groups



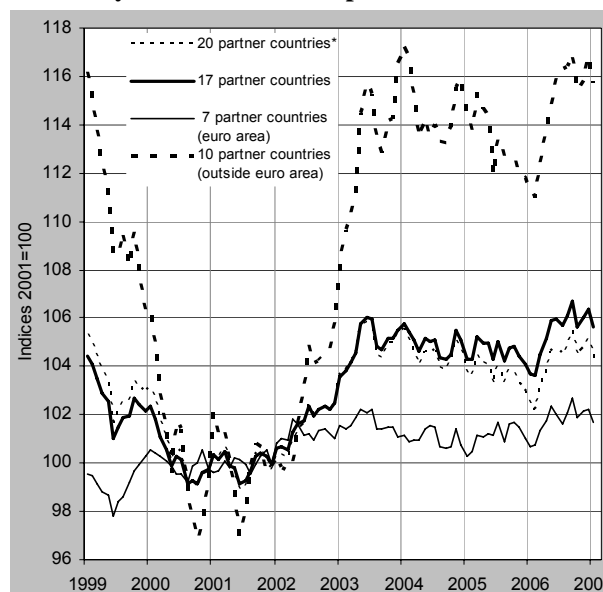
Source of data: SORS; calculations by IMAD.

The raising of excise duties on liquid fuels was also the main underlying factor of the increase in fiscal contribution to inflation in 2006. In accordance with its policy of counter-cyclical adjustment of excise duties on liquid fuels, the Government raised excise duties from their minimum level as oil prices fell. In addition, the Government also continued to harmonise the excise duties on tobacco and tobacco products with the rates agreed in the EU, which contributed a further 0.2 p.p. to inflation.

Price competitiveness

As projected in the autumn forecast, the price competitiveness of the Slovenian economy measured by relative consumer prices deteriorated somewhat in 2006. Amid the nominally stable tolar's exchange rate against the euro, the tolar's nominal effective exchange rate appreciated slightly (0.2%), mainly under the influence of the euro's appreciation against the US dollar and the Japanese yen. Since the growth of relative consumer prices was still low (0.6%) despite its slight acceleration, the real appreciation of the tolar's effective exchange rate was also relatively moderate (0.8%; autumn forecast: 0.7%). Slovenia's price competitiveness deteriorated less appreciably in comparison with competitors from the euro area than in comparison with competitors from outside the euro area (by 1.3%; euro area by 0.6%).

Figure 6: The tolar's real effective exchange rate deflated by relative consumer prices



Sources of data: BS, SORS, OECD; calculations by IMAD.

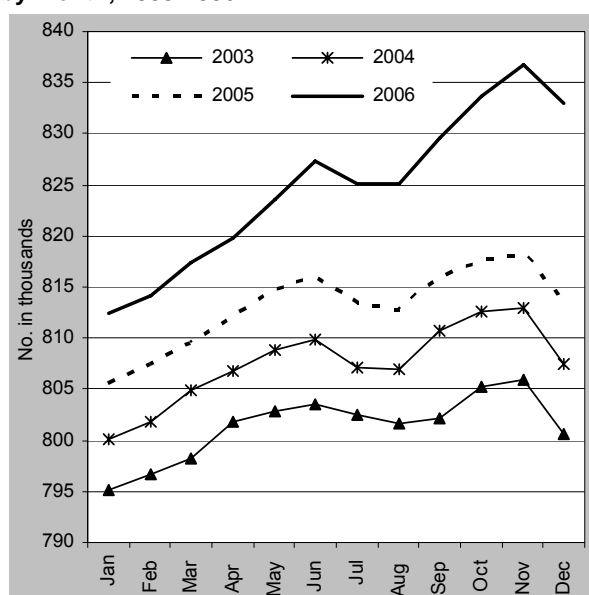
Note: *Austria, Belgium, Germany, Italy, France, the Netherlands, Spain (7 partners – euro area), UK, Denmark, Sweden, the Czech Republic, Hungary, Poland, Slovakia, the USA, Switzerland, Japan (10 partners – outside euro area), Croatia, Russia, Turkey.

Employment and unemployment

Employment growth picked up considerably in 2006, particularly in the second half of the year, and was, like GDP growth, at its highest level since 1999.

Employment rose by more than 1% according to all three statistics⁶, which differ in terms of the scope of the categories of employment they include. The difference between the statistics based on the labour force survey and between administrative sources shows that informal employment continues to increase along with formal employment, despite its high rise in 2004.

Figure 7: Number of persons in formal employment by month, 2003-2006



Source of data: SORS.

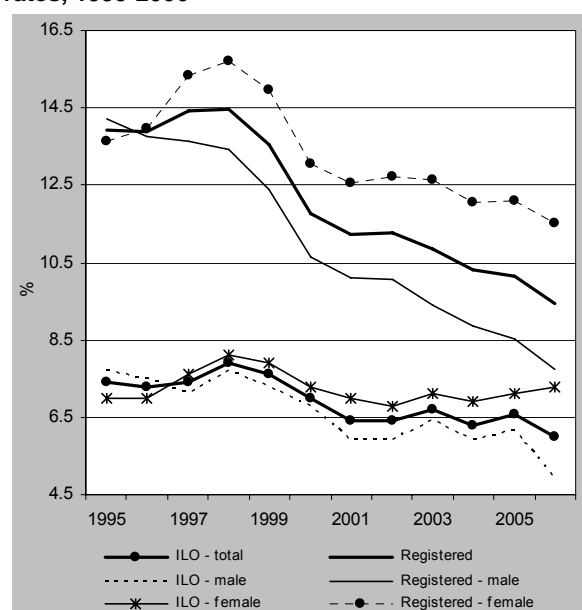
Employment increased in almost all activities.

Thanks to the robust residential and motorway construction, the increase in employment was again the highest in construction, like the year before. Construction was followed by real estate, renting, and business services, where over a quarter of the increase in employment derived from the higher number of employees in temporary employment agencies, which are an important factor of employment flexibility, while the people employed in them actually work in different sectors. Employment growth in these two groups of activities accounted for approximately 80% of the total increase in employment in 2006. At the same time, these two sectors also recorded the highest rise in the number of firms after 2003. On the other hand, the number of workers declined in agriculture, mining, manufacturing and private households in 2006 over 2005. Within manufacturing, the number of

⁶ By 1.2% according to the national accounts statistics, by 1.3% according to the labour force survey (IMAD's calculation based on SORS' quarterly data), and by 1.4% according to the monthly statistics on formal employment.

employees continued to drop sharply in the textile and food-processing industries, while the biggest increase was observed in the metal industry, where production surged last year.

Figure 8: Survey and registered unemployment rates, 1995-2006



Source of data: SORS.

The decline in unemployment in 2006 was mostly linked to the strong economy, whereas the decrease in registered unemployment was also partly due to administrative reasons. Compared with 2005, fewer first-time job-seekers and fewer people who lost their jobs registered as unemployed last year. At the same time, more unemployed people found work (Figure 9). The number of unemployed fell by 39,213 due to various administrative reasons and exits to inactivity (retirement, maternity leave), which is 18.3% more than in 2005⁷. In December, 78,303 persons were thus registered as unemployed, the lowest figure since August 1991. A decrease was observed in both the registered and survey unemployment rates. In the last two quarters of 2006, the latter reached its historically lowest level in Slovenia. Due to the higher growth of employment and the somewhat lower activity rate, the unemployment rates for 2006 are also lower than the IMAD projected in the autumn.

⁷ This increase can partly be attributed to the stricter criteria required to keep a person on the unemployment register, enforced in July 2006 with the Act Amending the Employment and Insurance against Unemployment Act. Most people were struck off the register for neglecting the duties of an unemployed person. There were 18,811 such cases in 2006; 13,748 thereof were taken off the register because they were unavailable for work.

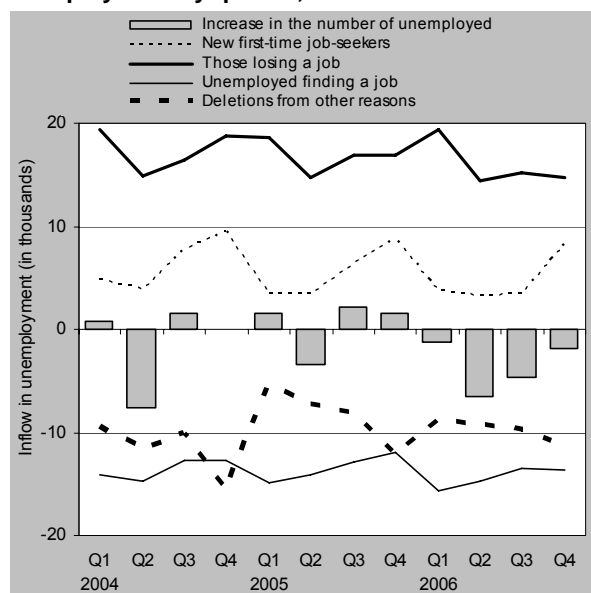
Table 1: Average numbers of survey and registered unemployed persons and survey and registered unemployment rates in 2005-2006

	2005	2006	2006/2005
Number of registered unemployed	92,600	85,836	-6.6%
Number of survey unemployed (ILO)	67,000	61,000	-8.9%
Registered unemployment rate	10.2%	9.4%	-
Survey unemployment rate (ILO)	6.6%	6.0%	-

Source of data: SORS.

Looking at the structure of unemployment, the number of tertiary educated and older unemployed persons increased last year. The number of vacancies and persons hired continued to grow at high rates. However, the demand for workers with primary or secondary education has been growing faster than the number of available jobs for higher-educated people. In 2006, this also applied to new jobs, in contrast with 2005, when the number of persons hired for jobs requiring higher education rose at the fastest pace. The number of unemployed with a higher education thus rose by 7.6% (7,561 persons) on average in 2006 over 2005, and by 60.6% over 2001, when their number was the lowest since 1991. For the third year in a row, there was also an increase in the number of the unemployed aged 50 and over. There were 4.2% more such people last year than in 2005.

Figure 9: Components of the increase in registered unemployment by quarter, 2004-2006



Source of data: SORS.

Wages

The gross wage per employee rose by 4.8% in nominal and by 2.2% in real terms in 2006. It lagged behind the estimated growth of productivity by 1.8 p.p. In comparison with the autumn forecast, the achieved nominal growth of the gross wage per employee is slightly lower, whereas its real growth is in line with the forecast due to the somewhat lower actual inflation.

In 2006, the average wage rise in the private sector was the same as in the previous year (2.8%). Wages in the private sector were adjusted by at least 2% in August based on the *Collective Agreement on the Wage Adjustment Mechanism, the Reimbursement of Work-related Costs, and Holiday Allowances*. The adjustment percentage was slightly higher in sectors where this was agreed in the sectoral collective agreements. Thanks to the favourable economic developments, a higher share of employees (around a quarter) than in 2005 (21.6%) received Christmas bonuses in November and December last year. The amount of the Christmas bonus was just slightly lower than the year before, i.e. close to 48% of the average gross wage. The highest proportions of recipients of this bonus were recorded in electricity, gas, and water supply, and in financial intermediation. The achieved growth of the gross wage per employee in the private sector (5.4% in nominal and 2.8% in real terms) was slightly lower than projected in the autumn forecast. Productivity growth in the private sector totalled 5.2%.

The modest real growth of wages in the public sector continued in 2006 (1.0%). The higher growth of gross wages in the private sector was largely underpinned by the more flexible wage formation in this sector, which strongly depends on business performance and other economic conditions (especially the payment of Christmas bonuses). In addition, the lower growth of wages in public services was also linked to the partial deferral of wage indexation in order to utilise the funds saved in this way for the elimination of wage disparities in the public sector. Last year, a proportion of the adjustment percentage (1.05%) was set aside for this purpose, whereas starting-level wages increased by 1.3% in July. Wages in the education sector were for the last time raised by 3% in July in accordance with the annex to the collective agreement for this activity. At the annual level, this translated into a roughly 1.5 p.p. faster nominal growth of wages in the activity relative to other public services. The actual nominal wage growth in the private sector (3.5%) was slightly higher than forecast in the autumn, mainly due to the higher growth of wages in public administration and health care towards the end of the year. Since inflation was lower than expected, the real growth of wages was also approximately 0.5 p.p. higher than projected.

General government sector revenue, expenditure, and deficit

Together with the revised data on the current general government deficit⁸, the national Statistical Office released data on the main categories of general government sector revenue and expenditure according to the methodology of the European System of Accounts (ESA-95) for the period from 2003 to 2006⁹.

The general government deficit in 2006 is estimated¹⁰ at 1.4% of GDP, 0.1% of GDP less than in 2005. Slovenia's fiscal position recorded a slight improvement relative to 2005 as both general government revenue and expenditure as shares of GDP decreased.

Total general government revenue is estimated to have totalled SIT 3,196 bn, up 6% in nominal terms from 2005, whereas its share relative to GDP decreased by 0.7 p.p. (from 45.5% of GDP in 2005 to 44.8% in 2006). Among the main categories of revenues, an increase was recorded in the current taxes on income and property (by 0.4% of GDP), primarily due to the faster growth of corporate income tax resulting from changed tax legislation. At the same time, the revenue from social security contributions decreased by 0.2% of GDP in 2006, while the share of taxes on production and imports fell by 0.5%. The growth of revenue from excise duties was slow (slower than GDP growth) due the retention of excise duties on mineral oils at the minimum level still allowed by EU regulations from July 2005 to September 2006, and could not be compensated for by the stronger growth of revenues from VAT. On the other hand, the reduction of payroll tax (by 0.3% of GDP) evidenced the first effects last year. Revenue from property also decreased by 0.2% of GDP.

Total general government expenditure in 2006 is estimated at SIT 3,296 bn. It increased by a nominal 5.9%, whereas its share in GDP shrank by 0.8 p.p. (from 47.0% of GDP in 2005 to 46.2% in 2006). Some minor structural changes in the general government expenditure were carried out between 2005 and 2006. The structural shares of intermediate consumption and subsidies remained the same. The share of other current transfers increased (by 0.1% of GDP) due to payments to the EU budget, as did gross capital formation (by 0.2% of GDP). On the other hand, decreases were recorded in the shares of social benefits in cash and in kind (by 0.3% of GDP), compensation of employees (by 0.3% of GDP), property income (by 0.1% of GDP), other taxes on production (by 0.1% of GDP), and capital transfers (by 0.2% of GDP).

⁸ According to the ESA-95 methodology, the general government sector comprises four general government budgets (the state budget, local budgets, and the pension and health funds), public funds (including KAD and SOD, the pension and restitution funds), public institutes and public agencies.

⁹ Data on general government revenue and expenditure are derived from the SORS' latest release: Main Aggregates of the General Government (30 March 2007).

¹⁰ On 30 March 2007, the SORS released revised data on the main categories of general government revenue and expenditure and the general government deficit for 2003-2006. The revision comprised further methodological harmonisation with the ESA-95 and a new estimate of the general government aggregates for 2006. The annual estimate of the general government deficit increased by 0.1 p.p. to total 1.5% of GDP (the previous estimate from October 2006 was 1.4% of GDP). The increase in the estimated general government deficit for 2006 was mainly due to the revised estimates of gross fixed capital formation and the income taxes of households.

Forecasts of Economic Trends for 2007-2009

Assumptions of the spring forecast

The global economy is expected to moderate slightly after several years of robust growth. In 2006, global GDP growth totalled around 5% for the fourth consecutive year. It was also more balanced across the regions. It accelerated in the EU and Japan, and remained at a high level in Russia and Asia, especially in China. This year, growth is projected to ease off slightly in Europe as well as Asia, including China, while a more pronounced slowdown is expected especially in the USA. Risks to the forecasts are fairly balanced. The main downside risks are the uncertainty regarding economic developments in the USA, where GDP growth could slow down further, and the potential increased instability in the global financial markets. Upside risks include the possibility that, contrary to current projections, economic growth in Europe and Asia will not decelerate. In Europe, this scenario could be underpinned by the lower than expected effects of the VAT increase on GDP growth.

The spring forecasts of GDP growth for Slovenia's main trading partners from the euro area for 2007 and 2008 are more favourable than the autumn forecasts. Last year, GDP growth accelerated substantially in most of Slovenia's main trading partners and thus exceeded our autumn assumptions (the only exception was France). While GDP growth will be lower in 2007 and 2008 than last year, it will nevertheless be higher than projected in the autumn (Table 2). The forecast for the euro area was mainly corrected due to the upward revision of the forecasts for Germany and Italy. GDP growth in Germany, Italy, and Austria will continue to be driven primarily by investment growth (since capacity utilisation is well above its long-term average), along with exports. Despite last year's noticeable improvement in the labour market situation, the outlook for the increase in private consumption remains modest – in 2007 inter alia due to tax increases in Germany and Italy. On the other hand, GDP growth in France is still largely based on private consumption, while exporters are still faced

with low competitiveness. A further slight slowdown in the euro area's GDP growth is also projected in 2009.

The slowdown in economic growth in Poland, Hungary and the Czech Republic in 2007 will be smaller than projected in the autumn. Last year's high economic growth in the Czech Republic and its moderation in Hungary were consistent with our autumn assumptions, whereas the acceleration in Poland exceeded them (Table 2). In 2007 and the following two years, a slight slowdown is projected in the Czech Republic and Poland. Nevertheless, their growth will remain at a high level and will rely even more on investment and private consumption, which already replaced exports as the main driver of GDP growth last year. In Hungary, the effects of the fiscal stabilisation programme, adopted in 2006, will visibly slow the growth of domestic demand. GDP growth will therefore be mainly based on exports. Nevertheless, its deceleration this year will be less than expected in the autumn, while a rebound is projected for 2008-2009. In all three countries, the inflow of EU funds is expected to have a positive impact on investment growth this year and in 2008.

Stable growth is also projected in the countries of former Yugoslavia, where domestic demand will be the main determinant of GDP growth. Economic growth in Croatia accelerated last year and exceeded our autumn assumptions. The spring assumptions regarding GDP growth for this and the following two years are also higher than in the autumn. Domestic demand will remain the main driver of economic growth, supported by the positive impact of exports. GDP growth in Serbia moderated slightly last year, but was nevertheless substantially above the autumn projections, which was also the reason for the higher estimates for the future. Economic growth in Bosnia-Herzegovina was lower last year than in 2005 and also below the autumn expectations. It will accelerate slightly in 2007-2009 on the back of the faster growth of investment, especially in infrastructure, yet it will remain below the autumn assumptions. In Macedonia, GDP growth remains fairly low for a country in transition. It slowed down further last year. Although it will be slightly higher this and the following two years, the autumn projections have remained unchanged.

Table 2: IMAD's assumptions of economic growth in Slovenia's main trading partners, 2007-2009

	2005	2006	2007		2008		2009
			Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
EU	1.7	2.9	2.1	2.5	2.1	2.4	2.2
Euro area	1.4	2.6	1.8	2.4	1.9	2.2	2.0
Germany	0.9	2.7	1.1	1.9	1.5	2.0	1.8
Italy	0.1	1.9	1.2	1.8	1.5	1.5	1.5
Austria	2.0	3.1	2.3	2.5	2.3	2.3	2.1
France	1.2	2.0	1.9	2.0	1.9	2.0	2.0
UK	1.9	2.7	2.4	2.6	2.5	2.4	2.2
Czech Republic	6.1	5.9	5.0	5.0	4.8	5.0	4.5
Hungary	4.2	3.9	2.3	2.7	2.8	3.0	3.5
Poland	3.5	5.8	4.5	5.5	4.7	5.0	4.8
Croatia	4.3	4.7	4.0	4.5	4.0	4.3	4.0
Bosnia & Herzegovina	6.0	5.3	6.0	5.5	6.0	5.5	5.5
Serbia	6.2	5.8	4.0	5.2	4.0	5.2	5.2
Macedonia	3.8	3.5	4.0	4.0	4.0	4.0	4.0
USA	3.2	3.4	2.7	2.4	3.1	3.0	3.0
Russia	6.4	6.7	5.9	5.6	5.5	5.2	5.2

Sources of data: Eurostat; Consensus Forecasts, December 2006, January 2007, February 2007; European Commission, DG ECFIN – Interim Forecast, February 2007; European Commission, DG ECFIN – Economic Forecasts, Autumn 2006, Economist Intelligence Unit Country Reports (for Bosnia, Serbia, and Macedonia), December 2006, January 2007; OECD Economic Outlook, November 2006; WIIW Research Report, February 2007; IMAD estimates.

The spring forecasts assume lower oil prices than the autumn forecasts. The price of Brent crude subsequently fell from the high summer level (around USD 70/barrel) and stabilised at a level around USD 60/barrel by the end of 2006. In the first three months of 2007, it fell further on average. Therefore, the autumn assumptions of the average oil price in 2007 and 2008 have been lowered in the spring forecast. However, oil prices are expected to bounce back to around USD 64/barrel. The assumed prices of a barrel of Brent crude are USD 62.5/barrel in 2007 and USD 64/barrel in 2008 (Table 3). There are two main reasons for the expected increase in oil prices by the end of 2007. The favourable global economic growth outlook underlies the expected higher demand. On the supply side, it is vital that the daily output of the OPEC has been 1.7 million barrels lower since November 2006. Moreover, it is also not possible to exclude the negative effect of the potential reescalation of

geopolitical tensions (elections in Nigeria and tensions over Iran), which also represent the main risk regarding a substantial increase in oil prices.

The spring forecasts are based on a slightly higher technical assumption of the euro/dollar exchange rate than last year. The technical assumption for this year is an exchange rate of USD 1.294 to EUR 1 (USD 1.292 for the next two years). It is based on developments in the six months from September 2006 to February 2007, when the euro was stronger against the dollar than in the previous period (March-August 2006), which served as a basis for the autumn technical assumption. The average euro/dollar exchange rate in 2006 totalled USD 1.254 to EUR 1, which is 0.9% more than in 2005.

Table 3: Spring Forecast assumptions of Brent crude prices, USD/barrel

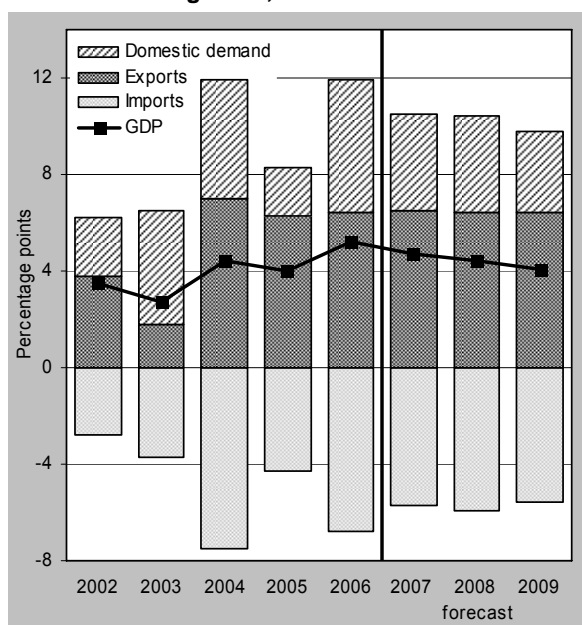
	2005	2006	2007		2008		2009
			Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
Average oil price	54.4	65.4	73.0	62.5	73.0	64.0	64.0

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

Economic growth

GDP growth is projected to remain above its long-term 4% average in 2007-2009. The most recent estimates of the international environment are more favourable than they were in the autumn. They will ensure a high contribution of export demand to GDP growth throughout the period. On the other hand, the expected slowdown in investment consumption growth from its high level recorded in 2006, resulting from the smaller impetus of infrastructural investment (motorway and housing construction), will be the main reason for the lower contribution of domestic spending to the overall aggregate demand in 2007 and again in 2009.

Figure 10: Contributions of export and domestic demand to GDP growth, 2002-2009



Source of data: SORS; forecasts by IMAD.

Gross domestic product will increase by 4.7% in 2007.

The forecast projects continued strong growth of exports, a higher increase in private consumption than last year, and considerably slower growth of gross fixed capital formation, which will hence be the main factor of the slowdown in GDP growth from its high level of 5.2%, recorded in 2006.

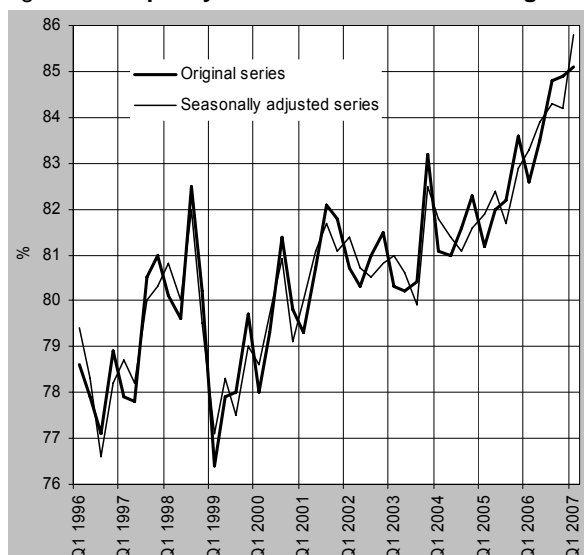
The forecasts regarding the international environment are relatively favourable, which will allow the growth of goods exports to remain strong. The growth of services exports is also projected to pick up. Although the expectations regarding the growth of export demand in Slovenia's main markets are less favourable than last year, the cooling in these markets will be much less intense than we projected in the autumn. The real growth of goods exports to the EU countries, whose share in Slovenia's exports totalled 68% last year, will decrease negligibly this year from last year's 11% (to 10.6%; within that

exports to new EU members are expected to continue to increase at a faster rate). The sustained high growth of exports to these markets also reflects the projected increase in the growth of road vehicle exports. Their production has been rising since November 2006 and will be additionally boosted by the manufacture of a new car model this year. The growth of services exports is projected to pick up by slightly over one percentage point this year (to 7.6%) on the back of the stronger growth of exports of tourist services, whose modest increase last year appears to have been transitional. This is also corroborated by the favourable current data on overnight stays and visits of foreign tourists. The high investment in the increase of the scope and quality of tourist capacities over the last few years has made this possible.

Despite the foreseen slowdown, the growth of investment consumption will remain much faster than the growth of other components of domestic demand.

Capacity utilisation, which reached its historical highs in the first quarter of 2007, along with the continued strong international environment and the business trends in manufacturing, will support the further growth of *investment* in machinery and equipment, although the latter will be lower than last year, when it was additionally boosted by expenditure prior to the abolition of the general investment tax relief as of 1 January 2007. At the same time, the growth of investment in motorway construction will moderate significantly this year. Nevertheless, the level of this investment remains very high. Investment in the construction of residential and non-residential buildings will increase at a similar rate as last year in 2007. On the other hand, the growth of *private consumption* will pick up transitorily this year. Taking into account the effects of the reduced personal income tax rates and the higher increase in wages, the estimated growth of disposable income for this year is higher than in 2006; however, we estimate that a major share of the additional increase in disposable income will be saved. The reason is the higher propensity to save by people in higher income brackets, whose net income will increase the most with the lower tax rates, and the limiting effect of the rising interest rates on household borrowing. At the same time, we expect that, given the continued increased housing construction and purchases of homes prior to the anticipated ending of the transitional period of a reduced VAT rate on new housing, households will predominantly take out long-term housing loans, whereas consumer loans are not expected to grow any faster than last year. The growth of *government consumption*, taking into account the realisation in 2006 and the general government budgets for 2007, is projected to moderate to 3.1%.

Figure 11: Capacity utilisation in manufacturing



Source of data: SORS.

The outlook for lower investment consumption growth will also result in the smaller increase in goods imports than in 2006. The latter will consequently reduce the overall increase in services imports due to the lower growth of imports of transport services. Compared with 2006, the growth of goods imports will slow down by almost two percentage points (to 8.8%), primarily due to the deceleration in the growth of imports of investment machinery and equipment. Despite the lower oil prices (on average), imports of intermediate goods will continue to increase due to the rising prices of other commodities, yet similarly at a slower pace. Imports of consumer goods will be the fastest growing component in the structure of goods by end-use product, which is linked to the projected pick-up in the growth of household spending.

Model-based forecast of economic trends for 2007

The IMAD double-checks its forecasts of GDP, industrial production, and inflation with its own dynamic factor model that was presented in detail in the Autumn Report 2006 (Box 1, p. 25). The most recent model forecasts, based on 71 series of quarterly data for 1994-2006, are largely compatible with the IMAD's official forecasts, which are arrived at using a mix of econometric and expert methods. Considerable divergence has occurred in the forecast of the increase in gross fixed capital formation, where the model-based forecast is higher than the expert forecast. The difference is the result of the high increase in the second half of 2006 (end point problem) and the changes in tax legislation. Similarly, the model forecast also projects lower growth of private consumption, as it disregards the changes in tax legislation. However, the model-based forecasts of GDP growth, exports, imports, industrial production, and inflation, are consistent with the expert forecasts.

Economic growth is projected to reach 4.4% in 2008.

To a greater extent than in 2007, GDP growth will be driven by gross fixed capital formation, whereas the growth of private consumption is projected to decrease after its transitory increase in 2007. At the same time, export growth will also fall next year, in line with the forecasts for the international environment.

The expected cooling of GDP growth in 2008 will primarily reflect the slowdown in exports.

The projected export growth is based on the further expected slight deceleration in GDP growth in the EU. We therefore estimate that the real growth of goods exports to these countries will decline by approximately one percentage point, to 9.4%. Although the assumptions regarding the economic growth in the countries of former Yugoslavia for 2008 remain the same as for 2007, the growth of export demand in these countries is expected to slow down. This is estimated to be a consequence of the rising trend with regard to Slovenian firms' production in those countries, coupled with the long-term increase in direct investment, notably in the manufacture of chemicals and chemical products, machinery, and the manufacture of food, beverages, and animal feeds. Owing to the high import component in capital investment, which is projected to increase at a faster pace in 2008, the real growth of goods imports will ease off negligibly. The growth of trade in services is set to accelerate in 2008 on the back of the faster growth of other services on the import side and the further pick-up in tourist services in Slovenia on the export side.

The acceleration in motorway construction in 2008 will boost the growth of gross fixed capital formation.

As expected, the growth of private and government consumption is softening. As the construction of the national motorway network is foreseen to be finalised earlier than originally planned, we can expect a rebound in motorway investment in 2008. In the private sector, the growth of investment will be supported by the lower tax burden on firms due to the abolition of the payroll tax and the gradual lowering of the corporate income tax. In addition, the realisation of investment projects will be facilitated by the higher inflow from the EU structural funds. Private consumption will increase at approximately the same rate as disposable income, whereas the structure of consumption is projected to experience a further pick-up in the purchases of durables and non-durables intended for home furnishings, following the vigorous housing construction in 2006-2007. According to projections based on the adopted budget, the growth of government consumption is set to remain at a similar level as in the year before.

Any faster cooling of economic growth in the USA in 2007 and 2008 would have a relatively small impact on the realisation of the IMAD's spring forecast.

Among the downside risks to the spring forecast, we estimated the consequences of a potential rapid slowdown of GDP growth in the USA this year and in 2008 that would follow an appreciable drop in real estate prices and housing investment. If GDP growth in the USA were 1.25 p.p. lower¹¹ than projected in the baseline scenario in both years, it would have a direct effect on the lower 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 cooling of the American economy, as their GDP growth would consequently slacken as well. To a much lesser extent, the deteriorated economic conditions in the external environment would also affect the growth

¹¹ The assumption behind the estimated slowdown of the US GDP growth is a 20% drop in housing prices and a recession in housing investment (Quarterly Report on the Euro Area, December 2006).

of investment, especially in machinery and equipment, where it is the most dependent on the business cycle. The overall impact of the indirect and direct effects of the slower GDP 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.

In 2009, economic growth will cyclically slow to 4.1%.

In addition to the slightly lower growth of exports in line with the expected further contraction of the business cycle in the international environment, the growth of domestic consumption will also be lower in 2009. Especially the growth rates of gross fixed capital formation will moderate due to the foreseen completion of motorway construction, whereas investment in machinery and equipment is set to continue. We also expect a higher level of investment in other infrastructural projects in comparison with the previous years. The growth of private consumption will remain at a similar level as in 2008.

Table 4: Spring forecasts of GDP growth and consumption aggregates, and a comparison with autumn forecasts

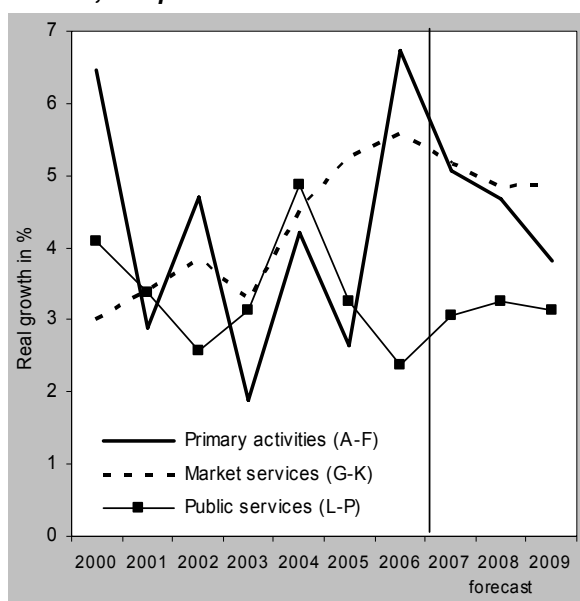
	Real growth rates (in %)					
	2006	2007		2008		2009
		Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
GROSS DOMESTIC PRODUCT	5.2	4.3	4.7	4.2	4.4	4.1
Exports of goods and services	10.0	8.3	9.7	8.5	9.2	8.8
Imports of goods and services	10.4	7.7	8.7	7.7	8.6	7.9
Private consumption	3.3	3.6	3.8	3.6	3.5	3.4
Government consumption	3.8	2.5	3.1	2.8	2.9	2.3
Gross fixed capital formation	11.9	5.5	5.9	4.5	6.6	4.4

Source of data: SORS, forecasts by IMAD.

The dynamics of value added by activity

In 2007, the real growth of value added is projected to be slightly lower than in 2006, but at the still relatively high level of 4.7%. In 2008 and 2009, the real growth of value added will ease off further, however it will remain above 4%. After its remarkable increase in 2006, the growth of value added in primary activities will slacken in 2007-2009. This year and in 2008, a slowdown – although much less pronounced – is also expected in the growth of market services' value added. After the deceleration in 2006, the real growth of value added in public services will pick up somewhat this year and is also projected to remain at the achieved level for the next two years (Figure 12).

Figure 12: Value added in primary activities, market services, and public services

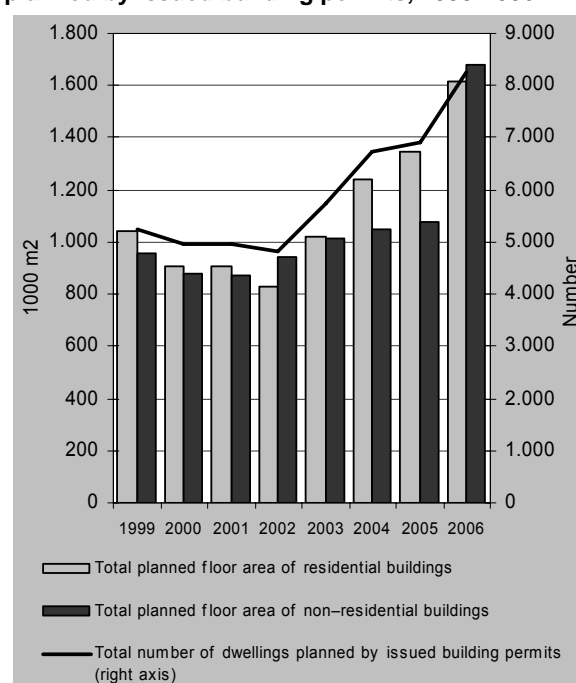


Source of data: SORS; forecasts by IMAD.

This year, the increase in the value added in primary activities (5.1%) will be smaller in both sectors that were the main contributors to the favourable results of the entire group last year, i.e. manufacturing and construction. The slowdown in *manufacturing's* value added growth will be moderate. It reflects the somewhat lower forecast of GDP growth in Slovenia's main trading partners. Nevertheless, we expect the relatively favourable trends from the end of 2006 to continue at least in the beginning of the year. These projections are also corroborated by the business expectations for the next three months. A moderation is expected in the second half of the year. Looking at the structure of growth, the more technology-intensive industries will continue to increase more rapidly. This year, their growth will be strongly supported by another rebound in automotive industry production, which has been growing fairly rapidly since November 2006. Activity in *construction* will again be propelled by motorway construction, along with the construction of non-residential and residential buildings, judging

from the number of issued building permits (Figure 13). The growth of value added will be lower after last year's very high result, but still well above the average recorded in the period 2000-2005. In addition, assuming that the weather conditions for construction will not be as favourable at the end of 2007 as they were in 2006, we expect a year-on-year decline in construction activity in the final months of the year. The value added in *mining and quarrying, and in electricity, gas, and water supply*, will roughly remain at last year's level in real terms, whereas *agriculture* could record a slight increase in value added after a two-year decline, based on the volume of areas sown in the autumn and the number of livestock counted at the beginning of the year.

Figure 13: Floor area and total number of homes planned by issued building permits, 1999-2006



Source of data: SORS

The growth of market services' value added will slow down in all activities except business services. Nevertheless, it will remain above the average of the last six years in all activities. The highest growth of value added is still expected in *financial intermediation*, where the development of the financial system and its integration with the European financial system will continue. The increase in housing loans is one of the factors that will boost the growth of value added especially this year. Given the vigorous growth of the number of building permits for residential buildings in previous years, the growth of housing loans is set to accelerate further this year. The growth of financial intermediation will also be underpinned by the changes in personal income tax legislation adopted last year, since a proportion of the increase in income from this source is anticipated to flow into savings. Non-banking financial services are also projected to continue to rise. The relatively high projected increase

in *transport, storage, and communications* will be based on the continuation of favourable developments in road freight transport, post and telecommunications, traffic in ports, and shipping with logistics. Amid the stronger household spending, *distributive trades*, in particular in retail trade will enjoy an increase this year, whereas growth in wholesale trade and the sale of motor vehicles will be somewhat slower after the boom in 2006. The growth of value added will also remain

fairly strong in *hotels and restaurants* which is made possible by the high investment in tourist infrastructure in terms of both its scope and quality seen in the past few years. In *business services*, we expect continued high growth rates in knowledge-based services, as well as services linked to real estate activities and architectural and engineering consultancy, due to the strong construction activity.

Table 5: Value added by activity and gross domestic product, real growth rates in %

	2005	2006	Forecast		
			2007	2008	2009
A. Agriculture, forestry, hunting	-5.2	-4.4	1.0	1.0	1.5
B. Fishing	9.5	1.7	0.0	1.0	1.0
C. Mining	-0.2	2.6	0.0	-0.5	-0.5
D. Manufacturing	2.8	7.4	5.8	4.8	4.5
E. Electricity, gas, and water supply	6.6	1.7	0.5	1.5	0.5
F. Construction	4.0	11.8	6.1	7.2	3.5
G. Distributive trades	4.0	5.6	4.3	3.8	3.3
H. Hotels and restaurants	0.7	5.6	5.0	5.3	5.0
I. Transport, storage, and communications	9.0	6.3	6.0	5.5	6.5
J. Financial intermediation	10.4	8.9	8.5	7.5	7.0
K. Real estate, renting, and business activities	3.6	4.3	4.3	4.3	4.5
L. Public administration, defence, and social security	2.3	1.9	2.8	2.8	2.0
M. Education	3.0	2.2	2.4	2.5	2.5
N. Health and social work	2.9	2.2	2.8	3.0	3.5
O. Other community, social, and personal services	5.8	3.8	5.0	5.5	5.5
P. Private households with employed persons	5.9	-3.5	1.0	1.0	1.0
VALUE ADDED	3.9	5.3	4.7	4.5	4.2
a) Taxes on products and services	4.8	4.0	4.4	3.8	3.9
a) Subsidies on products and services	-0.6	-2.4	-2.0	-2.0	-3.0
GROSS DOMESTIC PRODUCT	4.0	5.2	4.7	4.4	4.1

Source of data: SORS; forecasts by IMAD.

The value added in public services is forecast to total 3.1% and projected to be higher than last year in all activities. The projected pick-up in value added in *public administration* will be underpinned by the increased hiring in the run-up to Slovenia holding the EU presidency, which will also translate into a higher increase in wages. Within *education*, we expect that tertiary education will continue to expand, while the growth of primary and secondary education is set to remain subdued. Moreover, adult education is projected to start increasing more rapidly, which is already suggested by the higher investment and a rise in the number of participants in 2006. In *health and social care*, we project faster growth of social care this year due to the planned further expansion of institutional care capacities, the granting of concessions for the provision of services for the elderly, and the expansion of help at home, day-care centres, and sheltered housing services. The growth of health care services is also expected to gather some momentum due to the speedier granting of concessions in this sector. *Other social and personal services* will continue to witness brisk growth in the predominantly market-oriented segment of these services.

The growth of value added in primary activities will total 4.7% in 2008 and approximately one percentage point less in 2009. Value added in *manufacturing*, which exports the bulk of its production, will slacken further in the next two years as a result of the slightly lower projected GDP growth rates in the main trading partners. In the structure of growth, the contribution of the most rapidly expanding, i.e. mostly the more technology-intensive industries, will continue to increase. The expansion of these industries is also expected to benefit from the projected higher investment in research and development, stimulated especially by the tax relief introduced in 2006. The growth of value added in *construction* will accelerate further in 2008, particularly on the back of the additionally increased volume of motorway construction. In 2009, however, it is projected to halve as a result of lower motorway construction, in spite of the gradual increase in other infrastructural projects.

The growth of value added in market services will total 4.8% in 2008 and 4.9% in 2009. Particularly in the traditional market services, we expect that the high growth rates recorded in 2006 and projected for 2007 will be followed by a gradual convergence towards the

long-term averages. The only exception is the hotels and restaurants industry, which will receive a boost from the expected higher inflow of foreign visitors, especially in 2008, linked to Slovenia's presidency of the EU. The brisk expansion of knowledge-based services is expected to continue, especially in business and financial services, where Slovenia still lags considerably behind the more developed countries, both in terms of the scope and efficiency of these services. We also expect further rapid growth of telecommunications driven by the increased access, quality, and diversity of information and communication services as a result of growing competition among the suppliers, coupled with active government policy in this area (e.g. projects such as e-government, e-health, e-justice, and the national broadband network).

The growth of value added in public services will total 3.2% in 2008 and 3.1% in 2009. In *public administration*, it will remain at the relatively high 2007 level in 2008 due to the effect of Slovenia holding the EU presidency, whereas in 2009 it is expected to moderate. The growth of value added in *education* in the next two years will be slightly higher than this year, whereas its structure will see a further increase in the importance of tertiary and adult education. In *health and social care*, the growth of value added will gain even more momentum. In health care, it will be driven by the increasing demand for services, the faster introduction of new treatment methods, and private practice, whereas in social care it will be propelled by further improvements in the accessibility of social protection services. The vigorous expansion of activities within *other social and personal services* will continue to be driven by the predominantly market-oriented services. In the next two years, it will also be underpinned to some extent by the beginning of the realisation of projects in the area of arts, entertainment, and recreation, defined in the Resolution on National Development Projects for the Period 2007-2013.

Current account of the balance of payments

The current account deficit will narrow gradually in 2007-2009. Its narrowing will be largely linked to the deficit reduction in merchandise trade, since the real growth of exports will exceed the real growth of imports throughout the period. In addition, the narrowing will also be significantly supported by the higher increase in export prices than import prices, based on the assumed price dynamics of oil and other commodities. In contrast with trade in goods, trade in services will record slower real growth of exports than imports amid a slight deterioration in the terms of trade in services, which was also characteristic of the previous years. The surplus in services trade will continue to increase due to the higher surplus in the trade in transport services and travel, which follows the expected developments in goods trade and hotels and restaurants, whereas a widening of the deficit is expected in other services.

In the entire analysed period, the deficit in capital income will contribute significantly to current account deficit formation. The expenditures in capital income have exceeded the receipts in this account ever since 2002, and the gap has been increasing. This trend is set to continue in the future. Capital expenditures will continue to increase rapidly as a result of the vigorous borrowing of banks and enterprises in the previous years and the higher interest rates in international capital markets. The growth of capital expenditures will exceed the growth of receipts from interest rates obtained by lending to the rest of the world and capital exports in the form of investment in debt securities. In contrast with 2006, when the deficit increase was also significantly based on the higher payments of dividends and reinvested earnings, we expect that these will increase at a somewhat slower rate in the forecast period.

The deficit in current transfers will decrease gradually. This narrowing will be underpinned by the higher absorption of EU funding based on the new financial perspective. In the private sector's transfers, however, outflows will continue to be higher than inflows.

Table 6: Spring forecast of the current account and a comparison with the autumn forecast

	2006	2007		2008		2009
		Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
Current account of the balance of payments, EUR m	-773	-503	-629	-410	-273	-64
Current account of the balance of payments, % of GDP	-2.6	-1.6	-2.0	-1.2	-0.8	-0.2

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

Inflation

We estimate that consumer prices will continue to increase by approximately 2.5% per year in 2007-2009. The spring forecast for 2007 totals 2.2% for average inflation and 2.5% for year-on-year inflation. Inflation will also remain at a level of approximately 2.5% in the next two years. The reasons for the slight downward swing this year, when average inflation is projected to be lower than year-on-year inflation, are largely technical in nature¹².

The first analyses of price developments in the month prior to and the two months following the adoption of the euro show that the currency changeover did not cause a general price increase; it did, however, push up the prices of services provided by hotels and restaurants. Average inflation remained stable at 2.5% in this period, whereas year-on-year inflation stood at 2.1% in February, when prices declined for the second month in a row. The euro changeover can nevertheless be associated especially with price rises in the services provided by hotels and restaurants (Figure 14) and to some extent in some other services, which can be attributed to price corrections and rounding-up. The total contribution of the price rise attributable to the adoption of the euro is estimated to have totalled 0.24 p.p. in the period Dec. 06 - Feb. 07. This increase was thus one of the lowest in comparison with the corresponding increases in other EMU countries. Although a longer time series will have to be analysed in order to arrive at the final results, experience from the EMU countries shows that the majority of changes related to the currency changeover occurred in the month prior to and the month after the changeover (80%-90% of the total price rise).¹³

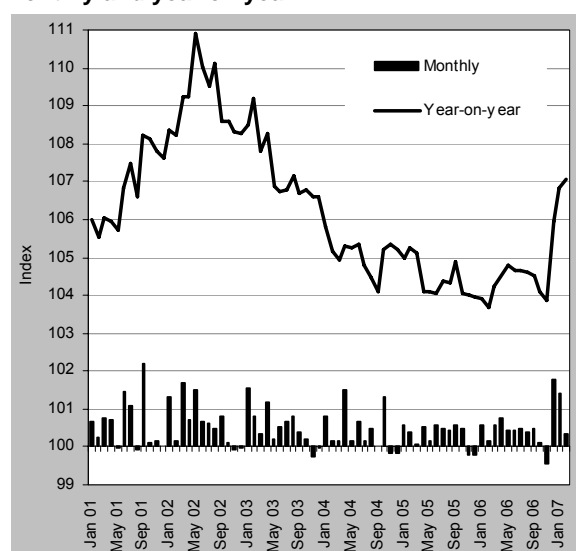
The forecast of inflation for 2007 is based on the expected preservation of the counter-inflationary macroeconomic policy mix. In accordance with the Government plan, administered prices, excluding the impact of taxes, will contribute close to 0.2 p.p. to inflation. This estimate assumes an increase in oil prices from the observed level in March to USD 64/barrel in Q2 and their persistence at that level until the end of the year. Since this increase will be much lower at the annual level than we assumed in the autumn forecast, and since the spring forecast does not project any raising of excise duties on liquid fuels, which was already implemented last year, inflation will be lower than projected in the autumn. The forecast

¹² The effect of the monthly deflations recorded in Q4 of 2006 and in the first two months of 2007 will be felt in average inflation for a longer period of time due to the differences in the computation of year-on-year and average inflation.

¹³ A somewhat more extensive analysis of the effects of the euro changeover on inflation in Slovenia is available on the IMAD website: <http://www.gov.si/umar/drugo/EuroCh.pdf>

also takes into account the increase in electricity prices for household consumers (by 4.9%) in April, which will add 0.13 p.p. to inflation. Such an increase is in line with the price trends recorded in the EU in the second half of 2006. It will facilitate the transition of electricity suppliers from the regulated to the liberalised market after 1 July 2007. After the liberalisation we therefore expect no additional price increases until the end of the year. The contribution to inflation from fiscal impacts is estimated at the same level as last year (around 0.5 p.p.) and includes the planned increases in various excise duties included in the national budget. The lower tax inflows resulting from the further reduction of the payroll tax and the reduced personal income tax rates, will thus be partly offset by the increased inflows induced by the accelerated harmonisation of excise duties on tobacco and tobacco products, the higher excise duties on alcohol and tobacco, and the imposition of an excise duty on electricity, in compliance with EU directives.

Figure 14: Prices of hotel and restaurant services, monthly and year on year



Source of data: SORS; calculations by IMAD.

The planned increase in private consumption due to the effect of the lower personal income tax rates and the increase in earnings will not cause any inflationary pressures. The estimated acceleration in private consumption growth will be relatively small and macroeconomically sustainable as the growth of private consumption will continue to lag behind GDP growth by almost one percentage point. The increase in wage growth in the public sector (following several years of weak real growth) reflects the gradual release of the funds intended for the elimination of wage disparities in the public sector, rather than an increase in general wage adjustment in the public sector that would evidence a laxer government policy in this area. Faster growth of wages in the public sector in the latter part of 2007 and the first half of 2008 will also partly reflect the increased workload related to the EU

presidency. We therefore think that such an increase in the public sector's wages, after they have lagged behind the wage increases in the private sector for several years, will not have a demonstrative effect on the wage growth in this sector, where the adopted agreements ensure that moderate wage growth will continue this year.

The developments in market-determined prices are projected to remain the same as last year. The contribution of market-determined price rises to inflation is estimated to be the same as last year, assuming that most price increases associated with the euro adoption have already taken place, which is also confirmed by the experiences of other countries. Market-determined prices of goods, in which food prices comprise a large proportion, are similarly projected to continue to rise moderately, at the level of average inflation.

Inflation will also remain stable in 2008 and 2009, at 2.5%. The forecast is based on the expected neutral contribution of external factors and the preservation of

the existing government policy mix¹⁴. While the administered prices plan for 2008 and 2009 is due to be prepared by the end of 2007, we estimate that, based on the hitherto dynamics of these prices (excluding liquid fuels), there are no economic reasons for the occurrence of any major pressures on consumer price rises from this source. Therefore, the forecast projects that trends in these prices will remain unchanged.

The most recent projections of relative consumer prices show that the moderate deterioration of Slovenia's price competitiveness will continue in 2007. Under the technical assumption of a rate of USD 1.294 to EUR 1, the effective exchange rate will appreciate by 0.2% in nominal terms and by 0.6% in real terms, which does not diverge from the autumn projections.

¹⁴ The potential raising of both VAT rates (from 8.5% to 9% and from 20% to 21%), which is one of the possibilities proposed to compensate for a possible shortfall in tax revenue in 2008 due to the lowering of the payroll tax and other tax changes, is not included in the forecast because the final decision on this issue has not been taken yet.

Table 7: Spring forecast of inflation and a comparison with the autumn forecast

	2006	2007		2008		2009
		Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
Inflation (annual average, %)	2.5	2.7	2.2	2.5	2.5	2.5
Inflation (Dec/Dec, %)	2.8	2.7	2.5	2.2	2.5	2.4

Source of data: SORS; forecasts by IMAD.

Employment and unemployment

Amid the cooling of the economic cycle, employment growth will also decelerate slightly in 2007-2009.

Throughout the period, employment will continue to increase at the fastest rate in business services and construction. It will also increase in other market service sectors. In addition to favourable economic developments, the growth of employment in the business sector will also be partly underpinned by the lowering of the payroll tax, which reduces the tax burden on wages and may enable increased hiring of highly educated labour, which would benefit the productivity of this sector in the long term. On the other hand, employment growth in the traditionally industrial branches will continue to decline. An increase in employment is also foreseen in the public services group, where employment in health and social care is expected to increase gradually throughout the period. In 2008 we also project a transitory surge in employment in public administration, linked to Slovenia holding the EU presidency.

Registered and survey unemployment rates will continue to decrease in the next few years and will be lower than projected in the autumn. On one hand, the

number of persons in employment will exceed the autumn forecast due to the higher increase in employment in 2006 than forecast in the autumn, whereas the projected employment growth rates in 2007-2009 remained roughly the same as in the autumn. We assume that the deceleration in economic growth in the next few years will translate into a slow decline in informal employment. On the other hand, the number of unemployed will be lower, as the activity rates will increase at a somewhat slower pace than projected in the autumn. This figure was lower than the IMAD's autumn forecast already in 2006 due to the higher increase in employment and the somewhat lower activity rate than projected in the autumn. The survey and registered unemployment rates will thus decrease somewhat more this year and in 2008. The decline in the registered unemployment rate will also be somewhat faster due to the decrease in the number of those unemployed who are not seeking employment or are unwilling to accept it. That the number of unemployed will be lower than we projected in the autumn is also evidenced by the first available data from the beginning of 2007.

Table 8: Spring forecasts of labour market trends and a comparison with autumn forecasts

	2006	2007		2008		2009
		Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Autumn Forecast (Sept. 2006)	Spring Forecast (March 2007)	Spring Forecast (March 2007)
Employment according to national accounts (increase in %)	1.2	0.8	0.9	0.9	0.8	0.7
Registered unemployment rate (%)	9.4	9.5	8.2	9.1	7.8	7.4
Survey unemployment rate (%)	6.0	6.4	5.7	6.4	5.4	5.4
Employment rate (%)	66.6	66.8	67.0	66.9	67.4	67.5
Gross wage per employee Real growth (%)	2.2	2.5	2.9	3.0	2.9	2.8

Source of data: SORS; forecasts by IMAD.

Wages

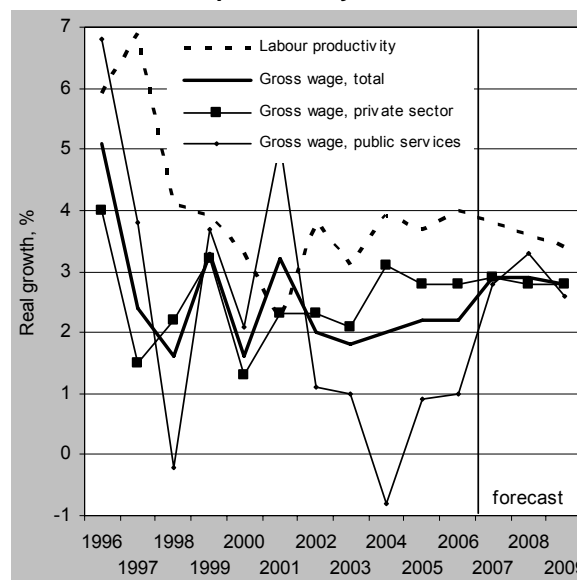
Social partners are still negotiating the framework of the future wage policy and other elements of the Social Agreement. In the private sector, the wage formation mechanism for 2007 has already been negotiated, whereas in the public sector an agreement on wage adjustment and the elimination of wage disparities in this sector for 2007-2009 has been initialled.

The wage formation mechanism in the private sector for 2007 is the same as in 2006, whereas an agreement for the years beyond 2007 has yet to be concluded. The wage formation mechanism for both years was defined in the *Collective Agreement on the Wage Adjustment Mechanism, Reimbursement of Work-related Costs, and Holiday Allowances*, according to which wages are raised by 2% in August. The collective agreement defines minimum standards that apply primarily to those employees who are not covered by any sectoral collective agreement. In the latter, the social partners mostly negotiated a slightly higher adjustment percentage, whereas sectoral negotiations for 2007 are still underway. In 2007, the adjustment in August will also include an additional increase by the difference in actual inflation exceeding the estimated 2.3% in the period Dec. 05 - Dec. 06. Pay rises based on productivity growth depend on the achieved business results and are mostly carried out at the level of individual companies. The social partners have not yet started to negotiate the adjustment mechanism for private sector salaries in 2008, since the bargaining on the wage policy guidelines set out in the Social Agreement for the next period is still underway.

The higher increase in wages in the public sector in 2007-2009 compared with the past few years will be mainly underpinned by the use of funds for the thus far deferred elimination of wage disparities in this sector. The wage policy for this period is set out in the *Agreement on the Base Wage Adjustment Mechanism and the Level of Expenditure Earmarked for the Elimination of Wage Disparities in 2007-2009* (hereinafter: the *Agreement*). The *Agreement* lays down the adjustment mechanism and additional funds for the elimination of disparities until 2009, when the disproportions in wages in this sector are due to be finally eliminated. Approximately a third of this expenditure is planned to be used for the elimination of disparities each year. The adjustment mechanism for 2007 defines that 1.3% will be used for the general adjustment, while 0.8% is earmarked for the elimination of disparities. In 2008 and 2009, half of the estimated consumer price rise will be used for the general indexation, while the other half will serve for the elimination of wage disparities. In all three years, additional funds, fixed as a percentage of the estimated overall increase in labour productivity, will be earmarked for the elimination of disparities. The

additional expenditure will total 14% of the estimated overall productivity growth in 2007, 30% in 2008 and 50% in 2009. In the event that inflation should exceed the forecasts in 2007-2009, the agreement also provides for an additional wage increase in January's gross wages by the actual difference.

Figure 15: Growth of the gross wage per employee and overall labour productivity, 1996-2009



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

The increase in wages in 2007 is projected to be higher than in 2006. This forecast is largely based on the higher increase in the public sector's wages, where wage disparities will begin to be eliminated, and the workload will increase due to Slovenia holding the presidency of the EU and the reduction of court backlogs. We estimate that the gross wage per employee will increase by a nominal 5.2% and by a real 2.9% in 2007. Labour productivity will rise by an estimated 3.8%. Wages in the *private sector* will rise by around 2% in August in accordance with the agreed indexation mechanism, and by an additional 0.5% to compensate for actual inflation exceeding the forecast 2.3% in 2006. In view of the expected dynamics of economic growth, wages are projected to rise slightly more in the first half of the year than in the second half. For the year as a whole, the gross wage is forecast to increase by 5.2% in nominal terms and by 2.9% in real terms, while labour productivity in the private sector will grow by 4.5%. In the *public sector*, it is foreseen that wages will begin to be paid in accordance with the Salary System in the Public Sector Act, however not until towards the end of 2007. Until then, starting-level wages will be disbursed pursuant to the Act Regulating Wage Rates in Public Institutions, State Bodies, and Local Community Bodies. In order to carry out July's 1.3% overall wage adjustment, as foreseen in the initialled *Agreement*, which already takes into account base wages, it will therefore be necessary to amend the

Salary System in the Public Sector Act. The wage adjustment in July will also compensate for actual inflation exceeding 2.35% in 2006. This means that January's gross wages will be raised by 0.45%, and July's indexation will therefore also include the outstanding payments from January onwards. The forecast of the wage rise in the private sector assumes that wages will start to be paid in accordance with the new system in September, and it therefore includes the increase by an estimated one-third of the funds earmarked for the elimination of disparities identified in public sector wages. The forecast also accounts for the increase in salaries in public administration due to the higher workload during the period Slovenia holds the EU presidency, and the increase in the salaries of judges and prosecutors working on the Lukenda project (reduction of court backlogs). These rises, however, are expected to take place mainly in the second half of the year. Based on the above assumptions and taking into account the funds for regular promotions and worker performance, we estimate that the gross wage per employee in the public sector will rise by a nominal 5.1% and by a real 2.8%.

Wages in the public sector are expected to rise faster than wages in the private sector in 2008, while the real growth rate of the overall wage for 2008 is projected to be the same as in 2007. The gross wage per employee is projected to rise by a nominal 5.5% and by a real 2.9% in 2008 (labour productivity by 3.6%). The estimated 5.4% nominal and 2.8% real increase in *private sector* wages is based on the estimated economic trends and adjusted for there being three working days more in 2008 compared with 2007. The increase in labour productivity in the private sector is projected to total 4.4%. The estimated increase in the gross wage per employee in the *public sector* takes into account the adjustment mechanism from the initialled *Agreement*. In addition, the forecast also includes the planned pay rise in July financed from the second third of funds earmarked for the elimination of wage disparities in the public sector. Furthermore, it is foreseen that gross wages in public administration will decline at the end of the period when Slovenia will hold the EU presidency, when the workload will decrease. Based on these assumptions and taking into account the regular funds for promotions and performance, the gross wage per employee in the public sector is projected to increase by a nominal 5.9% and by a real 3.3%. The higher real growth of gross wages in this sector in comparison with 2007 is largely attributable to the fact that the estimate for 2008 assumes that the new wage system will be in operation throughout the year, whereas the forecast for 2007 assumes that it will be applied only in the last four months.

In 2009, the real growth of wages will remain at the same level as in 2008 in the private sector, while moderating in the public sector. We estimate that the gross wage per employee will increase by 5.4% in nominal terms and by 2.8% in real terms in 2009. Labour productivity is projected to rise by 3.4%, hence the lagging of real wage growth behind productivity growth will continue to narrow. The projected real growth of wages in the *private sector* is the same as the overall estimated increase in wages. The estimate reflects the expected slight deceleration in economic activity as well as the fact that there will be two working days more in the year. Labour productivity in the private sector is set to increase by 4.0%. In the *public sector* the projected nominal increase in gross wages assumes the adjustment mechanism set out in the *Agreement* and the increase in wages by the final third of the funds earmarked for the elimination of disparities. Based on these assumptions and taking into account regular promotions and worker performance funds, the gross wage in the public sector is projected to increase by a nominal 5.2% and by a real 2.6%.

Comparison of the IMAD spring forecasts with the forecasts of other institutions

Upon finalisation, the Spring Forecast of Economic Trends was also presented to other forecasting institutions (the ARC – the Analysis and Research Centre of the Bank of Slovenia, the SKEP – the Economic Outlook and Policy Services of the Chamber of Commerce and Industry of Slovenia (CCIS), and the IER – the Institute for Economic Research). Some of these institutions have already published their first forecasts this year. Given the different time frames for the preparation of forecasts (seen from the table), which determine the selection of assumptions and statistical data included in the forecasts, and the different estimates of economic policy effects, the forecasts of the main macroeconomic aggregates diverge somewhat again this year. The discrepancies are most pronounced in the forecasts of the current account balance and the unemployment rate.

The forecasting institutions have mostly raised their GDP growth forecasts this year and project that GDP growth will remain above its long term 4% average throughout the period. The forecasters estimate that the high growth of investment in means of production and the rise in employment are also raising potential growth, which has been estimated at between 3.5% and 4% thus far. For the entire period, the IMAD projects a slightly lower increase in investment consumption than other forecasters, and slightly higher growth of exports and imports. The differences in investment forecasts for this year most probably reflect the uncertainty regarding the estimated share of investment in machinery and equipment that was brought forward last year due to the abolition of the general investment tax relief. On the other hand, the forecasters agree that the construction of residential and non-residential buildings will continue to increase vigorously this year, while remain strong. As in 2006, however, the realisation of these investments will depend on weather conditions. In 2009, the differences may also mirror the fact that the amount of expenditure earmarked for infrastructural investment has not yet been determined. Regarding exports, the IMAD and the EIPF (the Economic Institute of the Faculty of Law) expect a slightly lower increase than last year, whereas the BS and the CCIS project a more pronounced slowdown compared with 2006. In contrast with other institutions, the BS projects a rebound in export growth in 2008, assuming a higher contribution from the car industry to exports in comparison with other forecasters. Both the BS and the IMAD estimate that the proposed changes to personal income tax legislation will accelerate the growth of disposable income and transitionally also the growth of private consumption this year, whereas the CCIS projects that the increase in private consumption

will remain at the level of the last two years in 2007 and in 2008.

Amid the still buoyant economic activity, employment will preserve its strong dynamics this year at a level of around 1% according to forecasters, which will be followed by a gradual deceleration in the next two years. Given the high increase in employment and the higher than expected drop in unemployment in 2006, the IMAD's unemployment rate forecast has been revised downwards compared with the autumn forecast. On the other hand, the CCIS, the EIPF, and the WIIW have not lowered their survey unemployment rate forecasts. This difference appears to reflect the fact that their forecasts were prepared in January/February, when the survey unemployment rate figure in Q4 was still unknown (it was low, at 5.6%). The IMAD and the BS forecasts of wage developments differ marginally, whereas the CCIS forecasts are lower due to their lower estimated wage increases in the private and public sectors.

Inflation, which stabilised at 2.5% in 2005 and 2006, is forecast to persist around this level. Most forecasts of average inflation span a minimum range between 2.5% and 2.7%. The IMAD expects a slightly bigger decrease in 2007, while the WIIW projects such for 2008. The differences in forecasts appear to reflect the somewhat varying estimates of the increase in market-determined prices. Forecasters agree that these prices are returning to their long-term equilibrium level of around 2.5% growth, after having recorded low rises for two years. In 2008 and 2009, the differences in inflation forecasts may also mirror the different assumptions regarding the dynamics of administered prices, since the plan for their adjustment in this period has not been adopted yet. The risk of rapid economic growth leading to increased inflationary pressures is estimated as moderate by the forecasters due to the concurrent increase in potential growth.

The discrepancies between the forecasts of the current account deficit in 2008-2009 are mainly the result of the different assumptions regarding the export to import prices ratio in goods and services trade. The IMAD forecast assumes that export prices will rise faster than import prices in this period, which indicates an improvement in the terms of trade. The BS forecast, on the other hand, assumes neutral terms of trade, hence the BS projects that the deficit in goods and services trade will decrease at a slower rate than according to the IMAD forecast (which projects a trade surplus in 2008-2009). The estimated deficits in factor incomes and current transfers are similar in all forecasts.

Table 9: Comparison of published spring forecasts for selected economic indicators for Slovenia

	2007	2008	2009	2007	2008	2009	2007	2008	2007	2007	2008
	IMAD March 2007			ARC BS March 2007			SKEP CCIS January 2007		IER January 2007	WIIW February 2007	
	Real growth rates in %										
Gross domestic product	4.7	4.4	4.1	4.6	4.4	4.0	4.2	4.3	4.4	4.5	4.4
Exports of goods and services	9.7	9.2	8.8	8.4	9.7	7.8	7.5	7.5	9.4	-	-
Imports of goods and services	8.7	8.6	7.9	8.1	9.0	7.3	7.2	7.5	8.6	-	-
Gross capital formation	5.1	5.7	4.2	6.0	5.4	5.2	-	-	-	-	-
- gross fixed capital formation	5.9	6.6	4.4	-	-	-	7.0	8.0	6.4	7.0	7.0
Private consumption	3.8	3.5	3.4	3.5	3.4	3.2	3.2	3.2	2.6	3.0	3.0
Government consumption	3.1	2.9	2.3	3.2	2.7	2.7	2.8	3.0	-	-	-
Inflation (annual average, %)	2.2	2.5	2.5	2.7	2.7	2.6	2.6	2.6	2.5	2.6	2.3
Gross wage per employee (real growth in %)	2.9	2.9	2.8	2.7	2.8	2.7	2.2	2.2	-	-	-
Employment according to national accounts (% growth)	0.9	0.8	0.7	1.1	0.6	0.5	1.0	1.0	-	-	-
Survey unemployment rate (%)	5.7	5.4	5.4	-	-	-	6.5	6.5	6.0	6.0	6.0
Current account as a % of GDP	-2.0	-0.8	-0.2	-2.0	-2.1	-1.8	-	-	-	-2.2	-1.5

Sources of data: Spring Forecast 2007, March 2007, IMAD; Price Stability Report, March 2006, BS; Economic Trends, February 2006, SKEP CCIS; Economic Trends, January 2007 (interim forecast of economic trends), EIPF; Research Report No. 335, February 2007, WIIW.

Assessing the validity of the IMAD forecasts

Based on an analysis of the accuracy of forecasts over a longer period of time, we find that the IMAD forecasts show no systematic over- or underestimation. In view of the uncertainty of future economic trends, individual forecasts can never be entirely accurate; it is important, however, that their mean error is as small as possible over a longer time period. A mean error approximating a value 'zero' indicates that the forecasts are not biased, i.e. that they do not systematically under- or overestimate future trends. In other words, this means that the forecasting institution is neither optimistic nor pessimistic. The mean error in the *forecasts of real GDP growth* for the period 1997-2006 totals 0.16 p.p. in the autumn forecasts for the year ahead and 0.07 p.p. in the spring forecasts for the current year. The corresponding mean errors in the *forecasts of nominal GDP growth* total 0.05 p.p. and -0.05 p.p., respectively.¹⁵ The mean errors in the *forecasts of average inflation* amount to a respective 0.21 p.p. and 0.14 p.p. The mean error in the *forecast of year-on-year inflation* is 0.18 p.p. for the current year but somewhat higher, 0.52 p.p., in the autumn forecasts for the year ahead. With the exception of the latter, these indicators show that the IMAD forecasts are unbiased in the long term.

The IMAD forecasts of GDP growth were the most accurate among the Slovenian institutions, whereas the Bank of Slovenia was more accurate regarding inflation forecasts. The mean absolute errors (MAE)¹⁶ in the forecasts of real and nominal economic growth ranged between 0.63 and 0.97 p.p. in 1997(8)-2006. The root mean square errors (RMSE), which assign greater weight to larger errors, were only slightly higher (between 0.82 and 1.14 p.p.). In forecasts of average inflation, the mean absolute error totalled 0.42 p.p. for the current year and 0.79 p.p. for the year ahead. The errors in year-on-year inflation are somewhat higher again.¹⁷ A comparison of the absolute accuracy measures shows that the IMAD forecasts of GDP growth exhibit the lowest absolute accuracy measures among the Slovenian forecasters, whereas the BS achieves slightly better results in inflation forecasts. We find the same if we compare the standardised values of accuracy measures (MAE/sd and RMSE/sd), which take into account the variability of the forecast phenomenon. Compared with the European

Commission's forecasts for the older EU members, the IMAD's absolute accuracy measures are slightly worse¹⁸, whereas there are no significant differences in the relative accuracy measures.¹⁹

All institutions, including the IMAD, underestimated real GDP growth in 2006 (Table 10). The biggest underestimations in forecasts for 2006 were made in autumn 2005, when they totalled between 1.2 and 1.8 p.p. The errors in the following forecasts were smaller, ranging between 0.9 and 1.3 p.p. in spring 2006 and between 0.4 and 1.2 p.p. in autumn 2006. This shows that all forecasting institutions underestimated the strength of the expanding business cycle. In all three forecasts, the WIW made the biggest errors. The IMAD is the only forecaster among the above that also issues forecasts of nominal GDP growth. Its error in the nominal GDP growth forecast was the same as in the real GDP growth forecast in autumn 2005, but higher in spring 2006, reflecting the complexity of estimating implicit deflators.

The most accurate forecasts of average inflation for 2006 were prepared in autumn 2005. In autumn 2005, most forecasters released accurate forecasts of average inflation for 2006. In spring 2006, the forecasts were revised downwards, only to be revised upwards again in autumn 2006. The IMAD's forecast in autumn 2005 was accurate as well. Like all other institutions, the IMAD made a downward revision of its forecast in spring 2006 (the error totalled 0.4 p.p.). In the next forecast, the IMAD again revised its forecast upwards, as did all the other forecasters, mainly due to the high oil prices (the errors in the last forecasts of average and year-on-year inflation were the same, totalling 0.2 p.p.).

¹⁵ The most important forecast in terms of budgeting is the spring forecast of nominal GDP growth for the year ahead, since the process of budgetary planning begins upon its release. The mean error for this forecast totals 0.03 p.p.

¹⁶ For methodological explanations, see Ferjančič, M. (2005): "Analiza uspešnosti napovedi UMAR, Delovni zvezek 2005/13, Ljubljana.

¹⁷ Accuracy measures are presented in detail in the Statistical Appendix.

¹⁸ These findings generally apply to all new EU member states (see e.g. Keereman, F. (2005): "Economic forecasts and fiscal policy in the recently acceded Member States", European Commission, Economic Paper, nr. 234, November 2005.

¹⁹ Accuracy measures are presented in detail in the Statistical Appendix.

Table 10: Errors made by forecasting institutions in their forecasts of real GDP growth and average inflation for 2006

	GDP growth						Inflation					
	Autumn Forecast for the year ahead		Spring Forecast for the current year		Autumn Forecast for the current year		Autumn Forecast for the year ahead		Spring Forecast for the current year		Autumn Forecast for the current year	
	Forecast	Error in p.p.	Forecast	Error in p.p.	Forecast	Error in p.p.	Forecast	Error in p.p.	Forecast	Error in p.p.	Forecast	Error in p.p.
Realised	5.2	-	5.2	-	5.2	-	2.5		2.5		2.5	
IMAD ¹	4.0	1.2	4.2	1.0	4.7	0.5	2.5	0.0	2.1	0.4	2.7	-0.2
SKEP ²	4.0	1.2	4.1	1.1	4.5	0.7	2.6	-0.1	2.2	0.3	2.6	-0.1
BS ³	3.8	1.4	4.2	1.0	4.5	0.7	2.3	0.2	2.3	0.2	2.5	0.0
IMF ⁴	4.0	1.2	4.0	1.2	4.2	1.0	2.5	0.0	2.4	0.1	2.5	0.0
EC ^{5,6}	4.0	1.2	4.3	0.9	4.8	0.4	2.5	0.0	2.4	0.1	2.5	0.0
WIIW ⁷	3.4	1.8	3.9	1.3	4.0	1.2	2.5	0.0	2.4	0.1	2.6	-0.1

Sources: ¹Spring Report, 2006; Autumn Report, 2005-2006. IMAD.; ²Economic Trends, 2005-2006. CCIS, SKEP. ³Monetary Policy Report, 2005-2006.

BS. ⁴World Economic Outlook, 2005-2006. IMF. ⁵Economic Forecasts, 2005-2006. EC. ⁶The European Commission forecasts inflation based on the harmonised index of consumer prices. The comparable realisation used in all comparisons totals 2.5%. ⁷Research Reports, 2005-2006. WIIW. Note: Negative values indicate an overestimation, while positive values indicate an underestimation.