SLOVENIA

ANALYSIS OF ECONOMIC DEVELOPMENTS

AND TARGET DEVELOPMENTAL SCENARIO BY 2002

(1998 SPRING REPORT)

Institute of Macroeconomic Analysis and Development

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The Report is based on data available up to 30 May 1998

1. PREFACE

The 1998 Spring Report provides an estimate of economic developments and factors of growth over the last two years. A survey of developments in different areas in 1997 and the first months of 1998 is presented together with short-term development projections for 1998 and 1999. Selected economic policies are also examined. The last chapter includes the target development scenario for up to the year 2002. Apart from economic development analysis, the report tries to analyse other development dimensions, in particular the problems of regional, social and technological development. Besides, it measures the role of economic policy instruments in maintaining the quality of the environment.

For several years, the Spring Report has been prepared by the Institute of Macroeconomic Analysis and Development and adopted by the Government. It is one of the sources used to prepare the Budget Memorandum and the Budget.

In recent years, Slovenia has made many efforts to adopt international statistical standards. Changes in data compilation and recording have caused some delays with publishing, in some cases they have prevented inter-year comparisons of trends and even distorted the picture of actual developments. Despite complicating the proper monitoring and evaluating of current economic trends in the “transitional” periods, these methodological adjustments are unavoidable and will soon yield positive results.

For the first time, the Report includes quarterly estimates of gross domestic product by expenditure and a medium matrix of the national accounts for 1997. The development scenario up to 2002 was examined and brought into line with the European Commission (DG-2) within the framework of a document entitled “Joint Assessment of Medium-Term Economic Policy Priorities of Slovenia”.

The Report is based on data available up to 30 May 1998

2. SHORT SUMMARY - The period of growth continues

The period of economic growth, which started in Slovenia in 1993**, is continuing.** Based on SORS' quarterly estimates of GDP growth, **in 1997** Slovenia's economy **grew at a rate of 3.8%.** Despite a modest rise in production volumes in manufacturing (of only 0.2%), this sector's value added rose by 4.8% in real terms. A relatively rapid growth in value added was also recorded in electricity, gas and water supply (6.1%), construction (5.6%), hotels and restaurants (3.8%) and in public administration, defence and social insurance (4.8%).

Exports of goods were the driving force behind economic growth, rising 11.3% in real terms in 1997. The high real rates of growth in exports were spurred by favourable external factors (stronger economic growth in Slovenia's main trading partners, in particular Germany). Relative unit labour costs in manufacturing – the measure of international competitiveness **-** expressed in the basket of currencies, went up 0.9%. Given the fact that the real rates of growth in compensation of employees were only moderate, also due to a reduced tax burden on wages in 1996, the slight deterioration of international competitiveness was largely due to slower growth in labour productivity and appreciation of the tolar against the basket of currencies.

The **incomes policy** succeeded in finding proper mechanisms to keep the real growth in average wages below growth in labour productivity. However, slower wage growth led to slower growth in domestic demand and household consumption. Favourable trends were recorded in the cost structure of the gross domestic product, with the share of gross operating surplus rising from 19.0% in 1996 to 20.9% in 1997 and the costs of compensation of employees dropping.

The rapid growth in exports of goods went hand in hand with rapid growth in the imports of goods and services (in real terms by 9.6%). The foreign trade deficit narrowed compared to 1996 to amount to US$ 771.6 million in 1997 according to the balance of payments statistics. Slovenia managed to preserve its external equilibrium, with the current account in the balance of payments recording a US$ 36.6 million surplus.

1997 was characterised by **intensive price disparity corrections**. Thus, controlled prices contributed 4.5 percentage points to the 9.4% rise in retail prices in the period December 1996to December 1997 . However, in the same period, average annual inflation dropped from 9.7% to 9.1%.

In 1997 public finances were crucially affected by the provisional financing of the central budget expenditure, late adoption of the budget (in December), extending of the budgetary year into January 1998 and the first-ever recorded substantial general government deficit. General government expenditure accounted for 45.7% and general government revenues 44.6% of gross domestic product. After a surplus (of 0.3% of GDP) was recorded on the consolidated general government account in 1996, it turned into a deficit of 1.1% of gross domestic product in 1997.

1997 was also a year of the adoption of the Strategy of the Republic of Slovenia for Accession to the European Union, and the National Programme for Adoption of the *Acquis Communautaire*. Both documents set out the tasks Slovenia must fulfil in the coming years to finish its process of transition to a market economy and to accede to the EU. Since the documents also lay down the sequencing of the tasks and the realisation of many objectives already falling due within 1998, the timely realisation of the national programme tasks is of crucial importance. It is the timeliness of the objectives foreseen in the Strategy and the National Programme that will contribute to Slovenia's credibility in the eyes of the EU, and determine the level of the EU's pre-accession financial assistance and the tempo of Slovenia's accession to the EU.

Foreign institutes and international organisations expect the international environment to remain relatively favourable in 1998. Rates of economic growth and import demand in Slovenia's main trading partners should increase. In Slovenia, however, the implementation of structural reforms foreseen for the coming years might impede any higher rates of economic growth in 1998 and 1999. Thus, the Slovenian economy should grow at a rate of around 4% in both this and next year.

1998 is expected to see **growth in all sectors except mining**. In view of the further strengthening of economic growth and industrial production in Slovenia's main trading partners and improved terms of trade, economic growth in Slovenia should mainly be export driven. Foreign demand should go up by more than 5%, whilst domestic demand should grow at the more modest rate of 4%. Slow growth in wages should lead to modest growth in domestic private consumption (around 3%). Within domestic consumption, investment demand should record the highest rate of growth at around 6.5%. Positive trends are expected to continue in the cost structure of GDP, namely, higher net and gross operating surpluses. Similar trends should also be observed in 1999.

The expected **high growth in imports of goods**, in particular equipment and investment goods, should lead to larger foreign trade deficit than last year. This year, it is expected to stand at US$ 900 million. Even the services surplus will not be high enough to compensate for the total trade deficit. Hence, the current account in the balance of payments is estimated to record a deficit of US$ 80 million this year and is expected to further deepen in the coming years.

Despite favourable external conditions, domestic factors will not be entirely positive. The **price and cost competitiveness** of Slovenia's manufacturing sector will **slightly deteriorate in 1998**. This will be due to the expected 2% real appreciation of the tolar and a real rise in the costs of compensation of employees. Although wages growth will lag behind growth in labour productivity, this will not entirely offset the negative exchange rate and labour cost pressures on competitiveness. Although similar pressures on competitiveness are anticipated to also continue in 1999, they might not necessarily lead to its further deterioration.

In 1998, the consumer price index replaced the retail price index as the measure of **inflation**. The policy of price corrections is expected to be less intensive in the second half of the year than during the first. The end-year inflation is still expected to be 8% and average annual inflation around 8.5%.

Given the high structural and frictional unemployment and demographic pressures, the **labour market situation** is not expected to change significantly over the next two years. Although total employment is not likely to drop considerably, the problem of high registered unemployment is - for demographic reasons - not expected to be any smaller than last year. The registered unemployment rate is estimated to remain at around 14.4%, whilst the internationally comparable unemployment rate should remain at slightly more than 7% this and next year.

After a huge delay in adopting last year's budget - it was only passed in December - this year's budget was adopted in April. The estimates suggest this year's **general government expenditures** to account for 46.1% of gross domestic product, 0.4 of a percentage point more than in 1997. General government revenue should represent 45.1% of gross domestic product, up 0.5 of a percentage point from 1997. The general government deficit is therefore foreseen to equal 1% of gross domestic product, which is the highest still acceptable level.

The Minimum Wage and Wage Adjustment Mechanism Act adopted last year will remain in force until the middle of 1999. Given its efficient mechanisms of keeping a lid on wages growth , it is also expected that this year wages growth will lag behind growth in labour productivity. The gross wage per employee should increase in real terms by around 2.5%.

Further economic growth leading to higher employment and raising the general welfare of the population, and further **lowering of inflation are** the main **economic policy goals in the medium term**. Economic growth should help reduce the lag behind the developed EU countries. In the coming years, economic policy should gradually lower inflation (3-5% up to 2002) and strive towards a balanced general government account. Introduction of the value-added tax will be an incentive for exporters.

The introduction of the value-added tax and excise duties in the middle of 1999 will aggravate the process of cutting inflation. However, the value-added tax must be introduced from the point of view of taxation reform and alignment of the public finance sources' structure to that existing in the EU. The possible effects of the value-added tax on prices should not be built into the fiscal, price, monetary or incomes policies by way of any indexation mechanisms. The only exception in terms of reducing the value-added tax's negative effects should be made by extending social benefits to more deprived groups of population, that is to those in the lowest income groups, and by changing the personal income tax progressiveness so that it redistributes tax burdens from lower to higher income groups in the year 2000.

Excluding the inflationary effect of the introduction of the value-added tax, the average annual inflation in 1999 could be slightly below 7%, provided that the present price policy continues. This figure presumes 0.3-0.4% average monthly rises of uncontrolled prices, whilst the controlled prices should not grow any faster than inflation. An even more determined approach of the economic policy to the area of prices could help ease notably the inflationary effect of the value added tax in 1999. However, this calls for the concerted approach of fiscal, prices, monetary and incomes policies towards reducing the potential inflationary effects of the introduction of the value-added tax. When planning the budget revenues and expenses for 1999, only the expected rises in prices should be taken into account and not the possible inflationary effect of the value-added tax. Given the estimates that larger price corrections are no longer needed, the prices policy should be inflationary neutral (corrections of prices only to the extent that prices on average are expected to rise, excluding the possible effects of introduction of the value-added tax). For the same reasons, the monetary policy should be similarly restrictive as regards various indexation mechanisms. Only through the concerted action of economic policies pursued by the Government and the Bank of Slovenia can an agreement be expected between the social partners, which is of crucial importance for Slovenia to control the possible inflationary effects of the value-added tax. Moreover, even today the inflationary expectations of the imminent taxation reform should be calmed down and appropriate measures should be anticipated to control the possible negative consequences. Additional economic policy measures introduced this year that would more vigorously aim at lowering inflation (acceleration of disindexation process, a more restrictive policy of correcting controlled prices, a solid agreement that the potential effects of the introduction of the value-added tax will not be incorporated in the incomes policy nor the social agreement) would calm down inflationary expectations and, as a consequence, the effect of the introduction of the value-added tax on inflation in 1999 might even be entirely annuled.

With the proposed rates of the value-added tax (a general 19% rate and a reduced 8% rate plus many exceptions), the payroll tax will be preserved and a general government deficit of around 1% of gross domestic product is also expected in 1999. General government revenue has fallen due to cuts in tariff rates and certain other taxation changes, whilst on the other hand any larger cuts to general government expenditure can still not be expected due to the slow pace of systemic changes and the failure to adopt certain measures proposed in last year's austerity programme. The obstacles are the following: (I) the progress of the pension reform; (ii) the slow pace of changes in the system of social rights; (iii) wages policy in the public sector and the obligations adopted for increasing wages in the health-care and education sectors, together with the still non-uniform system of wages in the public sector exerting additional pressures on budget expenditure for wages; (iv) pressures for a real increase in the share and the level of funds for investment; (v) the still great role of the state in enterprise rehabilitation.

3. INSTITUTIONAL FRAMEWORK – The urgent need for rapid structural reforms in Slovenia

Over the last few years, the warnings of domestic and foreign experts about the too slow pace of structural reforms have already been mentioned on several occasions. The quality of the institutional environment can also be measured as part of the **country's global competitiveness** (Gmeiner, 1997). This assessment is based on factors crucially affecting the dynamics of value added and the sustainability of economic growth. Based on the empirical results of 12 countries having a roughly similar development pattern to Slovenia, the main factors affecting a country's competitiveness are the quality of its legal and political institutions, development of the financial market and the openness of the economy.

The problem of structural reforms was first brought up in the Strategy for Economic Development of Slovenia (hereafter SEDS) which was prepared by a group of experts and published by IMAD in 1994. The Strategy of the RS for Accession to the European Union (hereafter SAEU) was written at the end of 1997. In its economic and social part, the Strategy foresees that Slovenia will complete a large part of the institutional changes and reforms by the time of the accession to the EU. However, the changes are not only necessary for the sake of accession, but even more so for the successful completion of the process of transition which will enable Slovenia to act like an equal partner in an enlarged EU internal market and to achieve higher rates of economic growth.

Slovenia is in the last stage of transformation of social ownership into the ownership of known owners. In May, the Law on the Completion of Ownership Transformation and Privatisation of Legal Entities Owned by the Development Corporation of Slovenia was passed. After the expiry of a six-month period starting with the date of the Law coming into force of, social ownership will be practically non-existent. The privatisation gap will presumably be closed by the additional state property, which is to be set by the end of July this year. The closing of the privatisation gap will be the first step towards privatisation of state property. The state sector which emerged as a result of ownership transformation is too big according to European standards and must therefore be partly privatised, with certain activities being transferred from the public to the private sphere.

A large part of the processes of transition and integration into the EU depends on an **accelerated restructuring of the enterprise sector**, within the concept of open and export-oriented development. It should enable Slovenian enterprises to become more active and competitive on international markets, in particular on the EU internal market.

Now that the process of ownership transformation is almost finished, the following enterprise categories can be found in Slovenia: (i) newly-established private (domestic and foreign) companies which did not undergo the process of privatisation, have clearly established corporate governance and have no need for "transitional" restructuring; (ii) privatised companies (in majority internal or external ownership), which in most cases have neither clearly defined corporate governance nor have undergone the necessary restructuring; (iii) non-privatised companies in which the situation can be considered as alarming; and (iv) state enterprises in public utilities (and some monopolies).

More recent analyses (Rojec, Rems, Simoneti, 1998) show that the restructuring of the Slovenian corporate sector has been underway, but at too slow a pace. Restructuring is progressing the fastest in privatised externally- and internally-owned and foreign-owned companies, but is too slow in non-privatised and state-owned enterprises. This is reflected in the bankruptcies of the most loss-making enterprises, and in a boost in net operating profit in 1996. That year, net operating profit increased in almost all ownership categories of enterprises, most of all in externally- and internally-owned ones and the least or not at all in non-privatised enterprises. This could be a sign that the process of establishing efficient corporate governance leading to further restructuring has begun in externally- and internally-owned enterprises. Non-privatised enterprises, on the other hand, are still recording significant operating losses, which are decreasing too slowly.

Table 1: Trends of main performance indicators of companies by ownership categories in the period 1994-1996[1]

	Private	Foreign	Internal	External	Non-privatised	State
Net profit (+)/loss (-) per equity[2];%						
1994	0.4	5.1	0.7	1.7	-4.1	0.1
1995	7.0	4.6	-1.1	0.2	-5.6	0.2
1996	4.4	6.5	0.3	1.7	-4.1	-2.1
% of net profit (+)/loss (-) in sales[1];						
1994	0.1	1.8	0.3	1.4	-3.3	0.3
1995	1.8	1.5	-0.6	0.2	-3.7	0.7
1996	1.2	2.0	0.1	1.2	-2.8	-5.2
Net sales per assets;%						
1994	136.1	150.2	107.4	78.8	61.3	30.7
1995	130.0	160.9	112.5	79.8	67.5	30.7
1996	130.7	169.5	114.8	88.7	68.5	31.0
Assets per equity;%						
1994	264.0	190.2	163.6	152.8	198.9	129.5
1995	304.2	190.0	171.0	156.6	225.4	133.0
1996	312.5	187.9	176.2	158.7	213.7	133.5
Liabilities per equity;%						
1994	153.1	84.2	56.1	43.8	105.3	26.2
1995	190.2	85.0	62.3	47.4	120.0	27.8
1996	201.0	83.9	67.2	49.7	121.2	28.7

Source: Figures are computed using the Agency for Payments data. ***Notes:*** [1] Calculations are based on the data for 1902 companies which were active throughout the period 1994-1996; [2] Net operating profit or loss.

Restructuring of the Slovenian non-financial corporate sector has mostly been going on in a negative direction, that is by way of the dropping out of the greatest loss-making enterprises. The existing companies improving their performances have been scarcer. Negative restructuring has occurred the most in non-privatised companies. The state, with its measures and methods, seems to be more successful in the rehabilitation (financial restructuring, sale or liquidation), restructuring or liquidation of the greatest loss-makers, and less successful when it is the question of a more long-term development restructuring of companies (improving the situation in terms of operating profits). The latter is, no doubt, the task of new owners. In the longer run, the state cannot and should not play the role of an active company owner. Therefore, the non-privatised corporate sector has to be privatised in the shortest possible time and decisions should be made about the liquidation of some companies that are already "clinically dead". It is the costs of preserving those companies and the excessively high costs of financing for the corporate sector that seem to be the largest obstacles to any faster company restructuring, maybe even larger than the process of establishing efficient corporate governance (Rojec, Rems, Simoneti, 1998).

The **capital market** could provide one of the alternatives for more favourable terms of long-term financing. One of the things that Slovenian macro-economists most often resent about the capital market is the fact that there are virtually no primary issues of securities, providing an additional source of finance for companies. Thus, banks remain the major source of long-term financing. Another thing that has to be mentioned is the circumstances in which the capital market in Slovenia evolved. Namely, the major share of market capitalisation of securities in Slovenia still originates in privatisation and not in the need for long-term financing (Jašoviè, Simoneti, 1998). Despite some crucial structural weaknesses of the banking system, the capital market failed to become competitive to banks as regards long-term financing of companies. Costly infrastructure and a shallow capital market discouraged investors and issuers of securities to operate on the capital market. Operating, namely, entails relatively high transaction costs and complicated procedures, whilst the shallowness prevents companies obtaining capital at prices comparable to the loans offered by banks. The capital market is thus not used to raise capital to foster the development of companies but more to consolidate dispersed ownership.

In 1997 the **market for bank loans** failed to move towards increasing the long-term financing of companies. Although new loans were granted, their real levels far from compensated for the levels of the companies' matured loans and additionally raised funds. Hence, the net effect of new companies' financing was negative in 1997 (Jašoviè, Simoneti, 1998).

Enterprise restructuring will be stimulated also by adoption of the new **labour law**. New provisions, especially those regulating the hiring and laying off of workers, will increase the flexibility of the labour market. The provisions regulating redundancies, which might impose high costs of laying off on employers, will primarily focus on procedural rules, rules on the notice period and severance pay. In Slovenia regulation of redundancies has undergone several deregulatory changes. In 1989, laying off due to economic reasons was allowed by law. In 1991, the notice period in cases of redundancy was shortened. Nevertheless, compared to the regulations in other European countries, the current regulation still involves relatively complicated procedures and high severance costs (Kajzer, 1996). The new Employment Law, which is still being finalised, will increase flexibility as regards redundancies and, on the other hand, protect workers against the violation of rules. The law, for example, foresees the priority treatment of claims by workers in cases of bankruptcy or compulsory settlement. The start of the Guarantee Fund's operations also means a large step forward in this area.

The two milestones of the taxation reform (introduction of the value-added tax and excise duties) are scheduled to be introduced in the middle of 1999. The government has submitted a slightly amended bill on the value-added tax to the Parliament for its second reading. Instead of the original proposal of a 20%-rate of value-added tax, the new bill puts forward two rates of VAT namely, a general 19% rate and a reduced 8% rate. The introduction of the value-added tax and excise duties is an important step towards meeting European standards. The positive results expected from this are mainly the reduction of the grey economy and improved conditions for exporters.

The reduction of the proposed VAT rates determines the speed, direction and continuation of the **reform of pension and disability insurance**. Lower revenues from the VAT are likely to compensate for the loss of revenues from sales taxes, but not for covering increased expenditures in the current PAYG system arising from the introduction of the second compulsory pillar of pension and disability insurance. The speed of the pension system reform is likely to change. The first stage of the reform will primarily be focused on adapting and rationalising the current pension system, including the introduction of the third, voluntary pillar. However, the introduction of the second pillar of pension and disability insurance should be postponed to a later time.

The present pension system is causing a large and increasing general government imbalance. Without a radical change to the pension system, there is no chance of the deficit being reduced. The White Paper on pension system reform was presented last autumn. The experts who wrote it proposed that the future pension system be based on three pillars, the first, pay-as-you-go pillar, the second, compulsory savings-investment pillar and the third, voluntary pillar. The current discussions, however, are likely to lead to the postponement of the introduction of the second pillar and to modification of the first pillar, that is the present pay-as-you-go system.

On the one hand, the institutional changes (completion of privatisation) have led to positive developments in economic restructuring and restructuring in the direction towards an efficient corporate governance, although those are still rather slow in certain sectors of the economy. Foreign analysts still rank Slovenia as the least risky country of all transitions economies (Euromoney, September 1997), although its rating slightly fell after the Asian crisis (see Slovenian Economic Mirror, Annual Edition, 1997/12, p.8/I). On the other hand, the unfinished institutional changes, in particular in the area of pension and taxation systems, have led to difficulties on the general government account. Only by finding appropriate systemic solutions that will define anew the state's role in public financing will the government be able to control the growing general government expenditures and reduce the gap between general government revenues and expenditures.

4. INTERNATIONAL ECONOMIC ENVIRONMENT – Continuing favourable economic developments in Europe despite the Asian crisis

The financial crisis in south-east Asia has left a mark on the latest forecasts of economic developments in the member-countries of the OECD made by international organisations and institutes. Slowdown in growth was the most noticeable in Japan's economy, whilst the American and European economies are not likely to be so crucially affected (0.2 to 0.3 of a percentage point lower GDP growth in the EU during 1998). The EU's economic recovery which started last year should continue this year. In EU real gross domestic product rose on average by 2.6% in 1997. The EU countries with above-average economic growth (for example the UK, Ireland, the Netherlands, Denmark, Spain, Portugal) had stronger domestic demand and managed to cut unemployment in 1997. On the other hand, in some countries restrictive fiscal policies contracted domestic demand, whilst economic recovery was spurred mainly by exports. Some of Slovenia's main trading partners belong to the latter group, namely Germany, Austria and France. This year, economic growth in the EU is forecast to range between 2.7% (LINK) and 2.8% (European Commission, OECD). Apart from somewhat slower growth in exports, stronger domestic demand should be the main driving force behind economic growth in the EU. The more stable growth should contribute to higher demand for labour and a gradual contraction of unemployment in the EU. Inflation should be an average of around 2% by the end of the millennium.

Table 2: Economic growth, growth in industrial production and imports of goods and services in Slovenia's main trading partners (1997-2001)

	Real growth in GDP, in %					Real growth in industrial production[1], in %			Real growth in imports of goods and services, in %				
	1997	1998	1999	2000	2001	1997	1998	1999	1997	1998	1999	2000	2001
EU	2.6	2.7	2.7	nd	nd	3.8	nd	nd	6.6	7.1	6.6	nd	nd
Germany	2.2	2.6	2.8	2.0	2.1	4.0	4.0	3.4	4.6	5.8	5.7	3.9	4.2
Italy	1.4	2.4	3.0	3.0	3.0	2.8	2.6	3.0	10.2	7.6	10.2	8.2	5.8
Croatia	5.5	4.5	4.5	nd	nd	6.8	5.0	5.0	8.2	5.7	6.0	nd	nd
France	2.4	3.0	3.1	3.1	3.3	4.0	3.7	3.2	6.5	6.0	4.2	4.1	5.1
Austria	2.5	2.7	3.0	2.5	2.3	4.0	4.5	4.5	5.7	6.3	5.6	4.3	4.1
Russia	0.4	1.0	2.0	2.8	2.7	1.9	2.0	3.0	8.7	15.5	11.5	10.4	9.8
USA	3.8	2.7	2.3	2.3	2.3	5.0	4.9	0.7	13.9	10.2	6.7	6.5	6.0

Source: Eurostat, March, April 1998; European Commission, March 1998; IFO, March 1998; WIFO, March 1998; Project LINK World Outlook, March 1998; WIIW, March 1998; OECD Economic Outlook, December 1997; Dresdner Kleinwort Benson: Central Europe, January 1998 Note***:*** [1] The figure for Austria refers to manufacturing.

After growing 1.4% in 1996, the **German economy** recorded a 2.2% rate of growth in 1997 (Eurostat, April 1998), with exports of goods being its main generator of growth. Growth in foreign demand and improved competitiveness led to exports of goods soaring by 10.7% in real terms in 1997 (6.1% in 1996), whilst domestic demand remained weak. The economic recovery was largely fuelled by economic achievements in the western part of the country, given the fact that the eastern part recorded a lower rate of growth (1.6%) than its western counterpart for the first time since the unification. The German IFO Institute also forecasts similar rates of economic growth for 1998 (2.6%), although when taking into account the effects of the Asian crisis the latest figures are slightly lower (by 0.2 of a percentage point) than those of last autumn. Exports are still the main generator of growth. Nevertheless, the net contribution of exports to growth is expected to be slightly smaller next year and the contributions of private consumption and investment in equipment larger.

Last year, exports were the main driving force behind the 2% economic growth in **Austria**, with goods exports rising 10%. Relatively high rates of growth in exports are also expected in the future, according to WIFO forecasts (9% annual rises in 1998 and 1999). This will not only be due to an expected rise in import demand in Germany and Italy, but also due to the newly acquired exchange rate stability within the EMU, whereby any devaluations of trading partners' exchange rates are excluded so that the level of competitiveness is not in jeopardy. Strong exports contributed to a 4% rise in manufacturing and, moreover, domestic consumption this year is also expected to become an impetus for economic growth. Real growth in gross domestic product should thus rise to 3%, and the unemployment rate should drop from the present 4.4% to 4.2% by 1999.

In **France**, exports played a decisive role in the 2.4% growth in gross domestic product in 1997. Their role, however, is expected to shrink in 1998 according to the French Economic Ministry (Martin, 1998). Partly, this could be attributed to a drop in international trade (the Asian crisis), and partly to certain unique transactions in 1997. The forecast 3% economic growth in 1998 and 1999 should be achieved mainly by stronger domestic consumption (a 2.5% rise) and private sector investment (a 4.1% rise).

After only a modest 0.7% growth in gross domestic product in 1996, economic growth in **Italy** accelerated to 1.4% in 1997. Domestic demand contributed most to the rise, in particular private consumption. However, the main achievements of the Italian economy in 1997 compared to the previous year were a contraction of inflation from 4% to 2% and of the budget deficit from 6.7% to 2.7% of gross domestic product. On the other hand, unemployment remains high and is largely concentrated in the southern part of the country. With its economy growing an average 3% per year, Italy should exceed the average EU economic growth by the year 2000. That growth should largely be spurred by further growth in investment and private consumption, whereas the role of exports in economic growth should gradually decrease.

Last year, the average economic growth rate in the **CEFTA** countries was 3.7%, lower than the 4.8% recorded a year earlier (4.7% including Romania). That drop was largely due to a 6.6% slump in gross domestic product in Romania. Taking into account only five CEFTA members (without Romania), GDP growth increased to 5.1% over the previous year, with stronger growth in all countries except the Czech Republic.

Table 3: Economic growth, inflation and unemployment in CEFTA countries (1997-2001)

	Real growth in GDP, in %					Inflation (average annual rate)[1], in %					Unemployment rate, in %		
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001	1997	1998	1999
Czech Rep.	1.0	1.5	4.0	5.0	5.0	8.5	12.5	8.0	7.5	6.3	5.2	7.0	8.0
Hungary	4.0	5.0	5.0	nd	nd	18.3	14.5	11.0	nd	nd	10.4	10.3	10.2
Poland	6.9	6.0	6.0	nd	nd	14.9	13.0	10.0	9.5	8.6	10.5	10.0	10.0
Slovakia	6.5	4.0	3.0	4.9	4.7	6.1	7.0	8.0	6.0	6.0	12.5	13.0	14.0
Romania	-6.6	0.0	3.0	5.2	4.6	154.7	80.0	50.0	nd	nd	8.8	12.0	12.0

Source: WIIW, April 1998; Project LINK World Outlook, March 1998. ***Note***: [1] 2000 - 2001 end year inflation.

With its gross domestic product rising only 1% in 1997, the **Czech** economy came close to stagnation or stagflation, given the fact that inflation resumed two-digit levels at the end of the year (8.6% at the end of 1996 and 10% at the end of 1997). Over the last few years, the policy of fixed foreign exchange rates and domestic inflation exceeding inflation in western European countries has resulted in a real appreciation of the Czech currency and, consequently, in a major balance of payments crisis. The stabilisation programmes (abolition of the fixed exchange rates) adopted by the Czech Government in the spring of 1997 led to an improved position on the current account of the balance of payments, with exports growth exceeding that of imports and consequently resulting in a lower trade deficit. Although industrial production rose 6%, completion of structural reforms remains the major problem the Czech economy has to resolve in the coming years. This year, economic growth is forecast to range between 1.5% (WIIW, Business Monitor Int.) and 2.5% (Dresdner Kleinwort Benson), and the unemployment rate should increase to 7-8% in 1998 and 1999 (WIIW). A restrictive monetary policy (the central bank’s goal is 4.5% inflation in 2000; WIIW, April 1998) might result in the resumption of appreciation of the national currency, widening of the foreign trade deficit and overall economic stagnation, corresponding to the Czech central bank’s forecasts of 4% economic growth in the coming years (WIIW, April 1998).

Last year’s figures of 4% economic growth in **Hungary** confirm that the period involving the prevailing positive effects of macroeconomic stabilisation has begun. The economic growth was mainly export driven (20% real growth in exports in 1997, according to Dresdner Kleinwort Benson), with the current account deficit contracting from 5.7% in 1995 to 2.6% of gross domestic product in 1997. That export expansion might be explained by the rapid growth in production and exports of foreign-owned companies which, in the first phase of their development, mostly imported equipment and thus fuelled the foreign trade deficit. Although exports are expected to further rise, the trade deficit could again slightly increase in the future, as imports might rise due to a gradual recovery in private consumption. According to WIIW estimates, economic growth should average 5% in 1998 and 1999. Reducing the budget deficit (4.7% of GDP in 1997) and inflation (18.3% in 1997) remain the major challenges of the coming years.

Poland recorded the highest rate of economic growth in the CEFTA area in 1997 (6.9%). Unlike previous years, when economic growth was mainly export driven, domestic demand took up the role of the main lever of growth in 1997 (a 6% real rise in consumption and a 7% real rise in private consumption). Strong domestic demand has led to very different movements of the rates of growth in imports and exports and consequently to further widening of the foreign trade deficit (from 1.5% of GDP in 1995 to 7.7% in 1997, according to NOMURA February 1998 figures). The current account deficit in the balance of payments also rose to 3.4% of gross domestic product (up from 1% of GDP in 1996, NOMURA, February 1998). However, Poland did manage to narrow its budget deficit from 2.3% in 1996 to 1.4% of gross domestic product in 1997. Restrictive fiscal and monetary policies are also expected to be the leading economic policies in the future. Although this might lead to an "overheating" of the economy, the forecasts reveal the possibility of 4-6% rates of economic growth in Poland during 1998 and 1999.

Gross domestic product in **Slovakia** rose 6.5% in real terms in 1997. This figure exceeded the previous expectations and was partly a consequence of a downward adjustment of the economic growth figure for 1996 by 0.3 of a percentage point (WIIW, April 1998). Domestic demand was the main lever of economic growth, of which investment in infrastructure rose the most. Industrial production grew only modestly - 2.7% -which might partly be explained by the negative influence of high interest rates - a consequence of restrictive monetary and expansive fiscal policies (a budget deficit of 6.2% of GDP in 1997, according to Dresdner Kleinwort Benson's estimates). Although the foreign trade deficit narrowed last year, this was mainly due to administrative measures restricting imports. Economic growth should, however, decelerate to 3% by 1999 and inflation increase from the present 6% to 8% (WIIW, April 1998, NOMURA, February 1998). These expectations are mainly founded on large internal and external imbalances, the slow pace of restructuring and too great a role of the state in the economy.

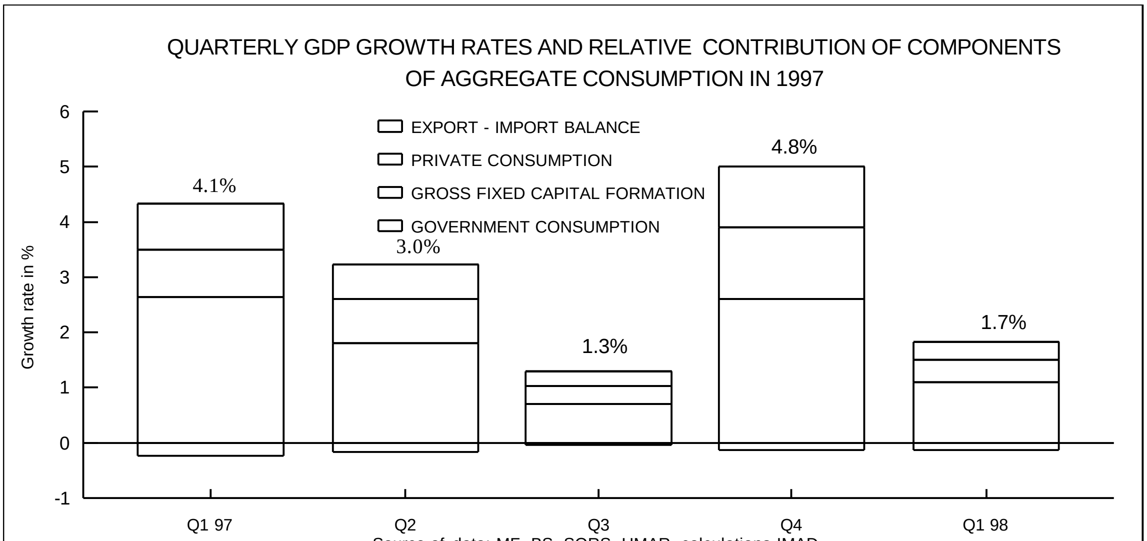
With gross domestic product dropping 6.6% and inflation reaching 155%, 1997 can be called the year of stagflation for **Romania**. On the other hand, the greatest achievements of that year were curtailment of the budget deficit to a level below 4% of gross domestic product and a slight reduction of the current account deficit. The latter, however, remains relatively high, accounting for 5.7% of gross domestic product (WIIW, April 1998). The WIIW analysts forecast that the first positive effects of stabilisation and restructuring in terms of higher economic growth and reduced inflation should become visible in 1999.

Croatia recorded an ongoing positive trend of accelerated economic growth in 1997 (5.6%), mostly due to a 6.8% rise in industrial production and a 41.3% boost in tourists' overnight stays. The average annual inflation was 3.6%, one of the lowest in transition economies. Despite a restrictive fiscal policy, the budget deficit (central government) rose to account for 1% of gross domestic product which was, however, considerably lower than the projections for 1997 (2.7%). The large current account deficit in the balance of payments (9.3% of gross domestic product) remains the Croatian economy's most severe problem. In 1997, high imports additionally fuelled the trade deficit which should be, in future years, well compensated for by the revenues from tourism. The unemployment rate reached 17.6%, partly due to the inflow of demobilised soldiers to the ranks of the unemployed. Hence, unemployment is expected to gradually decrease in the future as the economy grows, according to forecasts, at a 5-6% rate in 1998 and 1999 (DAIWA).

5. ANALYSIS OF CURRENT ECONOMIC TRENDS AND A SHORT-TERM PROJECTION

5.1 PRODUCTION STRUCTURE OF GROSS DOMESTIC PRODUCT – TARGET GROWTH OF 4% IN 1998 AND 1999

According to the quarterly estimates published by SORS in April, the gross domestic product rose by 3.8% in 1997 when measured at constant 1992 prices. This confirms last autumn's forecast of steady economic growth. Growth gradually slowed down in the first three quarters of last year, but in the last and strongest quarter it recovered and continued to go up in the first, normally the weakest, quarter of 1998. Value added increased in all sectors except fishing. On the supply side, growth was recorded in the commercial services, mainly in wholesale and retail trade, hotels and restaurants, and financial intermediation. On the demand side, growth in the economy was triggered by a rise in exports coupled by a rise in investments. Economic growth in Slovenia's main trading partners contributed to the rise in exports.



Source of data: MF, BS, SORS, UMAR, calculations IMAD.

In 1997 the share of manufacturing in value added increased for the first time since 1994 (to 29.2%, 28.6% in 1996), the same as the share of services (to 60.2%, 59.5% in 1996).

Compared to the production structure of the EU, that of Slovenia differs in a larger share of agriculture (EU 2.4%) and manufacturing (EU 21.2%), and a lower share of services (EU 66.3%)[1]. Denmark records the highest share of services amongst the EU countries (69.7%), and Ireland the lowest (54.9%). Despite the strengthening of the service sector, Slovenia still lags behind developed economies in this sector, particularly in business and financial services.

[1] The structural shares in the EU are for 1995.

According to the balance sheet and profit and loss statement statistics, the number of commercial companies operating in the service sector increased by 2% in 1997 compared to 1996. However, the number of employed did not change. Three-quarters of all commercial companies operate in the service sector, and they employ 39% of the total employed. The business results in the service sector as a whole were positive, owing to positive results in trade and transport, whilst in other activities of the service sector net losses exceeded net profits.

In 1998 and 1999, GDP is expected to grow by another 4%. The highest growth is anticipated in construction, hotels and restaurants, and transport. The estimated growth of 3% in manufacturing is lower than last year's (4.8%), which will decrease manufacturing's share in the value added. The share of services is anticipated to rise (up 0.3 points to 59.3%).

Table 4: Value added by sectors of NACE Rev. 1 and gross domestic product

	Structure in %, current prices			Real growth rates in %, prices 1992		
	1997	**1998**	**1999**	**1997**	**1998**	**1999**
A Agriculture, forestry and hunting	3.9	3.9	3.8	0.7	3.0	2.0
B Fishing	0.0	0.0	0.0	-0.6	3.0	2.0
C Mining	1.0	0.9	0.9	1.8	-1.5	0.0
D Manufacturing	25.2	24.9	24.7	4.8	3.0	3.0
E Electricity, gas and water supply	2.5	2.4	2.3	6.1	0.5	1.0
F Construction	4.8	4.9	5.1	5.6	6.5	7.0
G Wholesale, retail trade, certain repair	10.0	10.0	10.0	2.7	4.0	4.0
H Hotels and restaurants	2.8	2.8	2.8	3.8	5.5	5.0
I Transport, storage and communications	6.9	7.0	7.1	4.6	5.5	5.5
J Financial intermediation	3.8	3.8	3.8	2.4	3.5	4.0
K Real estate, renting and business services	9.8	9.9	9.8	2.9	6.0	2.0
L Public administration and defence	5.1	5.2	5.1	4.8	5.3	2.0
M Education	4.7	4.7	4.6	1.9	3.8	2.0
N Health services and social work	4.6	4.6	4.5	2.1	4.1	2.0
O Other community and personal services	3.1	3.1	3.0	3.7	4.5	2.3
FISIM	-2.1	-2.1	-2.0	1.5	1.7	2.0
1. VALUE ADDED (A...O+FISIM) in basic prices	86.1	86.1	85.5	3.7	4.1	3.1
2. Corrections (a - b)	13.9	13.9	14.5	4.2	3.1	8.8
a) taxes on products	15.3	15.4	15.8	4.1	5.0	5.8
b) subsidies	1.4	1.5	1.3	3.7	16.7	-10.0
3. GROSS DOMESTIC PRODUCT (3 = 1+2)	100.0	100.0	100.0	3.8	4.0	4.0

Source: SORS 1997, IMAD estimates 1998, target scenario 1999.

Preliminary data show that **agricultural production** picked up further 0.7% last year, which is a bit less than expected. The wheat yield improved by 11.6%. The potato yield was satisfactory but the crops were 1.75% lower due to reduced areas of planting. The crops of industrial plants and vegetables decreased by 7.8% and 6.5%, respectively, whilst the production of hay in meadows and rough grazing areas increased by 9.8%. Fruit crops in extensive orchards were poor (down 29.9%), whereas the yield of grapes was high again (up 7.7%).

According to the sample farm structure survey conducted in June 1997, the number of livestock increased for all animals, compared to the figures at the beginning of the year: the number of cattle rose 1.0%, pigs 4.3% and poultry 26.6%. Purchases in animal husbandry were 0.5% lower, as were purchases of milk (down 2.8%).

The value of goods trade in agricultural products and foodstuffs measured by the current US$ rate, fell by 5.8% last year (exports 5.4%, imports 6.0%). The 45% export-to-import ratio remained the same. An increase in trade is expected this year, mainly with the CEFTA countries because the additional protocol to the agreement has come into force.

The intensity of Slovenian agriculture is still low compared to that of the EU. The reasons include the small size of family farms and the old age of their owners. Nevertheless, the size of agricultural holdings has increased from 4.2 ha to 4.8 ha in the last six years. Agricultural policy has recently tried to accelerate the process of increasing farm area by granting loans for the purchase of land under favourable conditions. The so-called generation loans have also been introduced to encourage older generations to hand down their farms to younger and more educated members of farming families sooner.

The value added in **mining** went up by 1.8% in 1997. The extraction of fuels - mainly coal in Slovenia - increased by 4.7%, whilst the mining and quarrying of non-energy materials dropped by 14.3%. In 1997 the share of coal mining amounted to almost 85% of the total mining and quarrying activities. The amount of extracted lignite reached 4,142 thousand tonnes, which is an increase of 5.2% on last year. The amount of extracted brown coal was 811 thousand tonnes, 2.3% less than last year. 300 thousand tonnes of imported brown coal for the Thermal Power and Heating Plant of Ljubljana covered over a quarter of domestic consumption of brown coal.

Net losses in mining increased substantially in 1996 and totalled SIT 5,114 million. Last year, however, they were 44% lower in real terms with the figure reaching SIT 3,129 million. Coal mining recorded a loss of SIT 3,367 million last year, and the mining of non-energy materials a profit of SIT 237 million.

According to the forecasts of mining trends in the Energy Balance of the RS for 1998, where a 3.4% drop in lignite extraction and a 2.3% rise in brown coal extraction are expected, coupled with an expected halt in the negative trend of non-energy materials mining, value added in mining in 1998 is expected to fall by 1.5%. In the following years, the production volumes and value added are expected to remain unchanged.

Based on quarterly estimates, value added in the **manufacturing sector** rose by 4.8% in 1997, which is mainly related to substantial growth in the real value of exports. Growth was most marked in the last quarter (6.8%), but the trend was positive in the first three quarters as well (2.1%, 6.1% and 3.8%).

The substantial growth in value added in manufacturing was supported by good business results of manufacturing enterprises. The overall business results of the manufacturing sector in 1997 were positive. Net losses for the financial year fell 31.7% in real terms and net profits for the financial year increased by 47.7% in real terms. In 1997, net profit exceeded net losses by SIT 2 billion, whereas in 1996 net losses were nearly SIT 46 billion higher than net profit. Even in exporting manufacturing companies a positive trend was recorded, where net profit exceeded net losses by over SIT 6 billion (in 1996 net losses were SIT 38 billion). Five manufacturing sub-sectors (textiles and textile products, leather and leather products, chemical products and man-made fibres, machinery and equipment, and transport equipment) which generated an average two-thirds of their revenue from foreign markets in 1997, generated half of all revenue from export of goods and services in the manufacturing sector. The five sub-sectors generated almost a third of net losses and almost two-fifths of net profits in manufacturing. Almost two-fifths of net losses were due to the manufacture of metal and metal products, and a fifth of net profits was generated in the manufacture of chemicals, chemical products and man-made fibres.

Output in manufacturing in 1997 increased slightly (0.2%; last year's increase was 0.9%), which was considerably lower than the increase in value added. The big difference between the growth of value added and output in manufacturing indicates that the index of production volume in evaluating the growth of value added is of limited use due to problems in showing qualitative movements. Apparently, the stagnation in manufacturing output does not anticipate a slowdown in the growth of value added. Employment in manufacturing dropped 3.2% last year, one of the main reasons for the rise in productivity.

Production data by end-use groups of products for last year show that the production of consumer goods grew most markedly (13.3%): the production of durable consumer goods increased by 40.1% and the production of non-durable goods by 5.7%. The volume of intermediate goods production dropped by 3.2%, similarly the production of raw materials and fuels. A substantial drop was recorded in the production of investment goods (24.5%), which also accounts for the modest rise in manufacturing production volumes in 1997.

Production in manufacturing has been increasing steadily since April last year and the trend has even improved this year. In the first four months, output increased by 5.6% compared to the same period last year, and compared to last year's average by 1.7%.

An important factor in estimating the growth of value added is the dependence of manufacturing in Slovenia on cyclical trends in the EU. Based on OECD data on industrial production in Slovenia's most important trading partners, favourable developments can be expected in these markets. In Germany and Austria, industrial production is forecast to pick up 4%, but is expected to drop slightly the following year (3.4%). Italy and France also expect their production to go up this year (2.6% and 3.7%, respectively), In Italy, further improvements are forecast for next year (3%), whereas in France production is expected to drop slightly (3.2%). In 1998 the imports of goods and services of the EU countries are expected to grow 7.1% in real terms, and by 6.6% in 1999 (OECD, 1997).

It is estimated that in 1998 the value added in manufacturing will rise by approximately 3%, and by a further 3% the following year, provided that developments in foreign and domestic markets are favourable.

According to SORS records, the value of completed works in **construction** in 1998 dropped by 6.3% in real terms on a year earlier. Statistical data used in calculating this figure include about 10% of the companies engaged in construction, but do not take account of the activities of small companies and sole proprietors, which are gaining importance in this sector. Companies working in construction but whose activities are not registered in this sector are also excluded from the statistical data. A discrepancy between the recorded data and the actual situation is reflected in last year's growth in value added of 5.6%.

After accounting for 15% of total net losses of all commercial companies in 1995 and 1% in 1996, construction improved its business results last year and created a profit of SIT 3.4 million. The favourable trends are supported by growth in the number of employed, particularly those employed by contractors and sole proprietors. Data on total employed and self-employed persons show that 4.3% more people worked in construction in January 1998 compared to the same month last year.

The value of completed construction work abroad has been falling since 1993 and last year it reached only a third of the 1993 level. The European Construction Industry Federation's statistical report predicts 0.7% growth this year, mainly due to favourable trends in Great Britain, Italy and Spain. Construction activities in Germany, where 26% of the value of all construction work of Slovenia was carried out, will continue to fall, this year at a rate of 1.4%. Construction work abroad is not expected to increase much in the short term, domestic activities, on the other hand, will include the construction of transport infrastructure and a number of renovations. New construction sites, however, are not likely to open. This and next year value added in construction is estimated to grow by a further 6.5% and 7%, respectively. Construction is expected to increase its share in gross domestic product this year by one percentage point, and it is estimated to amount to between 4.9% and 5.1% next year. This is considerably lower than in the EU, where the sector creates a tenth of gross domestic product.

The **electricity, gas and water supply** sector recorded 6.1% growth in value added in 1997. Electricity supply rose by 8.2%[2] and the production and distribution of gas by 9.1%. The production and distribution of heat fell by 5.4%, and collecting, purifying and distributing of water by an estimated 2.5%. Electricity supply is the main activity within the sector and its share in the sector's value added is 80%. Total production of electricity in 1997 (non-weighted, measured in GWh and as shown in the electricity production-consumption balance) was up 2.7% on a year earlier, and the production structure also changed. The share of thermal power plants increased

[2] SORS calculates the growth in production and distribution of electricity by using weights which reflect the method and cost of production, and including the value added for each type of production - hydro or thermal power plants, etc.

by 12.0%, the share of the nuclear power plant by 9.8%, and the share of hydro power plants went down by 16.1%. Only half of all production of the Krško nuclear plant is for domestic consumption, the other half goes to Croatia due to the joint investment involved. Considering this fact, production in 1997 grew only by 1.1%. The consumption of electricity in Slovenia in 1997 increased by 3.5%. Net imports of electricity (excluding the electricity trade based on the joint investment) therefore increased by 37.1% and accounted for 6.9% of electricity consumption.

Electricity, gas and water supply sector recorded a SIT 22,338 million net loss, 4% higher than a year earlier in real terms. Electricity supply has the highest share of the loss. Based on the Energy Balance for 1998, it is estimated that electricity production in 1998 will be roughly the same as last year (0.1% growth). According to the current four-month data, the structure, that is an increase in the share of hydro-electric generation, is not likely to change (as expected by the Energy Balance), as the reconstruction of a number of hydro power plants is behind schedule. With a 4.5%-increase in the production and distribution of heat and 1.3% growth in gas supply, it is estimated that the value added in electricity, gas and water supply in 1998 will rise 0.5%, and in the following years at about 1.0% yearly.

In 1997, the value added of activities in **transport, storage and communications** edged up 4.6%. An increase in harbour freight transport at the end of the year contributed a great deal to such substantial growth, and it also spurred road and railway freight transport. Loading and unloading activities in harbours in 1997 went up 11.5% on a year earlier, and rail freight transport (measured in tonne-kilometres) by 11.9%. The growth in these activities exceeded that of traditionally fast growing telecommunications sector where an 8.5% growth was recorded in 1997, measured by the number of telephone subscribers. Airport transport improved 7.1%, tourist services 5.3%, loading and unloading activities in all transport sub-sectors and road freight transport (excluding independent private carriers) by 4.1%. Postal activities went up 4.0%. Lower growth rates or even downward movements in 1997 were recorded in passenger transport activities. Air passenger transport increased by 3.4%, rail passenger transport by 0.8%, urban and road (excluding independent private carriers) passenger transport, however, decreased by 0.4% and 6.5%, respectively.

Business results of transport, storage and communications improved substantially in 1997. Enterprises engaged in this sector generated a net profit of SIT 3,142 million in 1996 and as much as SIT 11,113 million in 1997, representing 224% growth in real terms. Net losses in land transport went down from SIT 4,416 million to SIT 2,468 million. After a loss of SIT 1,562 million in 1996, air transport recorded a net profit of SIT 214 million in 1997. Profits of other land transport services slumped by a quarter in real terms, but results were still positive at SIT 4,719 million. With SIT 8,639 million, which is a 2.4-fold improvement in real terms on 1996, postal and telecommunications services recorded the best business results of the sector.

In this and the following years transport, storage and communications are expected to continue to grow at an average annual rate of 5.5%. The reasons for such optimism lie in the positive results of harbour, rail and road freight transport, and loading and unloading activities at the beginning of this year.

In 1997, value added in the sector of **trade, repair of motor vehicles and consumer goods** increased 2.7% from a year earlier. According to SORS' data, profits in the retail sector and the sale of motor vehicles increased by 1.5% in real terms. Growth was fastest in the sale of non-food products (5.4% in real terms), the sale of food products, beverages and tobacco (3.9% in real terms), and motor fuels (1.3% in real terms). A 5.5% drop in profits in real terms was recorded in the sale and repair of motor vehicles. The real value of profits improved most noticeably in small enterprises (11.2%), barely in large enterprises (0.7%), whilst slumping in medium-sized enterprises (by 3.9%).

According to the balance sheet, and profit and loss statement statistics, trade companies made a net profit of SIT 22,036 million in 1997, which is a growth of 20.6% in real terms. The discrepancy between net profits and net losses (SIT 11,184 million) is the widest in the intermediation and retail sectors, and it is almost twice that of the previous year. Net profits fell by 60.3% in real terms in the retail sector and in the repair of consumer goods.

Preliminary SORS data on revenues in retail and sales of motor vehicles for the first two months show 6.3% growth in real terms compared to the same period a year earlier. The revenue from the sale of non-food products was up 21.7% in real terms, of food products, beverages and tobacco 10% in real terms, and of motor vehicles by 4.6%. The revenue from the sale of motor fuels was substantially lower (23.6%), mainly due to a drop in sales on the Italian border.

It is estimated that the sectors of trade, repair of motor vehicles and consumer goods will record a further 4% growth this and next year.

Value added in the sector of **hotels and restaurants** increased by 3.8% in real terms in 1997. Compared to a year earlier, the total number of overnight stays increased by 9.5%, of which most were foreign overnight stays (up 20.7%), and domestic ones were also slightly up (0.7%). The number of tourists rose by 10%; 17.1% more foreign and 2.8% more domestic tourists. The share of foreign tourists in the total number is on the increase (in 1997 it was 53.4% compared to 46.4% a year earlier). Consequently, the share of foreign overnight stays is also increasing (48.2% of total stays in 1997 and 41.4% in 1995).

In 1997 foreign exchange inflows from tourism came to US$ 1,188 million, which is 58.1% of all foreign exchange inflows in the services sector (the EU average is 24.1%, differences from country to country are considerable though; the shares vary from 17.1% in Belgium and Luxembourg to 63.5% in Spain). Foreign exchange inflows from tourism were 3.4% lower in nominal terms compared to 1996, but adjusted for inter-currency changes they were 6.2% higher in real terms. Payments to enterprises engaged in tourism increased substantially (32.6%), and 8.6% more cash was exchanged in exchange offices. The sale of goods to foreign visitors in duty-free shops slumped substantially (10.8%).

Commercial companies in the sector of hotels and restaurants improved their business results in 1997 compared to 1996. Net losses exceeded net profits by SIT

693 million, the real loss, however, is 79.3% lower than in 1996. The number of commercial companies increased by 6%, and the number of employed by 4.4%.

In the first four months this year, the total number of tourist overnight stays dropped 1.3% over the same period a year earlier. There were 0.6% fewer overnight stays by domestic tourists and 2% fewer by foreign tourists. The number of tourists visiting Slovenia dropped 1%, of which domestic by 1.1% and foreign by 0.9%. The adverse figures were mostly owing to poor results in March, whilst April already saw a considerable improvement.

The first three months of this year recorded US$ 242 million of foreign exchange inflows, 2.5% lower in real terms than in the same period last year (in nominal terms 8.9% lower). Payments to enterprises operating in tourism are on the increase this year and are 26.9% higher compared to the same period last year. This indicates that more visitors from abroad prefer to take a package holiday in Slovenia. The income of casinos increased by 13.7%. A substantial drop was recorded in duty-free shops (32%), a result of measures taken in Austria (restricted imports of tobacco products) and Italy (lower petrol prices in regions bordering Slovenia causing a drop in sales in duty-free shops).

Despite the unfavourable results at the beginning of the year, this year's tourist season is expected to be successful since more than half of all overnight stays and almost half of foreign exchange inflows are usually recorded from May to September. The hotels and restaurants sector is expected to grow 5.5% this year and similar growth is forecast for next year (about 5%).

5.2 THE COST AND EXPENDITURE STRUCTURE OF GROSS DOMESTIC PRODUCT - EXPORT-DRIVEN GROWTH AND POSITIVE MOVES IN THE COST STRUCTURE OF GROSS DOMESTIC PRODUCT

Economic growth in 1997 was 3.8%, slightly above IMAD's autumn forecasts. Real GDP growth was higher than expected largely due to more favourable export developments at the end of 1997. Last year, exports of goods and services rose 9.9% in real terms, whereas growth of 7.5% was projected in the last Autumn Report. As much as 90% of the value of total exports of goods and services (excluding travel) in 1997 was accounted for by exports of industrial products. Manufacturing sectors generated more than 50% of their revenues from foreign sales, some sub-sectors even generated more than two-thirds of their revenues from that source (manufacture of leather and leather products, chemicals and chemical products, machinery and equipment, and transport equipment).

Table 5: Growth in aggregate demand components, in %

	1996	1997	1998	1999
Total aggregate demand	3.0	5.4	4.4	4.2
of which:				
Foreign demand (exports)	2.5	9.9	5.3	5.5
Domestic demand	3.2	4.1	4.2	3.8
- intermediate consumption	2.9	3.7	4.1	3.1
- final consumption	2.5	3.5	3.6	4.1
- gross fixed capital formation	6.9	8.7	6.5	6.5

Source: SORS 1996, national Accounts estimates IMAD 1997-1999.

Exports were the main lever of economic growth in 1997, whilst domestic demand grew only modestly (except investment demand and government consumption). Given this year's forecasts of import growth in Slovenia's main trading partners (Germany, 5.5%, Austria, 5.7%, Italy, 6.9% and France 5.2%), exports are also expected to rise this year, by 5.3% in real terms.

Of all the components of domestic demand, **investment demand** (gross fixed capital formation) grew the fastest in 1997. This is also expected this year, although at a somewhat slower rate. Gross fixed capital formation increased its share in gross domestic product by 1.2 percentage points to 23.7% in 1997. In nominal terms, gross fixed capital formation increased by 20.2%, of which investment in machinery and equipment as well as investment in construction objects grew particularly fast. Since at the same time a rapid rise in foreign demand led to a drop in the share of investment in inventories, the share of gross capital formation in gross domestic product increased by only 0.6 of a percentage point. This year, gross fixed capital formation should rise 6.5% in real terms to account for 24.4% of gross domestic product.

Table 6: Gross domestic product by expenditure, in %

	Structure			
	1996	**1997**	**1998**	**1999**
GROSS DOMESTIC PRODUCT	100.0	100.0	100.0	100.0
External balance of goods and services	-0.9	-1.0	-1.7	-1.9
Domestic consumption & gross cap. Formation	100.9	101.0	101.7	101.9
- Private consumption	57.3	56.5	56.0	56.3
- Government consumption	20.1	20.4	20.5	20.2
- Gross fixed capital formation	22.5	23.7	24.4	24.6
- Changes in inventories	0.9	0.3	0.7	0.8

Source: SORS 1996, National Accounts estimates IMAD 1997-1999.

As regards the aggregates of domestic consumption, 1997 saw an above-average real rise in **government consumption** (5.8%). Based on the sectoral presentation of the accounts of generation, distribution and use of resources (see medium matrix SAM 1997 in the appendix), the gross national disposable income of the government sector was insufficient to cover the expenditures for government final consumption, let alone the gross capital formation which was, as a result, entirely financed by borrowing. In view of this year's budget, government consumption should grow somewhat slower in 1998 (4.6%), but still well above the real annual rises recorded in the EU countries over the last few years (2-3%). Moreover, comparisons with the EU countries show that as early as in 1995 (the latest available structural data for all EU countries) the share of non-market services in total value added in Slovenia exceeded the EU average. In Slovenia, the share of non-market services' value added in total value added, measured in current prices, was 16.9% and in the EU 14.8%. Only the Scandinavian countries (Denmark, Finland, Sweden) and France had their figures higher than Slovenia, whilst it was considerably lower in the Netherlands (10.7%), Luxembourg (12.3%), United Kingdom (12.7%), Italy (13.0%), Germany (13.4%) and Belgium (13.9%).

Growth in the **demand of residential households** for products and services of final consumption lagged behind the growth in gross domestic product in 1997. Given the strict normative framework of the incomes policy, modest growth of residential household consumption is also expected this year (3.2% in real terms).

Final consumption together with gross capital formation has been higher than gross domestic product since 1995. The trade deficit stood at 1.0% of gross domestic product in 1997, and is expected to slightly widen this year (to 1.7% of GDP). However, the positive factor services and current transfers balances helped retain the surplus (of 0.2% of GDP) in the current account in 1997.

The last two years have seen positive developments in the **cost structure** of gross domestic product. Cuts to employers' social security contribution rates and the lag in the nominal growth of the total wage and other remuneration bill behind the nominal growth in gross domestic product have resulted in a considerable drop in the share of compensation of employees' in gross domestic product (from 57.2% in 1995 to 53.5% of GDP in 1997). Moreover, the share of customs tariffs and import duties fell from 3.5% in 1995 to 2.0% of GDP in 1997 and the share of taxes on goods and services in gross domestic product fell from 16.6% in 1995 to 15.3% in 1997. The tax on payrolls, introduced in the second half of 1996, is not an element of the compensation of employees (according to the SNA statistics), but is classified along with other taxes on production. Consequently, the policy of restructuring tax sources, aimed at the disburdening of labour costs, has resulted in a rise in the share of other taxes on production. Given the fact that first, growth in compensation of employees lagged behind growth in GDP and second, customs tariffs and import duties were reduced, the position of capital owners in the primary distribution of gross domestic product has gradually improved over the last two years. The gross operating surplus – the income of capital owners and production managers - increased its share from 17.1% in 1995 to 20.9% of gross domestic product in 1997.

Table 7: Supply and use of resources, in %

	Structure			
	1996	**1997**	**1998**	**1999**
GROSS DOMESTIC PRODUCT	100.0	100.0	100.0	100.0
Factor income balance	0.8	0.7	0.7	0.7
GROSS NATIONAL INCOME	100.8	100.7	100.7	100.7
Current transfer balance	0.4	0.5	0.6	0.5
GROSS NATIONAL DISPOSABLE INCOME	101.2	101.2	101.3	101.2
Final consumption	77.5	76.9	76.5	76.5
GROSS SAVINGS	23.7	24.2	24.7	24.7
Current account balance	0.3	0.2	-0.4	-0.7
GROSS CAPITAL FORMATION	23.4	24.0	25.1	25.4
of which: gross fixed capital formation	22.5	23.7	24.4	24.6
NET CAPITAL FORMATION	5.4	6.1	7.1	7.6

***Source*:** SORS, BS, National Accounts estimates IMAD.

In 1997, **gross national savings** increased to 24.2% of GDP (in 1996, 23.7% of GDP), which was high enough to cover domestic gross capital formation. The share of this key macroeconomic category in GDP - a precondition for investment and further economic growth - is likely to increase to 24.7% of GDP in 1998. This year, the level of national savings will not be sufficient to finance all domestic investments, with the resulting deficit being financed by foreign loans (a deficit on the current account of 0.4% of GDP or US$ 80 million).

In 1997 the share of compensation of employees in GDP dropped by 1.3 percentage points. This was due to a well designed incomes policy, given the fact that the share of gross wages and other remuneration decreased by around 0.5 of a percentage point. The share of employers' contributions in GDP also dropped due to the reduction of contribution rates in the middle of 1996, which also affected the level of revenues from this source in 1997.

In 1998, the tendency of the share of compensation of employees in GDP falling will continue, since the incomes policy of 1997 is still in force. The share of gross wages and other remuneration in GDP is forecast to drop by almost 1 percentage point, due to the expected slower growth in gross wages. In 1998, gross wage per employee is expected to increase in real terms by around 2.5% and thus lag by 1 percentage point behind labour productivity. With employment rising 0.5%, the total wage bill should grow 3% in real terms. The total other remuneration bill is likely to grow even more slowly. These rates will not change in 1998 and consequently the share of employers' contributions in GDP, which follow the movements in the total wage bill, will decrease only marginally.

Table 8: Cost structure of gross domestic product, in %

	1996	1997	1998	1999
1. COMPENSATION OF EMPLOYEES (1= 1a+1b)	54.8	53.5	52.9	52.4
1a wages and salaries	47.6	47.1	46.6	46.2
1b employers' actual social contributions	7.3	6.3	6.3	6.2
2. NET TAXES ON PRODUCTION AND IMPORTS	15.3	14.9	14.8	15.5
3. GROSS OPERATING SURPLUS (3 = 3a+3b)	19.0	20.9	21.5	21.4
3a consumption of fixed capital	16.3	16.2	16.2	16.0
3b net operating surplus	2.8	4.8	5.3	5.4
4. GROSS MIXED INCOME (4= 4a+4b)	10.8	10.7	10.8	10.7
4a consumption of fixed capital	1.8	1.8	1.8	1.8
4b net mixed income	9.0	8.9	9.0	8.9
5. GROSS DOMESTIC PRODUCT (5= 1+2+3+4)	100.0	100.0	100.0	100.0

Source: SORS 1996-1997, IMAD estimate 1998, target scenario 1999.

A new agreement on the system of adjusting wages in line with growth in prices will have to be reached in 1999. Since the introduction of the value-added tax is scheduled for the middle of the year, appropriate mechanisms will have to be agreed upon in fiscal and incomes policies, preventing any large oscillations in the purchasing power of wages and other remuneration. Gross wages should rise 2.3% in real terms and lag by 1 percentage point behind labour productivity. The total wage bill is expected to rise 3% in real terms, as employment increases 0.7%. Finally, the share of gross wages and other remuneration in GDP should drop by a further 1 percentage point. Contribution rates will also remain unchanged in 1999 and the share of employers' contributions should fall slightly.

5.3. INTERNATIONAL ECONOMIC RELATIONS

5.3.1. INTERNATIONAL COMPETITIVENESS - A slight drop in competitiveness in 1997, similar forecasts for this year

After improving in 1996, the price and cost competitiveness of Slovenian manufacturers on domestic and foreign markets fell slightly in 1997. Although the costs of compensation of employees grew in real terms slower than in 1996 (4% in 1996, 2.7% in 1997) growth in labour productivity also slowed (from 6.7% to 4.5%), domestic inflation was 2.3% higher than the nominal effective exchange rate, leading to unit labour costs as measured in the basket of currencies rising 0.5%. According to available data unit labour costs in Slovenia's main trading partners were lowered in 1997, thus the relative unit labour costs in Slovenia rose around 1%.

The appreciation of the US dollar on the international exchange markets was one of the causes of a mere 0.5% real appreciation of the tolar against the basket of currencies (measured by relative inflation) in 1997. The tolar depreciated in real terms by 9.8% against the US dollar, whilst it appreciated against the currencies of Slovenia's main trading partners in the EU by 3.2% (4.6% against the DM), due to the constant excess supply of foreign currency in Slovenia's foreign exchange market. The currencies of other CEFTA countries were, however, even stronger than the tolar in 1997. Nevertheless, Slovenian manufacturers' competitiveness slightly deteriorated compared to the average of CEFTA countries in the first nine months of 1997. A drop in relative labour productivity - a consequence of stagnation in Slovenian manufacturing production - led to a slight increase in relative unit labour costs (0.7%) despite a relatively more favourable US$ exchange rate and a drop in relative wages in Slovenian manufacturing.

In the first quarter of 1998, the international competitiveness of Slovenian manufacturers deteriorated. Despite rising labour productivity (1.7% in March over December, according to seasonally adjusted data), the real rise in employees' compensation by 2.5% and appreciation of the tolar by 2% could not be entirely neutralised. Consequently, unit labour costs in the basket of currencies were 3% higher in March 1998 than last December. Despite these negative developments at the beginning of the year, Slovenian manufacturers' competitiveness was still better in the first quarter than a year earlier. Notably, this was due to high annualised growth in labour productivity (7.6% according to seasonally adjusted data), leading to a 1.8% drop in unit labour costs despite the rise in real compensation of employees and appreciation of the tolar. After appreciating 1.2% in April, the tolar was still 4.3% stronger against the basket of currencies than last December and 3.4% stronger than in April 1997. In the first four months, the tolar appreciated 2.3% compared to the same period last year.

On the assumption of more concerted movements in the nominal effective exchange rate and inflation by the end of the year (the Bank of Slovenia's intervention on the foreign exchange market at the end of May resulted in appreciation of the DM), the tolar's appreciation is estimated to range between 2 and 2.5% in 1998. Costs of compensation of employees are forecast to rise in real terms by 2.8%, provided that real wages, with the unchanged tax burden, grow at the same rate as last year (2.4%) and growth in other remuneration slows down (from last year's 7.5% to 4.8%). To neutralise the effects of the expected tolar appreciation and growth in compensation of employees on the manufacturing sector's competitiveness , labour productivity would have to rise by more than 7% in 1998, taking into account the simultaneous slight drop in labour costs in Slovenia's main trading partners. Since such a high rate of growth is highly unlikely to be achieved (it is estimated to average 5.3%), given the anticipated further slowdown in the decline of employment in manufacturing, the relative unit labour cost in the basket of currencies should increase by around 1.8%. Thus, in 1998 the international competitiveness of Slovenian manufacturers will further slightly deteriorate.

5.3.2. EXPORT-IMPORT FLOWS AND THE BALANCE OF PAYMENTS - The rapid rise in imports is leading to a larger trade deficit in 1998 and 1999

International trade was an important factor of growth in 1997. High growth in foreign demand was, given the modest growth in manufacturing production volumes, one of the main levers of real growth in exports. The openness of the economy also increased (goods and services trade as a percentage of GDP) to 115.8%, up 3.5 percentage points from 1996. Higher growth in exports (11.3% in real terms) than imports of goods (9.6% in real terms) led to a contraction of the trade deficit. The current account in the balance of payments thus had a surplus of US$ 36.6 million or 0.2% of GDP.

In the first quarter of 1998, exports and imports of goods increased in real terms 15.9% and 18.1%, respectively (excluding the effect of the exchange rate and foreign domicile prices) compared to the same period last year. Although the effect of the strong US dollar on export-import flows in the first quarter of this year was less pronounced than last year, it still distorted the picture of actual growth of trade flows. In the first quarter of this year, exports and imports of goods, measured in current US$, increased by 8.5% and 9%, respectively, over the same period last year. At the same time, the trade deficit with the EU trading partners increased by US$ 55.2 million to US$ 235.1 million. The balance of payments statistics showed the total trade deficit rising by US$ 14.8 million, resulting in the current account deficit of US$ 39.7 million, US$ 7.9 million more than in the same period last year.

The real volume of goods trade with the EU has increased. In the first quarter of 1998, 66.2% of goods exports went to the EU, 13.9% to the countries of former Yugoslavia, and 6.2% to the CEFTA countries. Real exports of goods to the EU thus rose 15.7%, to the former Yugoslav countries 8% and to CEFTA countries 22.2%.

Table 9: Trends of exports markets and the market shares of Slovenia's goods exports

	1993	1994	1995	1996	1997	1998	1999
Real growth rate of Slovenia's exports to 7 main trading partners	1.7	10.3	9.4	-2.1	9.4	7.9	7.5
Growth in exports markets [1]	-6.5	9.0	6.6	2.4	7.4	6.3	6.9
Change in market share, in %	8.7	1.2	2.6	-4.4	1.9	1.5	0.5

Source: OECD Economic Outlook, December 1997, World Economic Outlook, SORS, BS. ***Note***:[1] Real growth in imports of 7 main importers of Slovenian goods, weighted by the structure of Slovenian exports to these countries.

One of the reasons for the higher growth in imports (imports from the EU increased in real terms by 19.4%) and the consequent bigger trade deficit was appreciation of the tolar. The estimates based on quarterly data for the period 1993-1997 show that for every 1% real appreciation of the tolar, real imports of goods rise by 0.5%. Apart from the exchange rate, growth in production is the second most important factor of growth in real imports: a 1% real rise in domestic production raises real imports of goods by 0.7%.

Due to the greater supply of crude oil on the world market, the US$ price of oil is expected to slump by around 20% in 1998. Prices of other raw materials are also likely to drop (by around 7%), as are industrial producer prices (by 2%). Due to Slovenia's import dependence on investment and intermediate goods, this should, along with higher import weights, lead to import prices falling faster than export prices mainly due to inter-currency ratios. The US dollar is expected to appreciate 3.3% against the basket of currencies in exports and 3.5% in imports. Thus, the index of export prices is estimated to be 97.5 and index of import prices 96.6, so that the terms of trade should improve slightly.

In 1998 imports of goods are expected to grow faster than exports (in real terms 7.0% and 5.8%, respectively). Nevertheless, export results should remain positive, with the market share of Slovenia's exports of goods in the main trading partners increasing by around 1.5%. Due to higher imports of capital goods (investment and intermediate goods), the share of equipment and intermediate goods in goods trade is expected to increase as well. The trade deficit at the end of the year should be higher than last year and is expected to stand at US$ 900 million. Given the forecast 3.1% real growth in exports of services and 3.5% real growth in imports of services, the surplus in the services balance will be slightly lower than last year, amounting to US$ 580 million. The services surplus will shrink mostly due to smaller inflows from tourism, estimated to slump by around US$ 70 million (less purchases in duty-free shops and lower turnover in the exchange offices). Consequently, the surplus in the services balance, factor services and current transfers will not be high enough to compensate for the trade deficit. The deficit in the current account of the balance of payments should, according to those estimates, total US$ 80 million or 0.4% of GDP.

The Bank of Slovenia estimates net inflows of capital to the capital and financial account of the balance of payments to amount to US$ 80 million in 1998. Last year, however, Slovenia was still a net exporter of capital, with a net outflow of US$ 103 million. This change is largely a consequence of the following developments: first, gross inflows of foreign direct investment are expected to reach US$ 360 million, 12% more than last year; second, net inflows of portfolio investment should increase by US$ 545 million, including the foreseen issue of Eurobonds valued at Euro (ecu) 500 million, which will be used to finance the repayment of the principal and interests of the loans taken abroad in the past.

Slovenia's liabilities abroad are expected to rise by US$ 1 million in 1998 (last year US$ 369 million). This will be a result of lower domestic interest rates, which should raise domestic banks' competitiveness and stimulate companies to obtain loans in Slovenia rather than abroad. This year, companies' borrowing abroad should be cut by more than a half and to amount to US$ 150 million (last year US$ 337 million). The BS' international reserves should increase by US$ 657 million.

Favourable economic developments in the EU are expected to continue in 1999 and, consequently, real imports of goods in Slovenia's main trading partners should increase by 6.9% (OECD December 1997). This should spur the growth of Slovenian exports, expected at 5.5% in real terms. A gradual reduction of customs tariffs on goods imports from the EU and growth in domestic manufacturing should result in goods imports rising 6.7% in real terms. Imports of investment and intermediate goods will continue to rise, favourably affecting growth in manufacturing and thereby stimulating growth in exports of goods. According to those estimates, imports of investment goods should represent 18% (17.5% in 1998), and imports of intermediate goods 59.2% (59% in 1998) of total imports of goods in 1999. On the contrary, the modest growth in wages will lead to a drop in imports of consumer goods, representing 22.8% of total imports. Consequently, the trade deficit is expected to further increase to US$ 1035 million. The surplus in the services balance should increase to US$ 625 million, as real exports of services rise 5.7% and imports of services 5.4%. Apart from greater inflows from tourism, greater exports of other services (especially construction and fitting works, communications and computer services) should contribute to the services surplus. The current account deficit should, according to those projections, stand at US$ 150 million in 1999.

5.3.3. FOREIGN DIRECT INVESTMENT - Expectations of rapid growth in inward foreign direct investment in the coming years

The Bank of Slovenia introduced statistical monitoring of foreign direct investment stock in 1993. Inward FDI has been and remains the predominant category. In 1993 the coefficient between outward and inward investment was 0.294, in 1994 it was 0.211, in 1995 0.231 and in 1996 it was 0.189 - and this trend is expected to continue for some time into the future.

In the 1993-1996 period, the **stock of inward FDI in Slovenia** increased from US$ 954.3 million to US$ 1,934.3 million, i.e. by 102.7% (Table 10). Stock increases in 1994 and 1995 were relatively equal, whilst the increase in 1996 was smaller. In the 1993-1996 period, it was not only the annual stock which was increasing, but also the amount of annual inflows. As in the case of stock, the growth rate of inflows also slowed down in 1996. In 1997, however, the situation turned around, with inflows almost doubling compared to 1996. In 1997, inflows amounted to US$ 320 million, in nominal terms up 72% over 1996. One should also add to this increase the acquisition of car tyre manufacturer Sava by US Goodyear at the end of 1997, one of the largest, if not the largest, FDI project in Slovenia so far. This transaction is expected to influence FDI inflows in 1998. Due to this transaction, the end of the enterprise privatisation process, which will eventually lead to the conclusion of already initiated negotiations with strategic foreign partners and to intensified searching for strategic foreign partners by domestic enterprises, and due to the forthcoming privatisation of banks, insurance companies and public utilities, we expect the continuation of the rapid growth of inward FDI in Slovenia initiated in 1997. The experience of Spain and Portugal shows that after accession to the EU, FDI inflows surge decisively.

Table 10: Flows and stocks of inward and outward foreign direct investment (FDI)[1] of Slovenia in the period 1993-97, values in US$ million

	1993	1994	1995	1996	1997
VALUES IN US$ MILLION **INWARD FDI** **a. End-year stock**					
Total value[2]	954.0	1,331.0	1,744.7	1,934.3	nd
of which: Equity and reinvested profits	709.7	965.7	1,200.1	1,261.8	nd
Liabilities to foreign investor	346.6	494.0	677.6	841.6	nd
Claims to foreign investor	102.2	128.7	133.0	169.1	nd
Net liabilities to foreign investor	244.4	365.3	544.0	672.5	nd
b. Change of end-year stock					
Total value	nd	376.7	413.0	189.6	nd
Equity and reinvested profits	nd	256.0	234.0	61.7	nd
Net liabilities to foreign investor	nd	120.9	179.0	127.9	nd
c. Annual inflow	112.6	128.1	176.0	185.5	320.8
OUTWARD FDI **a. End-year stock**					
Total value [4]	280.6	280.8	403.6	366.1	nd
of which: Equity and reinvested profits	241.7	271.9	289.2	277.5	nd
Liabilities to company abroad	214.6	258.7	229.2	240.1	nd
Claims to company abroad	253.5	267.6	343.6	328.7	nd
Net claims to company abroad	38.9	8.9	114.4	88.6	nd
b. Change in stock					
Total value	nd	0.2	122.8	-37.5	nd
Equity and reinvested profits	nd	30.2	17.3	-11.7	nd
Net claims to company abroad	nd	-30.0	105.5	-25.8	nd
c. Annual outflow	-1.3	2.9	-5.5	-7.7	-25.5

Source: Bank of Slovenia. Notes: [1] Foreign direct investment = 10% or higher foreign equity share; [2] Total value = Equity + liabilities to foreign investor - claims to foreign investor; [3] Total value = Equity + claims to company abroad - liabilities to company abroad. nd. = no data.

If one divides FDI stock up into equity (including reinvested profits) and long-term net liabilities to foreign investors – the total value of FDI is the sum of equity and net claims of foreign investors to their companies abroad - the trend of the increasing importance of net liabilities is noticeable; their share in the total value of inward FDI in Slovenia increased from 25.6% in 1993, to 27% in 1994, 31.2% in 1995 and to 34.8% in 1996. This increasing share of net liabilities speaks of the consolidation of existing foreign investment companies in Slovenia, but also of unfavourable credit conditions for Slovenia's enterprise sector.

Austria, Croatia, Germany, France and Italy are the main investing countries in Slovenia. There is a clear trend of the increasing importance of Austria, whose share in total stock of inward FDI in Slovenia increased from 19.0% in 1993 to no less than 34.3% in 1996. It is characteristic for Austria that a large part of the increase was due to the increased net long-term liabilities of Slovenian foreign investment companies.

After independence**,** Slovenian companies' investment activity abroad almost stopped. Annual outflows of outward investment were negative (disinvestment).

Although data on the FDI stocks abroad indicate an increase, this was mostly on account of increased net claims of Slovenian investors to their companies abroad. Slovenian companies maintain close relations in terms of mutual crediting with their parent companies abroad. At the same time, they only rarely decide on new investment projects abroad.

As we have seen, Austria holds the predominant position as regards inward FDI in Slovenia. However, with regard to **outward FDI of Slovenia**, Croatia's predominance has been constantly and strongly increasing. At the end of 1996, FDI in Croatia represented 51.3% of total stock of Slovenian outward FDI, whilst in 1993 this share was only 24.9%.

Apart from Croatia, some countries in transition, FR Yugoslavia and Bosnia and Herzegovina are gaining in importance as a destination for Slovenian outward FDI. Although further expansion of investment activity in the transition countries and countries of former Yugoslavia is expected and is in line with the forecasts of individual companies and economic theory, it is somewhat worrying that in times when companies abroad are becoming an important factor of penetrating foreign markets, Slovenian companies are retreating from these companies (Germany, Austria and Macedonia) or are maintaining extremely poor levels of their presence, whilst at the same time tending to concentrate their foreign investment only in one country (Croatia).

5.4 INVESTMENT - FURTHER MODERATE GROWTH IN INVESTMENT ACTIVITY

Investing has been on the increase for five consecutive years, and such a continued increase is expected in 1998 and 1999. If investments go up by 6.5% this year and next year, they will account for 24.4% and 24.6% of the GDP respectively. The investment deficit from the 1988 to 1992 period could thus be completely compensated for in the six years following, and the investments in 1998 would equal those in 1987.

According to the data supplied by the Agency for Payments of the Republic of Slovenia, investment transfers during the first four months of the year exceeded the investment transfers performed in the first four months of the last year by 12% in real terms. Investments have been particularly stronger in hotels and restaurants (by 70% in real terms) and construction (by 55% in real terms). The largest transfers are those related to motorway construction performed by DARS (the Slovene Motorway Company) and the Ministry of Transport and Communications, followed by Telekom Slovenije (the national telecommunications operator) and ELES (the national electricity distributor). The transfers in the manufacturing industry are only slightly higher than last year, while the bulk of investment amounts are smaller transfers (e.g. this year there has been only one transfer above 500 million SIT). The aforementioned records are the only source enabling current monitoring of investment activity, but since they capture only a little more than a third of total investment activity they do not always facilitate valid conclusions.

Our estimate is that this year - like last year - the highest growth dynamics will be displayed by investments in transport infrastructure construction, primarily due to investments in modernisation of railway transportation, which are estimated to increase significantly. The continuation of moderate growth is also expected with corporate investments, and a slight revitalisation is anticipated in housing construction as well.

As far as the technical structure of investments is concerned, we are expecting a further rise in the share of equipment, which is predicted to be 53% this year (45.8% in 1992). Compared to the EU countries, there is a much higher percentage of investments in equipment in Slovenia (42% in the EU), while the percentage of investments in housing buildings is much lower (26% in the EU countries compared to 15% of total investments in Slovenia).

Investment efficiency, as measured by the marginal capital coefficient, equals 7 this year and exhibits some improvement with respect to the previous year, but this still indicates a lag in efficiency in comparison to some less successful economies in the EU (Spain 6, Portugal 5.9, Ireland 3.9). To a certain extent, the low efficiency is also a consequence of the structure of investments, i. e. of intensive investments in economic infrastructure construction, which has a deferred effect due to long activation periods.

Investments in economic infrastructure construction are not being realised in accordance with the SEDS (Strategy of Economic Development of Slovenia) guidelines. Their share in total investments is just above 21% (22.3% in the SEDS) and they represent from 4.1% (in 1995) to 5.1% (1997 estimate) of the GDP, while a 5.2-percent share in GDP is planned in the SEDS. The SEDS' strategic guidelines for investment realisation are only being followed by investments in energy supply and public utilities, whilst a severe shortfall is evident in road infrastructure and telecommunications.

There are two principal reasons for the difference between the achieved and planned investments. The first one, involving investments in motorways, is the relative slowness of opening new sections; the other reason, concerning other investments in infrastructure, is the lack of sources of funding.

In 1992, 62.3% of investments in economic infrastructure were financed by the state budget. The share of the state budget in investment sources has been decreasing thereafter, and in 1997 it reached its lowest level (27.9%). In 1998 it is supposed to rise again to 33.5%. Amongst various types of infrastructural investments, more than half of the investments are financed by the state budget only in roads and other transport, while the state budget's share is much lower elsewhere. To a large extent, investments are also financed by loans, guaranteed by the state. Investors' own funds are the prevailing source of financing only for investments in telecommunications.

All the investment financed by the state budget (including investment in agriculture and the non-market sector in addition to investment in economic infrastructure) represented 2.9% of the GDP and 13% of total state budget expenditure in 1994, but they gradually fell until 1997, reaching the then lowest level of 2.22% of the GDP and 8.67% of total state budget expenditure. The 1998 state budget indicates a strong increase to 2.7% of the GDP and 10.2% of total state budget expenditure.

5.5 EMPLOYMENT AND UNEMPLOYMENT - A MODERATE INCREASE IN THE NUMBER OF PERSONS IN EMPLOYMENT AND IN THE NUMBER OF UNEMPLOYED IN 1997

After a decade of an almost continuous decrease in the total number of persons in employment of Slovenia (according to current statistical sources)[3] the trend stopped during the first quarter of 1997, and during the following quarters (with the exception of summer months) it has even been growing. Even though there was a larger decrease in the number of persons in employment again in December 1997 and January 1998, the latest data indicates that in 1998 we can expect employment fluctuations similar to those of last year.

Compared to 1996, the number of employed in 1997 thereby increased by 0.2% on average, and the number of persons in employment was up 0.3%. The ZAP-M statistical data tell us that in 1997 the decrease in the number of employed continued in mining (by 5.0%), manufacturing (by 4.1%), hotels and restaurants (by 4.0%), agriculture (by 3.6%) and transport (by 2.5%), while in all other sectors there was an increase in employment, the largest still occurring in the state administration (4.8%). Unlike previous years which saw a large increase, growth in self-employment ceased in 1997 outside of agriculture, with growth in the number of employees of the self-employed also being somewhat slower than during the previous years, although still being quite high (10.3-percent). The majority of the self-employed outside of agriculture and their employees work in the manufacturing industry, construction, trade, business and other services, hotels and restaurants and transport.

The dynamics of the last few years have been increasingly changing the sectoral structure of employment in favour of services, increasing their share from 45.1% in 1992 to 52.2% in 1996. However, due to high employment in construction (especially in the small private sector) and greater employment in private farming in 1997, the sectoral structure remained nearly the same as in 1996: about 6% of persons in employment were employed in agriculture, 41.8% in industry and 52.2% in services.

[3] Starting with 1 January, 1997, SORS (the Statistical Office of the Republic of Slovenia) introduced several **methodological changes** to the employment statistics. The regular monthly record of the number of employed now includes an estimate of number of employed in companies with 1 or 2 employees (which is around 16,000), but still no adjustments are made for the missing responses in employers' monthly reports ZAP-M (SORS estimates this involves around 40,000 people). Within the self-employed category, the number of independent farmers is reduced taking into account the latest data from the Labour Force Survey. In addition to the new data, SORS is also publishing indexes for comparable categories for the same period of the previous year, which used to be the only source for analysing employment dynamics in 1997 compared to 1996. Starting from 1 January, 1997, a change to the Standard Activity Classification has also been implemented.

Global labour productivity has been increasing since 1993, annually by 3.5% on average, with the fastest increase in manufacturing (about 7.3% per annum). **In 1997 global productivity increased further by 3.7%,** while labour productivity in manufacturing increased by 6.6% (value added per employee) and 4.5% (physical productivity). Of the various types of manufacturing, productivity growth was the highest (about 15% and more) in leather and leather goods manufacturing, coke, oil derivatives and nuclear fuel production, rubber and plastic goods manufacturing and non-metallic minerals manufacturing, as well as in furniture manufacturing, other manufacturing activities and recycling (about 12%).

According to the anticipated slightly increased economic growth, we can expect that the number of employed will increase again in 1998 (by about 0.5%). The announcements of companies and organisations collected annually by the National Employment Office (the LP-ZAP survey), forecast a 2-percent employment fall in manufacturing and further stagnation in services. A continuation of the increase in the number of employed in hotels and restaurants, transport and trade companies is expected.

In 1997 there was again an increase in the number of registered unemployed by 4.5% compared to the previous year. In 1996 there was a decrease of 1.4%, mostly because of deletions from the register. Ordinary seasonal growth of registered unemployment was much smaller in 1997 compared to previous years, but the number of unemployed jumped in December with the unemployment rate reaching 14.8%. The average annual registered unemployment rate thus increased from 13.9% in 1996 to 14.4% in 1997, while the survey unemployment (in accordance with ILO methodology) was only 7.1 percent, therefore even a little lower than two years ago (when it was 7.3 percent).

The outflows and inflows shaping registered unemployment were somewhat better than in 1996, except for deletions from the register which in 1997 were just over one half of the level in 1996. More than 60,000 people lost their jobs (5,000 less than in 1996) and 56,000 unemployed obtained employment (1,500 more than in 1996). The inflow of first-time job-seekers continues to drop. The balance of flows show that since 1995 new employment - especially of the young - is again bypassing employment offices.

The high structural unemployment caused for several years by changes in the employment pattern in favour of more productive jobs, continues despite intensive active employment policy measures. As can be seen from the dynamics of individual categories of the unemployed, the unemployment pattern continues to worsen. The percentage of those aged over 40 is approaching 45%, the percentage of women is approaching 50% and the percentage of long-term unemployed has again exceeded 60%. The percentage of unskilled unemployed remains at the 47-percent level.

The forecasts for 1998 show that this year approximately the same number of people as last year will lose their job, but employment of the unemployed will be a little higher. If register deletions and the inflow of first-time job-seekers are a little lower than last year, the number of unemployed and the unemployment rate will stay at around the same level as last year. The reason for this is the expected upturn of the active population, which will share the same growth rate as employment. In 1998, we expect an increased inflow of school-leavers, including more graduates, whilst the number of new retirements will not rise significantly.

After 1987, when Slovenia achieved its highest active population and employment rates, the activity rate (as measured by statistical data for the population over 15 years of age) has been constantly decreasing. The activity rate of men fell from 72.6% in 1987 to 59.7% in 1996 and women's activity rate fell from 53.5% to 46.4%. The primary cause of this dramatic drop was accelerated retirement during the 1988-1992 period, and it was partly also due to prolongation of schooling. Last year men's activity rate dropped by a further percentage point, albeit the activity rate of women grew for the first time since 1988, namely by a trifle less than one percentage point. The activity rate of men in Slovenia is currently (based on a comparison of labour force surveys) slightly below the fifteen EU member-states' average. Higher activity rates of women than Slovenia's exist only in the Scandinavian states and the United Kingdom. A time-series comparison reveals that the increasing trend in women's activity rate and the decreasing trend in men's activity.

5.6 OPERATIONS OF COMMERCIAL COMPANIES, BANKS, SAVINGS BANKS AND SAVINGS CO-OPERATIVES

5.6.1 BUSINESS RESULTS OF COMMERCIAL COMPANIES[4] - Better results in 1997

By the close of 1997 there were 137,005 entries in the Companies Register, up 1.6% over 1996. Of these, 53,593 were companies (39.1%), 22,168 were institutes, bodies and other legal entities (16.2%), and 61,244 were physical entities (44.7%). The total number of companies increased by 1,013 (1.9%) over 1996. The predominant sectors were those of trade, motor vehicle repairs and consumer products (42.8%), real estate and business services (19.8%), and manufacturing (15.7%). Most of the companies (49,431 - a total of 92.2%) were private enterprises in the hands of domestic capital. There was a total of 2,272 joint ventures (4.2%), and 1,890 companies (3.5%) in the hands of foreign capital.

The analysis covered a total of 36,717 companies which submitted data on their 1997 balance sheets and profit and loss accounts to the Agency for Payments. The total number of employees in 1996 was 460,376. In 1997, most of the companies operated in the sectors of trade, motor vehicle repairs and consumer products (40.6%), although the largest number of employees was to be found in the manufacturing sector (46.7%) The total number of companies is still on the increase, although the number of employees is falling, albeit at a lower rate than before. As

[4] The analysis of the business results of companies is based on the statistics of the balance sheets and profit and loss accounts of those companies which submitted such information to the Agency for Payments. The analysis does not include data from those companies which would render statistics on the operations of companies inaccurate (this includes companies under bankruptcy procedures, certain funds and licensed investment companies).

such, the number of companies increased by 2.6% in 1997 and 6.5% in 1996. At the same time, the number of their employees fell by 1.5% in 1997 over the 1996 figure, and by 3.6% in 1996 over the previous year.

Despite the **overall business results** for last year being negative, they were **a great improvement over previous years**. The difference between revenues and expenses, which had been negative since 1991, changed to positive in 1997. Revenues exceeded expenses by SIT 17,861 million (0.3%). Companies recorded a positive difference between operating loss and operating profit in the amount of SIT 50,517 million. There was a negative difference between the loss and the profit from regular operation of SIT 51,158 million because of the negative difference between the financing revenues and financing expenses, amounting to SIT 102,099 million. The difference between extraordinary revenues and extraordinary expenses was positive and amounted to SIT 69,443 million. There was therefore a positive difference between total profit and total loss of SIT 17,861 million. If we subtract SIT 21,729 million in tax on profits from this amount, we end up with the negative difference between net profit and net loss of SIT 3,868 million.

Table 11: Net profit or loss of commercial companies

	In SIT million			As % of revenue		
	1995	**1996**	**1997**	**1995**	**1996**	**1997**
NET PROFIT / NET LOSS						
- from operating activity	-15673	-8463	50517	-0.3	-0.1	0.8
- from financing activity	-54150	-81676	-102099	-1.1	-1.4	-1.6
- from extraordinary activity	59892	48003	69443	1.2	0.8	1.1
- total	-9931	-42136	17861	-0.2	-0.7	0.3
Tax on profit	15006	18281	21729	0.3	0.3	0.3
NET LOSS OF THE FINANCIAL YEAR	-24937	-60417	-3868	-0.5	-1.1	-0.1

Source: Agency for Payments - Statistical data from the profit and loss statement of commercial companies for 1995, 1996 in 1997.

The net profit for the financial year increased in real terms by 33.5% over the previous year. It was recorded by 22,515 (61.3%) companies and amounted to a total of SIT 177,258 million. The largest number of contributing companies were in the trade, motor vehicle repairs and consumer products sectors (38%), although the greatest share of the amount came from the manufacturing sector (37.9%), and mainly from the chemicals, chemical products and man-made fibres (7.7%), the food-processing, beverages and tobacco products (7.0%), and the electrical and optical equipment (4.1%) manufacturing.

The net loss for the financial year fell in real terms by 8.9% over the previous year. It was recorded by 11,203 (30.5%) companies and amounted to a total of SIT 181,186 million. Again, the largest number of contributing companies were from the trade, motor vehicles repairs and consumer products sectors (44.0%), although the greatest share of the amount came from the manufacturing sector (36.0%), especially from the manufacture of basic iron and steel (14.3%).

Four sectors recorded positive difference between net profits and net losses of the financial year. These include the trade, motor vehicle repairs and consumer products sector, the transport, storage and communications sector (which recorded a considerable increase in net profits over the previous year), as well as the manufacturing and construction sectors (which still recorded a net loss in the previous year). Other sectors closed the 1997 financial year with a net loss, the largest being in the electricity, gas and water supply sector to the amount of SIT 22,338 million.

Table 12: Net profit or loss of the financial year of commercial companies by sectors

Sector	Net profit of the financial year		Net loss of the financial year		Net profit + Net loss -	
	1996	**1997**	**1996**	**1997**	**1996**	**1997**
A Agriculture, hunting, forestry	1348	1904	2711	2014	-1363	-110
B Fishing	13	17	27	70	-14	-53
C Mining	314	345	5428	3474	-5114	-3129
D Manufacturing	41742	67251	87462	65198	-45720	2053
E Electricity, gas and water supply	2231	2184	21830	24522	-19599	-22338
F Construction	4891	8228	5430	4803	-539	3425
G Wholesale, retail trade, certain repair	34172	44958	21405	22922	12767	22036
H Hotels and restaurants	1667	3094	4735	3788	-3068	-694
I Transport, storage and communications	11624	20026	8482	8913	3142	11113
J Financial intermediation	6650	2042	1294	8903	5356	-6861
K Real estate, renting, business services.	13619	21708	18868	29744	-5249	-8036
L Public administration and defence	87	0	118	160	-31	-160
M Education	134	256	146	562	-12	-306
N Health services and social care	1301	2016	1414	2690	-113	-674
O Other community and personal serv.	1971	3229	2831	3363	-860	-134
TOTAL COMMERCIAL COMPANIES	121764	177258	182181	181126	-60417	-3868

Source: Agency for Payments - Statistical data from profit and loss statement of commercial companies for 1996 in 1997.

At the close of 1997, the commercial companies' statements together recorded SIT 7,381,023 million in total assets and liabilities and capital. A comparison to the statistical data arising from the balance sheet dated 31 December 1996 shows growth in real terms of 8.4%. During this period, the share of fixed assets within the assets structure rose from 64.4% to 65.5% (primarily because of the increase in real estate prices). In the structure of liabilities and capital an even greater increase than in capital (up 2.6%) was recorded in the real-term value of long-term liabilities (50.4%) and short-term liabilities (4.5%). In this respect, the share of capital in the liabilities and capital structure fell from 54.6% to 51.6%, whilst short-term liabilities dropped from 30.0% to 28.9%, increasing the share of long-term liabilities from 10.9% to 15.1%.

5.6.2 PERFORMANCE OF BANKS, SAVINGS BANKS AND SAVINGS CO-OPERATIVES - Better returns on equity for banks

By May of this year, the Slovenian banking sector consisted of thirty banks (including two non-operating banks), six savings banks and seventy savings co-operatives. An acquisition last year reduced the number of banks by one, whilst the number of savings banks also fell by one because of regular bankruptcy proceedings. Of the functioning banks, 12 are wholly owned by local capital, 12 are joint ventures with a majority of local capital, whilst in four the majority or entire controlling interest is owned by foreign capital. No permits were issued for the establishment of a branch or representative office of a foreign bank in Slovenia last year.

According to unaudited data, the balance sheet total of banks, savings banks and savings co-operatives increased last year by 13.8% (4.1% in real terms), which is less than in 1996 (when the real-term growth was 5.6%). The three largest banks are credited for 50.7% of the entire balance sheet total, followed by 21.0% for the next four in size, and 28.3% for the rest. The share of an individual bank in the balance sheet total is a good indicator of that bank's market share.

In 1997, the average assets structure of banks, savings banks and savings co-operatives saw a sharp increase in investments in securities (by almost eight percentage points) due to a swap in time foreign currency deposits, which reduced the share of loans to the banking sector. The share of loans to the non-banking sector remained almost completely unchanged in 1997.

The liabilities of the banks, savings banks and savings co-operatives saw an increase of 3.5 percentage points in deposits from the non-banking sector (representing more than 67% of all liabilities), whilst deposits from the banking sector dropped by three percentage points (10% of all liabilities). The reason for this lies mainly in the lowering of liabilities to banks and to the Bank of Slovenia.

According to unaudited profit and loss accounts data, banks, savings banks and savings co-operatives made more than SIT 20 billion in pre-tax profits (compared to SIT 15.8 billion for 1996). Their revenues recorded a growth of 14.5%, whilst their expenses increased by 13.7%. Profits comprised 6.9% of the total revenues (6.2% in 1996). The return on equity grew from 10.2% in 1996 to 10.5% in 1997, whilst the net interest margin fell from 5.6% to 4.9% in the same period. Four banks recorded losses at the close of 1997 (two in 1996).

5.7 THE SECURITIES MARKET IN 1997

The total turnover on the Ljubljana Stock Exchange was 24.5% higher in 1997 than in 1996. The growth in turnover an in stock prices in 1997 was characterised by measures taken by the Bank of Slovenia, which in February intervened on the long-term securities market by the very significant introduction of custodian accounts and by limiting the extent of portfolio investments, which were the driving force of the Ljubljana Stock Exchange. At the end of July, the measure was limited to investments lasting more than 7 years.

The proportion of shares in the total turnover for 1997 was 80.8%, some 3.7% higher than in 1996. Bonds in 1997 comprised 10.6% of the total turnover (compared to 15.2% in 1996), whilst short-term securities comprised 8.5% of the total turnover on the Stock Exchange in 1997 (compared to 7.7% in 1996).

The SBI index rose to 1,404 points by the end of 1997, representing an 18.7% increase over 1996. In the same period the BIO index improved by 1.4%.

The beginning of 1998 marks the start of trading with shares of the first two investment funds (licensed investment companies). Other funds are expected to join the two during the course of the year.

The total turnover for the first quarter of 1998 (SIT 29.16 billion) represents 26.9% of the total turnover for last year, and is 9.7% lower than that of the first quarter of 1997. In 1998 greater attention is expected to be paid to taxes, pension reform and the easing of restrictions regarding foreign portfolio investments. Achieving stable and long-term demand for securities will depend on the participation of real institutional investors (pension savings funds), who could be attracted by the pension reform and the privatisation of insurance companies.

Table 13: Turnover on the Ljubljana Stock Exchange, in SIT billion

	1994	1995	1996	1997	$Q_1$98
Total turnover	112.8	88.1	87.0	108.3	29.6
Turnover of long-term securities on official A and B markets					
Total	86.4	61.7	64.7	63.0	24.3
Shares	53.4	40.4	53.0	53.5	22.8
Bonds	33.0	21.3	11.7	9.4	1.6
Turnover of long-term securities on an organised open C market					
Total	0.0	6.2	15.6	36.2	2.2
Shares	0.0	4.8	14.1	34.0	1.4
Bonds	0.0	1.5	1.5	2.1	0.8
Turnover of short-term securities					
Total	26.5	20.1	6.7	9.2	2.6

Source: Ljubljana Stock Exchange.

The market capitalisation of shares indicator (the number of quoted shares multiplied by their market value) in the gross domestic product (GDP) expresses the depth of the financial market. By the end of 1997, the market capitalisation of shares on the stock exchange (SIT 316 billion) represented 10.9% of the GDP (for 1997), which indicates a shallow capital market. Similar statistics were recorded in Poland (10%), whilst other CEFTA countries show distinctly deeper capital markets (27% for the Czech Republic). The proportion of market capitalisation shares of the GDP is growing in the most developed countries as well. By the end of 1996, their figures were 28% for Germany and 66% for Japan, despite its tradition of bank financing. The figure was 114% for the USA and 142% for the United Kingdom, confirming the great importance of the world's largest stock markets.

6. OTHER DIMENSIONS OF DEVELOPMENT

6.1 FORMATION AND EXPENDITURE OF FUNDS FOR ENVIRONMENTAL PROTECTION - THE BUDGETARY FUNDS FOR ENVIRONMENTAL PROTECTION ARE RISING, THE LEVEL ACHIEVED IS SIGNIFICANTLY LOWER THAN PROJECTED

According to the **Strategy for Economic Development of Slovenia** (SEDS), it has been estimated that the annual environmental damage amounts to 4 - 6% of the GDP. In order to improve the state of the environment, especially the environmental performance of the economy, the SEDS set the goal of increasing environmental protection expenditure to 1.5% of the GDP. Two-thirds of the increase should be financed from public funds.

There was only a slight increase in the proportion of the GDP allocated to environmental protection between 1993 and **1996**. The figure for 1993 was 0.43% of the GDP, in 1994 0.76% of the GDP, in 1995 0.58% of the GDP, and in 1996 0.50% of the GDP. This drop is mainly due to the decline of investment for environmental protection by the business sector.

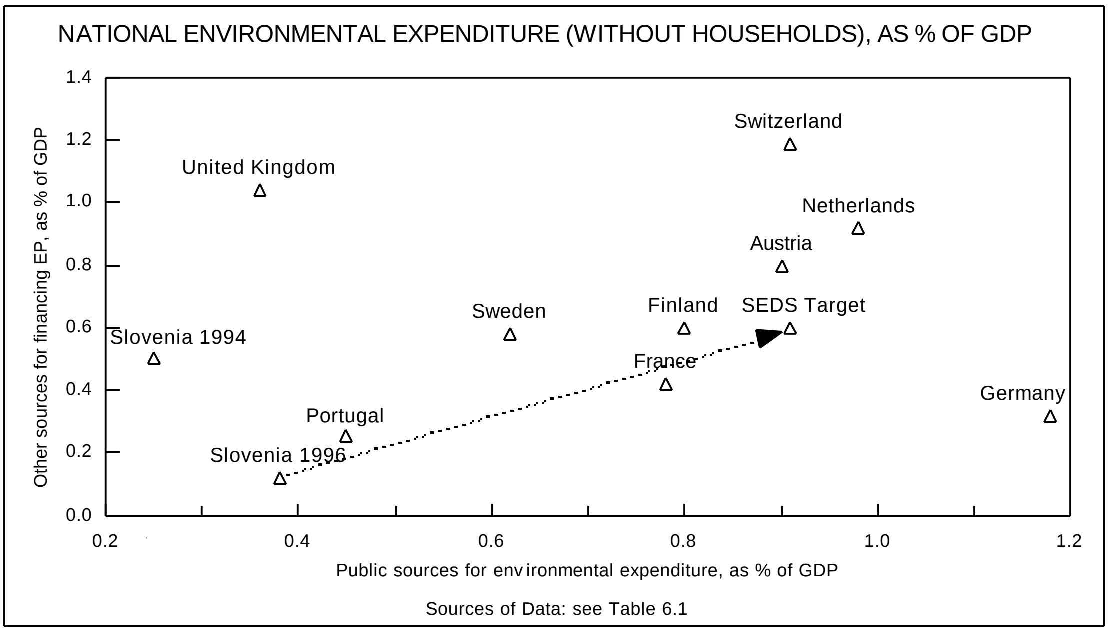
Environmental protection expenditure consists of **two financial flows** (OECD, 1996, pg. 4 - 11): (i) current expenditure and investment for environmental protection by polluters, and (ii) environmental pollution transfers to the budget (environmental levies, compensation, concessions, etc.) and environmental protection transfers (favourable loans, tax relief, irredeemable funds). Nationally, all transfers are neutralised: the transfer outflow of one is the transfer inflow of the other. We need not consider transfers in order to get insight into the level of national expenditure. However, in order to create a picture of channels of financing environmental protection, we must consider both flows. The reallocation of funds is actually one of the main tasks of environmental and public finance policies. The aspect of reallocation is therefore at least as important for the policy as is the level of expenditure for environmental protection.

Despite a rapid real-term growth of budgetary **revenue** resulting from environmental pollution, its contribution towards the total budget revenues is still minor: 1.95% in 1998 (1.58 in 1997; 0.65% in 1996 and 0.62% in 1995). The following are the most important sources of growth of budgetary revenue from environmental pollution: the extensive implementation of municipal environmental levies (started in 1996), the introduction of a carbon-dioxide tax in 1997, and a three-fold increase of the rate in 1998. The 1995 introduction of the levy on water pollution and its annual increase[5] made no significant contribution to the growth of budgetary revenue from environmental pollution, as most contributors successfully used tax relieves on building purifying plants. The fiscal revenue effect of the tax is therefore negligible.

Budgetary environmental protection **expenditure** has also seen significant growth in real terms since 1995 (16.1% in 1996, 25.3% in 1997, 19.0% in 1998). Environmental protection expenditure by the state and municipalities is very small,

[5] From SIT 800 per Pollution Unit (PU) in 1996, to SIT 1,200/PU in 1997, to SIT 2,100/PU in 1998.

but this is understandable as they are not major polluters. The state plays a significantly more important role in reallocating the funds for environmental protection. The Environmental Development Fund of the Republic of Slovenia has been developing into the biggest public provider of funds for environmental protection over the last few years. However, its credit potential has in recent years also been created mainly by received budgetary transfers.



The growth of **budgetary transfers for environmental protection** originates mainly in increased tax reliefs granted by the Ministry of the Environment to those water pollution taxpayers who build purifying plants. In 1996[6] tax reliefs in aggregate terms equalled 16% of all national environmental protection investments.

The role played by the state (central and local budgets) in the reallocation of funds for environmental protection only becomes clear after identifying **net flows** of transfers. Between 1991 and 1993, budget allocated more funds towards environmental protection than it collected from environmental pollution. This was done because revenue from environmental levies was at the time very low (see Table 14, row 3). In subsequent years, revenue from these sources increased significantly, and although expenditure was also increasing, it could not keep up with the revenue growth.

[6] The tax was introduced in the second half of 1995.

Table 14: Pollution abatement and control expenditure from the national (central and local) budget (CB,LB)

in SIT million, current prices		1991	1992	1993	1994	1995	1996	1997	1998
A **Environmental revenues** [1]	A=B+G	367.8	849.8	1,719.1	4,410.8	3,936.4	4,929.9	13,730.3	19,555.8
B Environ. revenues to CB	B=C+...+F	242.4	744.6	1,462.6	2,217.1	2,745.5	2,145.4	10,570.7	16,095.1
C Eco tax		241.8	85.1	0.3	0.1	...[2]	...	...	...
È Water use charge		...	617.1	1,130.2	1,542.8	1,666.0	1,147.9	1,400.8	1,550.0
D Compensation for use of agricultural land		0.6	42.4	332.1	674.2	1,079.5	799.7	796.5	880.0
E Waste water tax		...	...	...	...	...	197.8	296.7	445.1
F CO_2 tax		...	...	...	...	...	...	8,076.7	13,220.0
G Environ. revenues to LB.	G=H+...+K	125.4	105.2	256.4	2,193.7	1,190.9	2,784.5	3,159.6	3,460.7
H Compensation for use of agricultural land		118.1	79.6	136.8	1,982.6	614.5	1,098.5	961.8	1,038.8
I Compensation for extraction of natural resources		...	...	...	...	...	100.4	111.4	123.5
J Revenues from concessions		...	...	...	...	...	9.2	10.2	11.3
K Local environmental fees		7.3	25.6	119.6	211.1	576.4	1,576.4	2,076.1	2,287.1
a **Budgetary financing of environ. expenditure**	a=b+d	893.1	1,909.6	2,385.9	3,384.1	3,491.8	4,565.4	6,277.1	8,138.9
b CB expenditure	b=c+è	14.3	186.0	179.7	239.8	316.4	301.8	321.3	500.6
c CB investment		14.3	12.8	15.7	18.2	17.9	29.7	90.8	90.1
è CB current expenditure		0.0	173.2	164.0	221.6	298.6	272.1	230.5	410.5
d CB outward transfers	d=e+...+i	878.8	1,723.6	2,206.2	3,144.2	3,175.4	4,263.7	5,955.9	7,638.3
e From CB to the rest of the world		7.5	15.3	21.3	24.2	22.2	25.4	30.0	7.9
f From CB to LB		nd	nd	nd	nd	nd	nd	nd	nd
g From CB to Environmental Development Fund (EDF)		nd	228.2	...	43.6	...	...	700.0	200.0
h Transferred proceeds from privatisation to EDF		...	...	...	...	708.0	850.9	nd	nd
i Environmental transfers to abaters	i=j+k	871.3	1,480.1	2,184.9	3,076.5	2,445.1	3,387.3	5,225.8	7,430.4
j From CB		855.6	954.6	1,880.9	2,788.1	2,063.2	2,917.3	4,854.6	6,987.1
for construction of waste water treatment plants[3]		...	...	...	...	nd	1,420.0	3,000.0	5,250.0
k From LB		15.6	525.6	304.0	288.4	381.9	470.0	371.2	443.3
1 **Net budgetary environ. Expenditure**	1=b-A	-353.6	-663.9	-1,539.3	-4,171.0	-3,620.0	-4,628.1	-13,409.0	-19,055.2
2 **Outward environmental transfers less inward transfers**	2=d-A	511.0	873.8	487.1	-1,266.5	-761.0	-666.2	-7,774.4	-11,917.5
3 **Net expenditures plus outward environmental transfers**	3=d+1	525.2	1,059.8	666.8	-1,026.7	-444.6	-364.4	-7,453.2	-11,416.9
4 **Net expenditures (excl. revenues from CO_2 tax) plus outward environ. transfers**	4=a-A+F	525.2	1,059.8	666.8	-1,026.7	-444.6	-364.4	623.5	1,803.1

Source: Official Gazette of RS 4/95, 26/94, 5/96, 78/97, 34/98; Reporter of the National Assembly of RS 17/95, 42/97, 3/98; Bulletin Ministry of Finance X/96, 25/VI/97, 22/IV/98; Ministry of Environment and Physical Planning, OECD; estimates IMAD. ***Notes***: [1] Including proceeds from penalty payments for delayed payments of taxes, fees, etc. [2] ...=not relevant; nd=no data; 0=below 0.1; [3] Tax deduction for construction of waste water treatment plants.

Between 1995 and 1996, the budgetary revenue resulting from environmental pollution was approximately at the same level as the expenditure for environmental protection financed by the budget (Table 14, row 3). With the introduction of the carbon-dioxide air pollution tax (Table 14, row F), the revenue from public finance exceeded budgetary expenditure for environmental protection (Table 14, row 3).

If we compare the 1997 and 1998 levels of budgetary revenue resulting from environmental pollution, excluding the carbon-dioxide air pollution tax, with the expenditure for environmental protection finance from the budget, we see that budgetary financing in this period did indeed accelerate environmental protection. We estimate that in 1998 the state (including municipalities) will allocate SIT 1.8

billion more for environmental protection than it is expected to receive from environmentally related payments (excluding the carbon-dioxide air pollution tax).

It is quite clear that budgetary revenue from environmental pollution can increase rapidly, which is not true for the public (or other) financing of environmental protection. This leads us to the conclusion **that the extent of expenditure for environmental protection does not depend solely on the public finance funds available**. To support environmental protection expenditure, several institutional obstructions must first be removed. This includes: increasing the capacity of municipal authorities to implement local-development policies; resolving the legal proprietary disputes regarding the assets of the providers of public services and infrastructure; upgrading the normative system for environmental protection; augmenting inspection control; simplifying administrative procedures in cases of breaches of regulations, etc.

The 1998 general government expenditure for environmental protection is greater than that for 1993 by almost 60%, indicating that the trends as projected by the SEDS for environmental protection by public finance are being realised. However, we must consider that the level at which changes are taking place is too low to achieve the targeted level of total expenditure for environmental protection. The increase of a mere 0.10 percentage points (to 0.25% of the GDP in 1998) in budgetary environmental protection expenditure in the period between 1993 and 1998 means that an increase of 0.66 percentage points by the end of the year 2000 is rather unlikely.

6.2 THE SOCIAL DIMENSIONS OF DEVELOPMENT - SOCIAL DEVELOPMENT AS A COMBINATION OF SOCIAL, ECONOMIC AND VALUE SYSTEMS

Income and wealth inequality hinders economic growth and social integration in several ways. It decreases the economic effectiveness of the society and increases social apathy. If the inequality is too great, it increases the state income redistribution. Stanovnik (Stanovnik, 1997) estimates that the proportion of beneficiaries of social welfare in the total income of Slovene households has risen from 16.2 in 1983 to 22.6 in 1993. The proportion of social welfare beneficiaries amongst the poorest 10% of households has grown from 37.1% to 54.6%, and represents the main source of income for this category of the population. The proportion of earned income, however, has declined from 76.1% of the total income of Slovene households in 1983 to 63.7% one decade later. This decline is greater still for the poorest 10% of households, having fallen from 56.2% to 40.8%. The wealthiest 10% have seen a similar decline, from 74.1% to 61./%.

Relative poverty is expressed in poorer mental and physical health (see Lundberg 1994, Wilkinson 1997, and Sen, 1998, Economic Reform Monitor 1998) and in the increased occurrence of social diseases. Although there has been a greater redistribution of income, the relative poverty of those whose income is trailing too far behind has increased.

The **predominant value system** in Slovenia is too pragmatic for balanced social and economic development[7]. Personal wealth lies at the forefront; its significance is primarily for demonstrate (large houses, fast automobiles) rather than in investment for the future, savings, etc. This heightens the scramble for material possessions decline co-operation, solidarity and trust, which are basic requirements to activate **human capital**, and at the same time increases the need for social regulation and control.

Three factors necessitate the creation of stronger **regulatory mechanisms** to alleviate growing social anxieties and income deficiencies: (i) transition, which introduces changes at several levels simultaneously, (ii) the relatively high level of unemployment, and (iii) the increasing proportion of the senior population.

Unemployment denies a significant part of the population the opportunity for social integration during the most productive periods of their lives; the most affected are youth up to the age of 26, although their number fell by 4.4% between 1996 and 1997. Measures directed at this social groups will be carried out by unemployment and social services jointly, a novelty in the tackling of such problems. Also seriously affected are long-term unemployed persons - their families are subject to a variety of high-risk social situations, whilst the unemployed themselves are increasingly less likely to gain employment the longer they stay out of work. Early retirement in such cases can only be considered as the final measure, when all others have been exhausted.

The ageing of the population requires changes in policy on several fronts, including health, pension and disability insurance, and social care. The National Programme for Social Welfare up to 2005 thus adequately expands the most appropriate forms of nursing and assistance at home to the elderly.

The **continually increasing number of entitlements for social benefits** reflects a decline in social welfare and social exclusion. The means-tested **welfare allowance** for those families or individuals unable to secure sufficient income for subsistence (due to reasons beyond their control) was granted to 34,264 applicants in 1997, a 100% increase on the 1993 figure and a 14.4% increase over 1996 (22,988 beneficiaries). According to data released by the Ministry of Labour, Family and Social Affairs, the majority of the beneficiaries were single (60%), or unemployed without unemployment benefits of any kind (54%), and were between 18 and 45 years of age (82%). The second large group of beneficiaries were first-time job seekers (14%). The number of recipients of unemployment and child benefits is also on the rise. There were 36,603 recipients of unemployment benefits in 1997, a 16.5% increase on 1996 (when there were 31,424), whilst number of recipients of **child benefit** increased by 19.3%. This rise was partially a consequence of eased conditions for entitlement to child benefit, Had these conditions not changed the rise

[7] Of 43 countries in the world representing 70% of the population, Slovenes are ranked 18th regarding material orientation, and 38th regarding post-materialist values (Baseness et al, 1996). In terms of the proportion of the population which considers it important to be in possession of something that will cause envy in others, Slovenes are ranked fifth out of 43 countries (Besanez et al, 1996).

would have been 16%. However, the number of pensioners receiving **the social security income support** (granted to pensioners whose full retirement pension is below the subsistence level) does not follow the same tendencies as displayed by the two categories mentioned above. The **number of pensioners receiving this income support** has fallen by 20% over the last five years. There were 45,265 recipients in 1997, compared to 56,852 in 1992, which means that pensioners are becoming less affected in terms of material needs than are working-age social benefits' recipients and their children (there were 20,225 children living in families on social benefits in December, 1997).

6.3 REGIONAL DEVELOPMENT - TRANSITION TO A MARKET ECONOMY HAS INCREASED DISPARITIES BETWEEN REGIONS; A REGIONAL DEVELOPMENT STRATEGY IS BEING PREPARED

Disparities in the development levels of individual regions were already present before Slovenia gained its independence. However, those differences have grown even more during the transition to a market economy.

Demographic conditions are worsening throughout Slovenia. In the last years, the birth rate has been falling, whilst life expectancy has been growing, which in turn has caused an intense ageing of the population. However, there are differences between individual regions; on average, life expectancy in the eastern parts of Slovenia is 4 years shorter than that recorded in the western parts. The most frequently used is "human development index" - a synthesised indicator involving both social and economic development aspects and implying a division between the western part of Slovenia with relatively more favourable values and the eastern part with relatively less favourable values. Differences can also be noticed in the population density. On the one hand, the areas of high population density and urbanisation account for more than one-third of the territory and four-fifths of the population, whereas on the other hand, a good third of the entire territory is wholly non-urbanised.

Disparities among regions are also evident in terms of economic potentials. In 1997, the most successful business operations involved companies located in central Slovenia, accounting for 38.4% of total Slovenian profits. The Littoral-Karst Region, which in 1996 made almost 30% of total losses in Slovenia, earned the same share in profits in 1997, thus considerably improving its results. A good one-fifth of national profit was generated in the Dolenjska Region, positive results were also recorded in the Goriška and Karst Regions, which in 1996 still recorded losses. More than one-half of total losses in Slovenia was generated by the Podravje Region. Besides, shares of losses are also well above average in the Zasavje, Carinthia, and Posavje Regions. In real terms, value added increased fastest in the Littoral-Karst, Gorenjska, Dolenjska Regions and central Slovenia, whilst the biggest fall was recorded in the Posavje (14.6%), Carinthia and Pomurje (approx. 3%) Regions. Thus, differences in value added per capita as a measure of the economic power of individual regions again slightly grew, i.e. from 1 : 2 in 1992 to 1 : 2.8 in 1997. Differences, according to taxable personal income per capita as a measure of the economic power of individual inhabitants are not so substantial. In 1996, all regions exceeded 75% of the national average. However, according to this indicator even the most successful region (central Slovenia) stood only more than 20% above the national average. Since 1992, differences between regions have been stagnating, the index being 1 : 1.6.

Difficulties in regional economies are directly manifested in differences between unemployment rates. These differences increased from 1 : 2.2 in 1992 to 1 : 2.4 in 1997. However, disparities in unemployment rates do not substantially increase as unemployment is also growing in the regions which used to have lower unemployment rates, whilst regions characterised by high unemployment generally remain at the same level. In 1997, above-average unemployment rate in the labour force was recorded in the Podravje, Pomurje, Zasavje, Posavje and Savinja Regions. Unemployment rates in certain regions would have been even higher if some of the population had not migrated either abroad or to other regions within Slovenia.

Disparities in youth unemployment rates stood at 1 : 2.5. On average, the youth unemployment rate is higher than total unemployment by slightly less than three percentage points. The proportion of young persons in the unemployed is on a downward trend, however in the regions with the lowest proportions they account for a quarter of total unemployed. The situation is the worst in the Pomurje (37.4%) and Carinthia (33.8%) Regions.

From the point of view of employment possibilities and cutting unemployment, the education structure of the unemployed is unfavourable and in 1997 even deteriorated in the majority of regions. Thus, the structures are most unfavourable in the Dolenjsko and Pomurje Regions with 58% of their unemployed having only lower levels of education. The respective share (43%) was lowest in central Slovenia, which, however, was characterised by the highest and slightly rising share of job-seekers with university education. A relatively considerable share of persons with university education in the unemployed, which is a frequent incidence in the regions with under-average unemployment rates in the labour force (the Littoral-Karst, Gorenjsko and Gorica Regions), is alarming from the point of view of development. Disparities between regions in the share of unemployed with university and college education are 1 : 3. Mismatches of supply and demand on the labour market are also confirmed by the Evans index of mismatch which, since 1994 when it was 1.27, went up to 1.46 in 1997.

Differences in development levels and living standards are also evident when regions within the European Union members are compared. Moreover, those differences seem to be even improving. At the beginning of the 1990s, gross domestic product in the ten richest EU regions was 3.5 times above that recorded in the ten poorest regions. In the ten regions most affected by high unemployment, unemployment rates were 7 times above those in the regions least affected by unemployment. Differences in terms of school children and students stood at 1 : 2, differences in basic infrastructure 1 : 3, differences in subsidies for research and technology 1 : 7. In 1995, disparities in terms of gross domestic product per capita between the EU members was 1 : 2.6. At territorial levels, those disparities are even larger - at the NUTS 1 level 1 : 3 : 9, at the NUTS 2 level as much as 1 : 4 : 5.

It is generally known for the European Union that the lowest deviations from the average are recorded in the regions of the southern Mediterranean periphery (the south of Italy, Greece, Spain, Portugal), eastern periphery (eastern part of Germany) and north-western periphery (Ireland and certain parts of Great Britain). Considerably above average are areas of Northern Italy, Southern Germany, regions of Benelux and those of Northern Germany.

Even more unfavourable is the statistical picture of regional differences in levels of development within certain EU countries. During the decade from 1983 to 1993, they edged down only in the Netherlands but improved in all other EU countries, in Portugal the most. Expressed as differences between extreme values, the most significant regional discrepancies in 1995 were reported in the reunited Germany (3.5 : 1), Austria (2.3 : 1), Belgium (2.2 : 1), Italy and France (2.1 :1) and Great Britain (2.0 : 1). Regional differences below 100% were recorded in Portugal, Spain and Finland (1.8 : 1), Greece (1.7 : 1), the Netherlands (1.6 : 1) and Sweden (1.4 : 1). Slovenia's position equals the non-weighted average of EU countries and/or the level of Great Britain, which is slightly above Portugal and Spain.

Regional differences in terms of economic development of the candidates for accession to the EU in the first round of enlargement (Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia) on average and taking the group of countries as a whole, are approximately equal to those recorded in the EU. The gap between the two extreme values is 4.5 : 1. The development level is highest in the Czech Region of Prague (index level 233 compared to the six candidates' average) and lowest in the Polish Duchy of Nowosadeckie (index level 52). If measured in terms of the difference between the most and least developed regions within an individual country, the differences are highest in Poland (3.2 : 1), followed by Hungary (3.1 : 1). The regional differences in the Czech Republic are narrower than those recorded in Slovenia.

Slovenian regions compared with the "Europe of Regions" which is expected to be formed after the new members join the EU. If the new members had joined the EU in 1995, the Union's average would have dropped by almost 10% (from ECU 17,315 to 15,731). Consequently, below the EU-21 average one would have found Spain, Cyprus, Greece, Portugal, Slovenia, the Czech Republic, Hungary, Poland and Estonia (the order reflects the level of economic development measured by this index). With ECU 10,212 (PPP) per capita, Slovenia would reach 65% of the new EU average and 35% of the economic development level of Luxembourg, which is the most developed EU country having over ECU 29,000 (PPP) per capita. In the enlarged EU-21, Slovenia as a whole would have been better developed than one-third of NUTS-2 European regions with 97 million inhabitants, 37 million of whom live in the current EU member countries.

Our most developed region, central Slovenia, would have ranked 144th among the 281 regions of NUTS-2. This development level is similar to that of Kent, Lancashire and Essex in Great Britain, Hainaut in Belgium and Vali-Suomi in Finland.

Altogether 58 regions in the current EU member countries are at approximately the same or even lower development levels. Moreover, of all regions of EU candidates, only the Czech region of Prague is better developed than central Slovenia. On that scale, our least developed region of Pomurje would have ranked 214th, immediately below Iperos (Greece), which is an EU-15 region, taking the last place (this report does not take into account the French overseas departments). EU candidates' regions ranking higher than the Pomurje Region would only include the following: Prague, Cyprus (including the less-developed Turkish part), Budapest, Warsaw, Eastern Bohemia, Western Bohemia, Southern Bohemia, Northern Bohemia, Southern Moravia, Northern Moravia and Central Bohemia. The data show that in terms of economic development level, Slovenia is already included within the framework of the existing "Europe of Regions"; not only as a country and a NUTS-2 region as a whole, but also with all its NUTS-3 regions, also including the least-developed ones (see also: Strmšnik, 1997).

The European Union has already taken appropriate measures to reduce regional disparities. Today, the structural policy's objectives represent one of the basic elements for ensuring economic and social cohesion in the European Union. By eliminating such disparities, not only the regions lagging behind gain but so will the entire community.

Slovenia too has been engaged in regional development policy since the beginning of the 1970s. Since then, the system of promoting more harmonised development has produced a number of positive results. Experience shows that regional development policy must become more integrated and harmonised between various sectors. The reform of regional policy is also dictated by Slovenia's anticipated joining of the EU. At the point of entering the EU, Slovenia will be one of the less-developed countries to which aid will be directed by means of structural funds. During the pre-accession period, Slovenia will have to engage in a number of tasks in the field of regional development, mainly involving legislative harmonisation. First however, Slovenia will have to prepare and adopt a regional development strategy and a law regulating a harmonised regional development.

6.4 TECHNOLOGICAL DEVELOPMENT - NECESSARY ADDITIONAL INVESTMENTS IN RESEARCH AND DEVELOPMENT

The National Programme for the Adoption of the *Acquis* (Poroèevalec, 24/98, pp. 28 - 30), based on strategic materials and programmes, in the chapter dedicated to enterprise sector reform explicitly refers to the objective of improving competitiveness in up to 35 areas. In order to meet this objective, policies will have to be adopted for the restructuring of companies and directing them towards the market. Such emphasis is justified by the negative global competitiveness index and Slovenia's ranking amongst 49 countries assessed according to the methodology of the World Economic Forum (see also: Gmeiner, 1997) in terms of individual criteria for competitiveness (especially in the field of technology).

Table 15: Sectors with the highest R&D expenditures, Slovenia, 1996

Sector	Total	Intramural R&D expenditure				Extramural R&D expend.
		Total	Process research	Product research	General R&D	
Total manufacturing	17,940,116	15,998,393	3,735,330	6,880,540	5,382,523	1,941,723
	100.0	100.0	100.0	100.0	100.0	100.0
of which:						
Chemicals and chem. prod.	34.2	32.2	20.1	33.7	39.1	50.6
Pharmaceutics	29.4	27.2	16.3	30.1	31.2	48.2
Machinery and equipment	14.9	15.6	29.6	15.4	6.2	8.5
Radio and TV commun. and apparatus.	12.4	12.8	4.4	15.7	15.0	8.9
Electrical machin. and equip.	7.6	8.0	8.6	6.7	9.4	3.8
Rubber and plastic products	6.1	6.7	12.6	6.4	3.0	1.4
Medical and optical products	5.6	6.2	1.5	7.8	7.4	1.4
Total for selected sectors	80.8	81.5	76.8	85.7	80.1	74.6

Source: SORS, Rapid Reports No. 73, 17 March, 1998.

The analysis of technological development of Slovenia's manufacturing is part of a report on innovation activities in enterprises in 1996 (SORS, Rapid Reports No. 73, 17 March, 1998). Only one out of eight surveyed companies (altogether 880) has an in-house research and development department. Innovation activities normally result in innovative products or processes. As far as Slovene manufacturing is concerned, developing a technologically new product normally takes as long as twelve years and an innovative production process eight years (see Appendix, Table 17 for details). Such lagging-behind in comparison with the European competition represents a particularly pressing problem in five manufacturing industries where 9/10 of all products remain unchanged. In 1996, over four-fifths of all investments in R&D made by manufacturing companies were recorded in only a few industries.

The majority of R&D investments is aimed at product development. This is particularly evident in the pharmaceutical industry where besides intra-mural investments, a considerable share of funds is also allocated for financing external R&D institutions. Significantly lagging behind is the production of radio and TV communications, apparatus and equipment as well as the production of machines and appliances.

The evaluation of the technological level of Slovene industry and the complexity of products in terms of their production processes for 1995 which was carried out in 1997 (Institute of Economic Research in co-operation with the Chamber of Commerce and Industry of Slovenia, October 1997) shows that it is also necessary for Slovenian industry to invest in technology and product development. Assessments as to product complexity generally ranged from classes 4 to 6 out of 15 possible classes (within an average of 5.15), whereas technological production intensity was assessed at 6.10. That was more favourable only due to the fact that production is improved by means of information technology. This is why even in the medium run, Slovenian industry is lagging behind the programme in preserving and improving its competitiveness. This is particularly alarming in manufacture of basic iron and steel, non-ferrous minerals, sawmills and manufacture of wood boards, leather and fur manufacture, animal feeds manufacture, and recycling.

Given that technological development in the context of EU accession is becoming a key factor, the task of technology policy primarily involves: (i) measures to promote investment in research, development and particularly innovatory processes; (ii) measures to improve networks for transferring and employing technological know-how, and (iii) instruments to regulate market competition, involving issues ranging from standardisation to tax relief.

7. BASIC GUIDELINES OF ECONOMIC POLICIES FOR THE 1997 - 1999 PERIOD

7.1. FISCAL POLICY - NEXT YEAR'S GENERAL GOVERNMENT DEFICIT IS STILL NOT EXPECTED TO BE LOWER

In 1997 **general government revenue** was collected on the basis of the tax system and instruments existing at the end of 1996. In addition, certain changes were introduced affecting not only the volume but also the structure of general government revenue. Social security contributions comprised 38% of the total wage bill, less than the average in 1996 when the figure was 40.2%. In the middle of 1997, brackets of the tax on payrolls was made more progressive, meaning lower wages became less taxed. At the beginning of 1997, customs tariff rates for some products were reduced to comply with association agreement, considerably reducing revenues from this source. The sales tax on oil products was raised. In addition, a new tax on carbon dioxide emissions was introduced in January 1997, representing a new source of revenue for the budget.

Social security contributions, representing 35% of total general government revenue, fell in real terms by 2.3%, as social security contribution rates were cut and wages growth slowed. Reduction of customs rates led to a 30% real slump in revenues from customs duties, even bigger than expected at the beginning of the year. Revenues from personal income tax grew only 1.8%. Revenues from sales taxes were 6.1% higher in real terms, taking into account the taxes paid in January 1998 but belonging to 1997, and 1.4% excluding that transfer. On the other hand, the tax on carbon dioxide emissions introduced in January 1997 and the tax on payrolls, which were also collected throughout the year, contributed to higher general government revenue. However, they represent only a solid 3% of all general government revenue. Excluding the effect of the prolongation of the fiscal year into January 1998 and the revenues from the proceeds from privatisation of companies, general government revenue increased in real terms by a mere 1.2% in 1997 compared to a year earlier. If prolongation of the fiscal year and proceeds from privatisation are included, general government revenue rose 2.9%. The share of general government revenue in the gross domestic product was 44.6%, 0.6 of a percentage point less than in 1996.

On the side of **general government expenditure**, expenditure on cash benefits (social transfers) founded by the law and other acts regulating pension and disability insurance rose in real terms by 4.3% in 1997. Not only the indexation of pensions and other benefits in line with price movements but also the 1.5%-rise in the number of pensioners in 1997 contributed to higher expenditures. Expenditure on public pension and disability insurance thus had a 13.3% share in gross domestic product, roughly the same as in 1996.

In 1997 the scope of programmes and benefits arising from compulsory health insurance remained roughly the same as in 1996; expenditures for compulsory health insurance (including the transfers allocated to the health-care fund by the state) increased in real terms by 4.1%. Expenditure for public health care institutions, mainly for wages, recorded the highest real rise. Expenditure for drugs and sickness benefits rose moderately (1.5% in real terms). Thus, expenditure for compulsory health insurance represented 6.8% of gross domestic product in 1997, the same as in 1996.

In 1997, local government expenditures increased in real terms by 3.4%, whereby funds spent on wages recorded the highest real growth. Local government expenditure represented 4.8% of the gross domestic product, 0.1 of a percentage point less than in 1996.

The budget for 1997 was only adopted in December 1997. The budget spending was thus regulated by rules of provisional financing, which resulted in restrained budget expenditure throughout the year, a surge in expenditures after the adoption of the budget and, finally, a decree on prolongation of the fiscal year into January 1998. Total central government expenditure (excluding transfers to other general government funds) rose in real terms by 8.8% in 1997. The highest real rise of central government expenditures was recorded by social transfers (19.1%), payments of social services (17.8%), subsidies and transfers to the business sector (12.8%), and wages (9.8%). Expenditure on goods and services were up in real terms by 5.4%, whilst investment (acquisition of fixed assets) and capital transfers to financial institutions recorded the lowest real rate growth (2.9%). Central government expenditure accounted for 20.8% of gross domestic product in 1997, up 0.9 of a percentage point from a year earlier.

General government expenditure in 1997 was up in real terms by 6.1% and accounted for 45.7% of gross domestic product, 0.8 of a percentage point more than in 1996. In 1996, the general government result was still relatively favourable, with an almost balanced general government account. The consolidated account even recorded a surplus accounting for 0.3% of gross domestic product at the end of 1996. In 1997, however, the general government deficit reached 1.1% of the gross domestic product. The deterioration in the result was largely due to certain decisions adopted in 1996 which, on the one hand, reduced government revenue (notably, cuts in social security contribution rates) and, on the other hand, exerted pressure for higher government expenditure (wages, social transfers).

Reduction of the government deficit should be the main endeavour of economic policy in the area of public finances in 1998. In light of the difficult situation in 1997, which continues into 1998, cutting the government deficit will only be possible by further cuts to government expenditure and continuation of tax reform, in particular in the direction of seeking new environmental, property and other tax sources that would be sensible from economic and fiscal points of view. Hence, the Government has, while preparing this year's budget, adopted an austerity programme, the measures of which should contribute to realisation of this economic policy goal.

The changes in the tax system and instruments adopted at the beginning of this year will affect **general government revenue in 1998**. In its savings programme, the government set out certain measures that will influence the level of general government revenues. Some of the measures were introduced at the beginning of the year, whilst others are still before the Parliament so that their effects cannot be expected before the end of this year or even next year. Social security contributions still represent 38% of wages, the same as last year. By amending the Law on Social Security Contributions, the contributions are now also collected from other remuneration, so that revenues from social security contributions are expected to slightly increase this year. General government revenue is also expected to increase due to the new tax source introduced in 1998 – the tax on the balance sheet totals of banks and savings banks. Apart from having a public finance effect, this tax, including deductions for tolar loans, is an incentive for banks to transfer tolar assets to the real sector. Another contribution to higher general government revenue in 1998 will be made by higher sales tax rates. In January the sales tax rate on services in the first tariff group was raised from 5% to 6.5%. Sales tax rates on oil products were also raised. In March there was a considerable rise in the tax on carbon dioxide emissions. Judicial and registration duties were also raised. The Act on Administrative Duties, which will increase those duties, is before the Parliament. The tax on payrolls remained a tax source in 1998, and is foreseen in a new bill to be modified in a way to raise the lowest levels of wage taxation. The bill is, however, still before the Parliament; once it is adopted it will reduce government revenue. To comply with the association agreement, customs tariff rates will be further reduced in 1998 and therefore revenue from this source will shrink.

To help reduce the general government deficit in 1998, the Government foresaw in its austerity programme the sale of some state assets amounting to SIT 11.5 billion and revenues from the profit sharing of public utility companies and banks amounting to SIT 5 billion. As in 1997, this year's fiscal year for the collection of sales taxes will be prolonged until 15 January 1999. General government revenue, including the prolonged financing of the state budget into January 1999 and the foreseen revenues from the sale of state assets, should increase in real terms by 5.2% to account for 45.1% of gross domestic product, up 0.5 percentage points compared to 1997.

On the side of general government expenditures, expenditures stemming from the realisation of law and other acts on pension and disability insurance are expected to rise in real terms by 3.2%. New retirements are still growing at 1%, and additional pressure for retirements is expected due to insecurity arising from the forthcoming pension reform. The expenditures on pension and disability insurance will thus represent 13.2% of gross domestic product in 1998, down 0.1 of a percentage point from 1997.

The scope of programmes and benefits in the compulsory health insurance should be roughly the same in 1998 as they were in 1997. The expenditures for mandatory health insurance will account for 6.7% of gross domestic product, down 0.1 of a structural point from 1997. Local government expenditure is not expected to change in 1998 and should represent 4.8% of gross domestic product in 1998.

The accumulation of pressures on budget expenditures has led to considerable difficulties in balancing this year's budget, despite the proposed austerity measures. The Budget was eventually passed in April. This year's central budget expenditures should amount to SIT 870.5 billion, in nominal terms 15.4% more than last year. This amount also exceeds the level proposed in the first draft budget as well as in the budget memorandum for 1998.

In the structure of central budget expenditures, there has been an increase in the share of appropriations for purchases of goods and services, interest rates, guarantees, subsidies and transfers to the business sector and gross fixed capital formation. The austerity measures brought about a reduction of expenditures for wages from 27.3% in 1997 to 26.7% in 1998. However, transfers to the pension fund will still represent a substantial part of expenditures. It will account for 14.5% of central budget expenditures and 3.9% of gross domestic product. The central government expenditures (excluding transfers to other public finance funds) are expected to rise in real terms by 7.3% in 1998.

General government expenditure should increase in real terms by 4.9% in 1998. Its share in gross domestic product should rise from 45.7% in1997 to 46.1% in 1998. The general government deficit is estimated to account for 1% of gross domestic product.

Despite the endeavours of economic policy to reduce the government deficit and the foreseen taxation reform, **1999** is not expected to entirely avoid a deficit. The introduction of the value-added tax and excise duties is scheduled for the middle of 1999. Both the value-added tax bill and the excise duties act are still undergoing parliamentary procedure. The rates of the value-added tax proposed in the bill (a general rate of 19% and a reduced rate of 8%) are lower than originally foreseen (a general 20% rate). For this reason, payroll tax will remain in force although it was planned to be abolished in 1999. Due to the forecast slower growth in wages, the wage-based general government revenue is also expected to fall. Furthermore, the revenues from customs duties will further shrink, although this shortfall was in the original value-added tax bill proposed to be covered by the higher revenues from the value-added tax. The budget expenditures in the future will also be exceptionally covered by sales of state assets. At the same time, the inflow from the management of the state financial assets should be increased. Under all of the above-mentioned assumptions, the general government revenue is expected to fall to about 44% of gross domestic product in 1999.

Non-increasing general government expenditure should remain one of the economic policy goals of 1999. There are many measures that will be unavoidable in the reduction and redistribution of budget expenditures in all segments of budget expenditure. Those measures should be focused on the abolition or slower pace of the realisation of selected programmes and investments, including the regular monitoring of financing of certain tasks arising from the central budget. Some of the existing tasks should be transferred to contractors which are not financed from the general government budget, in the sense of privatisation of selected activities, which should relieve pressure on public financing. Only by finding appropriate systemic solutions that will define anew the state's role in public financing will the government be able to control the growing general government expenditures and reduce the gap between general government revenues and expenditures.

7.2. MONETARY POLICY - LOWER INTEREST RATES, REDUCED FOREIGN BORROWINGS AND HIGHER DOMESTIC BORROWING AT THE BEGINNING OF THE YEAR, ALONG WITH MODERATE GROWTH IN MONETARY AGGREGATES

The M3 money supply aggregate grew 22.9% in 1997, 0.9 higher than the upper ceiling of the Bank of Slovenia's annual target. M1 grew 19.4%, whilst the tolar-denominated savings and time deposits rose 35.7%. The time deposits for over 1 year soared 67.7%. On the other hand, households' foreign-exchange deposits grew only 5.8%, mostly due to changes in exchange rate ratios. In February 1998, the Council of the Bank of Slovenia assessed the monetary policy as being in line with its main orientations and that therefore it should not be changed. According to the target set for 1998, the growth of M3 aggregate should range between 18% and 26%. In the first quarter of 1998, M3 grew 18.2% in annual terms.

Monetisation of capital flows from abroad was the main source of issuing money in 1997. Banks purchased net SIT 61 billion of foreign money from companies and SIT 79.8 billion from exchange offices (in 1996 SIT 57.5 billion altogether). With its intensive foreign exchange intervention, the Bank of Slovenia transferred all net flows and additional current foreign exchange liquidity to the foreign exchange reserves of the BS, of which SIT 92.7 billion was purchased directly from banks and SIT 127.1 billion with the net issue of foreign exchange treasury bills.

In 1997 the total foreign exchange reserves of the Bank of Slovenia and banks increased by US$ 681 million (excluding the effect of inter-currency changes), of which the reserves held by the BS were up US$ 1,287 million and reserves with commercial banks dropped accordingly. At the end of the year, foreign exchange reserves stood at US$ 4,337 million (of which US$ 3,297 million were held by the BS), exceeding by 3.9% the stock of foreign debt (by 3.0% in 1996) and covering 4.9 months of average imports of goods and services (4.6 months in 1996).

In 1997, the bank's claims on the domestic non-banking sector rose by SIT 140.8 billion or 14.2%. Loans to households rose moderately compared to previous years (by SIT 33.1 billion or 16.0%), whilst investment in the government sector rose substantially, namely by SIT 29.1 billion in loans (a 71.5% rise) and by SIT 21.5 billion in commercial papers and bonds. Loan activity to companies was rather weak before September 1997 (a rise by SIT 23.9 billion in the first nine months), but jumped in the last quarter by SIT 33.4 billion. Thus, the annual rise was 12.0%.

However, in 1997 companies tended to raise more loans abroad (including money flowing from direct investments) than with domestic banks.

After December 1997, the issue of money from foreign exchange transactions waned somewhat (in the first quarter of 1998, foreign exchange reserves dropped by US$ 25 million), whilst the loan activity of domestic banks further increased. Loans to companies increased by a further SIT 31.2 billion in the first quarter. March saw an increase in loans to households, altogether by SIT 11.5 billion. Although in January and February the government sector raised loans with banks amounting to SIT 14 billion in the form of RS09 bonds, it was still a net repayer of loans.

In 1997, household savings with banks increased by 21.3% (all bank deposits), slightly less than a year earlier. In the first three months of 1998, however, they rose by a solid 6.8%. The shift from foreign currency to tolar-denominated savings was even more pronounced than in the previous year. In the year up to March 1998 the share of foreign currency deposits in total deposits shrank from 55.6% to 48.5%, whilst the share of tolar time-deposits increased from 23.2% to 31.6%. Short-term time deposits rose more than deposits for over 1 year. At the end of March, the latter represented only 19.1% (SIT 48.0 billion) of all tolar time-deposits of households. The high growth in long-term tolar deposits with banks mostly originated in the non-banking financial organisation sector.

Since the middle of 1996, the BS has offered primary money to banks mostly by way of final or temporary purchase of foreign currency, with tolar sterilisation of the excess intervention. This pattern no longer permits direct control over bank liquidity since banks have comprehensive secondary liquidity in the form of tolar treasury bills of the BS with different maturity periods. At the end of March 1998, this portfolio stood at SIT 68.9 billion, of which SIT 14.3 billion involved maturity periods of up to 60 days.

Good liquidity is also reflected in a reduction of the “real” part of the interest rate on the inter-bank money market from 1.9% in the first quarter of 1997 to -1% in the first quarter this year. In the same period, the total nominal interest rate remained almost unchanged, although oscillating between 8.5% and 10.5% due to the parallel growth of the basic interest rate (TOM) from 7.6% to 10.2% at the annual level.

Despite satisfactory liquidity and a growing pallet of financial resources from abroad at lower interest rates, bank interest rates in Slovenia did not fall markedly in 1997. Some adjustment to the situation on the market was made in early 1998. In the year to April, average bank interest rates fell from 11.7% to 8.5% above TOM for long-term loans, and from 10.5% to 7.3% above TOM for short-term loans. At the same time, average deposit interest rates fell from 3.7% to 2.3% above TOM for time deposits from 31 to 90 days, and from 6.3% to 5.3% above TOM for time deposits for above 1 year. This trend should continue this year although it is restrained by the level of inflation, that is by the problem of bringing deposit interest rates below the level of inflation. This is a precondition for domestic banks to match the foreign competition on the side of loans.

1997 saw an improvement of the liquidity of the business sector as measured either by the growth in assets in giro accounts (an annual rise of 24.8%) or growth in total bank deposits (a rise by 28.3%). In both cases, business sector liquidity increased also relative to growth in household deposits or in the government sector. Apart from adequate financing, mostly from abroad, this was mostly due to higher revenues from exports in the second half of the year (due to growth in the volume of exports and depreciation) and slower growth in costs. This trend was reversed in the first quarter of 1998. Companies increased their borrowing, mostly with domestic banks and at the same time drew money from bank deposits. In the same period, household deposits increased dramatically, both pointing to growth in wages and other remuneration (holiday bonuses) since December 1997.

7.3. INCOMES POLICY - GROWTH IN AVERAGE WAGES LAGS BEHIND PRODUCTIVITY GROWTH

Incomes policy should facilitate wages growing slower than labour productivity and thereby improved competitiveness of the economy. The **incomes policy for 1997** did fulfil this goal.

In the first half of 1997 (including May), wages were regulated by the Social Agreement for 1996 and the Act on the Implementation of the Social Agreement. In July the Minimum Wage and Wage Adjustment Mechanism Act was passed and will remain in force until the middle of 1999. Based on the experience of wage developments in 1996, the new Act is not restricted to regulating wages in the private sector as a whole, but includes specific provisions restricting wages growth based on individual agreements and base wages regulated by collective agreements. The wage adjustment mechanism as prescribed by the Act also covers the public sector. Indexation of base wages in line with price rises occurs only once a year, and that is by 85% of price rises. However, the Act incorporates a safeguard mechanism for the case when prices grow faster than originally expected. Payments based on positive business results are also regulated by the Act, and should not exceed the level of one average wage. The minimum monthly wage was set at 59,150 SIT.

In the period from June to December 1997, gross wages per employee covered by individual agreements rose nominally by 5.0%, slower than gross wages per employee covered by the collective agreement (7.2%). In the same period, the nominal gross wage per employee in the public sector rose by around 8%. In the period from December 1996 to December 1997, nominal gross wage per employee grew 12.1%. Deflated by the rise in retail prices - in 1997 still used as a general deflator - wages rose in real terms by 2.5%. In 1997 compared to 1996, average gross wages per employee rose nominally by 11.7 and in real terms by 2.4%. The growth was thus about 1.5 percentage points below growth in labour productivity (3.8%).

This year wages are still regulated by the Minimum Wage and Wage Adjustment Mechanism Act. In the first three months of 1998, wage movements were moderate in nominal terms whilst in real terms wages even slightly declined in all three months. Slow movements in wages at the beginning of the year were recorded in the private and public sectors. Taking into account seasonal rises in wages during the year and payments of Christmas bonuses in the private sector at the end of the year, gross wages are forecast to grow in real terms by 2.5% in 1998 compared to 1997. However, to achieve that rate of growth, wages in the public sector must not be raised before December 1998. This is one of last year's austerity measures aiming at reducing the government deficit. In the past period, the total wage bill in the public sector considerably increased due to promotions to higher income brackets, some annexes to collective agreements and new employment. This year, however, the public sector should not engage new employees, nor promotions, and no new annexes can be added to collective agreements. The annex to the collective agreement for doctors and dentists, which introduced certain wage supplements to bring their earnings closer to those of judges, and a foreseen rise in professors' salaries, have increased the chance of a spill-over effect in the public sector.

The Minimum Wage and Wage Adjustment Mechanism Act expires in the first half of 1999. Since this coincides with the introduction of the value-added tax, the interests of all social partners in the formation of the **1999 incomes policy** guidelines have to be brought into line in the shortest possible time.

The measures can be of different kinds, but the combination of a change in the personal income tax and a one-off rise in social benefits seems the most appropriate solution. By appropriate incomes and taxation policies, gross wages are estimated to rise in real terms by 2.3% in 1999, which would be around 1 percentage point lower than labour productivity growth.

The minimum wage set by the Minimum Wage and Wage Adjustment Mechanism Act is adjusted by growth in prices in the same way as wages in the private sector. In addition, the minimum wage level is corrected by a rise in gross domestic product once a year, to follow movements in general economic growth. The minimum wage has thus reached the level of the third tariff class in the general collective agreement and in at least three sectoral collective agreements, which might cause problems to the wages policy at the level of individual firms.

Compared to the European countries also having a minimum wage, Slovenia's minimum wage is relatively high. By reaching 48.7% of the average wage in manufacturing, it belongs to the upper half of European countries that have a minimum wage (Portugal, 59%, France, 59%, the Netherlands 49%, Belgium 48%, Luxembourg 47%, Greece 44% and Spain 42%). For Slovenia the ratio is, however, even slightly higher, since the wages of all those employed in manufacturing are taken into account, whilst international comparisons only include wages of blue-collar workers. The present minimum wage level is still acceptable. Further growth could diminish the positive role and deepen the negative consequence (disorder in the wages policy at the level of individual firms). The minimum wage has had a positive role since its institution, as it holds back the tendency of growing disparities between wages.

In March 1991, gross wages in the top 10% of the employed exceeded gross wages in the lowest 10% of employed by 3.05, in March 1992 this ratio was 3.11, in March

1993 3.33, in March 1994 3.22, and in March 1995 4.12. The Wage Agreement for 1995 for the first time instituted the minimum wage level for May that year. This was most likely the reason why the ratio fell to 3.29 in September and has since then remained at roughly the same level.

In 1997, **work-related allowances and other remuneration, as well as payments based on work contracts and service agreements**, grew more slowly than in previous years, in real terms by 1.4% compared to a year earlier. The percentage of these allowances in the total wage bill remained roughly the same (44%), although this level is still too high. This year, movements in these allowances show no signs of falling, but also no signs of increasing.

7.4. PRICES AND PRICE POLICY - CONDITIONS FOR A SLOWDOWN IN THE GROWTH OF CONTROLLED PRICES ARE FULFILLED

In the period from December 1996 to December 1997, retail prices increased by 9.4%, and the average annual inflation was 9.1%. Consumer prices, the official measure of inflation since 1 January 1998, increased by 8.8% in December-on-December terms and by 8.4% in average annual terms. In the first few months of this year, inflationary developments have followed last year's pattern, that is a higher rise in prices at the beginning of the year and a slowdown in the summer months. In May 1998, inflation was 4.9% over December 1997 and 8.3% in average annual terms.

Last year, price policy followed its strategic orientations and corrected price disparities more intensively. A number of changes were introduced in price control: prices of certain products were liberalised and price control itself was modified. Prices of controlled products and services increased by 16.5%. This contributed 4.5 percentage points to the 9.4% inflation. Prices of energy fuels increased on average by 21%, prices of oil products by 22.5%, and prices of household electricity 15.2%. Significant price rises were also recorded in postal services and telecommunications (13.9%), municipal utility services (12.6%) and compulsory car insurance (15.8%).

Last year, prices of urban passenger transport, basic bread types and some municipal utility services (food market, parking and funeral fees) were liberalised. The government also modified control over prices of natural gas pipeline supply and prices of heat and hot water distribution.

A harmonised consumer price index became the measure of inflation in January **1998**. This index measures changes in prices from the aspect of final consumption and no longer from the retail sale aspect as was the case in the previous retail price index. The new index was introduced to bring the measure of price movements in line with those used elsewhere in the world, including the EU.

The short-term **inflation target** this year is for average annual inflation of around 8%. Any larger reduction of inflation is not expected, as certain price distortions still need to be corrected this year. Besides, liberalisation of certain prices as well as the necessary fiscal changes will further fuel inflation.

In the first four months this year, controlled prices rose by 5.6%. They contributed 1.3 percentage points to the 4% inflation of that period, also taking into account the effects of liberalisation of some products and services. The prices of energy fuels rose on average by 7.7%, and the price of household electricity is 8% higher. Prices of oil products were raised twice this year, each time by an average 7.7%. Gasoline prices rose by 9.6%, but certain discounts were allowed on the prices of light fuel oil (-10.1%) which contributed to somewhat slower growth in the prices of energy fuels. Relative prices rose also in municipal utility services (8.7% in real terms) and railway passenger transport (6.7% in real terms). Price rises also occurred due to the changed tax rate on services (an increase of 1.5 percentage points) in February and higher tax on transport services (by an average 6.5%). The municipal tax on road use increased by 51%.

In April the wholesale prices of medicines and medical equipment and prices of fresh pork were liberalised to comply with the free-trade agreement with the EU. Liberalisation of meat prices coincides with the coming into force of the Additional Protocol to the CEFTA Agreement which will lead to further liberalisation of trade in agricultural products between CEFTA members. Hence, the market of agricultural products has opened up further. However, a programme of intervention prices was prepared to protect domestic producers of wheat, milk, beef, pigs and small cattle and to prevent possible distortions of the market due to a slump in the purchase prices of agricultural products. In 1997, the purchase prices of agricultural products decreased on average by 2.2% in real terms over a year earlier, and in the first two months this year by 1.2% in real terms compared to the same period last year.

There are only three products left in the basket of agricultural prices controlled by the government, namely flour (prices of wheat and wheat flour from commodity reserves are controlled), white crystal sugar and cow milk. In the case of the latter, the government now controls purchase prices rather than retail prices.

This year, positive impulses for lowering inflation have come from wages, lower customs tariffs, lower interest rates and, in the first months, also from a real appreciation of the tolar.

The value-added tax and excise duties will be introduced **in the middle of 1999**. The introduction of the value-added tax should affect the **aggregate growth in prices**. Excluding the effect of the value-added tax, inflation should average 6.5% in 1999, as a large part of price corrections were made in 1997 and 1998. It is difficult to measure the total effect of the value-added tax on inflation, since it depends on the efficiency and concordance of key macroeconomic policies. Taking into account the estimated inflation without the value-added tax and the calculations of the inflationary effect of the value-added tax (Bole, 1998), the average annual inflation should remain a single digit in 1999. A one-off rise in prices is expected, which should, however, level off in two months after the introduction of the value-added tax. The confidence of economic entities in the economic policy programme will be crucially important and should be established prior to actual introduction of the value-added tax. Inflation should be stable and average out at the lowest possible rates at least one year before the introduction, which is a precondition for the price pressure of the value-added tax having a truly one-off character. The optimal effect on prices would be achieved if inflationary impulses from the side of price policy were neutral, preventing the cost (multiplication) pressures from the side of unregulated prices. The effect of the value-added tax could be reduced or even entirely annuled by the concerted action and greater determination and restrictivity (compared to the present measures) of all economic policies bearing any effect on prices.

7.5. MICROECONOMIC POLICY - FOSTERING STRUCTURAL REFORMS AND INCREASING COMPETITIVE ABILITY

The reforms of the corporate and banking sectors will have to continue and even accelerate this and next year. This is also due to the expected synergy between the restructuring of the corporate sector and adaptation to the economic system in the European Union. Privatisation is one of the main levers as well as indicators of the level of corporate restructuring. Along with completion of privatisation of social ownership and enforcement of the completion of privatisation law, privatisation of state ownership is still in the pipeline. The government will, by offering state ownership for privatisation, speed up the process of restructuring infrastructural activities and public utilities and together with the regulation of sectoral laws create proper conditions for a gradual and controlled demonopolisation of these activities. To comply with the adopted Strategy for Accession to the European Union, the process of privatisation of the main public utilities and banks in state ownership should begin.

Given the fact that new investment represents the main lever of corporate restructuring, there is a need for a more favourable investment climate in Slovenia. Apart from macroeconomic stability, this calls for the reform of the financial sector (opening of the market, lowering of costs of financing) and encouragement of equity investment in companies. Increasing competitiveness of the corporate sector by horizontal programmes of structural adaptation and encouraging entrepreneurship will only be possible by improvement of investment conditions. A high degree of internationalisation is the key factor of competitiveness of Slovenian economy, but it requires competitiveness in programmes and products, innovation and cost competitiveness. Promoting foreign direct investment is only one of the programmes of horizontal competitiveness strategies, together with an efficient relation to research and development sphere, realisation of programmes of technological modernisation, informatisation, and creation of conditions for companies to efficiently enter the foreign markets. Apart from large-size companies - the main actors of product development - the role of small and medium-sized companies grows, in production activities as well as services. Offering competitive support to exports of goods and services and supporting corporate restructuring will remain the two specific roles of the two key para-state institutions, namely the Slovene Export Corporation and Development Corporation of Slovenia.

8. PROJECTIONS OF MAIN MACROECONOMIC CATEGORIES UP TO THE YEAR 2002

8.1. STARTING POINT - MACROECONOMIC SITUATION AND ACHIEVING THE GOALS SET OUT IN THE STRATEGY FOR ECONOMIC DEVELOPMENT OF SLOVENIA (SEDS) AND THE STRATEGY OF THE RS FOR THE ACCESSION TO THE EU

Results achieved in recent years and short-term development prospects for the period up until 1999 show that economic development in Slovenia is following a course somewhere between the two scenarios of the SEDS. The economy is going through a sensitive transitional period, when the current level of transition to a stable market economy still does not guarantee competitive macroeconomic environment for a rapid and lasting economic growth. The Strategy for Accession to the EU has been reflected in the National Programme for the Adoption of the *Aquis Communautaire*, but the likelihood of delays in some areas already exists. Not all decision-makers in public administration realised that the planned sequencing involves an international commitment for the country. Nor has the Parliament organised itself in a way suitable to the amount and kind of work which has to be done in the pre-accession period. Slowness in EU legislation harmonisation and a poor response to public administration institutional reforms may even influence the year of actual accession to the EU. At the same time, the delays are being reflected in the difficulties which economic policy faces in achieving and adjusting the key macroeconomic targets (curbing inflation, rapid economic growth and higher employment). The current inflation level (between 8% and 9%) seems to be highly persistent. Cutting it further not only involves the still unexploited inflationary effects of fiscal reform but also all economic policy makers and successful negotiation of the social agreement. The persevering unemployment is also persistent. In this area, the target of development can only be attained following long-term systemic changes to the labour market.

The current economic policy for 1998-1999 should improve structural relations in primary and final distribution of GDP. The share of labour costs and state expenditure should drop in favour of higher national savings and corporate funds allocated to development. This would provide a basis for investment impetus in manufacturing. The implementation of structural reforms necessary for the full entering of Slovenia into the European union together with technological development and investment will provide possibilities for further rises in labour productivity. Such development would be in line with the positive development scenario (+) drafted in the SEDS. Only in this way would Slovenia be able to integrate into the EU within the next 5 to 7 years without substantial domestic turmoil and ready itself as a country acting as an equal and competitive economic partner.

If before the year 2000 economic policy is not able to reduce the inflation rate and improve distribution ratios in favour of savings and investment, thus providing for balanced public finance, we could see the realisation of the negative development scenario (-) of SEDS. This would probably stop the process of harmonising Slovenian legislation with that of the EU. In this case, even after the year 2000

Slovenia would still be facing problems typical of economies in transition; namely with rehabilitation programmes, restructuring and macroeconomic instability.

8.2. ECONOMIC GROWTH AND INVESTMENT - ACHIEVING HIGH LEVELS OF ECONOMIC GROWTH DEPENDS ON INVESTMENT RETURNS, NATIONAL SAVINGS AND PROGRESS IN REFORMS

Slovenia has reached a point in its development where it needs quick and stable economic growth in order to finalise its transition to a market economy and eventually integrate into the European internal market. A decisive role in this process will be played by foreign markets. In the next few years, private and public expenditure will not influence economic growth as they have so far - what is needed is active incomes and fiscal policies which should by cutting back the respective types of expenditure boost the export competitiveness of the Slovene economy.

Table 16: Final domestic demand - national accounts estimates

	Structure in %			Real growth rate in %	
	1998	**1999**	**2002**	**1999**	**Average 2000-2002**
Final consumption	76.5	76.5	76.2	4.1	4.7
- private consumption	56.0	56.3	56.7	4.6	4.8
- government consumption	20.5	20.2	19.5	2.4	4.3
Gross fixed capital formation	24.4	24.6	25.6	6.5	6.0

Source: IMAD target development scenario.

Excess capacities and the expansion of existing production combined with uncertain future trends in foreign demand are not in themselves the sufficient basis of a quick economic growth. The latter is becoming ever more dependant on new business investment. Completely new product lines are needed to stimulate exports and production. Next year, gross capital formation is expected to slightly exceed 25% of GDP - an acceptable level in the long run. The efficiency and returns of these two factors must be improved if we want them to have a positive impact on economic growth. This can be achieved by enhancing the current investment structure so as to raise the shares of business investment and investment in equipment, technology and human resources as well as by allowing more foreign direct investment. The marginal capital coefficient is expected to improve from 8.4 in 1996 to 7.0 in 1998 and reach 6.0 in 2002.

The first condition for sufficient and quality investment should already be met this year. The finalisation of privatisation or ownership restructuring will enable industry to focus on legal status issues and more demanding development issues which will only inspire additional interest in transferring knowledge and technological progress to companies and creating the conditions for introducing new products and investment projects.

The second condition for new investment is rapid completion of the economic restructuring in the framework of the Development Corporation of Slovenia. This institution is expected to efficiently rehabilitate those companies in difficulty which failed to privatise themselves, and to enable production factors to be used for other purposes. The government will back the economic restructuring programme with budget funds, thus providing for quick solutions to this part of the ailing economy. This will prevent the inherited inadequate economic structure continuing into the future, burdening the taxpayers and hindering the development of successful companies.

The third condition is an appropriate macroeconomic policy ensuring an economic environment as stable and investment-friendly as possible. The current economic policy is primarily oriented towards reducing inflation and interest rates to levels comparable to European countries, preserving the external balance by achieving a macroeconomically sustainable current account deficit, further globalisation of the domestic economy and opening up of the market to foreign competition. Given the implementation of structural reforms and continuation of European integrations, this will lead to a better credit rating for Slovenia and a lower country risk. This is the best policy for attracting foreign capital in order to mobilise it for the modernisation and development of the Slovenian economy.

The economic policy, paying attention to the macroeconomic balance, is to provide for an adequate level of national savings. This represents the basis for efficiently solving problems concerning monetary and exchange policies, the two being too restricted by the smallness of the domestic monetary system. The inadequate national savings level makes these two policies considerably more vulnerable to unfavourable effects of international capital flows, mainly the inflow of speculative capital seeking quick gains by taking advantage of weak capital markets.

Table 17: Gross fixed capital formation - target development scenario

	Structure in % (gross fixed capital formation=100)		
	1998	1999	2002
GROSS FIXED CAPITAL FORMATION	100.0	100.0	100.0
Economic infrastructure	21.4	21.6	20.6
Certain services [1]	6.7	6.5	6.5
Enterprises	57.4	58.1	60.3
Dwellings	14.5	13.8	12.6

Source: IMAD target development scenario *Note*: [1] Education and culture, Health and social work, Public administration.

Another condition which has to be met for investment cycle and long-term sustainable economic growth is the liberalisation and development of the financial market, facilitating a cheap and efficient transfer of capital from savings to investments.

An industrial development pattern based exclusively on expansion of existing production which can be sold on foreign markets, is not suitable from the point of view of environmental protection. Urgently needed is an active strategy to reduce pollution intensity (through technological upgrading, employment of economic instruments for a more efficient consumption of energy and raw materials and installation of purifying plants). This can be significantly assisted by energy prices policy, technological policy and an adjusted fiscal policy.

The development strategy, environmental protection and accession to the EU are the objectives strategically supporting each other. However, the measures of various policies and structural reforms should be better linked to the environmental protection goals.

The target development scenario counts on moderate economic growth (4% in 1999 and 4.5% to 5% up to the year 2002). One needs to be cautious in such a forecast, since Slovenia's current economic development is above the levels of other countries in transition and near those recorded by the less developed EU member-states. In such conditions, each and every percentage point of economic growth is a success, especially if the country inevitably needs to continue with its restructuring, revitalisation programmes of production and great institutional changes. One of the elements preventing higher economic growth rates is the rehabilitation of companies owned by the Development Corporation of Slovenia - this is because several dozen companies, which are nevertheless important in overall production and exports, have stopped producing. The target economic growth rates between 4% and 5% are below what they could have been, but still above those anticipated in EU member states. They are still high enough to give Slovenia a chance of quickly catching-up the most developed European countries.

8.3 THE PRODUCTION STRUCTURE OF GROSS DOMESTIC PRODUCT - INCREASING SHARE OF THE SERVICE SECTOR AND INDUSTRIAL PRODUCTION GROWTH

The tendency to gradually move towards the production structure of small developed European countries is expected to continue. The share of market services is also expected to continue its upward trend. These trends reflect a global process resulting from technological advancement and from the economic rule of the transition to an economically better developed society. Agriculture is expected to adjust its production structure, i.e. increase crop and animal production based on locally produced fodder (cattle, sheep, goat and pig farming). The state is expected to encourage this policy by conforming the instruments of its agricultural policy to European standards and increasing its intervention in those areas of agriculture considered to be of high priority. The share of industry and construction is expected to stabilise at a good 38% of value added. This could be achieved with a real growth of manufacturing of 2% to 3% per annum, to be followed by increased supplies of energy, gas and water. The construction industry is expected to achieve a higher rate than the projected GDP growth. The share of state services in the GDP is expected to fall, whilst the share of market services is expected to increase. In addition to tourism, transportation, trade and the market share of services in health and education, the highest rise is expected in the financial service sector, in which Slovenia is lagging far behind developed countries. The share of services in value added is expected to increase to 60% by 2002.

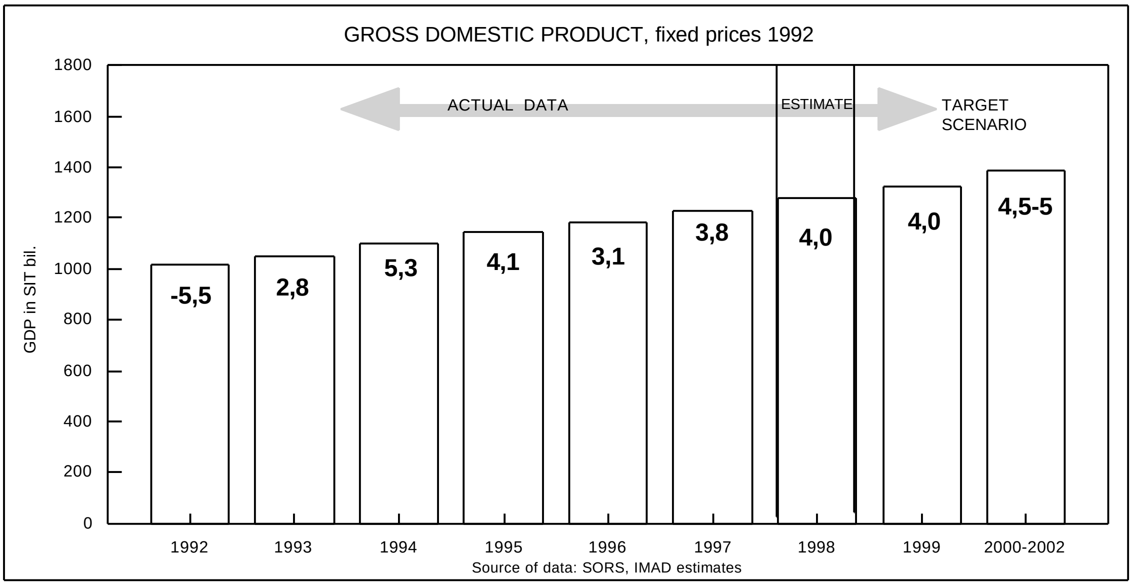


Table 18: Output structure of gross domestic product, by sectors NACE - Rev. 1

	Structure in %		
	1998	**1999**	**2002**
	(current prices)		1999 prices
1. VALUE ADDED	**86.1**	**85.5**	**85.5**
Value added	100.0	100.0	100.0
- Agriculture, fishery (A+B)	4.5	4.5	4.2
- Industry and construction (C+D+E+F)	38.5	38.6	38.3
- Services (G...O)	59.3	59.3	59.8
- Inputted bank services	-2.4	-2.4	-2.2
2. NET TAXES ON PRODUCT	**13.9**	**14.5**	**14.5**
3. GROSS DOMESTIC PRODUCT (3=1+2)	**100.0**	**100.0**	**100.0**

Source: Target development scenario IMAD.

8.4 DEMOGRAPHIC TRENDS, EMPLOYMENT AND UNEMPLOYMENT - ECONOMIC DEVELOPMENT DURING THE TRANSITION TO MARKET ECONOMY GIVES PRIORITY TO LABOUR PRODUCTIVITY OVER EMPLOYMENT

Because of the low birth rate, which has already reached the lowest EU birth rate levels, and given the continued annual immigration of 1,000 people, it is expected that the population of Slovenia will remain stagnant. The percentage of children in the population will continue to fall, whilst the percentage of the population aged 65 and over is expected to continue rising. Due to increased enrolments in secondary schools, and the rising number of final-year university students, the average schooling time is growing, therefore delaying the inflow of youth into the labour market. An increased inflow of university graduates into the labour market can be expected over the next few years, whilst it is anticipated that the number of people with incomplete secondary or vocational schooling will fall. Demographic trends demonstrate that the size of the labour force is expected to gradually increase by 2002. The current age structure of the labour force does not show any significant growth in the number of new annual retirements, and the number of pensioners is therefore also expected to rise only gradually during this period.

Table 19: Labour force, employment, and unemployment in Slovenia

in 000

	1998	**1999**	**2002**
Population total	1,987.1	1,987.2	1,987.5
- 20-59 years old	1,136.8	1,143.3	1,157.5
Labour force	872.7	879.3	892.1
- as % of total population	43.9	44.3	44.9
- as % of population 20-59	76.8	76.9	77.1
Employment	747.1	752.4	780.6
- year change in %	0.5	0.7	1.5
Registered unemployment	125.5	127.0	111.5
- Standardised (ILO) unemployment rate	7.1	7.1	6.9

Source: IMAD target development scenario.

Further developments in employment and unemployment will largely depend on the success of the economic policy encouraging investment into knowledge and increasing productivity. Demographic trends and economic development which gives priority to labour productivity over employment will not enable a rapid fall in unemployment. The projected increase in employment can only be achieved with the implementation of an active incomes policy, ensuring that increases in wages will lag behind growth in labour productivity.

8.5 INTERNATIONAL ECONOMIC RELATIONS - INCREASED BALANCE OF PAYMENT DEFICIT AND REAL GROWTH IN GOODS AND SERVICES FLOWS

The development scenario anticipates an average growth in exports of 5.5% in real terms over the next few years. In the long run, the domestic market is too small to provide sufficient demand locally. In addition to this, domestic demand is limited by the inferred incomes policy, which must guarantee the required level of national savings and the competitiveness of production by keeping the level of growth of gross wages below that of labour productivity. Faster growth in imports of 6.7% is expected to provide an adequate import component in domestic production (imports of intermediate goods) and growing investments (imports of equipment and technology). According to the development plan, the imports of equipment as a percentage of total imported goods is expected to exceed 20%.

Table 20: Structure of imports of goods by end use

in %

	1998	1999	Average 2000-2002
Imports of goods total	100.0	100.0	100.0
Investment goods	17.5	18.0	19.8
Intermediate goods	59.0	59.2	59.7
Consumer goods	23.5	22.8	20.5

Source: Target development scenario IMAD.

A real increase in the volume of exports can only be achieved (not least due to environmental limitations) by raising the share of value added per unit of exported goods. Greater investment activity, in addition to a better supply of high-quality imported materials, is expected to result in the production of new products that will become more competitive on the international market. Only an extensive (quantitative) increase in exports within the framework of existing production lines would be subject to restrictions in bulk and environmental protective measures, as well as to limitations represented by foreign demand. This is an inappropriate development scenario for Slovenia.

On the other hand, exports growth is restricted by current production capacities. Most exports are still industrial products, i.e. from the sector undergoing the most extensive restructuring. The recovery programme of the Development Corporation of Slovenia will also affect the exports as it covers some important exporters. The long-term effect of this on the economy will be encouraging because these companies are still exporting non-competitive goods in a bid to survive. In the short run, it will lead to a recession and contribute to a relatively slower increase in manufacturing share of GDP.

Table 21: Current account of the balance of payments

	In US$ million			As a % of GDP			Real growth rate in %	
	1998	1999	2002	1998	1999	2002	1999	average 2000-2002
Exports of goods and services	10,680	11,450	13,470	55.7	53.9	55.1	5.5	5.6
- Exports of goods	8,660	9,355	10,975	45.1	44.0	44.9	5.5	5.5
- Exports of services	2,020	2,095	2,495	10.5	9.9	10.2	5.7	6.0
Imports of goods and services	11,000	11,860	14,364	57.3	55.8	58.8	6.5	6.6
- Imports of goods	9,560	10,390	12,633	49.8	48.9	51.7	6.7	6.7
- Imports of services	1,440	1,470	1,731	7.5	6.9	7.1	5.4	5.6
External balance of goods and services	-320	-410	-894	-1.7	-1.9	-3.7		
- Goods	-900	-1,035	-1,659	-4.7	-4.9	-6.8		
- Services	580	625	764	3.0	2.9	3.1		
Current account balance	-80	-150	-400	-0.4	-0.7	-1.6		

Source: Target development scenario IMAD. ***Note***: 1998 and 1999 current prices and current US$ exchange rate; 2002 prices and US$ exchange rate 1999.

Due to company restructuring, it is quite probable that the growth rate of exports in the initial period of the development scenario will lag behind those recorded in European and global markets, and that such a growth rate will not increase the country’s share on foreign markets.

Expectedly, a more accelerated growth in the domestic service sector will be reflected in a greater international services trade. The service sector is likely to grow rapidly both in terms of imports and exports. Only a slight surplus is anticipated in the exchange of services. Such a development policy is expected to cause Slovenia's foreign trade deficit increase gradually, reaching US$ 1.7 million by 2002. The surplus in the services part of the balance of payments is unlikely to cover this deficit in its entirety. The deficit on the balance of payments current account is expected to amount to US$ 400 million in 2002. The net inflow of foreign accumulation will increase the available domestic investment funds and facilitate the restructuring of the economy. It would be advantageous if financing were to be conducted from direct capital flow as much as possible, further guaranteeing that these funds would not raise local expenditure but would instead be directed towards development.

The internal structure of export and import service flows is not expected to undergo major structural changes. There are still, for example, many unexploited opportunities in the tourist sector (existing excess capacities, expansion of existing capacities, potential increases in the quality and prices of services, etc.), which could support the prospect of increasing the share of tourism in total services exports. On the other hand, it is also true that the very same opportunities can be found in other fields such as international transport, communications and financial and other market services.

The target development scenario envisages greater regional diversification of goods trade by 2002. The share of exports to European Union countries is expected to fall (although exports to EU countries will increase in real terms) because of increased exports to other countries, especially CEFTA countries and those from the former Yugoslavia.

Slovenia is not well involved in international capital movements. A step forward in this direction would require improvements to institutions, instruments of regulation and legislation. Only when this condition has been fulfilled can our financial sector assume a position within the national economy that corresponds to financial sectors in countries with better developed systems of market regulation. The target scenario for economic policy anticipates a large increase in gross capital flows. The outflows consisting, for the most part, of loan repayments, both recently acquired loans (granted for the accelerated construction of infrastructure and environmental protection) as well as those obtained while Slovenia was still part of the former Yugoslavia. Whereas the most important type of capital export currently lies in the form of investment in the national foreign currency reserves, capital outflows from the private sector are expected to increase in the future (establishing companies abroad or crediting purchasers of our exports, for example). In addition to international loans for infrastructure and greater aid from the European Union via the PHARE, ISPA and SAPARD programmes, inflows are expected to be also augmented by increased foreign investments. The latter would be assisted and facilitated primarily by the completion of the processes of privatisation and restructuring, the consolidation of the legal order, further macroeconomic stabilisation, a favourable credit rating for Slovenia, lower country risk, and associate membership of the European Union. The inflow of foreign capital through foreign direct investment is expected to increase, possibly exceeding US$ 500 million annually by 2002.

8.6. INCOME AND FISCAL POLICIES - EFFICIENT INCOME AND FISCAL POLICIES LEADING TO A LARGER SHARE OF PROFITS AND INCREASED FUNDS FOR DEVELOPMENT

Support to economic growth with the simultaneous realisation of the austerity programme goals will only be possible through a consistent policy of reducing all kinds of costs. Within this framework, labour cost has a particularly crucial meaning. The target development scenario anticipates that the incomes policy for 1998 and 1999 will be able to maintain the positive trend from 1997 when the gross wage per employee increased within the limits of the growth of the global labour productivity. In 1998 too, the agreement between social partners is expected to ensure that wages increase at a rate around one percentage point behind that of labour productivity. The incomes policy is meant to back this orientation with the appropriate instruments. Wages in the business sector are defined by collective agreements as a result of the negotiations between employers and employees. Due to the process of ownership concentration, it is expected that the role of owners in defining the level of wages will increase. After the adoption of the law on civil servants and collective agreements, growth in gross wages in the sectors of public administration, education, health and social security, will be brought in line with the budget. Through fiscal policy instruments and stricter control, it would be possible to redirect part of other types of personal income which are now paid out to individuals as untaxed material costs back into wage payments.

The most urgent change in the social security system is connected with pensions. The present system, in which pensions are provided exclusively through the public pay-as-you-go system is not long-term viable. In the future, pension expenditures will grow much faster than its revenues, resulting in a growing deficit. The reasons are early retirements in the 1991 - 1992 period and the ageing of the population. The ratio of the retired to the active population will grow from 48% in 1995 to more than 90% in 2040. The present pension system will have to be completely reorganised. The share of the costs of the pension and disability insurance in the gross domestic product is expected to reach 12.8% by 2002. Due to the policy of unchanged contributions rates and providing the same level of pensions, the will grow in the following years and will have to be covered by higher transfers from the central budget.

To stop this trend, it is necessary to implement changes which include gradually increasing retirement age until it reaches the average European Union level, a gradual equalisation of the legal retirement age for men and women, changes to the calculation of the pension basis, a decrease in accrual rate, a combined pension indexation based on prices and wages, encouragement of later retirement with active measures (flexible retirement), increase in the number of insured persons, a more equal distribution of fiscal burdens between the employed and self-employed, a more efficient collection of contributions, etc.

Simultaneously, pursuant to the White Paper proposals on pension reform, a funded system is planned to be created, which is considered as a more appropriate form of facing the future challenges of providing pensions in the ageing society and which has potentially favourable effects on the economy. It is planned that part of the current uniform rate of pension and disability insurance contribution be paid to the personal pension account of an individual insured person. Due to the partial loss of the source for financing the obligatory pension scheme in the framework of the first pillar, it would be necessary to replace this with increased transfers from the central budget to the pension fund.

The decision to postpone the introduction of the second pillar reduced the pressure on public finance in 1999. In the long run, the current deficit in the pension system will have to be covered by new fiscal sources. Pension reform is for now expected to concentrate on changes in the first pillar and the preparation of conditions for introducing more radical changes represented by capital funding.

In public finance, the already started process of tax system reorganisation and developing a tax system similar to those in developed market economies is expected to continue. In the middle of 1999, value added tax is expected to be introduced. The necessary new fiscal sources are also expected to be ensured by the real-estate tax, carbon-dioxide tax and excise duties. The new tax office is expected to assess, calculate and collect those taxes more consistently, contributing to larger tax sources and a more equal distribution of tax burdens.

Public finance must also contribute its share to the growth of national savings. Thrift in spending general government resources and a considerable restructuring of budgetary expenditures will also be required by the new tasks arising from Slovenia's integration into the EU. New expenditures related to implementation of structural reforms and the harmonisation with the effective regulations in the EU will have to be included in the budgets of individual public finance funds and individual ministries.

Since the assessed general government revenues account for 44% of the GDP, the share of expenditures in the GDP should decrease by 1.1 percentage points (to 45%) to ensure an acceptable 1-percent general government deficit in 1999. To achieve the long-term goal, i. e. to balance the general government account after 2000, increased or new fiscal sources will have to be provided. Since it will no longer be possible to reduce the share of expenditures in the GDP, the state is supposed to perform the tasks arising from Slovenia's Strategy for Accession to the EU.

Table 22: Public finances

as % of GDP

	1998	**1999**	**Average 2000-2002**
1. General government revenues	45.1	44.0	45.0
2. General government expenditures	46.1	45.0	45.0
3. General government surplus/deficit (3=1-2)	-1.0	-1.0	0.0

Source: Target development scenario IMAD.

8.7. INFLATION - THROUGH CO-ORDINATED ACTIVITIES OF THE GOVERNMENT AND THE BANK OF SLOVENIA TO A FURTHER REDUCTION IN INFLATION

Slovenia meets the fiscal criteria for integrating into the uniform European Monetary System, but not the monetary criteria (annual inflation and interest rate levels). Fulfilment of these criteria is important because of the internal stability of the economy, protection of competition and for making exporting a more appealing activity in terms of income (given the already achieved stability of the tolar exchange rate). A further reduction in the remaining inflation to a level comparable to the European levels is therefore one of the most important development targets.

Around 2002, according to the provisions of the Association Agreement, Slovenia is expected to establish the full convertibility of its capital account. This will only be possible if the interest rates are at least approximately comparable to those in the European Union. Otherwise, instability can occur due to the inflow of short-term speculative capital, seeking profits in weak national markets with high interest rates. The conditions for achieving this are the gradual abolition of the current protection of the domestic banking sector, deepening of the capital market and curbing the level of inflation to 3-5% in the period before 2002. In this period, the monetary and prices policy will be limited by the urgent structural reforms with inflationary effects. Due to the in-built system solutions (ex-post indexation of the basic economic categories), it will be necessary, through the introduction of the value added tax, to prevent possible increases in prices being transferred to inflation through "price accumulation". The present policy of disindexation will have to be upgraded by solutions leading to the full abolition of indexation mechanisms. In monopolised products, the mechanisms of deregulation, opening of the market, encouragement of competition and anti-monopoly legislation will have to be used consistently.

Table 23: Main macroeconomic indicators of Slovenia: target development scenario

real growth rates in %

	1998	1999	Average 2000-2002
GDP	4.0	4.0	4.5-5.0
Employment	0.5	0.7	1.2
Rate of unemployment (ILO)	7.1	7.1	7.0
Productivity	3.5	3.3	3.5
Gross wage per employee	2.5	2.3	2.3
Exports of goods and services	5.3	5.5	5.6
- as % of GDP	55.7	54.5	
Imports of goods and services	6.5	6.5	6.6
- as % of GDP	57.3	56.5	
Current account balance in US$ million	-80.0	-150.0	
Final consumption (private and government)	3.6	4.1	4.6
- as % of GDP	76.5	76.6	
Gross fixed capital formation	6.5	6.5	6.0
- as % of GDP	24.4	24.6	

Source: Estimates and target scenario IMAD.

Table 24: Target development scenario for the main categories of national accounts system

	Current prices	Prices and exchange rate 1999			Structure of GDP in %				Real growth rates in %	
	1999	2000	2001	2002	1999	2000	2001	2002	1999	average 2000-2002
1 GROSS DOMESTIC PRODUCT	3,643,000	3,807,000	3,986,000	4,185,300	100.0	100.0	100.0	100.0	4.0	4.5-5.0
2 Primary income (revenues)	81,545	95,425	109,305	127,696	2.2	2.5	2.7	3.1	-3.3	16.1
3 Primary income (expenditures)	57,255	59,164	60,031	61,766	1.6	1.5	1.5	1.5	-4.9	2.6
4 GROSS NATIONAL INCOME (4=1+2-3)	3,667,290	3,843,262	4,035,274	4,251,230	100.7	101.0	101.2	101.6	4.0	5.0
5 Current transfers from the rest of the world	42,334	43,375	44,416	45,978	1.2	1.1	1.1	1.1	-0.7	2.8
6 Current transfers to the rest of the world	21,514	24,464	24,637	26,025	0.6	0.6	0.6	0.6	-3.2	6.7
7 GROSS NATIONAL DISPOSABLE INCOME (7=4+5-6)	3,688,110	3,862,173	4,055,053	4,271,182	101.2	101.4	101.7	102.1	4.0	5.0
8 FINAL CONSUMPTION	2,788,289	2,916,152	3,049,212	3,195,250	76.5	76.6	76.5	76.3	4.1	4.6
- private consumption	2,051,211	2,152,539	2,258,874	2,377,250	56.3	56.5	56.7	56.8	4.6	5.0
- government consumptiona potrošnja	737,078	763,613	790,338	818,000	20.2	20.1	19.8	19.5	2.4	3.5
9 GROSS NATIONAL SAVINGS (9=7-8)	899,821	946,021	1,005,841	1,075,932	24.7	24.8	25.2	25.7	3.9	6.1
10 Current account balance	-26,025	-34,700	-52,050	-69,227	-0.7	-0.9	-1.3	-1.7		
11 GROSS CAPITAL FORMATION (11=9-10)	925,846	980,721	1,057,891	1,145,159	25.4	25.8	26.5	27.4	6.8	7.3
EXPENDITURE ON GDP										
12 EXPORTS OF GOODS AND SERVICES	1,986,575	2,098,830	2,217,851	2,337,045	54.5	55.1	55.6	55.8	5.5	5.6
13 IMPORTS OF GOODS AND SERVICES	2,057,710	2,188,703	2,338,954	2,492,154	56.5	57.5	58.7	59.5	6.5	6.5
14 EXTERNAL TRADE BALANCE (exports-imports) (14=12-13)	-71,135	-89,873	-121,103	-155,109	-2.0	-2.4	-3.0	-3.7		
15 FINAL CONSUMPTION (15=16+17)	2,788,289	2,916,152	3,049,212	3,195,250	76.5	76.6	76.5	76.3	4.1	4.6
16 PRIVATE COSNUMPTION	2,051,211	2,152,539	2,258,874	2,377,250	56.3	56.5	56.7	56.8	4.6	5.0
17 GOVERNMENT CONSUMPTION	737,078	763,613	790,338	818,000	20.2	20.1	19.8	19.5	2.4	3.5
18 GROSS CAPITAL FORMATION (18=19+20)	925,846	980,721	1,057,891	1,145,159	25.4	25.8	26.5	27.4	6.8	7.3
19 GROSS FIXED CAPITAL FORMATION	896,948	951,210	1,008,756	1,069,782	24.6	25.0	25.3	25.6	6.5	6.0
20 CHANGES IN INVENTORIES	28,898	29,511	49,135	75.377	0.8	0.8	1.2	1.8		

Source: Target development scenario IMAD.