ANALYSIS OF ECONOMIC DEVELOPMENTS AND TARGET DEVELOPMENTAL SCENARIO BY 2001

SPRING REPORT 1997

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1. PREFACE- About statistics and its adjustment to international standards

The 1997 Spring Report provides an estimate of economic developments and factors of growth in recent years. A survey of developments in 1996 and the first months of 1997 of different areas is presented together with a short-term target development scenario for 1997 and 1998. Selected economic policies are also examined. Chapter 8 presents the target development scenario up to the year 2001. Apart from economic development analysis the report tries to analyse some other developmental dimensions and in particular the effects of the transition to a market economy on the environment, social and regional development.

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 State Budget.

The process of transition, the term that describes the transition of former socialist economies to market economy, does not only involve the countries' economic systems but also the system for monitoring of economic developments and other phenomena. Endeavours to adopt international statistical standards have been made in Slovenia. Changes in data compilation and recording have caused some delays with publishing. In some cases they prevented inter-year comparisons of trends and even distorted the picture of actual developments. Despite complicating proper monitoring and evaluation of current economic trends these methodological adjustments are unavoidable and will soon give positive effects.

Traditionally there were problems with recording the actual volumes of production and number of employed. In 1996, there were also problems with monitoring foreign trade flows and investment. Foreign trade flows were undervalued due to incorrectly completed customs declarations for imports and exports after processing. The first correction of data was available only after annual figures were published. Data on investment outlays published by the Agency for Payments (hereafter AP) is the only monthly available data on investment. In 1996 it could not be compared with previous years. Inter-year comparisons pointed to an exceptionally high rate of growth of investment. These, however, were due to a rise in purchases of shares and enterprises' assets (portfolio investment, a changed ownership structure), and the shift of investment outlay coding from the AP to enterprises. On the one hand, this move has contributed to the improvement in the quality of coding. On the other hand, it has made the data less comparable to that of previous years. The problem of undervalued foreign trade flows was dealt with in the Statistical Office of the Republic of Slovenia's (hereafter SORS) publication of figures for the January-December period. The problem of monitoring investment remains unresolved.

In the first half of 1997, data problems were mainly due to a shift to the Standard Classification of Activities (SCA), which required the adoption of a different classification of sectors and a changed system of weights. Consequently preliminary data on industrial production in the first three months of 1997 were only available in May. Before that developments in manufacturing could only be estimated by the Survey of Business Trends, which has been conducted by SORS since April 1995. The latter is in line with similar surveys adopted in the European Union (EU). With the shift to the SCA some problems also appeared in monitoring the sectoral wage and employment developments. However, certain improvements have been achieved in monthly monitoring of the number of employed as enterprises with 1-2 employees have been included.

A novel approach to price monitoring was introduced in 1997. In its reports of industrial producer price indices SORS has also started using the SCA (23 sectors of SCA). Moreover, the Consumer Price Index (CPI) is being calculated in line with the "harmonised CPI" used in the EU for international comparisons. In 1998, SORS will replace the Retail Price Index with the Consumer Price Index as a main measure of inflation.

SORS published several estimates of the National Accounts over the last few months. In its last report on gross domestic product (GDP) at constant prices for the period from 1990 to 1995 SORS has also published the final estimate of GDP at constant prices on the expenditure side. However, the expenditure side has not yet been aligned with GDP's output side using annual national accounts and quarterly national accounts statistics for 1995. According to the published SORS estimates of GDP for 1995 economic growth measured in terms of output was 3.9% and by expenditure side 4.1%..

"Transition of statistics" has made the analysis and forecasting of economic developments rather difficult. It is hoped that positive results of transition will soon become apparent as more accurate, stable and internationally comparable data is provided. In the first half of 1997, information about the economic developments over the past years changed very often, whilst the analysis of current trends was often based on preliminary and inconsistent information.

The Report is based on data available up to May 30th 1997

2. SHORT SUMMARY - The achieved level of development and development opportunities in the coming years

In view of less favourable economic developments in the EU and the slower pace of certain systemic changes than projected in the Strategy for Economic Development of Slovenia (SEDS) rates of economic growth were somewhat lower over the last two years than that forecast in the positive Scenario (+) of the SEDS. They were, however, still above that in the negative Scenario (-). The **1990's GDP level** was reached in 1996 whilst the production structure was substantially more favourable. The following achievements are assessed as particularly positive by both domestic and foreign analysts (for example 0ECD, 1997a): fall in the rate of inflation in the period from 1992 to 1995; a relatively short transformation depression period; orientation to foreign markets; and the preservation of internal and external equilibrium. On the other hand, the process of ownership transformation, tax reform, reform of the pension and social security systems are regarded as less successful parts of the transition.

The period of economic growth, which began in 1993, continued in 1996. After growing 5.3% and 4.1% in 1994 and 1995 respectively, GDP rose 3.1% in 1996. The year of 1996 was marked by modest growth in agriculture (1.7%) and manufacturing (1.4%), more rapid growth in services (3.6%) and construction (11.1%) and a drop in mining (-1.3%). Economic growth was driven primarily by domestic demand, which grew 3.4%. Nevertheless, the contribution of foreign demand should not be overlooked (it grew 2.5%). Despite a balanced development in 1996 (small surplus in the balance of payments and general government surplus) certain trends were worrisome: a rapid growth in wages, an increase in social benefits and social transfers, a decrease in the share of gross national savings in GDP, and slower growth in investment. The **developmental scenario for 1997 and 1998** counts on more favourable economic developments in international environment (especially in the EU countries) and projects a recovery of economic growth in Slovenia; maintenance of the external equilibrium; and a modest General Government deficit. Whether this scenario is **realised** will depend on whether Slovenia manages to: control the growth in budget expenditures (notably for wages in the public sector, social transfers and budget-financed investment) as a means of ensuring that the General Government deficit would not exceed 1% of GDP; level off the high growth in wages in the economy; launch the reforms of pension and social security systems; and complete the privatisation process. In addition, the tax system reform should be prepared; the extent and mode of the privatisation of state property (for instance, banks) must be decided upon; the service sector ought to be gradually liberalised; and the budget-financed part of services must be privatised at an accelerated pace. The realisation of short-term developmental scenario, which is also a precondition for a balanced and sustainable development in the period from 1999 to 2001, largely depends upon the effectiveness and co-ordination of economic policies.

Provided the above-mentioned preconditions are fulfilled, **economic growth** could reach **4% in 1997** and **4.5% in 1998**. Attainment of such a level of economic growth is premised on favourable economic developments in the EU, improved export competitiveness and moderate growth in domestic demand. Economic growth in the EU is estimated to accelerate in the years to come from 1.6% in 1996 to 2.4% in 1997 and 2.8% in 1998. Improved export competitiveness of the domestic industry in 1996, which is expected not to deteriorate in the next few years, ought to boost Slovenian exports.

Economic growth in 1997 and 1998 is expected to be generated primarily through growth in all sectors. The rapid growth in services and construction is expected to be maintained. In view of the rise in economic growth and industrial production in Slovenia's main trading partners and last year's improvement in export competitiveness of Slovenia slightly more favourable developments are anticipated in manufacturing than in 1996.

In the next few years the **importance of foreign demand** in GDP growth is expected to strengthen. Foreign demand is anticipated to grow around 4% in 1997 and by more than that in 1998. In both years domestic demand is also predicted to grow, and in particular investment demand. Investment demand was up as much as 17% in 1995. It further rose around 9% in 1996. Similar rates of growth (8-10%) are expected both this and next year. Investment in infrastructure represented an important part of total investment (around 20%) over the last four years. It is often backed directly or indirectly by the state. Its share in total investment is expected to remain unchanged in the future.

Whilst in most transition economies both the trade and balance of payments deficit is getting wider, Slovenia has managed to maintain an external equilibrium. According to balance of payments statistics, the **trade deficit** amounted to US$ 852.8 mil in 1996, down US$ 100.7 mil from a year earlier. The **current account** recorded a small **surplus** of US$ 46.5 mil. Due to a slowdown in economic growth in the European economies also in Slovenia foreign flows somewhat waned. As the situation in Europe has improved and new trade agreements are to be signed in the coming years, foreign trade is expected to soon gain momentum. This year like in 1996 exports of goods and services grew 2.8% in real terms whilst imports were up 1.3%. In 1998, both are expected to grow at higher rate. Although the **trade deficit** might increase slightly in the coming years the surplus in services is expected to be high enough to preserve the external equilibrium (a current account deficit of around 0.2% of GDP is forecast).

After a sharp decline of 11.8% in **export competitiveness** in 1995, measured in terms of unit labour costs in a currency basket, it increased considerably in 1996 (up 7.3%). The improvement was primarily due to the growth in productivity, the decrease in wage-related taxes and the real depreciation of the tolar. Better competitiveness is still impeded by the high rate of growth of wages and other remuneration. In 1997, export competitiveness is expected to improve slightly. This is, however, primarily dependant upon the exchange rate developments and the ability of the income policy to halt further wage rises.

In 1996, the average **gross wage per employee** was up 5.1% in real terms (deflated by the growth in retail prices) from 1995. In real terms wages in the market sector were up 4% and 6.7% in the non-market sector. Wages in the non-market sector grew the most due to strikes and concessions gained in the pre-election period. Wages in the market sector grew mostly as a consequence of a rapid growth in wages set in individual agreements. Social partners will, however, need to agree on a new income policy mechanisms if the trend of wages growing faster than labour productivity is to be stopped. Government endeavours are mostly focused on extending the period in which wages are indexed to inflation and on setting up of a mechanism which will link the growth in wages to enterprise performance (profit-sharing scheme).

Employment (number of persons in employment by SNA definition) is estimated to decreased slightly in 1996 (down 0.5%). In particular, the number employed in industry was down 6.5%, whilst it rose in some services and public administration. Despite a lower level of employment, the average annual percentage of registered unemployed remained the same as a year-before (13.9%). The rate of unemployment based on the ILO criteria (7.3%) also remained unchanged. In view of high structural and regional labour market disparities the likelihood of a substantial decrease in the number of unemployed remain small in the near future.

In 1996, end of year **inflation** (annualised rate of growth of retail prices) was 8.8% and thus around that of the year-before (8.6%). In 1996, for the first time the average annual rate of inflation was also single digit, 9.7% (in 1995 - 12.6%). In May 1997 retail prices were up 5.2% compared to December 1996. Annual inflation was 8.2% in April and 8.9% in May, up from 7.4% in March. In the first four months, the rise in controlled prices contributed more than 50% to inflation. As certain price disparities still need to be abolished (notably, for energy prices), there is little prospect that inflation will be reduced substantially this or in the coming year. A prudential price policy will be required in order to continue to lower inflation and abolish price disparities. It must also be supported by a neutral monetary and effective income policy.

The **General Government** Account recorded a **surplus** amounting to 0.3% of GDP in 1996. The share of General Government Expenditure in GDP remained the same as in the previous year (45.7%). General Government Revenue accounted for 46% of GDP. The dis-equilibrium between revenue and expenditure (deficit) appeared in the Pension Fund. The amount of funds transferred from the central budget to cover the Pension Fund deficit is growing each year (in 1996, it amounted to 2.7% of GDP; this year, around 4%). This is a consequence of reductions in the social contribution rate made in recent years, which were not accompanied by a decrease in the Pension Fund's expenditure.

A balanced General Government Account will be difficult to maintain this year not only because of the wider Pension Fund deficit but also due to a higher level of other expenditure. The share of expenditure for wages has soared as wages in the non-market sector rose due to strikes and employment in public administration increased last year. In addition, expenditure for social transfers has increased as the circle of child supplement beneficiaries widened. It seems that value added tax (VAT) will not be introduced before 1999. Although a new tax on motor vehicles (proposed in April) will be introduced and the tax on payroll kept, it is unlikely that a **General Government deficit** will be avoided this year. Since the share of General Government Revenue in GDP has fallen by a percentage point (from 46% of GDP in 1996 to 45% in 1997) a sound General Government deficit of 1% will only be attained if the share of General Government Expenditure remains at 46%. This is not substantially above the 1996 level of 45.7%. Provided that all necessary measures aimed at holding back General

Government Expenditure are taken and in particular concerning central government expenditure (wages and employment in the public sector, government investment and social transfers) the General Government deficit could possibly drop to 0.5% of GDP in 1998. However, this figure is premised on the General Government Revenue amounting to 44.9% and Expenditure 45.4% of GDP in 1998. On the revenue side this projection also presumes that the payroll tax is kept and excise duties are introduced. On the expenditure side a real increase is forecast not to exceed 3.1%.

By maintaining a General Government equilibrium over the last two years, the public finance policy supported the monetary policy. It did not create any additional pressures on interest or exchange rates by reducing the need to borrow both at home and abroad. Slovenia's external debt (around US$ 4 bil) has already reached the level where any additional borrowing abroad which would permanently increase annual interest payments to above US$ 100-120 mil would in the current situation caused problems (Bole, 1997), In view of the current rate of economic growth and the level of national saving any additional borrowing will in turn require further borrowing in order to meet interest payments. The issue of additional borrowing is important and could become acute problem in the future since most of the present borrowing is predominately used for consumption and infrastructure construction.

If economic policy manages to improve the developmentally unfavourable distribution proportions in favour of investment and implements the necessary decisions with regard to the key reforms, which have so far been put off, Slovenia can expect relatively high economic growth in the period from 1999-2001. The introduction of the VAT, which would replace the current sales tax, and a halt in growth of the General Government Expenditure would make the abolishment of the payroll tax and the re-establishment of the General Government equilibrium possible. The medium-term developmental scenario predicts a matched gradual reduction in the proportion of General Government Expenditure and Revenue in GDP (from 45.4% in 1998 to 45% in 1999 to 44.1% in 2001). Relatively high economic growth (4.5 - 5%) and greater labour market flexibility may cause the stagnation of the rate of employment to switch to a modest rate of growth in 1998.

3. THE INTERNATIONAL ECONOMIC ENVIRONMENT - Europe is optimistic and expects that the convergence criteria will be fulfilled

The first signs of economic recovery appeared in the second half of 1996 in **the European Union** (EU), after almost a year of rather sluggish economic growth. In 1996, economic growth was estimated to have been 1.6% (European Commission, 1997). Experts (Project Link, 1997; European Commission, 1997) expect it to pick up in 1997 and 1998. An optimistic outlook is due to a favourable investment climate (low interest rates, stability of prices, favourable exchange rate movements). The latter is expected to generate growth in investment and industrial production. In addition, economic growth should be spurred by growing exports into non-member states, as well as intense trade within the EU. Domestic demand is expected to grow only modestly in light of high unemployment and the adoption of restrictive fiscal policies in the most Member States. Despite more rapid economic growth of its main trading partners, Slovenia will face more moderate growth in foreign demand in the next few years than in 1994.

In **Germany** GDP grew 1.4% in 1996, slightly above the mid-1996 expectations. In the west part of the country GDP grew 1.3% and in the east 2%. Exports were the main generators of growth, as domestic demand was still too weak to contribute markedly to economic recovery. Overall the German economy recorded only a 1.3% growth in private consumption. Investment demand even slightly decreased (down 0.8%). Unemployment rate further soared, reaching 9.2% in the western and 15.7% in the eastern part of the country (Lemmer, 1997).

Table 1: Economic growth and unemployment in Slovenia's main trading partners

	Real growth in GDP (in %)				**Unemployment rate, ILO (in %)**		
	1996	**1997**	**1998**	**1999-2000**	**1996**	**1997**	**1998**
EU	1,6	2,4	2,8	2,6	11,0	10,5	10,3
Germany	1,4	2,3	2,9	2,2	9,0	9,7	9,5
Italy	0,8	1,2	2,0	2,4	12,0	12,0	11,8
Croatia[1]	3,5	4,0	4,0	nd	15,9	16,5	17,0
France	1,3	2,3	3,0	3,2	12,3	12,5	12,1
Austria	1,0	1,5	2,5	2,2	4,1	4,2	4,1
Russia	-6,0	1,0	2,0	3,7	9,4	10,0	11,0
USA	2,4	2,6	2,2	2,2	5,4	5,4	5,7

Source: European Commission, April 1997; EUROSTAT, April 1997; Project LINK World Outlook, March 1997; WIIW, March 1997. Note: [1] registered unemployment.

Despite relatively low interest rates, growing productivity, falling labour costs, a favourable exchange rate trend and a rise in foreign demand, economic growth is estimated to be only slightly above 2% in the years to follow. The reasons for such modest growth are mainly low domestic demand and investment. Further uncertainties arise from high unemployment and the expected fiscal restraints, which will be felt on both the consumption and production side.

Endeavours to fulfil Maastricht fiscal criteria have significantly impeded economic growth in **Italy**. In 1996, GDP grew only 0.8%, and is expected to be rise 1.2% in 1997. Maintaining a lid on the growth of wages in industry will cause only moderate growth in private consumption. Since Italy's main trading partners have recovered demand for exports is expected to increase. This will positively contribute to a better economic situation. Italy is faced with 12% unemployment, although the rate varies considerably throughout the country. In the north unemployment was 6-7%, whilst in the south it was up 20-25% (D' Adda, 1997).

After modest economic growth in the first half of 1996 the situation in **Austria** started improving in the second half of the year. In 1996, GDP grew 1%. Gradual recovery was a consequence of increased foreign demand and greater investment in machinery and equipment. In the years to come, these two factors are expected to be the main levers of economic growth. On average growth of 2% annually is expected until the end of the century. A restrictive fiscal policy will continue to impede almost all components of domestic demand. In light of modest economic growth, endeavours to raise productivity and cut the number employed in the public sector, unemployment is expected to increase further in 1997.

In **France** domestic demand increased considerably in 1996, whilst investment grew only modestly. Consequently the economy grew by a mere 1.3%. This year it is forecast to pick up to 2.3% thanks to more favourable monetary conditions, investment growth and exports. Higher economic growth should contribute to a rise employment and in 1998 to a reduction in the unemployment level.

After three years of incessantly rising economic growth in **the CEFTA countries**, it for the first time fell from the year-before (by 0.8 percentage points) in 1996. The growth was the highest in Slovakia (6.9%) and in Poland (6%). Those are the countries with the lowest starting position measured in terms of GDP per capita. The growth was somewhat slower in the Czech Republic (4.4%) and modest in Hungary (0.5%). Investment was still the main generator of growth: in Slovakia and Poland gross investment surged 38.9% and 22.1% respectively, whilst in Hungary it was down 4.4%. On average, CEFTA countries record faster growth than their main trading partners (EU). They are all, except for Poland, small countries with a high share of foreign trade in the GDP. Both these factors made the maintenance of the foreign trade equilibrium more difficult in these countries. In 1996, the recession in the EU, and Germany in particular, and the decreasing competitiveness of CEFTA countries (real appreciation of local currencies against DEM and the growth in wages) were the main causes of the difficulty. Current account deficits also widened in most countries. The only exception was Hungary, which using strict stabilisation measures adopted in 1995 managed to curb the trade and current account deficit in 1996. The other three members of the Vishegrad Group still successfully cover their current account deficit with inflows of foreign capital.

Table 2: Economic growth, inflation and current account deficits in CEFTA countries

	Real growth in GDP (in %)				**Inflation (in %)**			**Current account balance (as % of GDP)**		
	1996	1997	1998	1999-2000	1996	1997	1998	1996	1997	1998
Czech Rep.	4,4	4,5	5,0	3,9	8,8	9,5	8,0	-8,6	-9,0	-9,9
Hungary	0,5	2,0	3,5	3,8	23,6	19,0	13,0	-3,8	-4,3	-5,4
Poland	6,0	6,0	6,0	5,0	19,9	16,0	13,0	-1,0	-4,1	-4,3
Slovakia	6,9	5,0	5,0	5,5	5,8	7,0	7,0	-10,2	-12,4	-13,3

Source: NOMURA Research Institute, April 1997; Project LINK World Outlook, March 1997; WIIW, May 1997.

In 1996, economic growth in the **Czech Republic** was 4.4%, down from a year-earlier (4.8%). The slowdown in growth is also reflected in a slower growth in industrial production and a gradual increase in the long-lasting low rate of unemployment, which was at its highest (4.5%) in 1996. The former was caused by the recession in Germany, and lower competitiveness of domestic producers and a restrictive monetary policy. The current account deficit surged to 8.6% of GDP, mostly on account of a wide trade deficit. Estimates for 1997 and 1998 made by The Vienna Institute for Comparative Study (WIIW, 1997) already took into account a possible devaluation of the Czech koruny which occurred in May. This together with the liberalisation of prices of energy and dwelling rents could lead to higher inflation. After the events that took place in May economic growth estimates in 1997 and 1998 were corrected downwards.

Slovakia recorded the highest economic growth (6.9%) amongst the economies in transition in 1996. The main levers of growth were investment (33%) and public consumption (24%), whilst exports were less important than a year-earlier. On the output side, services rose the most, whilst industrial production grew only 2.5%. For the first time since 1993, Slovakia recorded a current account deficit amounting to 10.2% of the GDP in 1996. As the structure of production will in the next few years remain ill-suited demand for exports is not expected to rise considerably. Economic growth is anticipated to slow down and stabilise at around 5% in 1997 and 1998.

A mere 0.5% economic growth in **Hungary** was a result of the adverse effect of the stabilisation programme on domestic demand (negative growth in investment and real wages) in the past two years. However, after mid-1996, the situation started to brighten. In view of the growth in private consumption, investment (8%-10%) and a higher rise in exports than imports a 2%-3% rate of economic growth is expected in 1997. Over the last few years, Hungary managed to dramatically reduce the internal and external dis-equilibrium. It more than halved the shares of the budget and balance of payments deficits in GDP.

In **Poland** a 6% economic growth in 1996 is attributed to high domestic demand, both investment and private consumption. Furthermore, it succeeded in lowering inflation from 27.8% in 1995 to 19.9% in 1996. The budget deficit has been reduced. On the other hand, high economic growth and the real appreciation of the local currency boosted imports causing the trade deficit to almost double from 1995. Like the Czech Republic and Slovakia, Poland postponed the devaluation of its currency in order to halt inflation. The structure of imports may be an adverse factor in the future since the share of investment goods is rather low.

Estimates of the economic growth of **Croatia** in 1996 have ranged between 3.5% and 4%. This confirms the forecast economic recovery, although these figures are slightly lower than the official projections. Presently the main generators of growth are manufacture of investment goods and tourism. They are expected to remain the most important factors in the future. In 1997 and 1998 GDP is forecast to grow at around 4%. The urgent need for investment (a real drop by 14% in 1996) is inhibited by high interest rates. Inflation remains the lowest among the transition economies (3.5%), but may be threatened by the rise in private consumption in the future. The trade deficit, which in 1996 accounted for 17.4% of GDP, is expected to widen. Despite a considerable growth in imports of investment goods a significant boost in exports to the EU is not expected in the near future. Another pressing problem is high unemployment (in 1997 it is expected to be over 16%) which is one of the highest among transition economies.

4. THE INSTITUTIONAL ENVIRONMENT - Domestic shortcomings become

more apparent when the circumstances in the international economic environment are less favourable

Since the domestic economic developments are highly dependant upon the international economic situation, domestic shortcomings remain more or less hidden when developments abroad are favourable. On the other hand, they become more apparent when situation abroad becomes less advantageous. These shortcomings are mainly a result of a delay in certain important changes necessary in order to achieve faster rate of economic development and meet EU standards. In order to catch up gradually with the EU, institutional changes need to be carried out in a wide range of areas. This report shall focus on some weaknesses which need to be eliminated not only in view of the rapprochement with the EU, but more importantly in order to complete the process of transition and accelerate economic growth. The consequences of the slow pace of ownership transformation and privatisation, the delay in reforming the tax, social security and pension system and the rigidity of the labour, capital and real estate markets will be examined.

The **state and its institutions need to be modernised** and their effectiveness improved for several reasons. An insufficiently developed state impedes further development. It prevents a more rapid integration into the EU. It increases the transaction costs of the economy and thereby decreases its competitiveness. Structural and functional adjustments are required in public administration, local government, public services, the public sector, and in the protection of individual's administrative rights. The administration needs to be modernised and the adjustments made to the training of civil servants (Trpin, 1995). Adjustments in public administration are necessary for integration into the EU. In addition to these adjustments, changes are needed in public services and public sector. First, the public sector needs to be defined and public enterprises, public institutions, state and para-state (extra-budgetary) funds must be properly regulated. The use of legal norms applicable to commercial enterprises to public ones has resulted in unregulated ownership and management relationships. Defining the legal status of these organisation is a precondition for the liberalisation and privatisation of the public services and the introduction of competition.

The process of **ownership transformation of social enterprises is expected to be completed this year**. Ownership certificates are expected to be valid until the end of June 1997. Presently, the main problem facing the ownership transformation process is the so called privatisation gap estimated to be between SIT 100 and 137 bil. The asset structure of investment funds reflects the privatisation gap problem since they are unable to exchange the collected certificates for shares of privatized (ex-social) companies. The Law on Providing Assets for Investment Funds... (Official Gazette No.59;1996) states that a part of state property should be used to cover the privatisation gap. In addition, the Government proposal is currently in discussion to use the Republic of Slovenia's financial assets to cover the gap.

At the end-1995, Slovenia's financial assets amounted to SIT 1,375.10 bil and encompassed the Republic of Slovenia's equity and debt investments in other legal entities financed from the state budget by issue of government securities or obtained under special laws. Since a large part of quality assets were transferred to funds, the RS has few liquid assets (these are primarily state treasury liquidity surpluses, shares in commercial companies and banks in rehabilitation).

By mid-May, the Agency for Restructuring and Privatisation issued a first approval to 1,389 submitted ownership transformation programmes of enterprises in social ownership. The second approval, by which the transformation process is completed and which is a precondition for the enterprise to register its ownership structure at the Court Register, was granted to 1,005 enterprises.

Completion of the formal part of the privatisation process has altered the ownership structure of enterprises, but has little effect on their performance. The results of the first analysis of the relation between the type of ownership and enterprise performance indicate that private and foreign owned enterprises are better off (see Rems, Rojec, Simoneti, 1997). The analysis examined 2,023 enterprises which in 1995 fulfilled the following three criteria: (i) 10 or more employees; (ii) assets of SIT 90 mil or more; (iii) net revenues from sales SIT 180 mil or more. These enterprises account for 6% of the total number of enterprises which submitted their financial statements for 1995. However, they hold 83.5% of the total equity, 77.6% of total assets, 78.5% of employed and realised 76.4% of total sales (net revenues from sales), 87.5% of exports and 79.7% of net loss (operating profit - loss) of the entire non-financial corporate sector.

In 1995, on the whole examined enterprises generated a net loss of SIT 12,492 mil. In the analysis enterprises were divided into six ownership categories (see Table 3). Net profits were attained in foreign enterprises, private and state enterprises, whilst externally owned enterprises recorded a slight loss. Internally owned enterprises and in particular, non-privatised enterprises had a substantial loss. The latter's loss amounted to SIT 20,802 mil. Such a loss was expected since these included enterprises which had severe problems and were for this reason transferred to the Development Fund or did not submit an ownership transformation programme. Private and foreign enterprises had the best return on equity ratio. The ratio of non-privatised and partially internally privatised enterprises decreased. The results of a comparison in terms of the value added per employee were virtually identical. Above average value added per employee was recorded in foreign, state, externally owned and private enterprises. Internally owned enterprises achieved a below average value added and this was especially in case of non-privatised enterprises.

The indicator of profitability or return on equity (net profit or loss to equity) can be further dis-aggregated into three indicators: profit margin (net profit or loss to sales), total assets turnover (net sales to assets) and assets to equity ratios. The following conclusions can be drawn: (1) ownership categories with the best or worst return on equity have identical profit margin results. If the latter is low the enterprise has problems with costs. (2) Similarly, the most profitable categories of enterprises (private and foreign owned) have the best total assets turnover ratio, whilst the results are less favourable for the least profitable category - the non-privatised enterprises. Internal enterprises, which operate with a loss, typically had a high total assets turnover.) For state enterprises, which generate net profits, on the other hand this ratio was low. This is not in line with the supposedly positive influence of this turnover on profitability. However, this is a consequence of internally owned enterprises being highly labour intensive, whilst state enterprises are highly capital intensive; (3) The assets to equity ratio suggests that the above average profitability of private and foreign owned enterprises is at least in part a result of either their above average assets to equity ratio or relatively higher external sources of financing. On the other hand, a high assets to equity ratio for non-privatised enterprises relates to the fact that they generated substantial net losses. Apparently, enterprises with similar assets to equity ratio achieve entirely different results in profitability. Private and foreign owned enterprises can easily carry the burden of high indebtedness. However this is not the case with non-privatised enterprises. Moreover, it is very likely that private and foreign owned enterprises obtain loans for development, whilst non-privatised enterprises use it to cover past failed investments or meet current liquidity needs.

Table 3: Comparison of business indicators in 1995 by ownership categories of enterprises

Selected business indicators	total enterprises	indices, total enterprises = 100					
		private[1]	foreign[2]	internal[3]	external[4]	non-priv[5]	state[6]
Net sales per assets, in %	76.7	174	210	146	108	91	36
Assets per equity, in %	173.0	186	112	99	94	142	85
Value added per emp. ,000 SIT	1,834	106	131	92	107	74	118
Assets per enterprise, SIT mil	2,257	23	74	56	141	119	676
Sales per enterprise, SIT mil	1,731	41	156	82	153	108	244
Number of employed per ent.	188.0	30	72	108	146	125	261
Assets per employee, 000 SIT	12,009	77	103	52	97	95	259
Equipment in fixed assets, in %	22.5	120	203	96	99	84	93
Equipment per emp., 000 SIT	1,864	56	168	43	89	72	311
Labour costs in sales, in %	19.9	69	51	122	101	109	121
Labour costs/employee,000 SIT	1,830	92	110	93	106	93	113
Share of exports in sales, in %	28.0	75	155	88	102	154	34
Liabilities per equity, in %	65.1	315	133	97	81	208	65
growth from 1994							
Net return on equity	-0,5	5,7	4,6	-1,3	-0.0	-8,8	0,3
Share of net profit in sales	-0,4	1,3	1,5	-0,7	-0.0	-5,1	0,8

Source: APr, calculations made by authors

Notes: [1] **private enterprises, which did not undergo privatisation under Law on Ownership**

Transformation (LOT),
[2] foreign enterprises, majority owned by foreign persons,
[3] internal enterprises, privatised under LOT and in their programme of ownership transformation decided for majority ownership by employees, former employees and pensioners,
[4] external enterprises, privatised under LOT and in their programme of ownership transformation decided for majority external ownership (funds, small investors from public sales), including their subsidiary enterprises
[5] non-privatised enterprises, comprise three types of enterprises: [i] social ent. to be privatised under LOT, but have not yet received approval for ownership transformation programme; [ii] ent. owned by Development Fund and their subsidiaries; [iii] ent. in majority state ownership which do not perform any public service whatsoever nor are they in a monopoly situation in the market;
[6] state enterprises, in majority state ownership performing public services or in monopoly situation.

Higher profitability of private and foreign owned enterprises than that of other enterprises is a result of above-average profit margin and total assets turnover as well as a favourable assets to equity ratio. Losses of internally owned enterprises are to the largest extent a consequence of a low profit margin (the costs are too high) and in non-privatised enterprises due to below-average total assets turnover ratio and high indebtedness. State enterprises achieved above-average profitability mostly as a result of high profit margins, whilst their total assets turnover and assets to equity ratio were below-average.

Although the results of the above analysis do not establish a causal connection between an ownership category and an enterprise's performance, they clearl; y indicate that non-privatised enterprises achieve poorer results. This highlights the need for speeding up the process of privatisation. Similar analysis of the relationship between ownership categories and enterprise performance (for instance, Claessens, Djankov, Pohl; 1996) suggest that positive results are usually dependent upon the level of ownership concentration.

The positive influence of **the securities market** on economic development by channelling of savings into financing investment depends on the development of the market and the ratio between trading on the secondary and primary markets. Although the number of securities traded increased over the last four years, the turnover on the Ljubljana Stock Exchange (measured in DEM) decreased in 1995 and 1996 compared to 1994. In 1996, market capitalisation for securities on the Stock Exchange accounted for 5% of GDP. This was considerably lower than in the most "old" market economies and in some "new" ones (in France, it accounted for 35% of GDP; Great Britain 116.1%; Spain 29%; Czech Republic 43.5%). This indicates that the capital market is inadequately developed in Slovenia. In addition to a low turnover on the stock exchange, the substantial turnover on the off-the-exchange markets is worrying. Data suggest that in the first quarter of 1997 the turnover of shares of certain enterprises outside the organised market exceeded that of the official markets (Jašoviè, 1997). The main reason for trading on non-transparent markets is to consolidate ownership cheaply and quickly. Speculation caused by the difference in the share price on the organised and informal market is another reason. Prices of securities of public corporations before they are listed on Stock Exchange (on informal markets) are generally lower than after they are listed on the Stock Exchange. The share prices of eight public corporations with shares listed on the official market in 1996 were twice as high on the official market than on the informal one.

Another reason for the modest contribution of the capital market to economic development is the predominant role of trading on secondary markets. Enterprises have not yet started issuing securities as a means of rising capital to finance investments. The volume of primary public issues of shares even decreased in nominal terms in the period from 1994 to 1996. Trade in securities of enterprises which had undergone ownership transformation prevailed. Last year the share of public offerings for cash increased. However only two enterprises offered their shares for cash. The others who made such offerings were banks, saving banks and authorised investment funds. Thus, secondary trading currently predominates. Its purpose is not to acquire financial assets, but gain a controlling interest in enterprises. The Stock Exchange's subordination to the process of privatisation and gaining of a controlling interest in enterprises causes comparatively high liquidity of the market. The security turnover to market capitalisation ratio (higher the ratio, higher is liquidity) suggests that the Ljubljana Stock Exchange can be ranked amongst the more liquid European Stock Exchanges (Jašoviè, 1997).

Trading in privatisation shares along with the high propensity for consumption of small shareholders have had a negative effect on national savings . This is because a large part of the revenues acquired by selling privatisation shares are used for personal consumption rather than for savings.

Furthermore, Slovenia is still far from meeting the European **real estate market** standards. (Lavraè, 1994; 1995) Institutional limitations on the real estate market are another structural barrier preventing a more rapid economic growth. The combined effect of restitution in kind, obsolete, over-standardised and unclear spatial laws and inadequate spatial evidence holds back privatisation, investment, restructuring and advancement of entrepreneurship. The underdevelopment of the real estate market impedes labour force mobility and enterprise activity, both of which would help reduce unemployment. The local government remains dependent upon state funding since it still cannot efficiently collect property taxes. This is a consequence of inadequate information and legal infrastructure, which is necessary for the development of the real estate market. The deepening of the financial system, the emergence of large institutional investors and the establishment of the pension system as an investment pillar are all linked to investment in the real estate market.

Apart from positive effects, the development of the real estate market may have some negative effects. It may lead to depopulation of entire areas, class stratification, speculation or cause other negative externalities. However, the above are not reasons not to develop the real estate market, but rather highlight the necessity of setting up regulative institutions and information systems and adopting laws similar to those that have been established in developed market economies over the centuries. Undoubtedly, in view of its economic effects the most urgent task to be undertaken is the **establishment of a new Land Register**, and in particular for urban areas. This is foreseen although not explicitly stipulated in the newly promulgated Law on the Land Register. This calls for the computerisation of the existing Land Register and the computerisation and updating of the cadastral register and the establishment of a real estate register. All registers should be open to the public. It is difficult to imagine a market economy without legally identifiable owners. Such data will also serve as a basis for implementing a protective land policy and tax policy. The regulation of this area will be costly. The cost may be reduced somewhat by taking advantage of the motivation of owners and by examining the possibility of adopting other taxes (such as property taxes). The second most urgent task is the adoption of the **Law on the Privatisation of Building Land**. A large part of the building land is presently still socially owned, so that privatised enterprises, owners of houses and others only have a usufruct. This prevents the use of mortgages as a means of raising capital. Furthermore, a large-scale assessment of the market value of real estate is a precondition for the introduction of property taxes. The latter will be an important General Government Revenue source. Intensive expert work is required if an adequate initial system is to be put in place in a few years' time.

By setting up the Tax Administration Office in mid-1996 the first condition of the **tax reform** aimed at harmonising the structure of tax sources to that in the EU was carried out. The first steps were made in the area of environmental taxes (CO_2 tax, water contribution). The delays in introducing "true" property taxes were a consequence of the above-mentioned problems in the real estate market. Presently, only car ownership is properly recorded. Therefore, taxes should be imposed on all cars. This would serve as a basis for the introduction of real property taxes. At the same time, records for other kinds of property should be gradually compiled so as to ensure a non-discriminatory approach to the taxation of property.

In terms of the rapprochement to the EU the crucial task of the tax reform is the **introduction of the value added tax**. It seems to have been postponed to the beginning of 1999. The Law on the Value Added Tax and the Law on Excise Duties were tabled in Parliament last summer. The second part of tax reforms (amendment of the Law on Personal Income Tax and the Law on Profit) is being prepared. On the one hand, the postponement of the implementation of the value added tax aggravates the burden of the cascading sales tax on exports (Bole; 1995). On the other hand, given the possible inflationary effect of the VAT it is narrowing the period in which inflation should be reduced to the European level.

As set out in the SEDS and the Budget Memorandum up to the year 2001, the percentage of **General Government Expenditure** in GDP ought to be gradually reduced. The measures taken and laws accepted last year, however, were contradictory in nature. On the one hand, reforms of the pension and social security systems were being prepared and aimed at reducing General Government Expenditure in the future. On the other hand, the Parliament adopted a range of special developmental programmes for sectoral developmental planning and laws on social transfers. These in turn additionally burdened the central budget, raised the level of borrowing and increased the number of state guarantees issued.

The sectoral developmental programmes and the related general government expenditures are not in accordance with the actual budgetary capacity. The inadequacies of the programme have been pointed out at several occasions (see for example: Murn, 1995, 1996, Potoènik, Murn 1997). By the end of April 1997, 14 documents on sectoral developmental planning were adopted (strategies, resolutions, national programmes, programmes, policies), 15 programmes were still tabled in Parliament in addition to the 68 special developmental laws (of which 9 are yet to be adopted). All these documents will have an impact on the level of General Government Expenditure. The implementation of adopted and still tabled documents together with the undiminished expenditure for the tasks undertaken without such documents, would mean that the share of the central and local budgets in the GDP would be higher by 8.2 and 1.1 percentage points respectively in 1997. As the adoption of these documents has already given too many financial obligations to the central budget in 1995 and 1996, the Laws on the Implementation of the Budget for both years included special provisions whereunder these documents were implemented only to extent they were in line with the central budget. So far only programmes for the construction of motorways and laws on the elimination of the effects of natural catastrophes, rehabilitation of certain enterprises and state guarantees have been realised. As a partial solution to the problem the government has proposed amendments to the Standing Orders of the National Assembly. The current procedure for the adoption of national programmes (which is the same as that to adopt laws) should be changed so that the Parliament only discusses the indicatively devised strategies. The financial aspects of these documents would be dealt with as a part of the budgetary documents. The second part of the solution - the long-term budget programming - will be introduced with the new Law on Budget Principles. The latter will ensure the consistent monitoring whether the requirements set out in the documents for sectoral and developmental planning, and laws are in line with actual budgetary capacity.

Other pressing problems facing the present system of public finance are the wide range of **state and para-state funds and institutions** and the **lack of financial control over them**. By abolishing self-management associations and by setting up an integral budget after gaining independence, Slovenia's public finance system became more like that of developed economies. However, the establishment of funds, agencies and special companies with autonomous tasks on the central and local level is a step back. There are great differences between these public institutions in terms of their organisation, mode of financing and tasks they perform. No records are kept of such institutions on the local level. On the central level, however, there are four agencies funded from the central budget, two agencies financed through charges imposed based on services performed and/or by the central budget, and 14 funds and certain other institutions (such as DARS - Motorway Company of the Republic of Slovenia, SID - Slovene Export Corporation).

The problem of variety and lack of control over these institutions ought to be systemically solved as soon as possible (in particular their financing). They should be classified based on their functions in compliance with international standards. The state sector should include all institutions and their parts which carry out economic policy and are financed by the state (directly from the budget or using proceeds from privatisation or indirectly from retained capital revenue which in developed economies also form a part of the budget). The problems associated with institutions which belong to the state sector are related to their autonomy and lack of evidence and control, rather than their number. Regulation of the financing of the funds financed directly from proceeds from privatisation is particularly urgent. Since the proceeds from privatisation will decrease these funds will lose their main source of finance. The adoption of adequate systemic regulation is required whereby the state would finance the funds with explicitly defined functions whilst others would be eliminated. Unless such measures are taken, funds will soon become too heavy a burden for the central budget and will mean that additional capital will have to be borrowed.

Furthermore, pressures on budgetary expenditure will increase due to the present systems of social security and pension and disability insurance. The growing expenditure for social transfers is becoming a great burden on the budget. In view of the large number of beneficiaries the level of benefits is relatively low. The social security system will therefore need to be overhauled in order to decrease the number of beneficiaries and ensure that only the most needy ones are included. Less support should be given to recipients who are able to through work meet their own needs (see Chapter 6.2).

The basis of the pension system reform has been drawn. The first step, which includes the modifications of the existing system, should be taken this year. Reform in the broader sense, which will consist of the legal regulation of the existing and new system of compulsory savings for old-age (the second pillar), should be prepared in 1998 at the latest. These changes must be made to coincide with the implementation of the new Law on the Value Added Tax and the amendment of the Law on Personal Income Tax as they are supplementary to them and conditional upon them. Social security contributions, which are the largest component of labour cost, cannot be reduced unless an additional source of finance is found and the insurees are provided with additional means to ensure their own social security by saving for old-age. Newly established pension insurance funds will form the second and third pillar of the pension system (pension funds) and will act as financial intermediaries helping accelerate the development of the financial market.

The process of changing the way in which the **labour market** is regulated has also been rather slow. After an extensive period of preparations, a new labour law is presently being discussed at the expert level. The new law seeks to balance out the need for a more flexible labour market with employment security. Certain requirements and related costs such as the terms of hiring and firing are still of utmost importance to the employer when deciding whether to employ a new person. Due to the high firing costs (the long period for giving notice, high severance pays etc.) employers are opting for more flexible forms of employment and generally are more cautious about recruitment. The proposed law retains a relatively rigid dismissal procedure very similar to the German model. It, however, reduces laying off costs as it lowers the level of severance pays and the notice period. At the same time, the law guarantees protection to workers claims by ensuring that outstanding wages, wage compensations, compensations related to injury at work and severance pay are given priority in cases of termination of employment due to forced settlement and bankruptcy. Moreover, the Law on the Guarantee Fund of the RS also guarantees the payment of the above -mentioned employee claims in the event of the insolvency of the employer.

The speed and level of institutional changes is an important factor on which foreign analysts base their assessments of the situation in transition economies. In its recent analysis experts from the European Bank for Reconstruction and Development (EBRD, 1996, 1997) assessed Slovenia as falling slightly behind the Czech Republic and Hungary concerning the "speed of transition". This indicator is comprised of the following factors: the share of private sector contributions in GDP; the level of privatisation of large-size enterprises; the assessment of the policy of competitiveness and regulation of investment opportunities. Slovenia dropped from the 34th position in the Autumn to the 38th position in the Spring Euromoney country risk assessment. This can also be attributed to the slow pace of economic reforms (see SEM 3, 1996).

5. ECONOMIC TRENDS IN 1996 AND THE SHORT-TERM DEVELOPMENTAL SCENARIO

5.1. PRODUCTION - 3.1% GDP growth in 1996 and target growth of 4% and 4.5% respectively in 1997 and 1998

According to the quarterly National Accounts estimates published by SORS in mid-April, **Gross Domestic Product rose 3.1% in 1996**, measured at constant 1992 prices. This is slightly below IMAD's last autumn forecast of 3.5%. This was primarily due to slightly less favourable economic developments in the last quarter of 1996 than expected. It was also due to discrepancies in the estimates of the value added of the selected sectors (for example in agriculture). The correction of the value of GDP for 1995 at constant prices (an increase by 0.17%) and thereby a correction of the real growth in GDP in 1995 from 3.9% to 4.1% was another factor for lower GDP growth.

According to SORS's estimates **value added increased in all sectors except in mining in 1996**. Modest growth was recorded in agriculture (1.7%), and manufacturing (1.4%), whereas rapid growth continued in construction (11.1%). Growth in services was substantial. The highest rates were recorded in real estate, renting and business services (4.8%), followed by trade (4.7%), hotels and restaurants (4.5%) and public administration (4.2%). In 1996, industry's share in value added continued to decrease, whilst that of services increased. Industry accounted for 32.2% and services for 59.4% of total value added.

Balance sheet and profit and loss statement figures submitted by enterprises to the Agency for Payments are also indicative of such strengthening of the position of the service sector. Based on these data, in 1996 there were 27,338 commercial companies operating in the service sector (up from 25,600 in 1995). They employed 39% of the total employed in commercial companies (in 1995, 36.6%). Overall the business results were positive (like in 1995), and net profits exceeded net losses. In particular, positive results were achieved in trade, transport and communications and financial intermediation.

On the output side, **growth in all sectors is expected to contribute to an overall growth in GDP of 4% in 1997**. The highest growth is expected in construction, whereas a growth averaging between 4.5% and 6% is expected in most market services. Growth rates below 4% are expected in all other sectors (agriculture, mining, manufacturing and non-market services). These developments will further decrease manufacture's share in the value added (down 0.3 points to 27.8%). On the other hand, the share of services is anticipated to rise to 59.7% in 1997 and 59.9% in 1998.

Table 4: Gross domestic product by kind of activity

	Real growth in %			
	1995/1994	**1996/1995**	**1997/1996**	**1998/1997**
	Constant prices 1992			
A, B Agriculture, Forestry	1,6	1,7	1,5	3,0
C Mining and Quarrying	0,9	-1,3	2,2	1,0
D Manufacturing	2,5	1,4	2,5	3,0
E Electricity, Gas and Water Supply	0,2	1,0	2,0	1,0

F Construction	9,2	11,1	10,0	10,0
G Wholesale and Retail Trade, Repairs	4,7	4,7	5,0	5,0
H Hotels and Restaurants	3,0	4,5	5,5	4,5
I Transport, Storage and Communications	7,2	3,4	4,5	4,5
J Finance	3,5	2,3	6,0	5,0
K Real estate, Reting, business services	6,1	4,8	8,0	8,0
L Public administration	3,1	4,2	3,0	3,0
M Education services	2,8	2,0	2,5	2,5
N Health, Social Care	2,1	0,6	1,0	1,5
O Other community, social and personal services	2,3	1,3	2,0	2,2
FISIM	-0,5	1,6	2,5	2,0
1. TOTAL VALUE ADDED (A...O+FISIM)	3,7	3,0	4,0	4,3
2. Correction items (a-b)	6,4	4,1	4,1	5,6
a) Taxes on production and on imports	6,5	3,9	4,1	4,2
b) subsidies	6,8	2,7	4,1	-3,4
3. GROSS DOMESTIC PRODUCT (3=1+2)	4,1	3,1	4,1	4,5
Source: IMAD estimate 1996, target scenario 1997, 1998				

In 1996, growth in agriculture continued. Based on preliminary SORS's data, crop production picked up 4.4%. The yield of grapes jumped as much as 40% from the year before when the harvest was extremely poor. Fruit production remained the same as the year-earlier, whilst field crops were 2.5% lower. The gross index for agriculture was 1.3% higher than the net index as more animal fodder were used than the year before. Data on animal husbandry is not available yet. In 1995, it accounted for 62% of total agriculture. Only data on the abattoirs and purchases are presently available. Abattoirs report that output of beef and poultry rose 2% and of pork 5%. Purchase of agricultural products rose 1.9% in real terms.

The beginning of 1997 did not seem very promising. In autumn of 1996, farmers sowed 5.7% less cropland than the year before (9.5% less wheat). Severe frost this spring particularly damaged vineyards, fruit trees and vegetables.

Based on quarterly National Account estimates, **manufacturing** sector's **value added edged up 1.4% and output was up 1.1%** in 1996 compared to the year before (growth in 1995 was 2.6%). Employment in manufacturing dropped 7.9%. The performance of selected manufacturing branches varied considerably. Production grew most markedly in sectors producing food, beverages, fodder and tobacco products. This group recorded 5.7% growth in production. In the group involved in the production and distribution of electricity, manufacture of machinery equipment, manufacture of metal products and transport equipment, the highest growth of 10.1% was recorded in manufacture of electrical equipment. Production of the group as a whole was up 1.9%. Energy intensive branches increased production by 1.3%. Output of Slovenia's "traditional branches" (manufacture of chemical products, wood manufacturing, textile, leather and footwear industries) decreased on average by almost 1%.

In 1996, overall business results of manufacturing enterprises were negative. Net operating profits were up 18% (or SIT 6.6 bil) from the year before and amounted to SIT 41 bil. However, net losses surged by SIT 21 bil and totalled SIT 87 bil. Five manufacturing sub-branches (manufacture of textiles and textile products, leather and leather products, chemicals, chemical products and man-made fibres, machinery and equipment and transport equipment), which in 1996 on average generated two thirds of revenue on foreign markets, generated almost a half of the total net losses in manufacturing. Almost a third of the net losses in manufacturing was due to manufacture of transport equipment.

Preliminary data indicate that production in manufacturing was up 1.5% in the first four months of 1997 from a year-earlier. In the first three months a downward trend was recorded in production, but it reversed in April. The downswing at the beginning of the year can be partially attributed to unfavourable arrangement of working days, as working time was 3% shorter in the first three months than at the same time the year before (EIPF, April 1997). Positive developments recorded since April are expected to continue in the coming months as working day arrangements will be more efficient. The results of the Survey on Business Trends in Manufacturing (SORS) and the Survey conducted by the Chamber of Economy (GZS-SKEP, 1997) are also modestly optimistic. The optimism is primarily due to the rise in export orders and the acceleration in the growth of Western economies. In Germany, industrial production is forecast to pick up 3.4% in 1997 and a further 3.8% in 1998. After a drop in industrial production in Italy, 1.5% growth in 1997 and 2.4% in 1998 is expected. EU's imports are expected to rise 5.2% in real terms in 1997 and 6.5% in 1998 (OECD, 1996). A combination of a likely recession on the domestic market and the more favourable developments on the EU markets increase the likelihood of a 2.5% growth in manufacturing in 1997 and 3% in 1998. However, such growth is only attainable if the development-technological level of products and production process is at least partially raised in manufacturing.

In **construction**, the value of completed work rose 13.5% in real terms in 1996 from a year before. In the first nine months of 1996, the value of completed work abroad amounted to US$ 113 mil (in 1995, US$ 189 mil). **Value added in construction is estimated to have grown 11.1% in 1996.** Losses in construction exceeded profits by SIT 539 mil. In the first two months of 1997, the value of completed work rose by 1.1%. Since in construction the first months of the year are usually seasonally low this raises hopes of higher growth later on this year. Construction work abroad is not expected to increase much this year. Nevertheless, statistically unregistered construction activity, which accounts for almost 30% of total construction, will fuel growth also in the future. **The rate of growth may eventually average 10%.**

Production in **mining dropped 1.3%**. In the mining sector coal extraction remains the most important. In 1996, the extraction of brown coal fell 12.9% from a year earlier. In the Velenje lignite pit production edged up 0.5%. Extraction of lignite (in tons) exceeded 4.7-times that of brown coal. Extraction of non-ferrous minerals was down 2.9%. Last year, sand and stone quarrying continued to grow rapidly and was 25.0% higher than a year before. Net losses (net losses minus net profits) in mining increased substantially from 1995 (by almost 12 times) and totalled SIT 5,114 mil, of which a substantial part was due to coal mining. In the first four months of 1997, mining output was up 2.5% from the year before. According to developmental forecast in the Energy Balance for the RS for 1997 and expected further growth in sand and stone quarrying, mining output is expected to pick up by around 2% in 1997 and by slightly less than that in 1998.

The electricity, gas and water supply sector recorded **a 1% growth in 1996**. Production of electricity is the main activity within this sector. Its share in the sector's value added is 80%. In 1996 production of electricity was up 0.8% from 1995. There was also growth in the distribution of heat (6.3%); production, piping and distribution of gas (0.2%) and production and distribution of water (estimated 0.5%). In the first four months of 1997, activity in the electricity supply sector rose 6.2% from the same time a year-earlier. Based on the Energy Balance for 1997, IMAD estimates that the overall production of the electricity, gas and water supply sector will edge **up 2% in 1997 and around 1% in 1998**. Business results of enterprises in this sector deteriorated from a year earlier. Net losses (profits minus losses) in the electricity supply sector were almost 4-times higher than in 1995. Such a high increase was, however, also a result of depreciation being taken fully into account in 1996, unlike in 1995 when it was only partially taken into account. Net losses in the water supply sector increased to SIT 477 mil and in the gas supply sector to SIT 162 mil. The opposite was the case in the distribution of heat were a net profit of SIT 678 mil was generated. In 1996, the electricity gas and water supply sector as a whole increased its net profits by a solid 20% to SIT 2,231 mil, whilst net losses tripled to SIT 21,830 mil from 1995.

In 1996 the level of production in **transport, storage and communications** edged **up 3.4%.** In **freight transport**, forwarding activities advanced the most (up by more than 6%), followed by loading and unloading activities (up 4.3%). Maritime transport grew modestly (1.9%), and the road freight transport was up owing to private carriers. Railway freight transport (measured in net ton per km) declined by 17.1%. In **passenger transport**, growth was recorded in air transport (up 6.6%), airport activity (5.2%), railway transport (2.7%) and urban transport (2.5%). According to quantitative indicators, there was also a substantial growth in **communications** activity: number of telephone subscribers rose 8% and the volume of postal services 14%. **This year and in the next**, transport storage and communications is **expected to continue to grow at around 4.5%**. Enterprises engaged in transport, storage and communications generated a net loss of SIT 8,482 mil and a net profit of SIT 11,624 mil in 1996. Railway transport produced the highest loss in the sector amounting to SIT 3,941 mil, even thought results were still positive in 1995. In 1996, postal service ended the year in the red, its loss amounting to SIT 366 mil. Loss in air transport was up by a third to SIT 1,62 mil. Loss in other land transport services (excluding railways) doubled to SIT 475 mil. In all other activities within this sector profits exceeded losses. In telecommunications, net profit stood at SIT 3651 mil, up a solid 10% from 1995. Loading and unloading, and storage activities had a profit of SIT 2,214 mil, up more than 20% from 1995. The tourist agencies and forwarding companies increased their profits by a third to SIT 1,649 mil and 1,448 mil respectively.

In 1996, value added in the sector of **trade and repair of motor vehicles and consumer goods increased 4.7%** from a year-earlier. Turnover in retail trade was up in real terms by 2.9% and in wholesale trade up 3.4%. The profit margin's share in the structure of retail price increased from 15.3% at the end-1995 to 16% at the end-1996. A growth rate of around 5% is expected in this sector both this and the next year.

This sector generated a net profit of SIT 34,172 mil and a net loss of SIT 21,405 mil. Net profits exceeded net losses in all three activities comprising this sector: motor vehicles repair and trade in motor vehicles and fuels; intermediation, wholesale trade; and retail trade and repair of consumer goods. Almost a half of net profits (net profits less net losses) was generated by activities linked to motor vehicles (repair and sales of motor vehicles and retail trade in fuels). This sector generated 33.4% of total revenue, 28.1% of the net profit and 11.7% of the net loss of all commercial companies which submitted their 1996 financial statements to the AP.

In 1996 the **hotels and restaurants sector grew** in real terms **by 4.5%**. Total number of overnight stays decreased by 1%, of which domestic overnight stays were down 5% and foreign up 5%. The number of tourists rose by 5%. There were 2% fewer domestic tourists and 14% more foreign tourists. Most of the foreign tourists are Italians, Germans, Austrians and Croatians. They generated almost a third of foreign tourist turnover in Slovenia in 1996. Seasonal concentration was even more pronounced in 1996 than in 1995, as more than half of all overnight stays were in the period from June to September. In 1996, the foreign exchange inflow from tourism was US$ 1,221.7 mil, up 11% in real terms from a year-earlier. Hotel and restaurant prices rose 1.6 percentage points faster than retail prices. According to financial statement figures, enterprises in hospitality sector generated a net loss of SIT 4,735 mil and a net profit of SIT 1,667 mil. The data, however, does not include activities of private entrepreneurs, the share of which is substantial.

The latest data on tourism and foreign exchange inflows at the beginning of this year points to quite promising season, especially in terms of foreign tourists. In the first four months, the number of foreign tourists rose 14% and foreign overnight stays were up 18% compared to the year before. Over the same period, the number of domestic tourists edged up only 1% and the number of their overnight stays was up 2%. In total, 6% more tourists visited Slovenia and overnight stays were up 9% from the year before. **Favourable developments at the beginning of the year raise expectations of an even higher rate of growth in the hospitality sector in 1997 and 1998 averaging at around 5.5%.**

5.2 THE COST AND EXPENDITURE STRUCTURE OF GROSS DOMESTIC PRODUCT - Export demand will be an important lever of economic growth in the coming years

In view of Slovenia's open and export oriented economy, a positive economic trend in the EU (and in particular of Slovenia's main trading partners) is of key importance for its future development. Based on available statistical estimates, current economic trends and forecasts of European institutes and international organisations which project accelerated economic growth and a growth in imports of Slovenia's main trading partners, IMAD estimated that the Slovene **economy will grow by 4% in 1997**.

In 1995 and 1996, domestic demand was the main lever of economic growth. The impact of foreign demand was only modest. Of all domestic demand components, investment demand grew at the fastest rate. **In 1997**, **growth is expected to be generated equally by domestic and foreign demand**. The latter's level will exceed that in 1996. After a modest growth in export of goods and services in 1996 (up 2.5%), this year rise in foreign demand is expected to lead to a higher rate of growth in exports.

Slovenia is a small and open economy. Exports account for around 55% of GDP. Consequently, Slovenia is very dependant upon external terms of trade which were adverse in 1996 for exporters. Foreign exchange rates oscillated considerably, and in particular, the ratio between the German Mark (DM) and American Dollar (US$). In 1996, the average monthly exchange rate of DM rose 8.8% compared to the average exchange rate in 1995 and the average US$ exchange rate increased 14.2%. Furthermore, the DM was up 4.1% in 1995, whilst the US$ even lost in value, around 8.0%, from the previous year. It should be pointed out that Slovenian exports are in most cases (more than 50%) invoiced in DM. Rapidly increasing inventories due to difficulties with sales in 1995 have discouraged imports. Consequently, in 1996 imports grew much slower than the year before. Since imports were growing at slower rates than the year before, deficit in exchange of goods and services also narrowed slightly in 1996. In 1997 and 1998 the deficit is expected to be modest.

Table 5: Growth in aggregate demand (in %)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**
Total aggregate demand	4,3	6,2	5,1	3,2	4,3	4,7
of which:						
Foreign demand (Exports)	0,6	10,5	1,0	2,5	4,2	5,8
Domestic demand	5,4	5,1	6,3	3,4	4,3	4,4
- Intermediate consumption	1,1	5,1	3,7	3,0	4,0	4,3
- Final consumption	11,6	3,4	7,5	2,4	3,0	3,6
- Gross fixed capital formation	10,7	12,5	17,1	8,9	9,6	7,7
Source: SORS, Estimates of National Accounts IMAD						

In the structure of the expenditure side of GDP, the share of private consumption decreased (by 0.6 percentage points), whilst the share of gross fixed capital formation increased the most (up 0.9 percentage points). In view of the ongoing infrastructure construction, a 9.6% rate of real growth in investment is anticipated this year. Thus, gross fixed capital formation is expected to be represent 23.2% of GDP in 1997.

Table 6: Gross Domestic Product by Expenditure (in %)

	Stucture						
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GROSS DOMESTIC PRODUCT	100,0	100,0	100,0	100,0	100,0	100,0	100,0
TRADE BALANCE (EXPORT - IMPORT)	7,0	1,1	2,6	-1,3	-0,8	-0,9	-0,9
Domestic consumption	93,0	98,9	97,4	101,3	100,8	100,9	100,9
- Private consumption	55,1	58,5	56,6	57,9	57,3	56,4	55,8
- Government consumption	20,3	21,1	20,2	20,2	20,5	20,7	20,5
- Gross fixed capital formation	18,6	18,8	19,7	21,2	22,1	23,2	23,8

- Changes in inventories	-1,0	0,5	0,8	2,0	0,9	0,7	0,8
Source: Estimates of National Accounts IMAD							

Table 7: Cost structure of GDP (in %)							
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
1. compensation of employees (1 =1a+1b)	64,2	60,1	58,0	57,3	56,6	55,5	54,8
1a. wagws and salaries	53,6	50,1	48,7	48,3	49,2	49,0	48,4
1b. employes' actual soc. cont.	10,6	10,0	9,3	9,0	7,4	6,5	6,4
2. NET TAXES ON PRODUCTION AND ON IMPORT	12,3	13,9	14,2	14,8	15,5	15,5	15,6
3. GROSS OPERATING SURPLUS (3= 3a+3b)	13,7	15,0	17,1	17,1	16,9	17,9	18,2
3a. consumption of fixed capital	18,7	15,5	15,1	14,9	16,0	16,1	16,2
3b. net operqating surplus	-5,0	-0,5	2,0	2,3	0,9	1,8	2,0
4. GROSS MIXED INCOME (4= 4a+4b)	9,8	11,0	10,7	10,8	11,0	11,1	11,4
4a. consumption of fixed capital	1,2	1,6	1,8	1,7	1,8	1,8	1,8
4b. net mixed income	8,6	9,4	8,9	9,0	9,2	9,3	9,6
5. GROSS DOMESTIC PRODUCT (5= 1+2+3+4)	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Source: SORS: 1992-1995. IMAD: estimates 1996, target scenario 1997, 1998							

The estimated cost structure of GDP in 1996 was far from favourable. The relative share of compensation of employees decreased by 0.7 percentage points. However, unlike in previous years, at the same time the share of gross wages and other remuneration rose (by 0.9 percentage points) and the share of employers' social security contributions fell (by 1.6 percentage points). The SNA methodology does not include the payroll tax introduced last year in calculating compensation of employees. It is classified under the category "other taxes on production". Therefore the introduction of payroll tax has increased the taxes on production and imports (by 0.6 percentage points). Gross profit (i.e. net profit plus depreciation) which is the basic motivation for private entities' production activity, has remained at last year's level. The gross operating surplus of legal entities (excluding households) decreased (by 0.2 percentage points). The share of a similar balance category (gross mixed income) in GDP of non-corporate enterprises in the household sector (natural persons) increased by 0.2 percentage points. Last year the rise in share of Gross Profit in GDP was halted. . Compared to 1995 net profits dropped considerably in 1996. Their share in GDP fell by 1.2 percentage points, whilst the share of depreciation rose by 1.2 percentage points. In the structure of primary distribution the level of depreciation of fixed assets of commercial companies increased the most (index 131.7 on the previous year). A marked improvement in primary distribution is almost impossible, as key decisions concerning the movements in wages and taxes which will affect primary distribution in 1997 were already adopted in 1996.

Due to a positive income and current transfer balance, the Gross National Product was 0.8 percentage points higher than Gross Domestic Product in 1996. A positive income and transfer balance accounting for 0.8% of GDP is expected this year as well. Excluding the amount necessary to meet national final consumption, gross national savings accounted for 23% of GDP in 1996. This was slightly below the level necessary to cover domestic investment. For the second year in a row, the latter was net financed by borrowing abroad. This year, a roughly balanced current account is expected. This expectation is premised on a more successful economic policy of guaranteeing an adequate level of national saving. The share of national saving, a crucial macro-economic factor for future economic development, is forecast to increase to 23.8% of GDP in 1997. An adequate level of savings would enable the financing of gross fixed capital formation, which is expected to rise in real terms by 9.6% this year, whilst maintaining the level of net borrowing abroad at a modest level (0.1% of GDP).

Table 8: Supply and use of resources (in %)

	Structure						
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
GROSS DOMESTIC PRODUCT	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Factor income balance, net	-0,7	-0,4	0,8	0,8	0,5	0,6	0,7
GROSS NATIONAL PRODUCT	99,3	99,6	100,8	100,8	100,5	100,6	100,7
CURRENT TRANSFER BALANCE	0,8	0,6	0,6	0,4	0,4	0,3	0,3
GROSS NATIONAL DISPOSABLE INCOME	100,1	100,2	101,4	101,3	100,8	100,8	101,0
Final consumption	75,5	79,6	76,8	78,1	77,8	77,0	76,3
GROSS SAVING	24,6	20,6	24,5	23,2	23,0	23,8	24,6
CURRENT ACCOUNT BALANCE	7,0	1,3	3,9	0,0	0,0	-0,1	0,0
GROSS CAPITAL FORMATION	17,6	19,3	20,6	23,2	23,0	23,9	24,6
of which: Gross fixed capital formation	18,6	18,8	19,7	21,2	22,1	23,2	23,8
NET CAPITAL FORMATION	-2,3	2,2	3,6	6,6	5,2	6,0	6,6
Source: Estimates of National Accounts IMAD, target scenario 1997, 1998							

For the first time figures on the saving and financial balances of basic economic sectors were compiled for 1995 and certain relations were established. The upper part of Table 9 shows that sectors evaluate their financial surplus or deficit as the difference between their saving and investment. Savings are a result of a chain of processes, starting with the creation of a product and then followed by its distribution. An integral presentation of these processes is shown in IMAD's National Accounts Matrix in the Appendix (Table 17). In 1995, enterprise savings together with depreciation accounted for 11.8% of GDP, state savings and depreciation 3.4% of GDP and households savings and depreciation (including producers - natural persons) 8% of GDP. In 1995, national savings accounted for 23.2% of GDP. This share is relatively small especially as depreciation represents a large part of savings. In 1995, the ratio of investment to savings was relatively normal. The financial surplus of households accounted for 1.6% of GDP and was used (indirectly through banks) to cover enterprise loans. The role of the state and foreign entities was only marginal. A similar picture can be obtained by looking at financial figures, that is by using the data of the Bank of Slovenia (BS), which, however, like in other countries, is not free of statistical errors. BS's analysis enables the monitoring of sectoral financial balances since financial instruments used are disaggregated even in greater detail.

Such analysis should serve as a basis for the adoption of policies aimed at encouraging national saving. Provided that a prudential economic policy is maintained, a slight increase in the level of national saving is expected in the coming years. By the year 1998, it should increase by 1.4% of GDP and reach 24.6% of GDP.

Table 9: Savings and financial balances of sectors (in % of GDP)

1995	**enterprises**	**government**	**households**	**abroad**	**total**
1. savings (and depreciation)	11,8	3,4	8,0	0,0	23,2
2. investment and change in stocks	14,6	2,1	6,4	0,0	23,2
3. transfer of funds for roads	1,1	-1,1	0,0	0,0	0,0
4. financial balance by IMAD (1-2+3)	-1,7	0,1	1,6	0,0	0,0
5. statistical error (6-4)	-0,7	-0,1	0,4	0,4	0,0
6. financial balance by BS (7+8+9)	-2,4	0,0	2,0	0,4	0,0
7. money and deposits	-7,3	-0,3	5,4	2,2	0,0
8. loans	3,4	0,3	-3,7	0,0	0,0
9. other	1,5	0,0	0,3	-1,8	0,0

Source: SORS, BS, MF, IMAD's National Accounts Estimates

In 1996, compensation of employees rose 1.9% in real terms from a year earlier. Net wages and other remuneration soared 5.1% and their share in the structure of employee compensation rose. On the other hand, the share of social contributions and income taxes decreased in real terms by 2.4%. A real drop was recorded only in the rate of employers' social security contributions, which was a result of the disburdening of labour costs. As a result of a rapid growth in wages, and in particular of the highest wages, the rate of real growth in income tax revenue exceeded that of employee social security contributions revenue. The disburdening of labour costs by reducing contribution rates was partially offset by the introduction of the payroll tax.

This year, the level of compensation of employees is expected to pick up in real terms by 2%. Consequently, its share in the cost structure of GDP will continue to fall. Net wages and other remuneration are forecast to advance 3.6%, whilst contributions and taxes to drop in real terms by 0.4%. Considering the income policy goals, the gross wage per employee is expected to increase 3% this year. Due to stagnant employment the total wage bill is expected to increase by the same percentage. This year, no adjustments in employees' contribution rates are foreseen, however, a higher rate of growth in personal income tax is expected owing to the distribution of wages. Other remunerations will continue to grow faster than wages, although their share in the cost structure of GDP is expected to fall. The share of social security contributions and taxes will decrease as well, mostly due to employers' contributions.

Although contribution rates will not change this year, last year's reductions and consequent lower revenues from employers' contributions will affect this year's revenue from this source.

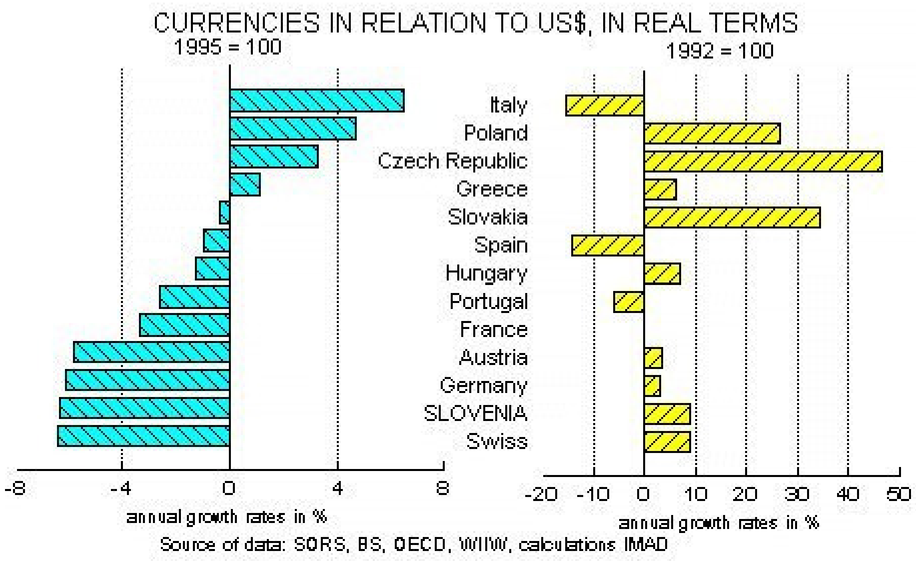
Table 10: The total wage bill - structure (in %)								
	Structure					**Real growth rate**		
	1994	**1995**	**1996**	**1997**	**1998**	**96/95**	**97/96**	**98/97**
COMPENSATION OF EMPLOYEES	100,0	100,0	100,0	100,0	100,0	1,9	2,0	3,1
Wages and allowances	57,9	58,1	59,9	60,9	61,0	5,1	3,6	3,2
Contributions and income tax	42,1	41,9	40,1	39,1	39,0	-2,4	-0,4	2,9
of which:								
- Income tax	10,3	10,4	11,0	11,2	11,3	7,1	4,3	3,5
- Employees' social securty contribution	15,8	15,6	16,0	16,1	16,0	3,8	3,0	2,7
- Employers' social securty contribution	16,0	15,7	13,1	11,8	11,7	-15,0	-8,5	2,7
Source: SORS: Compensation of employees 1994, 1995, Estimates IMAD: 1996, target scenario 1997, 1998								

In 1998, compensation of employees is estimated to rise 3.1% in real terms, of which net wages and other remuneration are expected to rise 3.2% and contributions and taxes 2.9%. According to the income policy, gross wage per employee is expected to rise 2.5%. Its rate of growth is expected to be one and a half percentage points lower than that of productivity. If employment grows at 0.2%, the total gross wage bill is predicted to increase by 2.7% that is, at the same rate as the total net wage bill, whereas a slightly higher rise in other remunerations is expected. Contribution rates will remain stable and personal income tax will grow in line with changes in wage distribution.

5.3 INTERNATIONAL ECONOMIC RELATIONS

5.3.1. EXPORT COMPETITIVENESS - After improving in 1996, chances of further improvement this year are small

In 1996, export competitiveness (measured by unit labour costs in the currency basket) of industry improved considerably for the first time since 1992. Unit labour costs in the currency basket fell by 7.3% from 1995. Labour costs per employee in industry grew moderately (2.7%), labour productivity increased considerably (9.2%) and the tolar depreciated in real terms against the basket of currencies. The slowdown in real growth in labour costs per employee was largely due to a lower tax burden on wages, as real growth in net wages and other remuneration was not much lower than before. After growing 7.1% in real terms in 1995, net wages and other remuneration in industry picked up a further 6.2% in 1996. At the same time industrial production grew only 1% and consequently the growth in wages and other remuneration was offset by downsizing. Despite the improvement in 1996, export competitiveness was still considerably below that in 1992.



In 1996, tolar depreciated against the US$ more than most other European currencies. Nevertheless, due to its strong appreciation in 1995, it was still one of the currencies which appreciated the most against the US$ in the period since 1992. In the period from 1992 to 1996, the appreciation was larger only of the Czech, Slovak and Polish national currency. Depreciation of tolar against the US$ in 1996 was the main reason for improved competitiveness of Slovenian exports compared to the average of CEFTA countries (for more details, see Statistical Appendix). Compared to CEFTA countries, unit labour costs in Slovenia, measured in US$, fell by 9.7 percentage points. Despite this relative drop, the average gross wage in Slovenia, measured in US$, was between 2.1 to 2.8 times higher than in CEFTA countries (in industry, the average gross wage was 795 US$ in Slovenia, whilst it was between 280 US$ and 373 US$ in CEFTA countries). The competitive advantage of Slovenia stemming from lower labour costs compared to those in more developed economies is lower than that of other CEFTA countries. Nevertheless, Slovenia has the best results with respect to several indicators on quality competition (WIFO, WIIW, 1997). In 1993 and 1994, Slovenian manufacturing achieved a markedly higher export unit value than other CEFTA members and a more favourable relation between export and import unit value (on average and in terms of technological classes). Comparatively speaking, Slovenia and Hungary exported the highest proportion of human capital intensive products to the OECD area. In addition, Slovenia ranked first in horizontal intra-industry trade. Furthermore, Slovenia recorded the largest trade surplus in the sector which successfully competes with the OECD in terms of quality, whereas its deficit was the lowest for the sector which experiences structural problems. Despite a relatively more favourable position of Slovenia compared to other CEFTA members, its quality lag behind developed economies remains substantial.

After 15 months of more or less constant betterment, export competitiveness deteriorated in the first three months of 1997. The ongoing growth in real labour costs per employee and the slight tolar appreciation has, according to seasonally adjusted data, together with a decrease in labour productivity eroded export competitiveness. The decrease in labour productivity was largely a consequence of a downward trend in industrial production. In the first four months, the tolar appreciated 0.8% in real terms, largely owing to US$ appreciation on the foreign exchange rate markets. The exchange rates of the DM, ATS, FRF and ITL depreciated in real terms against the tolar by between 2.5% to 3.4% due to the supply of foreign currency exceeding demand on the domestic foreign exchange market in the first four months. The income attractiveness of exports measured by the purchasing power parity, to DM and ATS currency areas has fallen below its lowest level in mid-1995. In March unit labour costs in the basket of currencies increased 4.6% from December of the preceding year.

On average export competitiveness is anticipated to increase somewhat in 1997 (by around 1%) provided that: (a) the tolar does not appreciate substantially against the basket of currencies (up to 2%); (b) real growth in the labour cost per employee does not exceed that in 1996 (2.7%), which is primarily dependant on the success of income policy to reduce the real growth in wages and other remuneration (from last year's 6.2% to 4.3%) since the effects of last year's tax disburdening of wages will be small; (c) an 8% growth in labour productivity in industry and an around 2.5% increase in industrial production.

5.3.2. EXPORT- IMPORT FLOWS AND THE BALANCE OF PAYMENTS - Accelerated growth in exports and imports of goods and small balance of payments deficit in 1997 and 1998

A slowdown in the growth of export and import flows **in 1996** was due to a slower growth in industrial production in the EU (0.3% only) and at home (1%). In real terms, exports of goods and services increased by 2.8% and imports 1.3%. According to the balance of payments statistics **the trade deficit stood at US$ 852.8 mil,** down US$ 100.7 mil from 1995. Owing to faster real growth in exports of services (4.1%) than imports of services (3.1%), the service balance surplus widened by US$ 60.9 mil to US$ 786.2 mil. Together the decrease in the trade deficit and an increase in service surplus generated a small **current account surplus of US$ 46.5 mil** (0.3% of GDP).

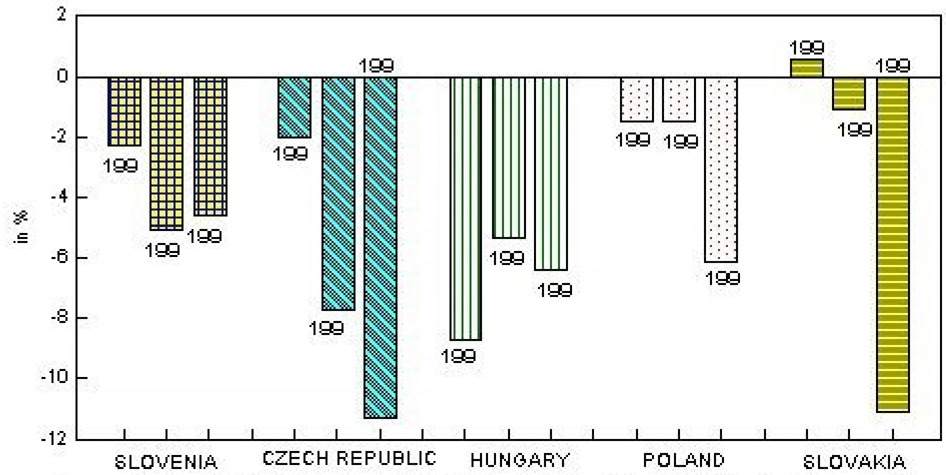
According to preliminary SORS's data, in the first quarter of 1997 exports of goods, measured in current US$, decreased 6.2% and imports 0.9% from the year before. Total goods trade fell by 3.4%. This was primarily due to the negative impact of inter-currency changes and in particular of the appreciation of the US$. Adjusting for inter-currency ratio changes, exports and imports of goods increased by 2.3% and 7.8% respectively. Exports and imports of services fell in nominal terms by 2.4% and 6.7% respectively. Traditional services, such as travel and transport, still dominate exports of services. They represent 81% of total exports of services. In the first quarter, the current account deficit stood at US$ 46.9 mil, whereas a year-earlier the current account recorded a surplus of US$ 49 mil.

Table 11: International terms of trade

	Total	EXPORT PRICES		Total	IMPORT PRICES		TERMS OF TRADE
		inter-currency changes	domicile prices		inter-currency changes	domicile prices	export prices/ import prices
1993	93,0	107,3	99,8	92,0	107,9	99,3	101,1
1994	106,7	98,8	105,4	108,6	99,1	107,6	98,3
1995	113,1	91,7	103,7	112,3	92,5	103,9	100,7
1996	97,8	102,6	100,3	98,5	102,1	100,5	99,3

1997est.	89,9	110,7	99,5	90,3	109,3	98,7	99,6
Source: SORS, BS, World Economic Outlook, calculations IMAD							

FOREIGN TRADE BALANCE AS % OF GDP IN CEFTA COUNTRIES



Source of data: BS, WIIW March 1997, LINK World Outlook, March 1997, calculations IMAD

In 1997 export and import prices will be falling due to a strong US$, which should average at around 1.7 DMs. This year the US$ is expected to appreciate 10% against the basket of currencies. If this eventuates than the international terms of trade will deteriorate only slightly (0.4%). Given the forecast 2.5% real growth in industrial production and the 5.5% real increase in imports of OECD countries, which are the main factors determining Slovenia's exports, IMAD estimates (using regressive analysis) that exports of goods should increase in real terms by around 4% in 1997. Similarly, import flows are affected by trends in industrial production, as well as by the real effective exchange rate movements and the real movements in net wages. In view of the forecast 2% real appreciation of the tolar, the 3.5% real growth in net wages per employee and the 2.5% growth in industrial production, imports of goods ought to increase in real terms by 4.4% in 1997. Consequently, this year's foreign trade deficit is expected to increase to US$ 920 mil.

Surplus in the service balance is estimated to amount to US$ 750 mil. A bigger inflow is expected in tourism which will represent 59.4% of the total export of services (last year, 57.8%). An increase in trade deficit and a decrease in service surplus will lead to a small current account deficit averaging around US$ 40 mil (0.2% of GDP).

In view of the forecast acceleration in economic growth and rise in the level of imports in the EU, continued real growth in the exports and imports of goods is expected in the coming years. Based on the forecast 3% growth in domestic industrial production in 1998, exports and imports of goods are expected to edge up in real terms 5.7% and 6% respectively. As imports of goods are forecast to grow faster than exports, the trade deficit is expected to widen to around US$ 1,003 mil. The current account will nevertheless remain roughly balanced (deficit of US$ 15 mil) in 1998.

5.3.3. FOREIGN DIRECT INVESTMENT - Favourable trends at the beginning of 1997

In the period from 1993 to 1995 the stocks of foreign direct investment (FDI) in Slovenia increased from US$ 954.3 mil to US$ 1,642.8 mil, or by 72.1%. The rise in FDI stocks was almost the same in 1994 and 1995 although slightly higher in 1995. Although rates of growth in FDI are high, in other transition economies FDI has grown even faster. In the period from 1993 to 1995 the annual inflow of FDI to Slovenia was also rising. In 1996, annual inflow amounted to US$ 185.9 mil, which was approximately US$ 10 mil more than the year before. In the first quarter of 1997, Slovenia received FDI worth US$ 83.1 mil, which was substantially more than the year earlier (US$ 22.4 mil). Taking FDI projects that have already been announced into account, a substantial increase in the inflow of FDI is forecast for this year compared to 1996. Based on the above data the current stocks of FDI are estimated at around US$ 2.1 bil.

Compared to developed Western countries and more successful transition economies, the level of FDI in Slovenia measured as the share of FDI in GDP and in gross investment has been relatively low. On the one hand, certain financial statements' entries of enterprises with foreign capital confirm the small role of FDI in the non-financial corporate sector. On the other hand, the shares of enterprises with foreign capital are surprisingly high as to exports, imports, trade balance, profit, tax on profit. Enterprises with foreign capital account for 3.4% of enterprises, 7.4% of total equity, 8.2% of total assets and employ 6% of all employed in the non-financial corporate sector. However, they generate 11.5% of the total sales, 15.3% of the operating profit, 6.1% of the operating loss and pay 15.5% of total tax on profits of the non-financial corporate sector. The most outstanding results of enterprises with foreign capital are with regard to exports and imports. Their exports and imports amount to as much as 20.1% of total exports and 19.1% of total imports of the non-financial corporate sector as a whole. Furthermore, these enterprises produce 23.9% of the trade balance surplus of the non-financial corporate sector. Thus, enterprises with foreign capital seem to be a relatively important category in the economy and in particular with regard to exports, imports, profit and tax on profit. This is particularly true in manufacturing where most of them are concentrated. Enterprises with foreign capital realise 17.6% of total sales, 18.7% of total imports, 21.0% of total profits, 23.2% of total exports, 23.8% of total tax on profits and 30.4% of the total trade balance surplus of the manufacturing sector.

In the period from 1994 to 1995, the importance of enterprises with foreign capital in the non-financial corporate sector increased although their share in the total number of enterprises decreased. In this period the share of enterprises with foreign capital increased with regard to the number of employees (up 0.7 percentage points), assets and sales (up 0.8 percentage points), exports (up 1.0 percentage points) and tax on profit (up 1.2 percentage points). The share of these enterprises in the loss of the non-financial corporate sector decreased. This trend was even more pronounced in manufacturing, where the shares of these enterprises in exports and total tax on profits increased most markedly (2.1 and 3.3 percentage points respectively), whereas their share in the loss declined by as much as 6.8 percentage points. Foreign trade and profitability seem to be areas where enterprises with foreign capital achieve better results than domestic enterprises.

5.3.4. FOREIGN PORTFOLIO INVESTMENT IN SLOVENIA - The introduction of custody accounts has halted the inflow of foreign capital in Slovenia's securities market

In mid-1996 foreign investor interest in portfolio investment in Slovenia's capital market increased. This happened after the most prestigious Slovenian enterprises listed their privatisation shares. These were in view of scarce domestic demand relatively cheap. At the same time Slovenia was relatively positively assessed in terms of country risk and credit rating.

Inflow of foreign capital for portfolio investments started growing more rapidly last September. In the period from September 1996 to February 1997 the monthly inflow of foreign capital averaged around US$ 30 mil. It was exceptionally high in January. A substantial inflow of foreign capital contributed to the excess supply of foreign currency in the foreign exchange market. This trend would most likely have continued in the months that followed had the Bank of Slovenia not introduced a new payment regime for the purchases of shares by foreign investors in February. According to the Bank of Slovenia, the main purpose of custody accounts is to ensure that transactions are made through banks enabling greater control over money flows and greater security of transactions.

In technical terms, the introduction of custody accounts is a good solution. It is also likely to be a useful means for ensuring domestic investors greater security of transactions. There is however one feature of Slovene custody accounts that is less acceptable for foreign investors. Namely, for every amount held in the custody accounts, a bank must hold an equivalent investment abroad or compulsory reserves. Banks have already provided a price list for running such custody accounts. The commission is to amount to 9-12% per year. Decisions whether to open such accounts will be made by foreign investors in the coming months.

5.4 INVESTMENT - Growth in investment continues and in particular in infrastructure

Growth in investment which started in 1993, continued in 1996 at the estimated rate of around 9%. Thus, the proportion of gross fixed capital formation in GDP rose from 21.2% in 1995 to 22.1% in 1996. Growth in investment is expected to continue this year and in the coming years. Although annual growth rates will not be as high as in 1995 (17%), they will average between 8% and 10%. Given the projected growth rates, the share of gross fixed capital formation in GDP is foreseen to continue to rise and reach 23.2% in 1997 and 23.8% in 1998.

Investment in infrastructure accounts for a significant part of total investment. In 1995, investment in infrastructure accounted for 21.4% of fixed capital formation. In 1996 its share increased to 23.5%. Its share is however expected to decrease to 22.4% and 21% respectively this and next year.

Apart from investment in infrastructure, investment in the corporate sector will be of utmost importance as it will ensure corporate restructuring and the necessary technological development. In 1996, investment in equipment is estimated to have increased by 5%. This year, investment in equipment should represent as much as 53% of total investment. This figure is based on a slightly higher rate of growth in investment in equipment than that in overall investment.

Investment in economic infrastructure and non-market services, which is financed from the central budget, accounted for 2.37% of GDP in 1996, down from the 2.8% recorded in the previous two years. A drop in budget-financed investment was a consequence of an increase in other budget expenditure. This shortfall was partly compensated from the proceeds from privatisation. Additional funds for investment in infrastructure provided from this source accounted for 0.08% of GDP.

Budget expenditure earmarked for investment based on sectoral developmental documents for the first time appeared in 1994 and were included in the 1994 Budget. In 1995 this was no longer possible. The situation was further aggravated in 1996. In both years, the Law on the

Implementation of the Budget set forth that budget expenditure stemming from sectoral developmental documents must not exceed the level set in the relevant budgets.

In 1997, requirements for investment in economic infrastructure and non-market services financed from the budget further increased. Taking into account the financing requirements (i) stemming from sectoral developmental documents were such documents are adopted; and (ii) based on the level of financing in 1996 were such documents have not yet been adopted, it can be concluded that budget expenditure will account for 4% of GDP in 1997. Such an increase in investment financing from the central budget cannot be expected. Local budgets have only modestly contributed to financing of investment. In 1994 and 1995, investment from local budgets accounted for only 0.89% of GDP. Sectoral developmental documents do not require larger funding from local budgets (on average 0.02% of GDP per year).

Investment in the construction of motorways and railways and in the energy sector is partly financed through borrowing, with or without state guarantees. At the end of 1996, state guarantees for loans accounted for 5% of GDP. In the period from 1997 to 2000 foreign loans amounting to SIT 97 bil (3.7% of GDP in 1997) and domestic loans amounting to SIT 31 bil are projected to be raised for the construction of motorway and railway infrastructure and investment in the electricity supply sector. Most of the loans will require state guarantees. Furthermore, according to the claims collected by the Ministry of Finance, borrowing for investment in economic infrastructure from foreign creditors is estimated to amount to SIT 164.2 bil and SIT 238.7 bil from domestic creditors in 1997.

5.5. BUSINESS RESULTS IN THE CORPORATE SECTOR

5.5.1. FINANCIAL STATEMENTS OF COMMERCIAL COMPANIES IN 1996 - Worse business results in 1996 than in 1995

The analysis of business results of commercial companies is based on balance sheets and profit and loss statements of commercial companies which submitted these documents to the AP. The analysis for 1996 does not include commercial companies which were undergoing bankruptcy procedures, certain funds and authorised investment funds as their inclusion would have made the analysis incomparable to that of previous years. The analysis incorporates data from balance sheets and profit and loss statements of 35,786 commercial companies which employ 467,238 workers. Commercial companies engaged in trade, repair of motor vehicles and consumer goods were the most numerous (41.4%), whereas companies in the manufacturing sector had the largest number of employees (47.7%).

Table 12: Business results of commercial companies

	in SIT mil			index in %		structure in %		
	1994	1995	1996	95/94	96/95	1994	1995	1996
1. TOTAL REVENUES	4.288.751	5.000.198	5.675.134	116,6	113,5	100,0	100,0	100,0
1.1. Operating revenues	3.973.722	4.656.188	5.313.406	117,2	114,1	92,7	93,1	93,6
in which:								
revenues from sales on the	2.902.294	3.462.672	3.960.935	119,3	114,4	67,7	69,3	69,8

domestic market								
revenues from sales on the foreign market	1.000.624	1.121.167	1.269.740	112,0	113,3	23,3	22,4	22,4
1.2. Financial revenues	185.595	192.396	197.669	103,7	102,7	4,3	3,8	3,5
1.3. Extraordinary revenues	129.434	151.614	164.059	117,1	108,2	3,0	3,0	2,9
2. TOTAL EXPENSES	4.313.673	5.010.131	5.717.271	116,1	114,1	100,6	100,2	100,7
2.1. Operating expenses	3.986.915	4.671.862	5.321.870	117,2	113,9	93,0	93,4	93,8
in which:								
costs of goods, materials and services	2.998.822	3.526.450	4.026.663	117,6	114,2	69,9	70,5	71,0
costs of labour:	723.265	835.872	906.553	115,6	108,5	16,9	16,7	16,0
wages and salaries	509.027	582.871	642.920	114,5	110,3	11,9	11,7	11,3
social security	115.006	131.251	118.816	114,1	90,5	2,7	2,6	2,1
other labour costs	99.232	121.750	144.817	122,7	118,9	2,3	2,4	2,6
depreciation	194.009	229.653	293.875	118,4	128,0	4,5	4,6	5,2
current assets write-offs	37.086	45.070	52.814	121,5	117,2	0,9	0,9	0,9
long-term provisions	24.425	23.463	22.918	96,1	97,7	0,6	0,5	0,4
changes in the value of inventories of products and work-in-progress	-21.735	-21.136	-21.842	97,2	103,3	-0,5	-0,4	-0,4
2.2. Financing expenses	240.163	246.547	279.345	102,7	113,3	5,6	4,9	4,9
2.3. Extraordinary expenses	86.595	91.722	116.056	105,9	126,5	2,0	1,8	2,0
3. TOTAL PROFIT	94.906	127.918	139.976	134,8	109,4	2,2	2,6	2,5
4. TOTAL LOSS	119.829	137.850	182.112	115,0	132,1	2,8	2,8	3,2
5. Taxes on profit	11.545	15.006	18.281	130,0	121,8	0,3	0,3	0,3
6. NET PROFIT FOR THE FINANCIAL YEAR	83.403	112.956	121.764	135,4	107,8	1,9	2,3	2,1
7. NET LOSS FOR THE FINANCIAL	119.870	137.893	182.181	115,0	132,1	2,8	2,8	3,2

YEAR								
8. DIFFERENCE BETWEEN NET PROFIT AND NET LOSS	-36.467	-24.937	-60.417	68,4	242,3	-0,9	-0,5	-1,1
9. NUMBER OF EMPLOYED	475120	484.602	467.238	102,0	96,4			
10. NUMBER OF COMPANIES	30.941	33.609	35.786	108,6	106,5			
Source: AP - Statistical data from the Profit and Loss Statement of commercial companies for 1994, 1995 and 1996								

In 1996, the overall business result was negative. Although the difference between revenue and expense had been narrowing gradually, it substantially increased again in 1996. Total net losses exceeded net profits by SIT 60,417 mil in 1996. The net profit for the 1996 financial year decreased in real terms by 1.7%, whilst the net loss increased by 20.4%. 21,729 commercial companies recorded a net profit amounting to SIT 121,764 mil. The greatest share of the net profit was generated by enterprises engaged in manufacturing (34.3%), followed by those in trade, repair of motor vehicles and consumer goods (28.1%) and in real estate, renting and business services (11.2%). Net losses were recorded in 11,205 commercial companies amounting to SIT 182,181 mil. The greatest proportion of total net loss was generated by enterprises in manufacturing (48.0%), followed by those in the electricity, gas and water supply sector (12.0%), trade, repair of motor vehicles and consumer goods (11.7%) and real estate, renting and business services (10.4%). Thus, the net net profit (difference between net profit and net loss for the financial year) was generated in three sectors only that is in trade, repair of motor vehicles and consumer goods; transport, storage and communications; and financial intermediation. In all other sectors net losses were higher than net profits.

In 1996 almost a third of commercial companies did not employ any workers. These companies generated only 1.4% of total revenues, 0.7% of total net revenues from sales on the foreign market, and accounted for 3.4% of total commercial company assets. Only 0.4% of commercial companies employed more than 500 people. These contributed 31.1% to total revenues, 48.5% to total net revenue from sales on the foreign market and accounted for 32.9% of total commercial company assets.

Pursuant to the Article 51 of the Law on Commercial Companies, commercial companies are divided into three categories: small, medium and large. 93.2% of commercial companies were small size companies. However, it was the large size companies, representing only 2.4% of all companies, that contributed the most to the overall business result in 1996. Their contribution was slightly lower in 1996 than the year before. Large size enterprises employed 61.2% of all workers, contributed 63.2% to total revenue and 78.4% to total net revenue from sales on the foreign market. The number of medium size companies was almost double that of large size enterprises. Nonetheless, their contribution to overall business results was not as significant as that of large size companies nor of the small size companies. Moreover, their contribution even decreased from the year before. In 1996, only small size companies increased their share in overall business results. They employed 22.1% of all workers and contributed 21.5% to total revenue and 10.4% to total net revenue from sales on the foreign market. The 1996 financial year was concluded with net profits being made by 69.7% of medium size companies, 66.8% of large size companies and 60.1% of small size companies. On the other hand, net losses were recorded in 31.5% of both large and small size companies and in 27.9% of medium size enterprises.

At the end of 1996 the total structure of assets and liabilities of commercial companies was similar to that at the end of 1995. However, the liquidity problems of commercial companies deepened. The number of giro accounts blocked for more than five days recorded by the AP points to a deepening in the liquidity problems faced by commercial companies in 1996. Throughout 1996 the number of companies with blocked giro accounts was rising at an average 6,230 blocked giro accounts per month. Outstanding liabilities amounted to SIT 66,614 mil, up in nominal terms by 15.9% from 1995.

5.5.2. BUSINESS RESULTS OF BANKS, SAVING BANKS AND CREDIT INSTITUTIONS - Increased profits in 1996

In May 1997, the Slovenian banking sector comprised of 30 banks (including two non-operating banks), 7 saving banks and more than 70 credit institutions. Last year no new banks were established and three banks withdrew from the banking system: two were acquired by larger banks and Komercialna banka Triglav bank went bankrupt. One bank is entirely foreign owned, three banks are majority foreign owned and 14 banks are partly foreign owned.

In 1996, total assets of banks, saving banks and credit institutions rose by 15% in nominal terms (5.6% in real terms) according to unaudited data. The rise was lower than the year before. The three largest banks held more than half the total bank assets, the following five banks a quarter and another quarter was held by the remaining 21 banks. Banks which are majority foreign owned recorded the highest rise in assets.

Unaudited financial reports for 1996 indicate that the share of loans to non-banking sector and to banks and saving banks in the structure of assets increased in banks, saving banks and credit institutions, whilst the share of other assets (fixed assets, investment in capital, etc.) decreased. The total amount of loans was up 18%, although loans to households grew less than the year before.

On the liability side, deposits to the non-banking sector dominated and their share even increased to over 64%. On the other hand, the share of short and long-term bank loans fell. Household deposits continue to represent the largest share of non-banking deposits, despite enterprise deposits growing at a faster rate in 1996. Although demand deposits grew the least (long-term liabilities the most) they still accounted for a quarter of total liabilities, which may jeopardise general liquidity. The share of short-term securities in liabilities remains marginal, even though they represent important liquidity reserves. Moreover, in view of the relatively underdeveloped capital market and the losses made in securities trading, their share is even decreasing. This led the Bank of Slovenia to enforce the regulation of last August which requires that the most liquid assets be matched with demand deposits.

Last year the revenue of banks and saving banks increased by 13%. Expenses grew by 12.4%. Banks and savings banks generated a SIT 16.8 bil profit before tax (up from SIT 13.7 bil in 1995). The share of profit in revenue fell from 6.7% in 1995 to 6.2% in 1996. A higher interest margin, i.e. the ratio of interest revenue to average assets also contributed to positive results. All but two banks were profitable in 1996 (in 1995 three banks made losses).

In 1995 the average capital adequacy ratio was 21.7%. Despite a drop by 1.7 percentage points in 1996 it remains very high. Such a high level of capital adequacy provides additional protection against foreign exchange risks and against current and potential non-performing assets. However it also reduces banks' profitability.

5.6 EMPLOYMENT AND UNEMPLOYMENT - Stagnant employment and persistent unemployment

According to SORS the average number of employed calculated using the monthly employers' reports (ZAP-M) declined again in 1996. The 2.1% decrease in the number of employed in enterprises and other organisations was primarily due to a drop in employment in industry and mining by 6.3%. Employment decreased by less in transport and communications, trade, water management and forestry (by 1-2%). Employment in crafts and services and hotels and restaurants picked up by 1.2% after falling in the previous years. Employment also rose in financial and business services, housing and utility services at a rate which exceeded that in 1995. On the other hand, growth in health and social security, education and culture and public administration was somewhat slower than in the preceding year, as was the growth in the number of self-employed and employed in the small-scale sector.

SORS has not yet published data on employment using the National Accounts methodology for 1996. Nevertheless, the above mentioned figures together with the results of the May 1996 Labour Force Survey confirm the estimated 0.5% drop in overall employment in 1996. Based on the National Accounts methodology, the actual labour force exceeded that registered in monthly employment statistics by 70,000 people. The former figure includes around 16,000 employees in enterprises with less then 3 employees, and others which are employed in enterprises which are not included in monthly reports or are working under other employment scheme (for example, additional work, work with shorter working time, contractual work, etc.).

The drop in employment in 1996 can be partially attributed to somewhat slower economic growth, and in particular to the competitive pressures to increase labour productivity. Competition on the foreign markets calls for continuous technological improvement and for further reduction of labour costs. This is particularly the case for industry where both the drop in employment and the growth in productivity were the most pronounced. Although employment shrunk due to the closure of unprofitable entities, downsizing also occurred in sectors which had been restructured and adjusted to market conditions but nevertheless had to cut down the number of employees in order to compete.

Expectations of enterprises and other organisation, compiled by the National Employment Office are again rather pessimistic this year. A further 4% drop in employment in industry is expected. No change in services is expected. The employment level is forecast to fall in trade, transport and hospitality. However, employment figures for the first three months paint a less pessimistic picture. The actual employment level will largely depend on the rate of economic growth and the ability of the economy and the current production structure to compete on the domestic and foreign markets. In view of the target 4% economic growth in 1997 and 4.5% in 1998, IMAD expects employment to stagnate or grow only modestly at 0.5% in 1998.

Last year's drop in employment did not lead to higher registered unemployment, although 65.000 people lost their jobs and only 55,000 were recruited. Due to a radical update of unemployment registers the number of registered unemployed actually fell from 1995. The rate of registered unemployed remained unchanged (13.9%). In addition the internationally comparable rate of employment (by ILO methodology) was marginally lower than in 1995.

In spite of an active labour market policy , structural unemployment remains high. In 1996 the average number of job vacancies was higher than in 1995. Furthermore, the dynamics of certain unemployment categories suggest that the situation may have worsened as the share of the unskilled (in March 1997, it rose to 48%); of those older than 40 (almost 40%) and women (48.8%) amongst the unemployed has risen and the number of long-term unemployed remains above 55%. This year fewer people are expected to lose jobs and more of the unemployed are expected to be recruited than last year. As fewer erasures from the unemployment registers are expected, the number of unemployed is foreseen to increase slightly (to around 123,000, in 1996, 119.800) this year as is the registered rate of unemployment (14.1%, in 1996, 13.9%).

Based on the expected higher rate of economic growth this year and in 1998 and further implementation of an active labour market policy, a slight increase in total employment is expected in 1998. The decrease in the level of employment is expected to slow down in industry and construction, whilst employment in services is to continue growing.

6. ENVIRONMENTAL, SOCIAL AND REGIONAL DIMENSIONS OF TRANSITION PROCESS

6.1 THE ENVIRONMENT - Inefficient use of natural resources calls for new environmental protection incentives

According to the United Nation' s (UN) Commission on Sustainable Development the following are regarded as natural resource intensive industries: manufacture of oil products; manufacture of basic iron and steel; manufacture of non-ferrous products; and the chemical industry. European Commission representative at the UN is of the opinion that in the case of Slovenia activities using large amounts of water and wood (manufacture of wood and leather) should also be regarded as natural resource intensive industries. In the period of transformational recovery since 1993, the share of these industries in GDP (in 1995, 9.8%) did not fall. Moreover, their contribution to value added in manufacture actually increased (in 1995, 40.2%, up by one-quarter from 1988). In 1996, growth in production in these industries exceeded the average in the manufacturing sector.

Since 1995, **primary energy** per capita has amounted to around 90% of the EU average (in 1993, 85%). The consumption of **final energy** has grown faster than GDP. It is estimated to have grown by 13% in 1997 compared to 1990, but it is 1.4% lower than in 1996. In 1997, the use of hard fuels is being replaced by liquid fuels. This is mainly a result of a decrease in the consumption of domestic coal, which contains a high level of sulphur, by industry and households and not on account of the consumption in the energy sector. The latter accounts for as much as 80% of total SO_2 emissions released. Consumption of coal in energy sector is expected to be the key reason for **an increase in SO_2 emissions** in 1997 (the 1997 Energy Balance forecasts a rise 6.7%). This will be first rise since 1992. The consumption of lignite (in particular of domestic lignite by the thermo power plant Šoštanj) generating around half of the total SO_2 emissions, is expected to pick up a further 7.8%. This will represent the highest rise in the past sixteen years. The consumption of brown coal (in particular domestic brown coal by the thermo power plant Trbovlje) contributing a third to total SO_2 emissions is anticipated to rise by 9.7%. In 1997, SO_2 emissions in Slovenia are thus expected to exceed the OECD average by 48% (in 1996, they exceeded it by 37%). Emissions of CO_2 are expected to rise 3.7% and NO_x emissions 2.7%.

Increased emissions call for the internalisation of external costs. Since consumer behaviour, structure of consumption and production allocation are largely determined by price, price and tax policies play an important role in environmental protection. Prices of quite a few products and services which are important from the environmental point of view are controlled by the government. A rise in prices of such goods and services has exceeded the average rise in prices (see Chapter 7.4), although there are many price disparities.

Electricity prices in Slovenia slightly exceed that in the EU countries with cheapest electricity (Ireland, Greece). Despite recent rises in **prices of oil products** the lag behind the level in the EU remains wide. In the EU retail prices of oil products vary primarily due to different levels of excise duties. There is a large discrepancy in the level of taxes imposed on oil products in the EU. In certain countries they are as much as 50-75% higher than the minimum tax set for gasoline (the differences are even greater for unleaded gasoline). Under the proposed Law on Value Added and Excise duties (see National Assembly Reporter No. 29/96) tax imposed on oil products in Slovenia is to remain amongst the lowest in Europe in the future.

By the end of 1995, important **economic measures** aimed at environmental protection were adopted. **A new charge on waste water** was imposed. It rose from SIT 200 per unit of BOD to SIT 600 in 1996 and to SIT 1,200 in 1997. This tax is supposed to gradually rise up to the year 2007. In addition, fee is levied on **water use** (revenue is earmarked for water works). Nominally their level, however, has not changed since their introduction in 1995.

A CO_2 tax was imposed at the beginning of 1997. The amount levied is based on the level of carbon in certain fuels. However, the tax will not be imposed on domestic coal used for electricity production until 2004. Neither the level of the progressive growth of this tax nor its indexation to inflation have been determined at the time of its introduction.

The packet of economic measures currently tabled in Parliament includes a special **tax on motor vehicles**. This is a progressive tax linked to the level of gasoline consumption. The main weakness of this measure is that it only needs to be paid at the time of the purchase of a new car or at the time of the import of a used one. However, new cars are more environmentally friendly than old ones. The proposed tax does not tax the latter.

In 1996, environmental taxes and non-tax revenue contributed around 0.21% to the state budget and accounted for 0.05% of GDP. In 1997, they are expected to contribute 1.8% to the state budget (around 0.43% of GDP). According to estimates for 1997, revenue from environmental and other related taxes will exceed average yearly expenditure for environmental protection of the last few years. In 1994, expenditure for environmental protection was higher due to the renovation of the Thermo power plant Šoštanj for environmental reasons. Since then the share of environmental expenditure in GDP has fallen. The rise in expenditure for environmental projects undertaken by the Ecological Development Fund has been too low to offset the drop in budgetary expenditure for environmental projects and of funds acquired directly from polluters.

Table 13: Estimated expenditure for environmental projects (as % of GDP)

Estimated expenditure for environmental projects, as % oF GDP	1994	1995	1996
Budgetary expenditure for environmental projects	0,56	0,37	0,32
from economic ministries	0,27	0,13	0,09
from Ministry of Environment and Physical Planning	0,24	0,23	0,21
Expenditure for environmental projects in economy	0,78	0,62	0,39
invetsment	0,67	0,5	0,26
current expenditure	0,11	0,12	0,13
Ecological Development Fund	0.00	0,04	0,12
Exp.for environmental projects in economy, as % of fixed capital formation	3,41	2,39	2,92
Exp.for environmental projects in the market sector, as % of the state budget	1,12	0,8	0,69
Source: Official Gazette. RS No. 26/94, 40/95, 5/96, SORS, IMAD (SEDS and National Accounts estimate), MEPP, Ecological Development Fund (Provisional Financial Strategy ERS RS, 24 October 1994)			

At the beginning of 1997 (24/I/1997), **environmental reserves** of around DM 637 mil (using the exchange rate of 1/I/1993, 1 DEM = 61.15 SIT) were estimated in the process of ownership transformation. These must be invested in environmental projects by the year 2003 or used to eliminate toxic waste. Unlike most other transitional economies, Slovenia focused on the problem of environmental damage at the very beginning of the ownership transformation of enterprises. Consequently measures adopted apply not only to foreign but also to domestic owners of enterprises. The Law on Long-Term Environmental Liabilities has been tabled in Parliament (National Assembly Reporter 50/96). It sets out the conditions concerning the environmental reserves. It also provides enterprises with possible solutions were these are not satisfied (in most cases provision of additional capital by the Eco Fund for the revalued reserves which were not invested in eco-projects).

6.2. THE SOCIAL DIMENSION OF DEVELOPMENT AND THE REGULATION OF CHANGES - The deterioration in the quality of life calls for new regulation mechanisms

Transition to a market economy **increased social differences and lowered the quality of life for certain social groups**. The objective position of an individual has changed. Economic and social risks (greater unemployment, lower social security, breaking up of social networks) are higher. The individual's subjective perception of his position has also changed. The subjective perception has also been affected by the change in the society's value system from the prior solidarity-egalitarian society into a pronounced individual-profit oriented one. The majority of the people were not ready for such a rapid change in values. The previous welfare state system had suppressed an individual's will to himself innovate and improve the social and economic position.

If unemployment remains high in the coming years the feeling of insecurity and inequality will grow. Moreover, higher unemployment causes greater poverty and social exclusion, greater susceptibility to physical and mental disease, and lowers the quality of life. **Social exclusion** is demonstrated in the lack of opportunity, possibility and co-operation in social institutions otherwise available to everyone. Limited opportunities are particularly worrisome with regard to access to certain public programmes. As many services have been transferred to the private sector, access is in particular limited in education, health-care, or housing.

The highest level of social security is ensured through employment. The latter varies in form over time. In addition to active employment and social-security policies there is a need for deregulation of the labour market. Deregulation will introduce flexible forms of employment and work. This in turn will ease access to work and lead to greater social inclusion. Nevertheless, the level of social security will be lower than with regular employment.

The systems for the regulations of social security also need to be changed. Universal systems are becoming less important. A target-oriented selective redistribution mechanisms focused on the needs of certain groups which are outside the social networks and/or are socially excluded ought to be introduced. One of the tasks of the social policy is to replace the passive distribution of public funds for social security with instruments of redistribution which stimulate recipients to take up an active stance and find their own way out of social exclusion.

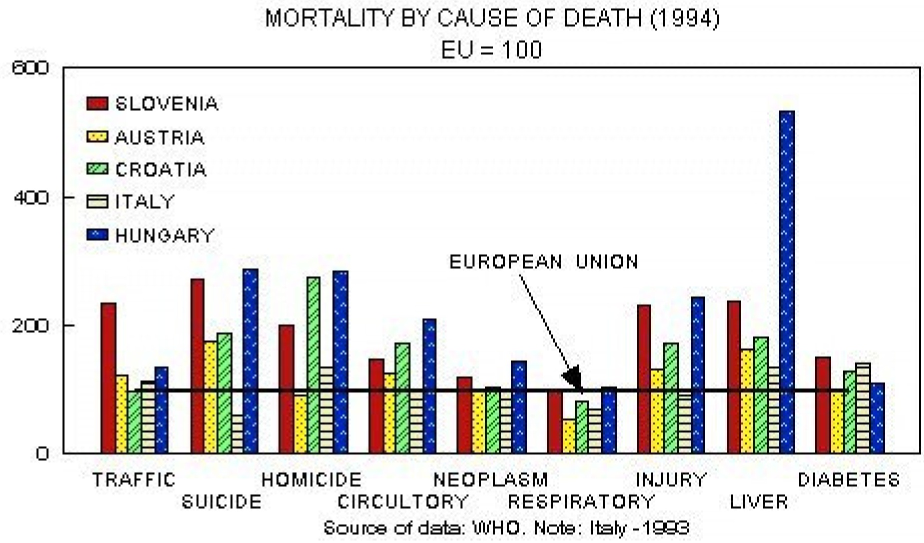
The state's primary means to alleviate individual's poverty are cash benefits and an appropriate tax policy. It is estimated that without cash benefits around 40% of households in the EU would be below the poverty line. Cash benefits reduce the share of households living in poverty. In the EU around 15% are below the poverty line (European Commission, 1996). In Slovenia the figure is 13.6% (Ružiè, 1994).

In Slovenia the **"means tested welfare allowance"** is the most important social corrective ensuring material and social security to those segments of the population which cannot provide it themselves. It is aimed at decreasing poverty. In 1996, almost 30,000 Slovenes were receiving this allowance, up as much as 86% from 1993. At the end of 1996, the following groups were receiving the allowance (Ošlaj, 1996): singles (64%) and unemployed who were not receiving unemployment benefit (54%). The majority of the recipients (84%) were between 18 and 45 years old. Young people between 18 and 21 years old (29%) and first-time job-seekers (10%) represented quite a high proportion of recipients. Typically welfare allowance beneficiaries have only primary education: 64% of the beneficiaries did not finish secondary school (of which, 49% have or have not finished primary school). Amongst the young recipients most have finished their studies, but have been unable to find jobs. The funds used for this allowance ought to be used to help young persons to more easily incorporate in economic activities rather than alleviate their presumably poor income position. For this to be achieved a harmonised approach to education, employment and social-security policies must be adopted.

Socio-economic structure of the poor premised on the data on household expenditure indicates that the following household categories are the poorest: households with one person who is 65 and over; a single person under 65; and elderly couples without children (Žnidaršiè, 1996). Households where nobody is working and those where the head of the household has only primary school education are usually also poor. Under the existing social security system poverty of the elderly is alleviated by way of the means tested welfare allowances, minimum pensions and income support for pensioners. However, this allowance should not be the only means to address the poverty of elderly people. Social services are even more important.

Tax instruments can also be used to achieve certain social policy goals. The personal income tax is one such instrument. However, the existing system of child tax allowance and allowance for other dependant family members is in certain respects deficient. It grants a comparatively higher tax brake to families where at least one taxpayer earns an income ranked in a higher tax bracket. A modified child tax allowance system, which would reduce the tax obligation instead of the tax base, would in absolute terms disburden everybody evenly. However, in relative terms it would disburden families with lower incomes more.

In the nineties there has been a change in the nature of the causes of death. Deaths due to neoplasms have increased by around 15% since 1993. Deaths due to diseases of the circulatory system are still considerably above the EU average. The level of deaths due to external causes (accidents, traffic accidents, homicide, suicide) were already very high. Although it fell slightly before 1990, it rose again in the period from 1991 to 1994. The overall mortality rate decreased slightly in 1995. It can only be hoped that this is a sign of a more permanent improvement.



6.3. REGIONAL DEVELOPMENT - Rising unemployment in regions with below average rates of unemployment

The main **consequences of the transition to a market economy** for regional development are the **growing disparities between regions** as well as within regions. Economic performance of regions, measured by enterprise business results, has varied considerably in the past. The high dependence of a regions performance on the results of a few enterprises has been the main reason for this. The results of regional comparisons are influenced by the method for collecting data on enterprise performance, which uses the head office approach.

The analysis of enterprise performance shows that **in 1996 three regions generated net profits: the Dolenjska, Central Slovenia and Pomurska regions**. More than 80% of the total net profit of Slovenia was produced in the Dolenjska region. The situation deteriorated substantially in the Littoral-Karst region (troubles in the Cimos plant), which in 1995 recorded a net profit accounting for 10% of total Slovenia's net profit. In 1996, however, this region generated the largest net loss of all regions, accounting for almost 30% of total losses. The performance of the Central Slovenia region was poorer. It still generated profits, but looses also rose. Such results are to a large extent a consequence of using the principle of head offices as a mechanism for data collection (high losses in the energy sector and iron manufacturing which are located in the Central Slovenia region). Losses increased the most in the Zasavska and Savinjska regions.

Table 14: Selected indicators of business results of commercial companies in 1995 and 1996

Regions	Gross value added per capita		The share of net revenues from sales on the foreign market in revenues		The share of net loss for the financial year in revenues		Wages per employee		Net profit for the financial year per employee	
	1995	1996	1995	1996	1995	1996	1995	1996	1995	1996
Central Slovenia	144,6	145,4	68,9	65,5	71,7	78,6	109,0	110,7	152,3	150,8
Littoral Karst	106,1	101,8	102,9	106,7	107,6	308,0	111,2	110,3	194,8	175,9
Gorenjska	99,4	95,9	139,1	133,3	106,3	109,3	94,3	91,0	46,8	52,9
Goris ka	100,4	105,5	121,0	126,4	117,5	95,7	106,5	106,4	86,1	119,4
Savinjska	90,5	87,9	102,7	102,7	83,8	92,0	94,6	94,6	44,5	46,1
Dolenjska	104,4	107,6	218,2	225,4	68,2	32,2	97,0	101,0	104,2	117,0
Pomurska	58,5	55,6	82,4	84,3	97,5	57,8	90,8	88,4	79,1	74,8
Karst	61,7	61,0	161,3	175,8	137,4	80,4	95,5	87,4	43,3	52,8
Podravska	69,9	71,4	85,1	86,7	183,6	113,8	92,8	91,0	85,8	68,3
Carinthia	67,3	72,8	177,0	187,7	168,1	136,4	90,2	89,3	36,9	42,3
Lower Posavska	68,5	70,3	128,4	127,1	131,9	92,0	88,8	84,9	100,0	64,5
Zasavska	98,7	91,9	79,9	82,8	148,5	247,9	91,8	99,5	45,0	58,2
SLOVENIA	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: AP, SORS, calculations IMAD

In 1996, economic power of a region in terms of **gross value added per capita was the highest in Central Slovenia**. It was 2.6-times higher than in the Pomurska region, which had the lowest value overall. Above average result were also recorded in the Dolenjska, Goriška and Littoral-Karst regions. Compared to 1995, gross value added per capita rose markedly in the Carinthia, Goriška, Dolenjska, Podravska and Central Slovenia regions. On the other hand, it dropped in the Pomurska and Zasavska regions. In 1996, the difference between the regions widened only slightly. However, disparities within regions were substantial.

Economic power can also be measured by the level of net income per capita using personal income tax figures (the latest data available is for 1994). This data points to a slight widening of the gap between and within regions. Due to the daily migration of labour force, regional disparities based on this indicator are lower than using the gross value added per capita indicator. In 1993 and 1994, the average net income per capita was above-average in the

Central Slovenia, Littoral-Karst, Gorenjska, Goriška and Karst regions. A comparison of annual results shows that in the Central Slovenia and Goriška regions this indicator has been rising rapidly. An above average increase is also recorded in the Savinjska, Carinthia and Podravska regions. A real drop in net income per capita was recorded in the Dolenjska and Littoral Karst regions. Wages represent the largest part of taxable income. In regions with a higher proportion of secondary and tertiary educated people wages have been higher (Central Slovenia, Littoral-Karst and Goriška regions). The same was the case for regions with a high share of services.

The unemployment rate, measured **as a percentage of unemployed of the total working age population**, **has decreased slightly since 1994**. In regions where this indicator has been the lowest, the rate of unemployment has been growing the fastest (the Dolenjska, Carinthia regions). In 1995, the unemployment rate was the highest in the Podravska region. It was more than twofold higher than in the Goriška region, whose rate of unemployment is the lowest (7.4%). In 1996, an above average unemployment rate was also recorded in the Pomurska, Lower Posavska, Zasavska and Savinjska regions. The highest rise in unemployment was in the Zasavska, Pomurska, Dolenjska and Carinthia regions. This is primarily due to bankruptcies which increase the number of job-seekers. In 1996, their number exceeded the average in the Carinthia, Podravska, Savinjska and Dolenjska regions.

Youth unemployment has decreased in almost all regions, and in particular in the Central Slovenia and the Podravska regions. It has remained high (over one-third) in the Pomurska, Carinthia, Lower Posavska, Karst and Savinjska regions. However the share of unemployed above 40 years old has risen. In the Central Slovenia and Gorenjska regions they account for as much as 40% of all unemployed. The large proportion of unskilled among unemployed is another pressing problem. More than 50% of the unemployed have only low (1st or 2nd degree) education in the Pomurska and Dolenjska regions. Female unemployment has been rising steadily in all regions. On average, the number of job vacancies has been growing over the past few years, although there is still a mismatch between labour demand and supply. The so called Evans index of the labour market mismatch suggests that the regional mismatch has been growing (in 1994, the index was 1.27, in 1996 it rose to 1.44).

7. BASIC GUIDELINES OF ECONOMIC POLICIES IN 1997 AND 1998

7.1 FISCAL POLICY - A need to introduce restrictive measures and systemic changes in 1997 to preserve a viable general government deficit in 1998

The year 1996 was marked by preparations for the introduction of the value added tax, new customs law, reduction in social security contribution rates and introduction of the payroll tax. In the mid-1996 a new Tax Administration Office was established and two laws were tabled in the Parliament, namely the Law on the Value Added Tax and the Law on Excise Duties. The new customs legislation meant a step ahead in Slovenia's economic adjustment to international environment and rapprochement to the EU, but has also led to lower general government revenues. There were two reductions in social security contribution rates. At the beginning of 1996 they were cut by 2.7 percentage points and in July by further 4 percentage points. Total contribution rate thus fell from 44.7% of total wage bill in 1995 to around 40% on average in 1996 and after July's reduction to 38%. Along with cuts in contribution rates a new tax on payroll was imposed in the second half of the year. By the introduction of progressive payroll tax, lower wages became less taxed.

The general government outturn **in 1996** was quite favourable. **General Government** Account was almost balanced and at the end of year the consolidated account recorded a **surplus accounting for 0.3% of gross domestic product.** In 1995 General Government Revenue rose in real terms by 3.6% from the year before reaching 46% of gross domestic product, up 0.3 structural points from 1995. In view of lower pension and disability contribution rates the Pension Fund revenues fell in real terms by around 10% in 1996. The missing funds were provided from the central budget. The transfer from the central budget from current expenditure together with repayment of outstanding debt from previous year amounted to 3.3% of gross domestic product. As much as 22.6% of the Pension Fund revenue was transferred from the central budget. In view of higher contribution rates for obligatory health insurance revenues of the Health-Care Fund (excluding the pensioners' contribution for health insurance) increased by 11% in real terms. The central and local budget revenues together were higher 8.5% in real terms than in 1995.

In 1996 total General Government Expenditure was up in real terms by 2.9% and accounted for 45.7% of gross domestic product, the same as in 1995. Compared to 1995 the shares of expenditures of the Pension and Health-Care Funds in gross domestic product remained virtually unchanged at 13.6% and 6.9%, respectively. The percentage of local government expenditure in gross domestic product soared from 4.6% in 1995 to 4.9% in 1996. The proportion of central government expenditure (excluding transfers to Pension, Health-Care and local funds) dropped from 20.4% to 19.8% of GDP in 1996 (see Statistical Appendix, Table 13).

In the structure of overall central government expenditure the highest increase was recorded in the share of expenditures transferred to the Pension Fund which rose 7 percentage points to reach 11.2% of the central budget expenditure in 1996. A marginal increase occurred in the share of expenditure for wages in the government institutions and contractual organisations (up 0.2 structural points), the share of interest payments (up 0.1 structural points) and the share of payments for government guarantees (up 0.2 structural points). The shares of all other central government expenditures decreased, most of all the expenditures for investments (down 3 structural points). The structure of central government expenditure implies that the increasing share of transfers to the Pension Fund crowded out some developmentally important expenditures, for example for investment.

The 1997 General Government Revenue is based on the tax system and instruments which existed already at the end of 1996. Social security contributions comprise 38% of total wage bill, the same as in the second half of 1996 and less than on average in 1996. Tax on payroll has been preserved in 1997, although its scale became more progressive in July. At the beginning of 1997 tariff rates for certain products were reduced to comply with the association agreements, which will reduce the overall revenues from this source in 1997. In the area of sales taxes, sales tax on oil products was raised at the end of March with another less extensive increase foreseen for July. A new tax on carbon dioxide emissions was introduced at the beginning of the year representing a new source of revenue for the budget. In addition, it is an incentive to polluters to reduce the level of pollution and use environmentally more friendly alternatives. Presumably, a new tax on cars will be introduced in July. The Tax Administration Office, which was constituted last summer, will contribute to the more efficient assessment, calculation and collection of taxes in 1997. In view of the above changes in tax sources, this year General Government Revenue is to edge up 1.9% in real terms from 1996. Its share in gross domestic product is to fall by 1 percentage point from 46% to 45% in 1997.

In 1997 the policy of a balanced General Government Account should remain one of the key macro-economic goals, although it will probably be very difficult to achieve in view of a curtailed General Government Revenue and growing pressures for greater Expenditure. Nevertheless, the general government deficit should not exceed 1% of gross domestic product. To achieve this, the share of General Government Expenditure in gross domestic product should not exceed 46%, which allows it to increase only 0.3 percentage points in 1997. General Government Revenue can rise 4.8% in real terms at the most.

To pay out all the benefits as devised in laws and other provisions on pension and disability insurance the expenditure for pension and disability insurance will have to retain its share in gross domestic product at 13.6%. This year more retirements are expected in view of the more beneficent Law on War Victims. The programmes and benefits of the obligatory health insurance will remain the same as last year. The share of expenditures for obligatory health insurance (including the funds provided by the state) will reach 6.9% of gross domestic products, which is on par with last year's share. The local government expenditure should amount to 4.8% of GDP, up 0.1 structural point from the year before.

In the first half of 1997 the provisional financing rules were applied to all budgetary expenditures allowing for monthly budgetary expenditure not above one-twelfth of last year's expenditure. Although such a financing regime ensures uninterrupted financing of tasks and functions of budget users, the level and structure of expenditure do not meet the needs and conditions in 1997. Thus, difficulties occurred in meeting the budgetary claims in the area of social transfers, wages in the public sector, projected investment, etc. In May the Law on Additional Financing of Government Expenditure in the First Half of the Year was passed by the Parliament and allows for higher budgetary expenditure in the first half of the year than was set in the December Decree.

The largest part of central budget expenditure is accounted for by wages, social transfers and transfers to the Pension Fund. Pressures of these expenditure items in 1997 largely result from the decisions taken already in 1996. **To get the general government deficit below 1% of gross domestic product in 1997,** the central budget expenditures are not allowed to exceed SIT 730 bil. Although this means 12% higher central budget in real terms than in 1996, it will still be far from the needs and wishes of all budgetary users. Given this magnitude of the central budget the increase in central government expenditure would be by 7.3% in real terms without transfers to the Pension Fund, local governments and Health-Care Fund. The share of central government expenditure in gross domestic product would rise by 0.6 percentage points from 1996 to reach 20.4% of gross domestic product.

In negotiations on the 1997 Budget, measures aimed at reducing budgetary expenditures in all its components are unavoidable. In particular, such measures ought to be taken in the area of wages in the government institutions and contractual organisations and in the area of social transfers where some benefits will need to be reduced. The measures should also be aimed at giving up or slowing down of some programmes and investments and at control over the financing of some tasks paid from the budget. Furthermore, part of the current tasks must be passed on to non-government services in the sense of privatisation of activities which would disburden general government financing also in the long run.

The proposed changes and measures must be focused not only on solving this year's problems but also on reducing the volume and changing the structure of general government financing in the coming years, notably in 1998. Only by adopting systemic reforms and solutions which will ex novo define the role of the state in general government financing, it will be possible to hold down the increasing General Government Expenditure, realise the policy of gradual reducing the burdens on the economy and increasing its competitiveness and at the same time reducing the gap between General Government Revenues and Expenditure.

In 1998, General Government Deficit is projected to drop again to 0.5% of gross domestic product. This will be attained only by way of further reducing of General Government Expenditure (to around 45.4% of GDP), continuation of the tax reform so as to find economically and fiscally reasonable environmental and property taxes and introduction of the value added tax at the beginning of 1999 which will more than replace the lacking revenues from sales taxes.

7.2 MONETARY POLICY - Monetary policy will be dictated by the balance of payments situation

In 1996, Bank of Slovenia did not change its operational targets. The Bank set an intermediate target for M1 growth based on monthly analysis of money demand. This policy encompasses a floating exchange rate regime with Bank of Slovenia intervening on the foreign exchange market only within the given money limits. The main goal of this policy is to reduce inflation to the comparable European level in a few years' time and to gradually and in appropriate circumstances change the floating exchange rate to the fixed exchange rate regime. In the opinion of the Bank of Slovenia the current state of the balance of payments and the foreign exchange market does not allow for such shift in the short run, as foreign currency flows are high compared to domestic money aggregates, and also highly variable and unpredictable.

In early May this year, Bank of Slovenia announced the 1997 target of the monetary policy: 18% growth in M3 (by the last quarter of 1997), within 4 percentage point ceiling above or below the target. In 1996 this aggregate grew 19.9%. By announcing this target the Bank of Slovenia set the framework of its operations in 1997, for the first time as an annual and declarative target and for the first time in relation to a wide money aggregate. The announcement of the limits on money growth in 1997 was also an appeal to the social partners and the Government to take similar steps.

However, the achievement of this target will depend on many factors. First, the general government deficit should not exceed 0.5 of gross domestic product, second, net money inflow from the balance of payments should be on par with last year's flow and third, end-year inflation should not exceed 8.8%. According to the Bank of Slovenia such inflationary target will only be realised provided that the growth in uncontrolled retail prices remains modest (in the first four months it was around 5-6% in annualised terms) and restrictive policy is applied in the adjustment of controlled prices.

The main problem monetary policy will be facing in 1997 is the neutralisation of money and exchange rate pressures of the balance of payments inflows within the context of anti-inflationary and annual money targets. In the first months of 1997, problems arose from the excessive supply of foreign currency on the market. In the first four months, the surplus on the corporate foreign exchange market amounted to DM 97 mil and in exchange offices it was DM 340 mil. A substantial part of the excessive supply in exchange offices resulted from the trend of converting foreign currency deposits to tolar time deposits. Another source of foreign currency is said to be the inflow of foreign capital for portfolio investment.

Expansion of domestic loans, and in particular to households, began in 1995 and lasted up to mid-1996. In the second half of 1996 growth in loans to domestic sectors waned until it slightly recovered again in the early 1997. Since June 1996, foreign exchange reserves (in the balance sheet of the Bank of Slovenia and BS's foreign exchange bills in balance sheets of commercial banks) grew the most in total banking system assets due to inflows from the balance of payments. Slowdown in growth in loans to households and enterprises was not reflected in slower growth in deposits of both sectors as in the second half of the year they were fuelled from flows from abroad. A high increase in domestic bank loans in 1995 undoubtedly contributed to a high surge in final household consumption and worsened situation on the current account of the balance of payments in the second half of 1995. Moreover, in mid-1996 the loan expansion led to liquidity problems of some, predominantly smaller banks and eventually to the liquidation and bankruptcy of one of them. After the failure of this bank in June, banks have restrained their policies on liquidity and loans.

In 1996 overall deposits with banks increased on average by 22.9%. The trend of converting foreign exchange to tolar denominated deposits continued. Total foreign exchange deposits of households rose 16.4% and total tolar deposits were up 33.6%. Adjusted for the inter-currency changes, revaluation and interest, total inflow into net household tolar deposits amounted to SIT 47 bil, and inflow to foreign exchange deposits stood at SIT 31 bil (net loans taken at banks amounted to SIT 47 bil). Time tolar deposits picked up 46.1%, of which long-term ones were up 64.7% despite them still representing only 23% of all time tolar deposits of households.

Since 1994 household savings with banks have been very susceptible to short-term changes in the exchange rate movements relative to tolar revaluation. In the period from August to October 1996 foreign currency deposits grew faster than tolar ones, whilst in the first three months this year individuals even drew from foreign currency deposits (for the first time since 1991!) in order to save in tolar-denominated deposits. At the end of 1996, foreign currency deposits still accounted for 59% of total household deposits (down from 62% at the end of 1995 and 72% at the end of 1993).

In 1996 tolar deposits of enterprises grew 23.0%, of which time deposits were up 25.2%. Long-term enterprise deposits grew 44.2% during the year and represented 26% of time deposits at the end of year. At the end of 1996, household deposits accounted for 55% of total deposits with banks, the share of enterprises deposits was 27%, non-banking financial organisations' deposits 4% and public sector deposits 15%.

In 1996 interest rate movement was most affected by a drop in the revaluation clause (basic interest rate - TOM) from 10-13% on an annual level in the first half of the year to around 6% in December; **in the first months this year it was around 8%. In May 1997 the Bank of Slovenia has extended the period of previous inflation to which TOM is indexed from 6 to 12 months.** This will do away with monthly oscillations of interest rates resulting from oscillations in TOM due to oscillations in monthly inflation rates. Furthermore, adjustments in interest rates will become linked to changes in real interest rates and not to the current inflation.

Under the first amendment to the inter-bank agreement on the highest deposit interest rates, real deposit interest rates of banks fell on average by 1.5 to 2 percentage points in January 1996. A new **inter-bank agreement on the highest deposit interest rates**, in force since April 1997, reduced deposit interest rates by further 1-1.5 percentage points. Consequently, the average real interest rate for short-term deposits (31 to 90 days) fell below 4% and for long-term deposits below 6%. Under this agreement banks are obligated to carry over the positive effects of lower deposit interest rates also to the level of lending interest rates. In May the lending interest rates fell also following the recommendation of the Agency for Restructuring and Privatisation to banks under rehabilitation to reduce lending interest rates for best customers. Thus, average real interest rates for long-term loans fell from 13-14% at the end-1995 to around 10% in May this year.

7.3 INCOME POLICY - An urgent halt in wage growth

Effective income and fiscal policies are crucial for the achievement of developmentally favourable distribution proportions. Thus, **the main target of income policy ought to be a halt in wage growth** and its lag behind growth in labour productivity. In Slovenia, wages are determined largely by collective agreements. In addition, a part of wages is regulated under individual agreements and a part by the Law on Wage Ratios and other laws. Nevertheless, in the tripartite negotiations, the social partners: employers, employees and the Government are trying to reach an agreement which would apply to all wages. **This year's negotiations on the Social Agreement are still underway. The New Social Agreement should be adopted for the period by the end of 1999.**

In 1996, the main goal of the income policy was to act in line with collective agreements and to achieve that growth in gross wage per employee lagged behind growth in labour productivity. The 1996 Social Agreement was adopted rather late (in June 1996) and did not place any restrictions on wages set by individual agreements. In the period from December 1995 to December 1996 gross wage per employee in the economic sector was up 6.6%. In real terms, gross wage rose 4% in 1996 on average from the year before (deflated by retail price index). Under the Law on Implementation of the Social Agreement the AP introduced two separate registers in mid-1996, one for wages determined by collective agreement and one for wages set by individual agreements. Based on these data gross wages per employee by the collective agreement picked up in real terms by 1% and that by individual agreements by as much as 5.9%. Wages set by individual agreements represent 11% of total gross wage bill. Moreover, these wages have adverse spill-over effects on the movements of other wages.

Rises in wages of certain segments of the public sector (members of parliament, judges), which are not regulated by the Law on Wage Ratios, put the Government in a rather difficult situation. Thus, when other segments of the public sector went on strike for higher wages the Government could not reject them, and even more so in the pre-election period. In the non-market sector, the average gross wage per employee rose as much as 9.7% in the period from December 1996 to December 1995 (on average in 1996 by 6.7%). Thus, growth in wages in market and non-market sector was substantial. Overall, gross wages per employee increased in real terms 7.8% in the period from December 1996 to December 1995 and 5.1% on average in 1996 from the year before, whereas labour productivity rose by only 3.6%.

The new government has tried to improve its negotiating position of an employer and a social partner by "freezing" the wages and other remuneration of state functionaries. In fact, their wages are not to be indexed by retail price growth by the beginning of 1998. The aim of this measure was mostly demonstrative.

The crucial goal in 1997 will be to slow down growth in gross wage per employee. In order to achieve this the average real gross wage per employee should not rise by more than 3%, and its real growth rates must be reduced to 1-2% in the period from January to December. Only in this way growth in wages will manage to fall behind growth in labour productivity by 1 percentage point.

In order to improve competitiveness of the economy also in the years to follow growth in wages will have to lag behind growth in labour productivity. In 1998 growth in gross wage per employee could be somewhat slower (up 2.5% in real terms from 1997) provided that measures are taken aimed at keeping down wages in the public sector and a Social Agreement is passed viable also in macroeconomic terms. In this way in 1998 wage growth would be lower than labour productivity growth, which would eventually contribute to improved distribution proportions.

Such developments will be ensured only by adequate income policy instruments. A partial indexation of wages by 85% of consumer price growth should only be made once a year. Base wages determined by collective agreements would rise only due to indexation with growth in prices. The already extensive wage ranges ought to be narrowed. Minimum wage should not be raised, only to the level as foreseen by indexation. A too high level of minimum wage has already shattered the ratios between the base wages in the first three tariff classes of the General Collective Agreement for the Market Sector. Furthermore, wages will have to be more associated to enterprise performance, and in particular wages set by individual agreements. The public sector wage scheme will have to find ways of paying out wages in line with the budget capacities.

Also this year, work related allowances and other remunerations are growing rapidly. The percentage of these allowances in total wage bill is rising. In 1995 they accounted for 33% of total wage bill and in 1996 their share rose to 43.8%. Although payments stemming from work contracts and service agreements are not increasing in nominal terms, work related allowances and other remunerations are constantly rising faster than total wage bill. The allowances include various business expenses (travel expenses, daily allowances, accommodation allowances), the annual holiday bonus, etc. Employers also use these forms of payments to pay out regular wages so as to avoid paying social security contributions. Such behaviour, however, ought to be stopped by proper tax policy instruments.

7.4 PRICE POLICY AND MOVEMENTS - In view of intense abolishing of price disparities average annual inflation will not be considerably lower in 1997 and 1998.

In 1996 average annual inflation was 9.7%, down from 12.7% a year earlier. However, the end-year inflation was 8.8%, which was slightly higher than in 1995 (8.6%). In the first three months of 1997, the annual inflation rate was decreasing. In March it was 7.4% but has risen to 8.2% in April and 8.9% in May. The rises in monthly inflation in April (2.0%) and May (1.3%) were expected and were in line with the aim of abolishing price disparities.

According to the 1997 and 1998 short-term development scenario, the average annual inflation rate will in this period decrease only slightly as certain price disparities are yet to be abolished. Thus average annual inflation is estimated to average around 9% in 1997 and around 8% in 1998. These inflation targets are still based on the rise in retail prices. Next year, however, a harmonised Consumer Price Index will be introduced as a measurement of inflation. Although the drop in inflation will not be substantial it calls for a concerted management of price, monetary and income policies. In particular, greater contribution should be made by the income policy by keeping a lid on the growth in wages and other remunerations. Furthermore indexation mechanisms will need to be gradually abolished in all areas.

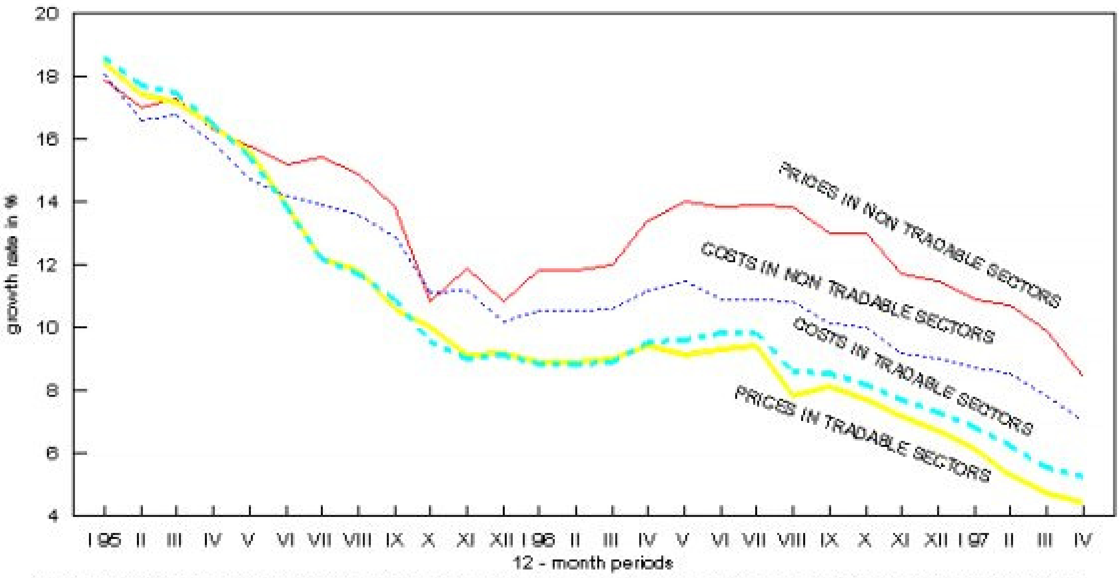
In 1997 the Government took up an active role in abolishing price disparities, in particular as regards prices of energy sources. In the last twelve months to April the price policy contributed around 3 percentage points to 8.2% growth in retail prices and around 2 percentage points to a 3.8% rise in retail prices in the first four months. As substantial rises occurred mostly in the prices of energy sources there is not much room left for abolishment of price disparities in other areas.

In the past years price policy contributed substantially to lower inflation, but price disparities remained wide. At the same time the development component of the price policy was neglected, as the prices of energy sources have an important role also in allocation of production and structure of consumption.

In the twelve month period to April, prices of energy sources contributed the most to inflation. They were up 11.3% and directly contributed 2.16 percentage points to inflation. Above average growth was recorded also in prices of some industrial products, for instance wheat products (they were up 12.8% contributing 0.362 percentage points to inflation), processed meat (up 12.0% contributing 0.387 percentage points). In this period prices of services were up 8.7%, most of all prices of housing services (17.6%) as non-profit rents and other dwelling-related costs were gradually rising. Prices of personal services were up 14.1%, passenger transport up 13.6%, urban passenger transport up 16.7% and prices of utilities rose 11.8%. Also substantial growth was recorded in prices of tobacco products (16.6%).

In 1996 and in the first months of 1997 prices of basic foodstuffs grew below average. In April 1997 prices of foodstuffs were up 6.2% from last April and 0.5% from last December. With regard to agricultural price policy, farmers are being paid directly for their products, which is in line with the adopted agreements and brings Slovenia closer to the mechanisms and concepts of the EU's Common Agricultural Policy.

GROWTH IN PRODUCER PRICES AND PURCHASE COSTS OF INTERMEDIATE GOODS



Source of data: SORS, calculated by inter-sectoral price model by IMAD. Note: value structure of Input-Output table 95 at market prices, tradable sectors export or import the above average share if their output, nontradable sectors are neither above average exporters nor importers

By abolishing price disparities the price policy provides proper impulses to economic subjects in terms of development. But higher prices affect tradable sectors more than non-tradable ones. Due to competition on the domestic and foreign markets tradable sectors cannot offset higher costs by higher prices. Thus, costs are rising faster than prices. In addition, exchange rate movements also contribute to the growing gap between costs and prices. As growing labour costs and costs of inputs cannot be entirely compensated by higher prices the income position of tradable sectors deteriorates. If costs are translated into higher prices even partially this decreases their competitiveness and has an overall negative effect on their activity. The price mechanism in the non-tradable sector allows higher costs to be translated into higher prices, and consequently prices in non-tradable sector grow faster than costs. Furthermore, the outputs of non-tradable sectors are important inputs of tradable sectors, which further aggravates the position of tradable sectors. Price mechanism in the non-tradable sector is an important generator of inflation in the economy. Over the last two years the gap between the prices in tradable and non-tradable sectors has widened. As a restrictive monetary policy, which can help reduce inflation, has certain negative side effects on the production (notably, of the tradable sector), it needs to be supported also by an effective income policy.

8. MEDIUM-TERM DEVELOPMENT SCENARIO - PROJECTIONS OF MAIN MACROECONOMIC CATEGORIES BY THE YEAR 2001

8.1 Current macroeconomic situation and fulfilment of scenarios from the Strategy for Economic Development of Slovenia (SEDS)

The results achieved in the past few years and short-term development perspectives by 1998 suggest that economic development in Slovenia is proceeding somewhere in-between both SEDS's scenarios. Currently, Slovenian economy is in a sensitive period of transition and has been due to external conditions (unstable economic developments in Europe and uncertainties arising from economic and political transition in the EU) and the achieved level of transition to a stable market economy unable to establish competitive macroeconomic environment for sustainable economic growth. There has been a certain discordance between the need for further rapid restructuring and increasing productivity on the micro level and a somewhat slow process of setting up a competitive economic environment (also comparable with Europe) on the macro level. This is reflected in difficulties with the achievement of the key macroeconomic goals (lower inflation, higher economic growth and higher employment). The current level of annual inflation (between 8 and 9%) seems to be very persistent. Its further reduction will not be possible until after 1998 and will be conditioned by concerted operations of all policy makers and by necessary systemic changes. Also, unemployment remains high and employment continues to decline. To achieve developmental goals in these areas long-term systemic changes on the labour market will be required.

The economic policy in 1997 and 1998 should improve developmentally unfavourable structural relations in the primary and final distribution of the gross domestic product. The proportion of wages and government spending ought to decline and the proportion of national saving and enterprise assets intended for development should increase. These would create appropriate conditions for additional investment momentum in manufacturing. Adequate structural reforms need to be phased for Slovenia to integrate fully into European economic area. These, together with adequate investment and technological development will ensure conditions for further growth in labour productivity. Namely, the entry into the European economic area will require increased labour productivity of enterprises along with gradual opening up of the domestic services market, increased energy prices, abolishment of direct subsidising of production, etc. Such a development would be in line with the positive Scenario (+) from the SEDS and would lead Slovenia to enter possibly the EU in 2001 without any larger internal shocks and as an equal and competitive economic partner.

Unless economic policy in Slovenia manages to preserve external equilibrium, improve distribution proportions in favour of savings and investment and re-establish general government equilibrium the negative Scenario (-) from the SEDS would be realised instead. The process of adjustment to and harmonisation of laws with the EU and the phasing of structural reforms would probably be delayed. Also, after the year 2000 Slovenia would still be tackling the classical problems of transition economies, i.e. rehabilitation, restructuring and macroeconomic instability. Due to Slovenia's smallness and dependency on exports its "life" outside economic integrations and without favourable trade agreements with the EU Member States would be rather difficult. Even if it manages to entry the EU in the face of the negative Scenario (-) the effects of integration would be far from only positive.

8.2 ECONOMIC GROWTH - Higher growth rates will only be achieved if supported by growth in business investment, adequate level of domestic savings and progress with reforms

Slovenia has reached a point in its development where due to the unstable foreign demand its free capacities and expansion of the existing production by themselves are not sufficient for economic growth. Growth has become more directly dependant on new business investment (in particular, new production programmes and products need to be introduced) which in turn depends on the level national saving. The first condition for revival in investment in manufacturing is the completion of the process of ownership transformation. This ought to happen this year and would enable the industrial enterprises to pay more attention to more demanding development issues rather than be engaged in regulating their legal status. Only after this happens the interest will rise for the transfer of know-how and technological progress into enterprises which will consequently lead to the emergence of new products and investment projects. In the first place, macroeconomic policy will have to ensure the adequate level of national saving. To spend beyond the possibilities at the cost of the accumulated property and future generations is a bad solution. Liberalisation and development of the financial market will be the third condition for an investment cycle in manufacturing and long-term sustainable economic growth. The financial market should provide a cheap and effective transfer of capital from savers to investors. Thus the Government ought to proceed with the strategy of support to the entrepreneurial sector and exports by proper industrial policy instruments and by establishing stable and internationally comparable macroeconomic business conditions.

The development pattern applied in industry which is premised on the expansion of the existing production able to compete abroad is improper also in terms of environmental protection. An active strategy is needed for the reduction of pollution intensity (by technical renovation, economic instruments aimed at a more rational energy and raw material consumption and installation of cleaning facilities). Also, an appropriate price policy for energy sources, technological policy and the adjustment of tax policy so as to replace the present CO_2 tax with the real environmental tax will be required. Slovenia ought to introduce the carbon tax also in order to adjust to the rules adopted in the EU. Environmental protection and economic development are targets which are strategically inter-related. Thus, the measures of selected policies ought to be observed also from the environmental point of view.

The long-term developmental scenario foresees a modest increase in economic growth (4.5% in 1999 and 2000 and 5% in 2001). These estimates are rather cautious owing to the achieved level of economic development in Slovenia which is higher than in other transition economies and closer to that in less developed EU economies. In such circumstances each percentage point of economic growth is considered a success, and in particular if a country is faced with the unavoidable requirements such as further stabilisation, restructuring in production, institutional changes and insufficient level of national saving. Although the target 4% and 5% growth rates are below the potential ones, they are still above the growth rates forecast in the EU, which will allow Slovenia to continue catching up with the most developed European countries.

8.3 OUTPUT STRUCTURE OF GROSS DOMESTIC PRODUCT - Increasing share of services and growing industrial production

The process of gradual adjustment to the production structure of small developed European countries should continue. The share of market services should further increase at the cost of the share of manufacturing and partially agriculture. This is, however, a world-wide process caused by technological development and an economic legality of transformation into an economically more developed society. In agriculture, mostly crop production should increase, whilst production in animal husbandry should somewhat decrease in the years to follow. This course of development will be encouraged also by the government by adjusting the agricultural policy instruments to the European solutions and by increasing interventions in priority agricultural issues. The share of industry should average at 25% of gross domestic product. This should be achieved in line with real growth in manufacturing and eventually also growth in the electricity, gas and water supply. A more rapid growth than that of GDP should be generated in construction which should bring the percentage of this sector in GDP to the level in the years before it started declining strongly. The share of non-market services in GDP should decrease and the share of market services should rise. The greatest upswing, apart from tourism, transport and trade and health and education related market services should be achieved by financial services in terms of which Slovenia still falls considerably behind the developed neighbouring countries.

Table 15: Gross national product by kind of activity NACE Rev. 1						
	Real growth rate in %			% of GDP		
	1998	2001	Average 1999-2001	1999	2000	2001
	prices 1992	prices 1998				
A, B Agriculture, Forestry	3,0	2,8	2,8	4,1	4,0	3,9
C Mining and Quarrying	1,0	0,0	0,0	0,9	0,9	0,8
D Manufacturing	3,0	3,0	3,0	23,0	22,7	22,3
E Electricity, Gas and Water Supply	1,0	2,0	1,4	2,2	2,1	2,0
F Construction	10,0	10,0	10,0	5,6	5,9	6,2
G Wholesale and Retail Trade, Repairs	5,0	5,5	5,2	10,6	10,7	10,7
H Hotels and Restaurants	4,5	5,5	5,4	2,8	2,8	2,8
I Transport, Storage and Communications	4,5	5,0	4,7	6,4	6,4	6,4
J,K,L,M,N,O Finance, Real Estate, Renting and Business Activity, Public Administration, Education Services, Health and Social Care, Other community, social and personal services	4,6	5,5	5,3	30,9	31,0	31,1
FISIM	2,0	2,0	2,0	-1,8	-1,8	-1,7
1 TOTAL VALUE ADDED (A...O)	4,3	4,9	4,7	84,6	84,6	84,6
2 Correction (Taxes on production and on imports - subsidies)	5,6	5,1	4,2	15,4	15,4	15,4
3 GROSS DOMESTIC PRODUCT (3=1+2)	**4,5**	**5,0**	**4,6**	100,0	100,0	100,0
TOTAL VALUE ADDED				100,0	100,0	100,0
of which:						
Agriculture (A+B)	3,0	2,8	2,8	4,8	4,7	4,6
Industry and Construction (C+D+E+F)	3,7	4,2	4,0	37,4	37,3	37,0
- Industry (C+D+E)	2,8	2,9	2,7	30,8	30,3	29,7
- Construction F	10,0	10,0	10,0	6,6	7,0	7,3

Services (G...O)	4,7	5,4	5,2	59,9	60,1	60,4
FISIM	2,0	2,0	2,0	-2,2	-2,1	-2,1
Source: Target scenario IMAD						

8.4 DEMOGRAPHIC TRENDS, EMPLOYMENT AND UNEMPLOYMENT - In transitional development labour productivity has a priority over employment. The achievement of both goals at a time will depend largely on the rate of economic growth and education

In view of low birth rate in Slovenia, which is already amongst the lowest compared to the EU countries, and the immigration rate of around 1000 persons per year, population in Slovenia is expected to stagnate in the coming years. The share of children will continue decreasing and the share of population above 65 years old increasing. Due to increased number of high school enrolments and students in the last classes the average time of studies has prolonged and in turn postponed the inflow of young job-seekers on the labour market. In the years to follow an increased inflow of graduate job-seekers is expected, whilst the share of unskilled young job-seekers (with only primary school education) is anticipated to decrease. Employment of foreigners is expected to continue growing at a modest rate. Demographic trends indicate a gradual rise in the number of persons in employment by the year 2001. The present age structure of the persons in employment does not suggest any larger increases in new retirements, so that the number of pensioners will grow only modestly. The number of persons in employment can decrease only due to larger inflow from the labour market to the non-active persons.

Further trends in employment and unemployment will depend to a large extent on the economic policy and its ability to encourage investment and increase efficiency in production. In view of current demographic trends and transitional nature of economic development which favours higher labour productivity over employment, unemployment will not decrease soon.

8.5 INTERNATIONAL ECONOMIC RELATIONS - Maintenance of external equilibrium coupled with growth in exports and imports of goods and services

The target developmental scenario forecasts a 5.3% average real growth in exports of goods, which will be supported also by increased export competitiveness in the period from 1999 to 2001. In the long run, domestic market will be too small to ensure sufficient demand. Moreover, domestic demand will be somewhat held down by a restrictive income policy which will be aimed in particular at keeping growth in wages below that in labour productivity, increasing the level of national saving and competitiveness of production. Growth in exports and imports should guarantee sufficient import component in domestic production (imports of intermediate goods) and in growing investment (imports of equipment and technology). The developmental scenario anticipates a 20% share of equipment in total imports by the year 2001.

An increase in the real level of exports of goods will be impossible (also due to environmental protection restrictions) without rising the share of value added in a unit of exported good. Increasing the exports of goods only extensively (quantitatively) has certain spatial and environmental limitations as well as certain limitations on the side of foreign demand. Thus, this orientation is inappropriate for Slovenia.

A rapid growth in domestic services sector should be reflected also in accelerated foreign trade in services. It ought to advance speedily, both on the import and export side. Surplus on the services balance is expected to only marginally widen. This is necessary in order to maintain the balance of payments in proper equilibrium in the long run (repayment of debts and maintenance of the level of foreign exchange reserves required in a small economy). A wide balance of payment deficit would not be in line with long-term orientation of the SEDS, as Slovenia should not rise whatsoever its external debt. A negative outturn on the balance of payment would only temporarily alleviate pressures on economic restructuring but would at the same time call for additional borrowing in order to finance domestic consumption, but at the cost of future generations.

There are no larger structural changes foreseen in the internal structure of exports and imports of services. In tourism there are still many unused capacities (free capacities within the existing system, chances for extending the existing capacities, room for improvement in quality and for increase in prices, etc.) which could lead to increased share of tourism in total exports of services. On the other hand, similar opportunities are observed in international transport, communications and financial and other market services.

The target scenario predicts a greater geographical diversification of goods trade by the year 2001. The proportion of exports to the EU should lower (in line with real increase in exports to this area) at a cost of higher share of other countries, notably, from the CEFTA and former Yugoslavia area.

Table 16: Projections of **Slovenia's** main macroeconomic indicators

				real growth rates in %
	1999	**2000**	**2001**	**1999-2001 average**
GROSS DOMESTIC PRODUCT	4.5	4.5	5,0	4,7
PRODUCTIVITY	3,8	3,5	4,0	3,8
EMPLOYMENT	0,7	1,0	1,0	0,9
RATE OF REGISTERED UNEMPLOYMENT	14,0	13,9	13,8	13,9
GROSS WAGE PER EMPLOYEE	2,4	2,5	3,0	2,6
GENERAL GOVERNMENT REVENUE	4,8	3,6	3,9	4,1
- as % of GDP	45,0	44,6	44,1	
- taxes	26,2	26,1	25,9	
- social security contributions (health care, employment, pension and disability, maternity)	15.3	15,1	15,0	
- non-tax revenues	3,5	3,4	3,3	
GENERAL GOVERNMENT EXPENDITURE	3,7	3,6	3,9	3,7
- as % of GDP	45,0	44,6	44,1	
- central and local governments	25,2	25,0	24,7	
- pension and disability insurance fund	13,2	13,1	12,9	

- health insurance fund	6,7	6,6	6,5	
General government surplus (deficit), as % of GDP	0,0	0,0	0,0	
EXPORTS OF GOODS AND SERVICES	5,5	4,7	5,7	5,3
- as % of GDP	50,7	50,8	51,2	
IMPORTS of goods and services	5,6	5,0	5,4	5,3
- as % of GDP	51,7	52,0	52,2	
Current account of the balance of payments, in US$ mil	25.0	-25.0	65.0	
FINAL CONSUMPTION (private and government)	3,6	3,7	4,4	3,9
- as % of GDP	75,7	75,1	74,7	
GROSS FIXED CAPITAL FORMATION	8,0	6,8	6,4	7,1
- as % of GDP	24,6	25,2	25,5	
Source: IMAD's target development scenario				

Slovenia is only modestly integrated in international capital flows. To achieve greater integration it will have to upgrade its institutions, regulatory instruments and laws. Only after these conditions are met the financial sector in Slovenia will be able to take up the same role in a national economy as it has in the countries with a developed market regulation. The target economic policy scenario counts on a substantial increase in gross capital flows. Outflows will increase mostly due to repayment of debts, namely the new ones (raised for an accelerated construction of infrastructure and rehabilitation of the environment) as well as the old ones originating from the times of the former Yugoslavia. Currently, the main form of capital exports is investment in foreign exchange reserves. This ought to change in the future as the capital outflows of private corporate sector should increase, for example by setting up enterprises abroad or by offering credits to purchasers of Slovenia's exports. On the side of capital inflows, Slovenia counts on the inflow of international loans for infrastructure construction as well as on increased foreign investment. The latter should expand in particular due to completion of privatisation, setting up of proper regulatory framework, further macroeconomic stabilisation, favourable credit rating of Slovenia which added also to improved country risk assessment, as well as the associate membership in the EU.

8.6 FISCAL AND INCOME POLICIES - Only by efficient income and fiscal policies Slovenia would ensure higher profits and greater funds for development

Only a consistent policy of reducing all kinds of costs will support economic growth as well as stabilisation goals. In this context the price of labour is of particular importance. According to the short-term target scenario, in 1997 and 1998 the income policy should manage to halt the growth in wages and thus secure the growth in wages to lag behind the growth in labour productivity by 1 percentage point after 1998. The income policy should adopt adequate measures to meet this goal. In the market sector the level of wages has already been regulated by the collective agreements which are concluded between employers and employees. By the ongoing privatisation the role of owners in setting the level of wages will increase. After the adoption of the Law on Civil Servants and conclusion of collective agreements growth in gross wages in public administration, education, health-care and social security sectors will be regulated in line with the general government capacities. Only by proper tax instruments and strict control the part of incomes currently paid out in the form of untaxed remuneration will be channelled back to the payment system.

In the public finance area the tax system should be overhauled and brought closer to the systems of developed market economies. This process has already began. The level of excise duties on the monopoly products should be gradually raised to the EU levels. Property taxes and a real environmental tax ought to be imposed. Value added tax is scheduled to be introduced at the beginning of 1999. The new Tax Administration Office will in the future opt for a more consistent assessment, calculation and collection of taxes which would lead to larger tax resources and a more even distribution of tax burdens.

Furthermore, proper management of public finances must also contribute to the goal of increasing the level of national saving. Thus, General Government Revenue and Expenditure ought to grow at a slower rate than gross domestic product and a balanced General Government Account should be maintained by the year 2001.

The long-term strategic orientation is to reduce the share of General Government Revenue in gross domestic product to around 44% in 2001. Thus, the currently active policy aimed at disburdening of economy and reducing the role of the state in the distribution of national income should continue also in the future. The achievement of this target will also call for certain economising measures in General Government Expenditure, which should be reduced to around 44% of gross domestic product by the year 2001.

Growth in expenditures for pension and disability insurance ought to be halted in particular. They should grow in line with growth in the number of beneficiaries, which has, however, levelled off since 1996. Expenditures for pensions should decrease also after the realisation of the first phase of the pension system reform which is scheduled for 1998. In addition, the first pillar of the pension system will have to be supplemented with the second pillar. All these measures would lead to a lower share of pension and disability insurance funds in gross domestic product (12.9% in 2001). The expenditures for obligatory health insurance should grow slightly slower than gross domestic product and account for around 6.5% of gross domestic product in 2001. The share of central and local budget expenditure in General Government Expenditure should slightly increase (to 56% and 24.7% of gross domestic product, respectively in 2001).

8.7 INFLATION - Only co-ordinated approach of the Government and the Bank of Slovenia will lead to further lowering of inflation

Slovenia meets both fiscal criteria set for the EU Member States to enter the European Monetary Union but not the monetary criteria (annual inflation and the level of interest rates). These criteria can also be considered to reflect internal economic stability, competitiveness and income attractiveness of exports (along with the already achieved stability of the tolar). Thus, further reduction of inflation to the European level is one of the crucial developmental goals.

The price policy should remain restrictive in the controlled sector. It should, however, not cause and disturbances in regular supply, jeopardise the value of state assets or produce any additional pressures for budget subsidies. The retail prices of electricity and oil products ought to be raised due to developmental reasons and as a part of the fiscal reform.

In view of the in-built systemic solutions (ex-post indexation of key macroeconomic categories by retail price index) is should be prevented that the future rises in prices of infrastructure and introduction of the value added tax are not on the whole passed on to inflation. After 1998 the current disindexation mechanisms will have to be modified in a way to be gradually entirely abolished.

The Government should support the monetary goals set by Bank of Slovenia. In turn the Bank of Slovenia should by its measures support the endeavours of the Government to achieve higher economic growth and increase employment. Cuts in interest rates are of particular significance. The interest rate policy should be premised on the Bank of Slovenia instruments parallel to the development of the money market and opening-up to foreign competition. Systemic solutions in the domestic banking system need to be undertaken, including the privatisation of the state-owned banks.

Table 17: Projection of main agregates of national account system

	current prices	**constant prices and exchange rate 1998**			**Structure in %**				**real growth rate 1999-2001**
	1998	1999	2000	2001	1998	1999	2000	2001	
	million SIT								
1 GROSS DOMESTIC PRODUCT	3,213,800	3,358,400	3,509,500	3,685,000	100,0	100,0	100,0	100,0	4,7
2 GROSS NATIONAL INCOME	3,234,658	3,387,755	3,540,400	3,725,943	100,6	100,9	100,9	101,1	4,8
3 GROSS NATIONAL DISPOSABLE INCOME	3,244,404	3,398,134	3,548,329	3,734,518	101,0	101,2	101,1	101,3	4,8
4 Final national consumption	2,452,575	2,541,050	2,635,070	2,752,105	76,3	75,7	75,1	74,7	3,9
- privat consumption	1,793,803	1,856,586	1,925,280	2,013,923	55,8	55,3	54,9	54,7	3,9
- government consumption	658,772	684,464	709,790	738,182	20,5	20,4	20,2	20,0	3,9
5 GROSS NATIONAL SAVINGS (5=3-4)	791,829	857,084	913,259	982,413	24,6	25,5	26,0	26,7	7,5
6 CURRENT ACCOUNT BALANCE	476	6,305	-1,384	12,485	0,0	0,2	0,0	0,3	
7 GROSS CAPITAL FORMATION	791,353	850,779	914,642	969,928	24,6	25,3	26,1	26,3	7,0

(7=5-6)									
COST STRUCTURE ON GDP									
8 Compensation of employees	1,760,870	1,815,212	1,875,814	1,946,674	54,8	54,0	53,4	52,8	3,4
9 Taxes on production and on imports	564,290	577,938	600,835	627,748	17,6	17,2	17,1	17,0	3,6
10 Subsidies	63,661	62,388	61,764	61,146	2,0	1,9	1,8	1,7	-1,3
11 Gross operating surplus and gross mixed income	952,301	1,027,638	1,094,615	1,171,724	29,6	30,6	31,2	31,8	7,2
EXPENDITURE ON GDP									
12 Exports of goods and services	1,614,989	1,703,813	1,783,893	1,885,574	50,3	50,7	50,8	51,2	5,3
13 Imports of goods and services	1,645,116	1,737,242	1,824,105	1,922,607	51,2	51,7	52,0	52,2	5,3
14 Foreign TRADE balance (14=12-13)	-30,127	-33,429	-40,212	-37,033	-0,9	-1,0	-1,1	-1,0	
15 FINAL CONSUMPTION (15=16+17)	2,452,575	2,541,050	2,635,070	2,752,105	76,3	75,7	75,1	74,7	3,9
16 PRIVAT CONSUMPTION	1,793,803	1,856,586	1,925,280	2,013,923	55,8	55,3	54,9	54,7	3,9
17 GOVERNMENT CONSUMPTION	658,772	684,464	709,790	738,182	20,5	20,4	20,2	20,0	3,9
18 GROSS CAPITAL FORMATION (18=19+20)	791,352	850,779	914,642	969,928	24,6	25,3	26,1	26,3	7,0
19 GROSS FIXED CAPITAL	765,630	826,880	883,108	939,675	23,8	24,6	25,2	25,5	7,1

FORMATION									
20 CHANGES IN INVENTORIES	25,722	23,899	31,534	30,253	0,8	0,7	0,9	0,8	6,9
Source: Target scenario IMAD									