While adopting the Programme for Entering the ERM2 and Introducing the Euro, the Government appointed the IMAD to prepare a **new inflation forecast for 2004 and 2005** by 15 January in order to incorporate the effects of this Programme. The new forecast will also be used in indexing social transfers. Measures taken by the Government and the Bank of Slovenia in the last quarter of 2003 (SEM 12/2003:3) helped inflation to drop faster than forecast in autumn, while the biggest impact of these measures is expected in 2004 and 2005. However, inflation's downward trend is likely to be slower than in 2003 because of the results achieved last year (no more significant falls can be expected in the contribution of administered prices and fiscal burdens to inflation) and changed conditions in the international environment (low levels of interest rates). Hence, inflation is expected to fall by 1.0 percentage point to **3.6% in 2004**; inflation should decline towards 3.6% in the first six months thanks to relatively high price levels seen in the same period of 2003, while this level should be maintained in the second half of the year. In **2005**, inflation should drop by a further 0.7 of a percentage point to **2.9%**.

The contribution of **administered prices** should total a maximum of 0.5 of a percentage point in 2003 in line with the Plan of Raising Administered Prices, leading to their slow rise, and a maximum of 0.4 of a percentage point in 2004. The contribution of **fiscal changes** should also fall, adding 0.4 of a percentage point in 2004 and 0.3 of a percentage point in 2005. Namely, the Plan of Raising Administered Prices includes rises in tax burdens, except those resulting from higher excise duties on tobacco and tobacco products. The latter will be raised in January and July of both 2004 and 2005 as part of the process of harmonising excise duty rates with the EU. The Government will continue to make counter-cyclical adjustments to excise duties on liquid fuels in order to buffer the impact of possible fluctuations in world oil prices on domestic retail fuel prices. As a result, indirect effects of higher fuel prices should be reduced and inflationary expectations anchored. **Monetary policy** should also help bring inflation down further; it will continue to slow the tolar's depreciation down against the euro in line with measures to meet the Maastricht criteria. According to the IMAD's estimates, the euro should appreciate by 1.4% in 2004 if the Maastricht criteria are to be satisifed in 2005, while the tolar's predictable depreciation typical of the past few years should stop at the end of 2004. If the delayed impact of the euro's appreciation on prices is taken into account, the exchange rate's contribution to inflation should be about 1.6 percentage point in 2004 and about 1.0 percentage point in 2005. Inflationary pressures from the domestic environment will also be reduced thanks to last year's **abolition of indexation mechanisms**. The wage adjustment agreement for the public sector adopted in July 2003 will ensure that wage growth does not create any inflationary pressures on the demand side in the upcoming two years. A similar agreement is expected to be adopted for the private sector. Inflationary expectations were also anchored by abolishing indexation in the financial sector in 2003. Provided that these measures are implemented, the main reason for inflation's inertia at a level above the Maastricht criteria will be **structural imbalances**, which create constant upward pressures on prices, primarily in the non-tradable sector of the economy. This, together with the Slovenian economy's faster productivity growth compared to the EU average (the Balassa-Samuelson effect), is the main reason that inflation is still likely to be about 1.5 percentage points higher in the next two years.

In **December, manufacturing's production volumes** shrank by 15.1% over November for seasonal reasons (New Year's holidays), however, they climbed by 8.3% over December 2002 which had one working day less. After rising moderately in the first quarter over the same period the year before (up 1.3%), production activity fell in the second and third quarters (down 0.2% and 0.3%, respectively) because of the slow economic recovery in the EU, but entered an upward trend in September. In December, production rose by a trend rate of 0.2% over November according to the Tramo-Seats method. Hence, production volumes rose significantly in the last quarter, going up by 5.8% year on year. In **2003** as a whole, manufacturing's production volumes increased by 1.6% (2.8% in 2001 and 2.0% in 2002), more than projected by the autumn forecasts. Improved economic conditions were reflected in December's relatively favourable business climate measured by the confidence indicator. This was largely due to higher production expectations for the next 3-4 months. Manufacturing's accelerated production activity could be related to the strong growth in **exports** of goods seen in autumn 2003 (see p. 4). Growth in imports of goods remained robust up until November in line with stronger growth in private (see p. 13) and investment consumption. The latter are also indicated by loan flows; falls in lending interest rates pushed the **volume of borrowing** up for both households and enterprises. Household long-term borrowing increased up until November (up 6.2%), in parallel with the strengthening of private spending, while corporate tolar borrowing rose even more after falling in 2002 which, unlike in previous years, mainly involved long-term borrowing (up 7.1%). Corporate foreign currency borrowing continued to rise fast in both domestic and international markets (see p. 8). Deposit interest rates also dropped, which was the likely reason for the subdued growth seen in **household savings**. November's **household tolar savings in banks** recorded the lowest growth so far (up 4.6% over December 2002), while inflows into mutual funds remained robust from 2002 (see p. 7).