Economic growth forecasts for 2004 and 2005

*The spring **economic growth** forecast for 2004 (3.6%) and 2005 (3.7%) is unchanged compared to the autumn forecasts.* Given the minor changes in international environment assumptions, the forecast of real export growth is closely in line with the autumn projections, while the forecast of domestic consumption is slightly higher than in autumn which, together with accelerated imports, yields the same economic growth forecasts for 2004 (3.6%) and 2005 (2005) as in autumn (see Main Indicators on p. A 13).

*Growth in export demand should strengthen in **2004** thanks to the improved conditions in the international economic environment.* As far as the regional distribution is concerned, **exports** of goods to EU members should increase, while exports to the countries of former Yugoslavia should drop. Exports to new EU members which used to be part of the CEFTA are expected to maintain high growth rates from 2003. On the other hand, high export levels seen with the former Soviet Union and the USA are expected to slow down this year. These developments are the expected result of economic integration processes (increased trade between EU members and lower trade with non-members). The expiry of free-trade agreements with the countries of former Yugoslavia is estimated to reduce annual economic growth by 0.1 of a percentage point. However, the effect of adopting the Common Customs Tariff and the lifting of barriers to trade in sensitive products within the EU and border controls, thereby reducing the cost of trade, should have a positive impact on economic growth. The overall net result is expected to be positive. A further strengthening of domestic consumption will keep import growth at a relatively high level. The growth contribution of international trade is still estimated to be negative (-1.0 percentage point), but lower than in 2003 (-2.0 percentage points). As a result, the current account of the balance of payments should turn from a surplus of 0.1% of GDP to deficit, which should be low (0.2% of GDP) thanks to the expected improvement in the terms of trade and higher transfers from the rest of the world than in 2003.

In 2004, domestic consumption should continue rising, thereby providing the main lever of economic growth. Further growth in **domestic consumption** will be fuelled by increased private and investment spending. Private consumption growth will be underpinned by the start of a new cycle of buying durable goods, which is estimated to have already started in 2003, while the burden of loans raised in 1999 will be easing further. Private consumption will also be encouraged by the gradual improvement in the labour market and lower interest rates in the money market. The latter will result from the process of convergence with the euro-zone countries and entry into the ERM2, which is envisaged to take place before the end of 2004, according to the joint programme of the government and the Bank of Slovenia, or even earlier if the macroeconomic conditions are favourable. Private consumption will also be boosted by funds released from the first national housing savings scheme. Some of these savings should turn into consumption either directly or indirectly through the purchase of dwellings or other durable and semi-durable goods. Robust growth in gross fixed capital formation is expected to be maintained. Government investment should maintain strong growth, fuelled by motorway construction and the setting-up of the Schengen border, housing investment should rise fast, according to the issued building permits, and the private sector's investment should accelerate in line with the improved economic cycle. The forecast of expenditure on government consumption is harmonised with the adopted budget for 2004.

*In **2005**, export growth should accelerate further on the assumption of favourable trends in the international environment, while domestic demand should fall slightly so their contribution to economic growth should be more balanced, however, domestic spending is still likely to contribute relatively more.* Private consumption, underpinned by continued employment growth and moderate wage growth, is set to maintain the level of 2004. Growth in gross fixed capital formation should remain robust, primarily fuelled by private sector's investment, housing construction should continue rising, and investment in motorway construction should sustain this year's strong pace. According to the preliminary budget for 2005, government consumption should rise less than in 2004. Following the slightly weakened domestic demand and a further rise in exports, import growth is projected to be lower than in 2004. The growth contribution of international trade is still expected to be negative, albeit lower than in 2004 (-0.7 of a percentage point). The current account deficit is estimated to widen to 0.4% of GDP, while remaining within sustainable limits, thanks to imports rising faster than exports.

Labour market outlook for 2004 and 2005

Labour market performance should improve in line with the rebound in economic activity. Employment (according to the national accounts), which contracted in the past two years, is expected to increase by 0.4% in 2004 and 0.6% in 2005, while both registered and survey unemployment rates are anticipated to fall, especially in 2005.

Real wage growth is estimated to be about one percentage point below labour productivity growth (GDP per employee) in both 2004 and 2005. The real gross wage per employee is expected to rise by 2% in 2004 (2.5% in the private and 0.5% in the public sector) and by 2.2% in 2005 (2.5% in the private and 1.2% in the public sector). Public-sector wages will be adjusted in line with the agreement adopted last year, according to which wages should be raised by 3.1% in nominal terms in 2004 and 3% in 2005. Negotiations about the adjustment mechanism for the private sector for this and next year were concluded at the end of April (see p. 13), while wage growth will be additionally influenced by the improved economic climate and more working days than in 2003. These trends should help fulfil the Social Agreement's objective, according to which the real gross wage per employee should rise one percentage point less than labour productivity growth.

Inflation forecasts for 2004 and 2005

Inflation is expected to decline further this and next year: by about 1.3 percentage points in 2004 to an annual rate of 3.3% and by about 0.4 of a percentage point in 2005 to an annual rate of less than 2.9%. Measures adopted in 2003 envisage an even distribution of monthly falls in inflation throughout 2004. However, since inflation was higher in the first than in the second half of 2003, the annual inflation should fall relatively fast in the first half of 2004, while the achieved level should be maintained in the second half of the year.

The slowdown in inflation will be the result of co-ordinated macroeconomic policy measures, while the government will retain the current stance of fiscal, incomes and administered prices policies. The plan of rises in administered prices for this and next year is in line with the administered prices policy from 2003, according to which administered prices should rise by as much as 3.4% in 2004 and 2.3% in 2005. The government also plans to co-operate with independent regulators that shape prices mainly in telecommunications, post and broadcasting, and electricity distribution. As in 2003, this should help ensure that these prices rise in step with other prices in the upcoming two years. The plan of rises in administered prices also determines the level of tax burden, which has pushed prices up significantly in the past few years. The contribution of the tax burden to inflation will be reduced this and next year thanks to environmental and other taxes and excise duties being raised more in line with the general price level (the exception is excise duties on tobacco and tobacco products, which will continue to be raised in 2004 and 2005 as part of the process of harmonising 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, thereby reducing indirect effects of higher fuel prices and anchoring inflationary expectations. Inflationary pressures from the domestic environment will also be reduced thanks to changes to indexation mechanisms. The wage adjustment agreement for the public sector adopted in July 2003 and the one for the private sector adopted in April this year will ensure that wage growth does not create any inflationary pressures on the demand side in the upcoming two years. Inflationary expectations should also be eased by the de-indexation introduced in the financial sector last year.

Further pursuing of the monetary policy set out in the Programme for Entering the ERM2 and Introducing the Euro should also help bring inflation down. According to measures designed to meet the Maastricht criteria, the tolar's depreciation against the euro will continue to slow down while, drawing on the assumption of the high pass-through effect of the exchange rate on consumer prices, the contribution of the exchange rate to price rises will fall.

Changes in the international environment expected in 2004 should not put any additional pressure on price rises. The relatively slow recovery of economic activity in the EU will assist the fall in inflation in this region and, consequently, have a positive impact on prices in Slovenia. The relatively high oil prices coupled with the US dollar's relatively low value have already been revealed in price rises, while pursuing the policy of counter-cyclical adjustment of excise duties. If the dollar's value is unchanged, the only inflationary pressure would come from a longer-term rise in oil prices above the estimated level, which is unlikely according to prevailing expectations.

Provided that these economic policy measures are consistently implemented, the price rise above the EU-15 average will primarily be due to persistent structural imbalances. Inflation in Slovenia is estimated to be 1.0 to 1.5 percentage points higher above the EU-15 average this and next year as a result of these imbalances, which create constant upward pressures on prices especially in the non-tradable sector, and faster productivity growth in the Slovenian economy compared to the main trading partners (the Balassa-Samuelson effect). For a sustainable reduction of inflation it will be necessary to conclude structural reforms, mainly in those sectors where prices are regulated by the government and in the field of financial and labour market operations.

Main risk factors

In addition to the baseline scenario, we prepared two alternative scenarios which reflect the estimated size of the main risks in meeting the forecasts. The first one is based on the assumption that after joining the EU the Slovenian economy's competitiveness will be lower than estimated, leading to lower domestic production growth and higher unemployment. The second one is based on the assumption that falls in nominal interest rates after entering the ERM2 will additionally boost domestic consumption, thereby accelerating macroeconomic imbalances in international trade and inflation. The purpose of the alternative scenarios is to assess the scope of the possible impact of these risks, while noting that the baseline scenario is the most likely outcome of economic developments in 2004.