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Macroeconomic Imbalances

Slovenia 2014

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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Slovenia continues to experience *excessive macroeconomic imbalances which require specific monitoring and continuing strong policy action.* Imbalances have been unwinding over the last year, thanks to macroeconomic adjustment and decisive policy action by Slovenia. Yet the magnitude of the necessary correction means that substantial risks are still present. The Commission will continue the specific monitoring of the policies recommended by the Council to Slovenia in the context of the European Semester, and will regularly report to the Council and the Euro Group.

More specifically, the risk stemming from an economic structure characterized by weak corporate governance, high level of state involvement in the economy, losses in cost competitiveness, the corporate debt overhang, the increase in government debt warrant very close attention. While considerable progress has been made in repairing the banks' balance sheets, determined action with respect to the full implementation of a comprehensive banking sector strategy, including restructuring, privatisation and enhanced supervision is still required.

Slovenia continues to struggle with the legacy of its previous boom, with corporates remaining unsustainably over-indebted. The transfer of non-performing loans (NPLs) to the Bank Asset Management Company (BAMC) has improved the banks' balance sheets but NPLs remain elevated relative to pre-crisis levels and still need to be durably restructured based on the recently amended insolvency framework. As domestic demand, and especially investment, contracted significantly, the current account has corrected sharply, turning into a large surplus, but cost competitiveness losses have not been recouped and reforms so far have not fully addressed the labour market flexibility and competitiveness challenge. Weak corporate governance, particularly but not only in state-owned enterprises, reduces the overall efficiency of the economy through possible inefficient allocation of resources. Significant withdrawal of the state from the corporate and financial sector, combined with a comprehensive strategy for the management of core assets and divestment of non-core assets, could improve the adjustment capacity of the economy. Finally, the substantial increase in government debt in recent years, albeit from a relatively low level, creates new challenges. While the headline fiscal deficit is expected to be above the targets due to the significant expenditures related to bank recapitalisation in 2013 and 2014, the deficit is also projected to exceed the target in 2015 under a no-policy-change scenario. The structural adjustment likewise falls slightly short of what would be needed. Taken together, these shortcomings and challenges weigh on the near term macroeconomic performance. The recent fall in sovereign bond yields relieves some pressure but the pace of implementation of the programme of structural reform needs to accelerate.

Excerpt of country-specific findings on Slovenia, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Slovenia was experiencing excessive macroeconomic imbalances, in particular with respect to developments related to the extent of state involvement in the economy, corporate sector deleveraging, banking stability and to some extent also external competitiveness. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of a serious imbalance in April 2013, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this In-Depth Review (IDR) provides an economic analysis of the Slovenian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **The Slovenian economy was severely affected by the crisis and is undergoing considerable adjustment**. In 2013 real GDP was 10% below the peak levels experienced in 2008 but a fragile recovery, driven by net exports, is expected to commence in the second half of 2014. As domestic demand, and especially investment, contracted significantly, the current account has corrected sharply from a deficit of 7% of GDP in 2008 to a surplus of 3.1% of GDP in 2012, and a further increase of the surplus is expected. The current account surplus reduces Slovenia's net foreign liabilities, as the Net International Investment Position (NIIP) has seen a marked improvement and now stands at a level below 40% of GDP.

- **Slovenia has taken decisive policy action in 2013 which has stabilised the banking sector but further restructuring and consolidation is required for the sector to return to long-term sustainability and profitability**. As a result of four consecutive years of balance sheet contraction and asset transfers the Slovenian banking sector has shrunk by one fifth. Policy action has included asset quality reviews, stress tests, recapitalisation of the state owned banks and the transfer of Non-Performing Loans (NPLs) to the Bank Asset Management Company (BAMC). Although the prompt restructuring of banks' balance sheets is being facilitated by the transfer of NPLs to the BAMC, the level of NPLs remains elevated relative to pre-crisis levels and could pose a threat to future viability and privatisation of banks if not swiftly resolved. Once the current phase of bank restructuring, privatisation and impaired loan resolution is completed, the principal residual risk to the sector will be the ability to return to sustainable profitability and to maintain resilience to absorb potential future shocks. As there is limited scope to widen net interest margins, profitability developments and the strengthening of the sector will be largely determined by efficiency improvements and related cost reductions over the medium term.

- **The sharp increase in government debt in recent years, albeit from a relatively low level, creates new challenges and risks which underscores the need for sustainable policy actions.** The debt-to-GDP ratio rose from just 22% in 2008 to 54% in 2012. In 2013 the debt is estimated to have risen by a further 18 pps to 72% of GDP. While the bank recapitalisations and transfers to the BAMC in December 2013 account for a significant part of this increase, a substantial proportion of it relates to the accumulation of primary deficits. The debt is forecast to continue increasing over 2014-15 and Slovenia appears to face sustainability risks in the medium and long term due to the steep rise in ageing-related spending. Higher debt and shortened maturities increase the importance of viable debt management strategies, as illustrated by the substantial impact on interest rate expenditure from debt issuances in late 2013 at elevated interest rates.

- **A substantial loss of export market shares over the past five years indicates Slovenia is not competing effectively in world markets.** While export volumes are returning to the peak levels reached in 2008, they are not growing in line with the expansion in global trade. The reversal of Slovenia's previous gains in export market shares is driven by cost-competitiveness losses, which also inhibits investment and job creation. These losses are particularly marked versus the catching-up economies of central Europe which are a natural benchmark for Slovenia as a production location, and versus the member states receiving financial assistance, which are a benchmark as regards the pace of

macroeconomic adjustment. Slovenia's divergent unit labour cost developments from these benchmark economies provides clear evidence of Slovenia's overall cost-competitiveness losses, driven by labour cost growth which is out of line with productivity trends and labour market inflexibilities.

- **The postponement of financial restructuring of viable companies delays the re-establishment of investment capacity and the recovery of the Slovenian economy as a whole.** The level of NPLs in the Slovenian corporate sector has substantially increased in recent years. The high level of indebtedness and financial distress limited the corporate sectors capacity to invest and significantly contributed to the prolonged decline in investment experienced in Slovenia. Furthermore, the fall in operational profitability of companies indicates a decrease in efficiency and a loss of competitiveness. This has wider implications for the economy with a sharp deterioration in the corporate sector's contribution in terms of net added value to GDP from pre-crisis levels. The restructuring of companies has been severely constrained by a cumbersome legislative framework and weak corporate governance, particularly but not only in state owned enterprises. A new legislative framework for corporate restructuring was introduced in December 2013, the purpose of which is to improve the efficiency of insolvency proceedings and provides for the preventive restructuring of viable businesses with unsustainable debt overhangs before they become insolvent. The introduction of the reform is welcome, though its impact is yet to be assessed as it remains largely untested.

- **The complex nexus of state ownership limits adjustment and distorts resource allocation, especially as regards new investment.** It also appears to deter foreign direct investment (FDI) which is lower than in peer countries. It also creates risks to public finances, either directly or by way of contingent liabilities from guarantees provided. Amendments to the legislation underpinning the Slovenia Sovereign Holding (SSH) aimed at reconstituting it as a vehicle for consolidating the management of direct and indirect ownership stakes of the State and the classification of non-core assets for privatisation have been delayed.

The IDR discusses the policy challenges stemming from the imbalance and risks identified above and possible avenues for the way forward in order for Slovenia to successfully pursue the full unwinding of these imbalances. A number of considerations, outlined below, could guide future policy response:

- **Decisive action as regards operational restructuring, consolidation and privatisation would improve profitability and enhance the long-term viability and sustainability of the financial sector.** Further determined action, particularly regarding operational restructuring, would improve the profitability outlook of the financial sector. Decisive and swift action as regards consolidation and privatisation would enhance the long term sustainability of the sector. Furthermore, medium term viability and the prevention of repeated build-up of risks will depend on the quality of micro and macro supervision, risk management and governance. Prompt asset divestments by the BAMC and implementation of the privatisation programme could minimise potential future losses for the assets concerned as well as generating proceeds for the reduction of debt.

- **Prudent and credible fiscal and economic policy-making will be required to maintain market confidence and ensure debt sustainability in the medium and long term.** Given the substantial increase in the level of public debt in Slovenia, albeit from a relatively low level, decisive policy action is required. First and foremost, sustained primary surpluses are needed to put debt onto a downward path. The right fiscal institutions, including an effective fiscal council and fiscal rules can provide important anchors for such a fiscal policy. The margin for revenue increases has been largely exploited in the 2014 budget, so expenditure consolidation options will need to be fully explored. A good alternative to potentially damaging and inefficient linear expenditure cuts could be a more targeted reorganisation of state activities. Credible expenditure reviews could inform the budgetary measures required to meet the overall fiscal consolidation objectives and also identify options to enhance efficiency, cost effectiveness and exploit synergies to reduce duplication of services. In view

of the steep increase in ageing-related spending implied by Slovenia's demographics, the pension and long term care systems will need to be reformed in the near term if the overall expenditure envelope is to be stabilised over the medium and long term.

- **Restoration of cost competitiveness over the medium term could boost export performance.** Containment of labour cost growth could help to regain cost competitiveness in the near term. Public policy can influence labour costs via a number of channels, including the reform of the minimum wage, labour taxation (including employers' social security contributions) and public sector wages. Namely, the structure of the minimum wage could be revised in order to differentiate between different labour market groups, while indexation could take other economic trends into account, including productivity.

- **Policies to address the corporate debt overhang which focus on supporting prompt debt restructuring could unlock new private investment.** Financial and operational restructuring could prioritise the most vulnerable companies, financial holdings and the state-owned entities where the majority of the debt overhang is concentrated. Close monitoring and corrective action is needed to ensure that the recently revised insolvency framework and its implementation by the courts deliver the necessary improvements in the restructuring of distressed companies. Early intervention by both debtors and creditors via the new preventive restructuring procedure could allow for viable businesses to be restructured before they become insolvent. If shortcomings emerge the new legislation could be revised. In addition, policies supporting enhanced reporting and corporate governance practices in key sectors of the economy, and particularly in state-owned entities, will be necessary to improve profitability and competitiveness.

- **A significant withdrawal of the state from Slovenia’s corporate and financial sector, combined with a comprehensive transparent strategy for the management of core assets and the prompt divestment of non-core state assets, could improve the adjustment capacity of the real economy and reduce the risk to public finances.** The state will remain an important actor in many key restructuring cases, through the BAMC, the state owned banks and state shareholdings. Private restructuring deals concluded between privatised companies and privatised banks are likely to adhere more closely to commercial principles and deliver more durable value than solutions orchestrated by the state. Decisive progress with regard to the privatisation of the 15 state owned entities identified for accelerated privatisation and the adoption of a comprehensive strategy for core and non-core state assets could provide a clear signal to the market regarding Slovenia's commitment to implementing the necessary reforms. Continued transparent privatisation could also help unlock productivity increases and provide the competitiveness boost the Slovenian economy and enterprises urgently need.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its third Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific "in-depth reviews" (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

This is the third IDR for Slovenia. The previous IDR was published on 10 April 2013 on the basis of which the Commission concluded that Slovenia was experiencing excessive macroeconomic imbalances, in particular as regards developments related to corporate sector deleveraging, banking stability and to some extent also external competitiveness. Overall, in the AMR the Commission found it useful, also taking into account the identification of a serious imbalance in April, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this IDR takes a broad view of the Slovenian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

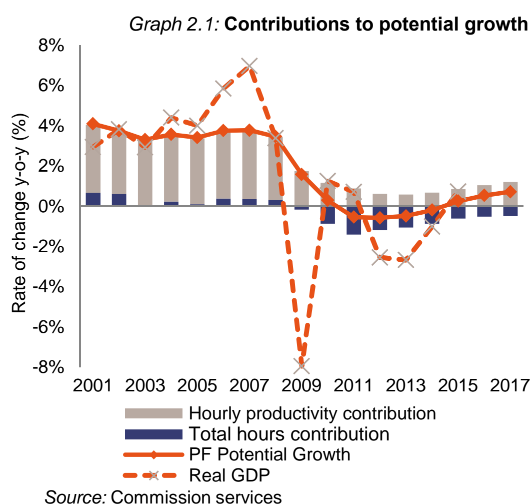
Against this background, Section 2 gives an overview of macroeconomic developments, Section 3 looks more in detail into the main imbalances and risks, focussing in particular on the financial sector renewal, debt sustainability and the loss of cost competitiveness and export performance. Section 4 addresses specific topics related to corporate cash flows and investment, like corporate performance and distress, deleveraging pressure and quantifies the size and scale of the risk inherent in the corporate sector. Section 5 discusses policy considerations.

2. MACROECONOMIC DEVELOPMENTS

Growth and export performance

The crisis has had a profound and prolonged impact on the Slovenian economy. Real GDP in 2013([1]) was 10% below the peak achieved in 2008 and the economy continues to contract, with only a tepid recovery forecast from the second half of 2014 according to the Commission services Winter 2014 forecast. The period has been marked throughout by compression of domestic demand, particularly investment, which translated into declining potential growth, where the majority of the decline is attributable to factors other than labour input, i.e. capital and total factor productivity (see Graph 2.1). The impact of reduced investment may be overstated due to the prevalence of non-productive investment in the pre-crisis years (see in-depth sections of 2012 and 2013 IDRs).

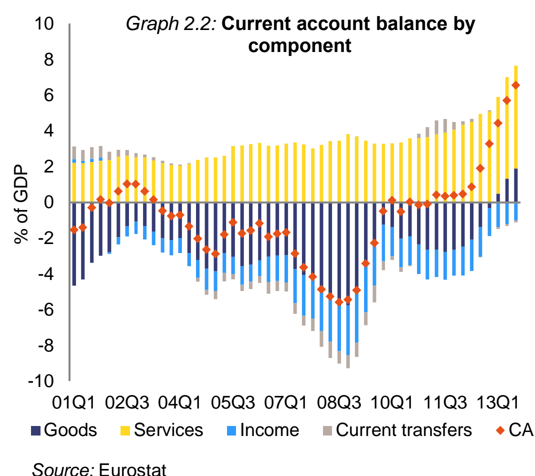
Graph 2.1: **Contributions to potential growth**



Source: Commission services

The current account has corrected sharply from a deficit of 7% of GDP in 2008 to a surplus of 3.1% of GDP in 2012. Additional widening of the surplus is expected in 2013-15. The increase in the services trade surplus and the disappearance of the goods trade deficit have contributed relatively equally to this correction (see Graph 2.2). In nominal terms the exports of services increased by 9.5% in the period 2008-2013 and represent 15.5% of GDP in 2013. Exports of goods increased in nominal terms by 7.6% in the same period and represented 63.2% of GDP, signalising the importance of merchandise trade for the GDP.

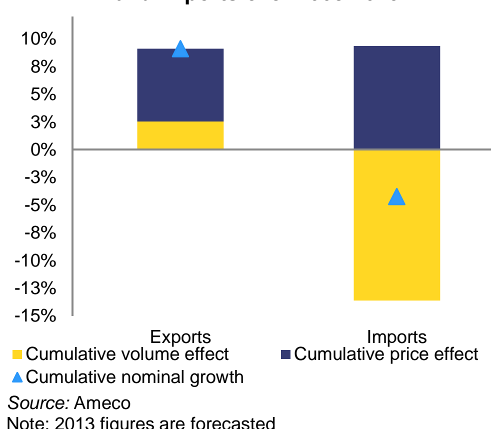
Graph 2.2: **Current account balance by component**



Source: Eurostat

Compression of domestic demand has translated into a decline of imports. Over the period 2008-2013, import volumes declined by 13.6% while exports volumes increased only by 2.5% in the same period. However, the cumulative price effect has been positive both for imports and exports (see Graph 2.3), thus stemming the impact of the decline in import volumes on the current account balance.

Graph 2.3: **Cumulative change of exports and imports over 2008-2013**



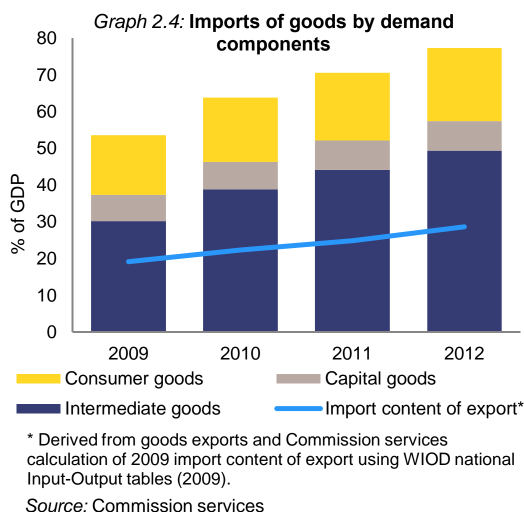
Source: Ameco

Note: 2013 figures are forecasted

The bulk of the change in imports of goods since 2008 can be attributed to the decline in construction investment and disposable income. Given the weakness of domestic demand, the only import growth in recent years has occurred in

([1]) Real GDP value (constant prices) according to European Commission Winter forecast (February 2014).

intermediate goods, which is driven by Slovenia's export industries (see Graph 2.4).

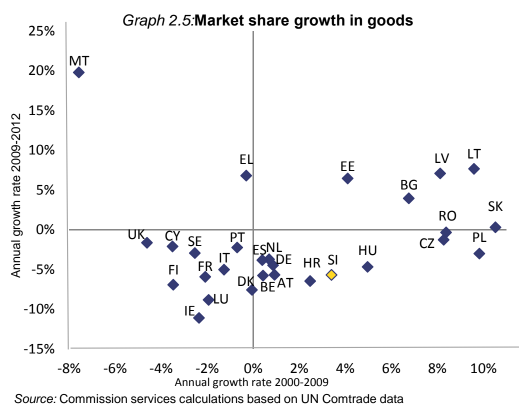


Graph 2.4: **Imports of goods by demand components**

* Derived from goods exports and Commission services calculation of 2009 import content of export using WIOD national Input-Output tables (2009).

Source: Commission services

Export performance has been below the average of peers. Slovenia has lost almost a fifth of its market share in world exports over the last five years. Since 2009, catching up Visegrád member states such as the Czech Republic, Poland and Slovakia have participated more in the rebound in world trade in goods (see Graph 2.5). The competitiveness developments underlying this underperformance are examined in more detail in Section 3.3.



Graph 2.5: **Market share growth in goods**

Source: Commission services calculations based on UN Comtrade data

Financing conditions

Domestic bank credit has continued to contract, particularly to the corporate segment. Restricted access to finance for viable companies due to market fragmentation could limit the growth potential of the economy which is primarily composed of SMEs. Domestic deleveraging is, however, a key driver of the development of the financial position of Slovenia. Section 3.1 further analyses banking sector developments which are characterised by balance sheet cleaning and contraction.

Credit to households has also shrunk. This may reflect the expectation of further house price declines. The Eurosystem Household Finance and Consumption Survey indeed finds that Slovenian households, despite their strong balance sheets, were faced with the second highest refusal rate for credits (28%) in the euro area. They also refrained the most from applying for credit due to perceived credit constraints over the past two years. Overall households' financial strength ([2]) would be suggestive of credit supply constraints, although banks state that demand from viable households is lacking. If confirmed, any such supply constraints could be a factor depressing consumption and the housing market. Following a cumulative fall in house prices from their peak by almost 20% (29% after inflation adjustment), the overvaluation gap that built up during the boom has considerably narrowed. However, our analysis of the housing market indicates that, although prices may start showing signs of a stabilisation, the outlook for house prices continues to be negative as economic fundamentals are likely to drag down the equilibrium house price level, while the still fragile credit market conditions increase the risks of an undershooting of the equilibrium house price level (see Box 2.1).

Asset market developments have been weak but improved after banking sector assessment. Nevertheless this development is too recent to have passed through to economy-wide borrowing costs ([3]). House prices have continued to decline with transaction and construction volumes remaining low (Box 2.1 assesses the scope for further correction in the housing market). The stock market remains subdued with a relatively low number of liquid listed blue-chip companies,

([2]) Corroborated by relatively low loan-to-value ratios reported by the Bank of Slovenia.

([3]) In Slovenia interest rates on corporate loans have been elevated since early 2009 and there was no significant increase since. In practice the link between sovereign interest rates and corporate financing conditions does not seem to be very strong.

some of which are earmarked for disposal by banks and the state.

Box 2.1: House price outlook in Slovenia

As of 2013 Q3, house prices were down by 20% from their 2008 peak, corresponding to 29% in inflation-adjusted terms (Graph 1a). Transaction volumes in the four quarters to 2013Q3 decreased significantly from average 2007 levels (-58% for new dwellings, -44% for existing dwellings[1]). This low level of market activity was directly mirrored by the evolution of new lending for house purchases, which came to a virtual standstill in 2013. Residential investment remained subdued in 2013, estimated around 2.6% of GDP compared to the peak of 4.6% in 2008.

In order to assess the house price outlook a three-step analytical framework is applied (i) cyclical developments are used to characterize the recent house price dynamics and identify boom/bust patterns; (ii) the cyclical analysis is supplemented by indicators of over-/under-valuation (price to income ratio, price to rental ratio, and a fundamental model of house prices) and (iii) possible pressures coming from overall credit market conditions and household balance sheets are assessed as both of these can shape the short-term house price dynamics.

The difference between the actual inflation-adjusted house price and its filtered trend (Graph 1b) is used to calculate an indicator of "severity" of the upward and downward cyclical phases that combines the magnitude and duration of the peak-to-trough and trough-to-peak phases .[2] The most recent upward phase (ending in 2007 Q4) can be qualified as a boom, given the value of the "severity" indicator relative to historical upturn episodes in EU Member States. The current bear phase, reaching about 75% of the boom's "severity", cannot yet be qualified as an outright bust.

The second step of the analysis (Graph 1c) is based on three valuation indicators, which consistently signal that the overvaluation gap has significantly narrowed since 2008. However, this should not be interpreted as equivalent to an absence of downward pressures on house prices, as additional corrections can come from the general economic deterioration dragging down housing market fundamentals.

Moreover, short-term house price dynamics are to a large extent determined by households' ability and willingness to finance housing assets through credit, irrespective of the housing market's valuation level. In general, past episodes of housing cycles suggest that house prices tend to undershoot the equilibrium levels in their downward phase. As a last step, Graph 1d presents the most recent indicators of credit supply and demand deleveraging pressures across EU Member States.[3] Slovenia continues to be among countries with the highest pressures, on both the supply and the demand side. The current credit market conditions signal reduced numbers of households applying for mortgage credit and rather low approval rates for those households that do apply.

Given the fragility of the credit market conditions, while the housing market may start showing signs of a stabilisation, the outlook for house prices continues to be negative.

([1]) The very low levels of reported transactions in 2013 Q3 are in part also due to a technical problem in the authorities' information systems, which can explain only a limited part of the fall in transactions.
([2]) For further details see European Commission (2012): "Assessing the dynamics of house prices in the euro area", *Quarterly report on the euro area*, 4/2012.
([3]) See details on the methodology in Cuerpo, C., I. Drumond, J. Lendvai, P. Pontuch and R. Raciborski (2013): "Indebtedness, Deleveraging Dynamics and Macroeconomic Adjustment", European Economy, Economic Paper no. 477.

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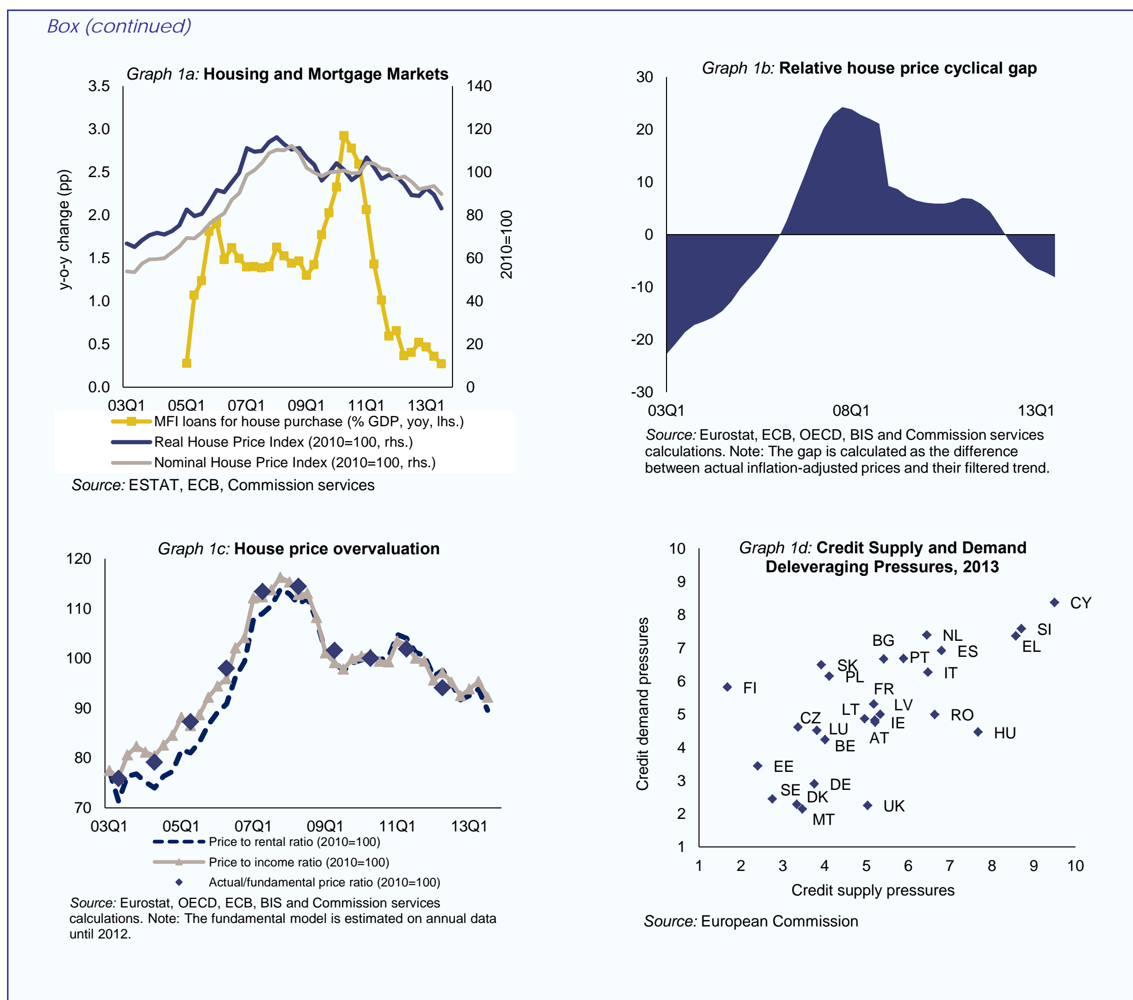
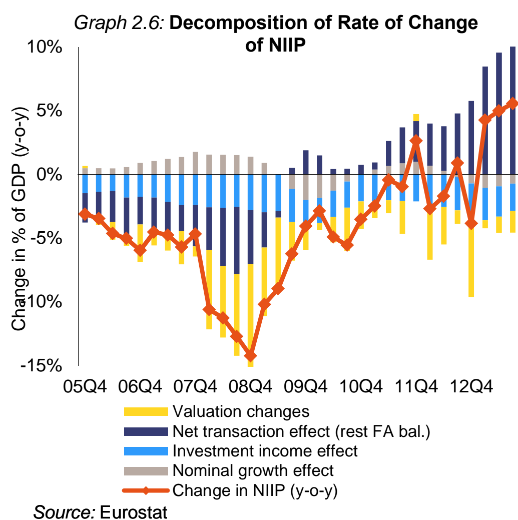


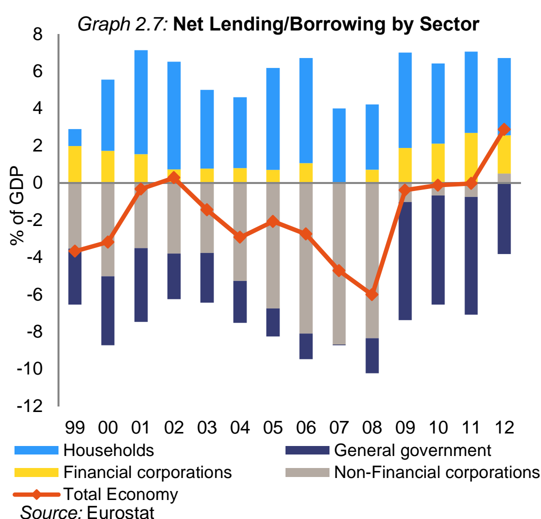
The current account surplus reduces Slovenia's net foreign liabilities. Between 2005 and the beginning of 2009, Slovenia quickly accumulated a substantial negative Net International Investment Position (NIIP) of approximately 40% of GDP. The primary driver was the foreign borrowing of Slovenian banks to fund investment, particularly in booming construction and acquisition activities ([4]) (see net transaction effects in Graph 2.6). The secondary driver was the emergence of negative net valuation changes in 2008, stemming principally from sustained reductions in asset values within 'other investments', part of which may reflect Slovenia's exposure to depressed markets in the former Yugoslavia. The sudden halt in foreign bank financing in 2009 led to substantial net repayments of debt. The persistence of negative trends in net valuations offset the positive impact of transactions on NIIP until end of 2012. Since 2013, due to improving transaction effects and declining negative valuation effects, the NIIP has seen a marked improvement and now stands at a level below 40% of GDP.

The collapse in corporate borrowing has driven the change in Slovenia's financial position. Decomposing net lending and borrowing by sector (see Graph 2.7) shows the extent to which non-financial corporations (NFC) have ceased borrowing, but also reveals that modest deleveraging only commenced in 2012 (corporate deleveraging is further analysed in Section 4). It also shows the impact of government borrowing which is examined in greater detail in Section 3.2, including a stock-taking of the impact of one-off capital support operations in 2013-14.

([4]) See 2012 IDR.



Source: Eurostat



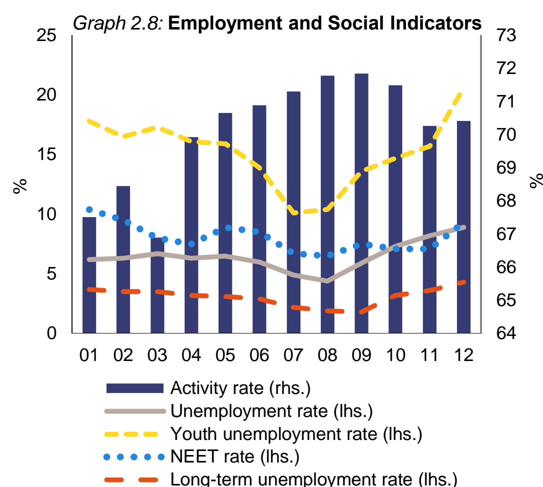
Source: Eurostat

Employment and social conditions

Unemployment increased from 4.4% in 2008 to 8.9% in 2012 and has continued to increase moderately throughout 2013; yet it remains below the EU-28 average. There is substantial upward risk to unemployment as there has only been a limited reallocation of the workforce released by labour shedding in construction, real estate and, to some degree, manufacturing ([5]). Real wages are now edging downwards but remain above 2008 levels. Section 3.3 examines the competitiveness implications of labour market developments.

([5]) Pharmaceuticals, energy and insurance are among the sectors that have weathered the crisis better.

Employment protection, strong household balance sheets and broader social support have muted the social consequences of the crisis to some extent. Youth unemployment remain below the levels seen in other vulnerable EU economies, though the annual increase in 2012 of 31% was the highest in the EU-28 and levels are still rising. Although the key social indicators stay below the EU average, the underlying trend is not reassuring. The NEET ([6]) rate increased from 6.5% in 2008 to 9.3% in 2012 (EU average in 2012 is 13.2%) and the share of long term unemployed is up from 1.8% in 2009 to 4.3% in 2012 (EU average in 2012 is 4.7%). As detailed in the 2013 IDR, unemployment, much more than low pay, is a key determinant of risk of poverty and social exclusion. Young people have been the most severely affected by the crisis (see Graph 2.8) as has been the case across Europe. The risk of labour market scarring increases as long as economic growth does not resume. This would particularly hit younger unemployed people whose skills and lifetime earnings potential can atrophy over time and older unemployed people who are at a higher risk of transitioning into inactivity. Despite these trends, Slovenia remains one of the most equal societies in the EU, with a Gini coefficient below 0.24.



Source: Eurostat

([6]) A NEET is a young person who is "Not in Education, Employment or Training".

Table 2.1:

Key economic, financial and social indicators - Slovenia

							Forecast		
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (yoy)	7.0	3.4	-7.9	1.3	0.7	-2.5	-1.6	-0.1	1.3
Private consumption (yoy)	6.3	2.3	-0.1	1.5	0.8	-4.8	-3.5	-2.0	-0.1
Public consumption (yoy)	0.6	5.9	2.5	1.3	-1.6	-1.3	-2.7	-1.6	0.3
Gross fixed capital formation (yoy)	13.3	7.1	-23.8	-15.3	-5.5	-8.2	-3.9	-2.1	0.7
Exports of goods and services (yoy)	13.7	4.0	-16.1	10.2	7.0	0.6	2.9	3.8	4.5
Imports of goods and services (yoy)	16.7	3.7	-19.2	7.4	5.6	-4.7	0.2	1.7	3.3
Output gap	6.2	5.6	-4.1	-2.9	-1.7	-3.3	-3.8	-3.4	-2.3
Contribution to GDP growth:									
Domestic demand (yoy)	6.9	4.2	-6.4	-2.4	-0.9	-4.5	-3.2	-1.8	0.1
Inventories (yoy)	2.1	-1.0	-4.1	1.9	0.6	-1.8	-0.4	0.0	0.0
Net exports (yoy)	-2.0	0.1	2.6	1.8	1.0	3.8	2.0	1.7	1.2
Current account balance BoP (% of GDP)	-4.2	-5.4	-0.5	-0.1	0.4	3.3	.	.	.
Trade balance (% of GDP), BoP	-1.2	-1.9	2.0	1.3	1.4	4.8	.	.	.
Terms of trade of goods and services (yoy)	0.9	-1.5	3.7	-3.9	-1.4	-1.0	0.2	0.7	-0.1
Net international investment position (% of GDP)	-21.8	-35.9	-39.8	-43.2	-40.8	-44.9	.	.	.
Net external debt (% of GDP)	20.4	30.9	37.2	40.3	37.0	41.2	.	.	.
Gross external debt (% of GDP)	100.5	105.3	113.8	114.8	110.9	115.7	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	9.0	8.6	8.0	6.1	5.2	4.7	.	.	.
Private credit flow (consolidated, % of GDP)	21.8	15.9	2.9	2.0	0.5	-3.0	.	.	.
Private sector debt, consolidated (% of GDP)	97.9	107.7	115.9	118.0	115.7	114.1	.	.	.
Deflated house price index (yoy)	18.7	1.5	-10.0	-1.4	1.0	-8.4	.	.	.
Residential investment (% of GDP)	4.2	4.6	3.9	3.2	2.8	2.8	.	.	.
Total Financial Sector Liabilities, non-consolidated, (% of GDP)	28.5	6.6	7.4	-3.4	-1.3	-0.7	.	.	.
Tier 1 ratio (1)	6.7	8.7	8.9	8.3	8.8	9.1	.	.	.
Overall solvency ratio (2)	10.6	11.7	11.7	11.3	11.8	11.4	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	.	.	.	.	.	.	.	.
Employment, persons (yoy)	3.2	2.4	-1.4	-1.9	-1.4	-0.5	-2.6	-1.2	-0.3
Unemployment rate	4.9	4.4	5.9	7.3	8.2	8.9	10.2	10.8	10.7
Long-term unemployment rate (% of active population)	2.2	1.9	1.8	3.2	3.6	4.3	.	.	.
Youth unemployment rate (% of active population in the same age group)	10.1	10.4	13.6	14.7	15.7	20.6	22.7	.	.
Activity rate (15-64 years)	71.3	71.8	71.8	71.5	70.3	70.4	.	.	.
Young people not in employment, education or training (% of total population)	6.7	6.5	7.5	7.1	7.1	9.3	.	.	.
People at-risk poverty or social exclusion (% total population)	17.1	18.5	17.1	18.3	19.3	19.6	.	.	.
At-risk poverty rate (% of total population)	11.5	12.3	11.3	12.7	13.6	13.5	.	.	.
Severe material deprivation rate (% of total population)	5.1	6.7	6.1	5.9	6.1	6.6	.	.	.
Persons living in households with very low work intensity (% of total population)	7.3	6.7	5.6	7.0	7.6	7.5	.	.	.
GDP deflator (yoy)	4.2	4.1	3.3	-1.1	1.2	0.2	1.6	0.7	1.3
Harmonised index of consumer prices (yoy)	3.8	5.5	0.9	2.1	2.1	2.8	1.9	0.8	1.3
Compensation of employees/head (yoy)	6.2	7.2	1.8	3.9	1.6	-1.0	1.0	-0.3	0.9
Labour Productivity (real, person employed, yoy)	3.5	0.8	-6.2	3.5	2.4	-1.7	.	.	.
Unit labour costs (whole economy, yoy)	2.6	6.4	8.6	0.4	-0.7	0.8	0.7	-1.3	-0.7
Real unit labour costs (yoy)	-1.6	2.1	5.1	1.5	-1.9	0.5	-0.9	-1.9	-2.0
REER (ULC, yoy)	0.9	2.4	6.0	-0.9	-1.2	-2.3	0.5	-1.3	-2.0
REER (HICP, yoy)	1.2	1.6	2.3	-2.6	-0.8	-1.2	1.3	0.7	-0.7
General government balance (% of GDP)	0.0	-1.9	-6.3	-5.9	-6.3	-3.8	-14.9	-3.9	-3.3
Structural budget balance (% of GDP)	-2.9	-4.5	-4.4	-4.5	-4.6	-2.3	-1.9	-1.7	-2.2
General government gross debt (% of GDP)	23.1	22.0	35.2	38.7	47.1	54.4	71.9	75.4	78.0

Source: Eurostat, ECB, AMECO.

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

3. IMBALANCES AND RISKS

3.1. FINANCIAL SECTOR RENEWAL

Balance sheet contraction, raising NPLs and erosion of capital buffers have marked the last four years triggering decisive policy action. At the end of 2013 the total assets of the Slovenian banking sector, which comprised of 23 entities (17 banks, including seven subsidiary banks, three branches of foreign banks and three savings banks), stood at approximately EUR 41 billion (116% of GDP), down from EUR 52 billion (146% of GDP) at the end of 2009. As detailed in previous IDRs, the first phase of deleveraging was triggered by the international financial crisis, many Slovenia-specific elements, like the high level of state influence in banks and corporates, were revealed and reinforced by the crisis, in particular the spiking of non-performing loans (NPLs) in the corporate sector, concentrated in large and state owned companies. These credit quality trends, together with deteriorating collateral values, quickly eroded capital bases.

Policy action taken in 2013 addressed the immediate stability risks in the banking sector. Credit risk has been credibly quantified and provided for with substantial capital injections into state owned banks. The prompt restructuring of banks' balance sheets is being facilitated by the transfer of NPLs to the Bank Asset Management Company (BAMC). However, NPLs in the remaining domestic credit portfolios stands at approximately 12% ([7]) and remain elevated relative to pre-crisis levels.

The policy actions in relation to the financial sector announced by the Slovenian authorities on 12 December 2013 was assessed in the Commission's enhanced monitoring report ([8]) to the Economic Policy Committee of the Council (see Box 3.1). The asset quality review (AQR) highlighted several vulnerabilities of the banks practices and procedures and in light of this Bank of Slovenia (BoS) requested banks to prepare remedial actions plans to address the key issues identified.

The remainder of the section assesses the medium term trends in the financial sector.

Corporate deleveraging is only now starting in earnest and will be a key driver of bank deleveraging. The initial contraction in bank credit to companies in 2010-11 was partially compensated by other sources of credit, including from abroad (see Section 2). Forbearance by creditors has sheltered many large loss making corporates to date. Companies' debt-equity ratios remain elevated due also to lower equity values. The pace of deleveraging could pick up if wide scale financial restructuring now gets underway (see Section 4). The residual NPLs after transfers to the BAMC also represent a significant credit risk though it has been conservatively assessed (for the period to 2015 but not beyond) in the stress test and specifically provided for in the recapitalisations. This could generate further losses, thus limiting growth potential in an economy primarily composed of SMEs.

Deleveraging pressures will also continue on the liabilities side. Banks may anticipate the repayment of significant volumes of ECB funding (LTROs) and deposit volumes are expected to stagnate in line with economic activity ([9]). Given domestic banks have limited or no access to financial markets they are likely to adjust their loan books accordingly. Foreign banks which currently operate with elevated LTD ratios are likely to remain under pressure by their parent institutions or the supervisor to reduce their intra group financing which is likely to result in further deleveraging.

([7]) Applying the EBA harmonised definition for NPLs the level might even be higher.

([8]) Report available at: http://ec.europa.eu/economy_finance/economic_governance/documents/20140224_si_imbalances_epc_report_en.pdf

([9]) At end-2013, the deposit base was reduced by EUR 2.1 billion via the conversion of state deposits into equity of the three major domestic banks. A further less significant one-off reduction of state deposits can be expected in 2014 in the context of the still outstanding recapitalisation cases.

Box 3.1: Banking sector: assessment of the policy actions taken in 2013

In the second half of 2013, a comprehensive **Asset Quality Review** (AQR) and (bottom up and top down) **Stress Test** (ST) were completed by independent third parties, the results of which were published on 12 December 2013.

The **scope of the exercise** was substantial; it covered approximately 70% of the Slovenian banking system and granular data was provided by the participating institutions for 2 million loans and 14,000 collateral assets. The AQR incorporated the results of 4,235 individual loan file reviews and the assessment of 15,358 real estate valuations conducted by independent third parties. The constituent elements of the AQR provided a set of robust data inputs for the ST. It also identified several weaknesses of the banks' risk management systems which if left unaddressed could result in a repeated build-up of losses ([1]). The ST used macroeconomic scenario agreed by the Steering Committee supervising the exercise, including the European Commission, the EBA and the ECB.

The **capital shortfall** (**[2]**) identified for the eight participating institutions by the bottom-up stress testing exercise over a 3-year period (2013-2015) amounted to approximately EUR 4,046 million in the base case and EUR 4,778 million in the adverse case (in excess of 13% GDP). After full burden sharing by holders of shares and subordinated debt instruments and taking into account the transfer of non-performing claims to the **BAMC,** the remaining capital requirement of the three biggest banks to be provided by the State amounted to EUR 3,012 million ([3]).

The **recapitalisation measures** for the two largest state-owned banks (NLB, NKBM) were approved ([4]) by the European Commission on 18 December 2013. In parallel, the Commission temporarily approved rescue aid for Abanka ([5]) and also adopted a decision allowing for new aid in the form of a State recapitalisation of up to EUR 236 million for Probanka and of up to EUR 285 million for Factor Banka (of which EUR 176 million and EUR 269 million was provided) . Once the decisions were adopted, recapitalisation of the five institutions totalling EUR 3,214 million was completed by Slovenia by way of cash and marketable sovereign securities ([6]). In addition, EUR 200 million was provided to the BAMC by way of marketable sovereign securities to ensure its normal operations.

Transfers to the BAMC from the two largest state-owned banks (NLB and NKBM) amounted to a gross value of EUR 3,301 million. These were transferred for a total consideration ([7]) of EUR 1,012 million, representing an average discount of 69%. With regards to Abanka, the third largest bank, loans with a gross value of approximately EUR 1,150 million for an estimated consideration of EUR 543 million will be

([1]) The data integrity validation (DIV) exercise highlighted deficiencies in IT systems and paper records, with significant gaps in several loan files. Most of the banks did not assign rating classes to their obligors in line with the Regulations on credit risk losses issued by Bank of Slovenia (BoS) with instances of non-performing loans classified as performing in particular in the non-retail segments. There was widespread renewal of loans where impairments should have been recognised, particularly in the corporate sector. In many instances, the collateral valuations were out of date and hence did not reflect recent falls in property prices. The loan file reviews identified insufficient portfolio segmentation, unclear NPL definition / late NPL identification and unrealistic assumptions regarding probability of default (PD) and loss given default (LGD) estimates.
([2]) Assuming that no new deferred tax assets can be accrued over the period.
([3]) Probanka and Factor Banka were excluded from the ST as a result of the initiation of an orderly wind-down process in early September.
([4]) Further details available here: http://europa.eu/rapid/press-release_IP-13-1276_en.htm
([5]) The final state aid decision will be taken in the context of the assessment of Abanka's restructuring plan, which Slovenia submited in mid-February February 2014.
([6]) Discussions between the Slovenian authorities and the ECB on the use of sovereign bonds for the recapitalisations of banks is still ongoing.
([7]) The transfer prices were determined in accordance with European Commission state aid rules and reflect the long term real economic value of the loans.

(Continued on the next page)

Box (continued)

transferred once the European Commission approves the restructuring plan that was submitted by the authorities in February 2014. While there have been ceratin delays, BAMC and the banks concluded an operational service agreement, whereby the banks will continue to manage the day to day servicing of the loans until end April 2014 but all decision powers rest with the BAMC.

Two privately owned domestic banks (Banka Celje and Gorenjska banka) and three foreign-owned subsidiaries (UniCredit Banka Slovenija, Hypo Alpe-Adria-Bank and Raiffeisen banka), which are currently in compliance with Bank of Slovenia capital requirements but for which the stress test identified a potential capital shortfall have until June 2014 to increase their capital in line with the findings of the stress test. If this is unattainable, the government will provide the necessary capital backstops, in line with EU Competition rules.

In parallel, the government announced its intention to **fully privatise NKBM and Abanka** in 2014 and to reduce its participating interest in NLB to no more than 25% plus one share in the medium term. The NKBM privatisation process has been restarted and an engagement letter with a new financial advisor has been signed. The authorities expect it will be completed in August 2014. Both Factor Banka and Probanka are in wind down and will most likely exit the market in 2014.

Overall, this policy action and ongoing implementation pave the way for a smooth deleveraging of the non-financial corporate sector. Viable banks have been recapitalised, their balance sheets are being cleaned or substantial provisions have been built for the remaining NPLs. The new insolvency framework adopted in December 2013 is expected to facilitate the deleveraging process.

Table 1:

Overview of recapitalisations and transfers to BAMC

Institution	Total capital increase EUR million		Capital increase via cash	Capital increase via sovereign securities	Transfer value/gross value of assets transferred to BAMC EUR million	
	2013	2014	EUR million	EUR million	2013	2014
NLB	1551		1141	410	622/2278	
NKBM	870		620	250	390/1023	
Abanka	348	243	348	243		543/1150
Probanka	176		160	16		
Factor banka	269		160	109		
Total	3214	243	2429	785	1012/3301	543/1150

Source: Bank of Slovenia and BAMC

The banking sector is currently undergoing consolidation but further consoldation is likely in the coming years. Further merger activities, in particular between smaller domestic banks, could exploit cost synergies resulting in the creation of a fourth large domestic bank. A full privatisation of such a bank would have a beneficial impact on the quality of its governance and risk management. Box 3.2 presents a potential scenario for the evolution of the banking sector in 2014 -2015 and finds that despite the signficiant consolidation experienced in recent years, a further reduction in the size of banks' balance sheets is likely over the period.

Banking sector income and profitability are set to remain depressed over the medium term, limiting the scope for internal capital generation. The deleveraging trends on the asset and liability sides will reduce the basis for bank incomes ([10]) and curb margins. On the asset side, lending rates are already elevated, with firms paying a substantial premium over euro area competitors. As described in section 4, higher interest rates may not be affordable for firms. On the liability side, the scope for one-off profit taking has been exhausted. Furthermore, the repayment of the LTRO funding will have a negative impact on the banks' average funding costs ([11]). As a consequence capital for viable firms could become more costly.

Scope for a further increase of the profitability beyond 2015 seems to be limited to cost reductions. The weak real economy and already high effective interest level strictly limit interest income and interest expense will be affected by the potentially increasing average cost of funding. This leaves reduction of the underlying cost base as the key strategic imperative for banks in the short term if they are to improve profitability and their capacity to build a sustainable capital base through retained earnings. This highlights the importance of realising the full cost reduction potential of the on-going restructuring of the major domestic banks in the near term. Further consolidation in the sector would also help to eliminate inefficiencies and to raise synergies.

([10]) However, Net Interest Income (NII) will decrease less significantly than total assets due to the transfer of EUR 4.8 billion of NPLs to the BAMC.

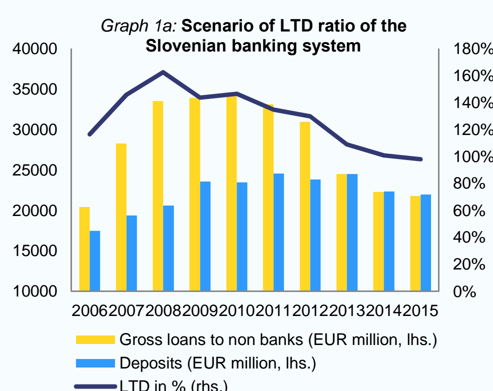
([11]) The NII margin (basis total assets) will at the same time be positively influenced in 2014 and 2015 by the transfer of NPLs to the BAMC.

Box 3.2: A scenario for banking sector trends to 2015.

This box presents a potential scenario (not a forecast) for the evolution of the banking sector balance sheet deleveraging process, profit and loss and efficiency indicators over the coming two years. This scenario arises from a staff exercise to quantify the impacts of the outlook described above, using as a basis the existing state aid commitments, banks' business plans, Bank of Slovenia assessments of the potential size of the sector and the Commission services macroeconomic forecast.

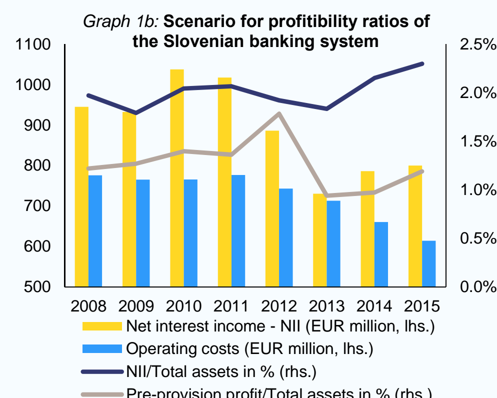
Under plausible assumptions, the total assets of the banking system could decrease by a further 14% by end-2015. This would result in total sector assets equating to approximately 97% of GDP ([1]). These trends would bring the loan-to-deposit ratio of the sector close to or slightly below 100% by 2015 (see graph 1a). Pre-provision profit would remain depressed, struggling to rise above 1.2% of total assets (see graph 1b). Table 1 presents the key features of this scenario.

Graph 1a: **Scenario of LTD ratio of the Slovenian banking system**



Source: Staff scenario based on BoS, business plans NLB, NKBM, Probanka, Factor Banka

Graph 1b: **Scenario for profitibility ratios of the Slovenian banking system**



Source: Staff scenario based on BoS, business plans NLB, NKBM, Probanka, Factor Banka

The following assumptions are made:

- The stock of outstanding credit to non-financial corporations contracts at least through 2015([2]);
- Banks adjust their volumes of liquid assets to liabilities according to the long run average proportion;
- No resumption of access to wholesale markets and no new placement of government deposits, which may prove to be conservative assumptions;
- Domestic banks reduce their loan portfolios to an extent that they can fully fund their activities via their own deposit base resulting in LTD ratios below or close to 100%;
- Foreign-owned banks retain some financing from parent institutions so their LTD ratios still remain above 100% despite declining more significantly than in domestic banks;
- The number of banks will decrease from currently 23 to around 16 to 19;
- The number of employees will decrease in proportion with assets
- Effective interest rates are assumed to remain unchanged at the average 2012 level;
- The effective Net Interest Income margin increases during the deleveraging process from 1.8% in 2013 to 2.3% in 2015 ([3]).

([1]) The sizable drop in the amount of outstanding bank credit to non-financial corporations in 2013 is partly due to the transfer of loans with a gross value EUR 3.3 billion to the BAMC.
([2]) This is in line with the historical experience of deleveraging processes following financial crises. IMF Country Report No. 13/231 - Euro area policy (http://www.imf.org/external/pubs/ft/scr/2013/cr13231.pdf)
([3]) This is partly a statistical artefact of the transfer of NPLs.

(Continued on the next page)

Box (continued)

Table 1:
A staff scenario for developments in the Slovenian banking sector for the period 2013 - 2015

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total assets, EUR million	34,080	42,598	47,948	52,009	50,760	49,243	46,125	40,979	36,800	35,400
Total asset growth, in %		25%	13%	8%	-2%	-3%	-6%	-11%	-10%	-4%
Total assets as % of GDP	110%	123%	129%	146%	143%	136%	130%	116%	103%	97%
Number of banking employees	11,832	11,996	12,232	12,188	11,943	11,813	11,498	10,800	9,400	8,850
Gross loans to non banks, EUR million	20,422	28,285	33,530	33,909	34,469	33,143	30,964	24,511	22,300	21,800

Source: Staff scenarion for based on bank of Slovenia data, state aid decisions, comprehensive banking sector assessment, Commission services forecasts and own calculations

3.2. COMING TO TERMS WITH HIGHER SOVEREIGN DEBT

The more than tripling of the government debt ratio in recent years creates new challenges and risks. Firstly, the higher and increasing debt level and shortened maturities increase (re)financing needs and hence the importance of prudent debt management. Secondly, the higher yields for recent stressed debt issuance and the overall debt increase results in overall higher interest costs. Finally, the general government is fully and explicitly exposed to the risks associated with the assets transfer from the banks to the BAMC. These are valued at around 4.4% of GDP but the proportion of this value that is eventually realised will depend largely on policy trade-offs and on the BAMC's work-out strategy, both of which are yet to be clearly defined. This section quantifies developments to-date and describes baseline and alternative scenarios for the debt-path over the time horizon 2015-30 (see Box 3.3).

The debt-to-GDP ratio rose rapidly in recent years, from just 22% in 2008 to 54% in 2012. Approximately half of this increase is due to the accumulation of primary deficits; one quarter derives from the impact of slow growth and high interest rates (the so-called snow-ball effect); and the remaining quarter is due to stock-flow-adjustments in the form of capital support operations.

In 2013 the debt is estimated to have risen by a further 18 pps to nearly 72% of GDP. The impact of the bank recapitalisations and the transfers to the BAMC decided in December 2013 (see Box 3.1) is of the order of almost 13pps of GDP. This was financed by the issuance of a new bond, tapping existing bonds and depleting the government cash buffer. This also entails a one-off increase in the headline deficit, of around 10 pps in 2013 and 0.7 pps in 2014, but without consequences on the structural adjustment path in both years. Although sizeable, this increase could be considered as the materialisation of contingent liabilities that were anticipated by the market, thus not significantly worsening the market perception of debt sustainability.

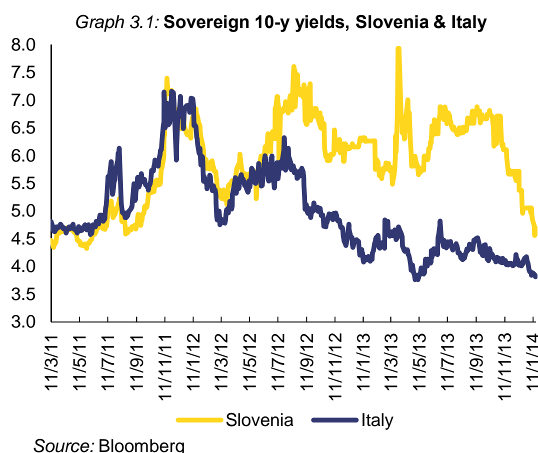
Higher debt and shortened maturities increase the importance of securing market confidence and debt management strategies. Slovenia's public debt rollover needs in 2009 were of the order of EUR 1.5 billion, resulting from an end-2008 debt of just over EUR 8 billion. This could quadruple to an average of around EUR 6 billion per year in 2014, on the basis of an estimated outstanding debt at end-2013 of EUR 25 billion and a reduction in average maturities by around three years ([12]). Total financing needs also comprise fiscal deficits of about EUR 2 billion. This underscores the need to access markets at more affordable rates and to issue longer dated maturities, alongside the achievement of primary surpluses.

Recent issuance of debt at elevated interest rates has a substantial impact on public expenditure. To illustrate, the impact on public expenditure of these issuances, we quantify the difference in the interest rate burden if Slovenian bond yields had followed those of Italy (see Graph 3.1) between mid-2012 and end-2013. The rationale for using Italy as a benchmark ([13]) is due to the high correlation of the two countries 10 year

([12]) The actual rollover need in 2014 is lower due to gaps in the maturity structure of the debt.
([13]) Italy itself was exposed to interest rate pressure.

sovereign bonds at the start of the period([14]). Additional interest costs of 0.2% of GDP could have been saved (EUR 30 million on T-bills and EUR 43 million on bonds). For 2014, the impact of past stressed issuance is around 0.4% of GDP (EUR 30 million on T-bills and EUR 104 million on bonds). This premium reflects market concerns regarding the underlying health of the financial sector and the cost of policy inaction from 2008 to 2013. This results in the transfer of consolidation pressure to other revenue and expenditure items. Even if rates on new issuances were to remain at current levels from now on, the impact of this period of elevated yields on interest expenditure would take until 2023 to fully fade out. If new stresses were to develop, the direct impact on public finances would be significant, given the now higher financing needs. The indirect impact on economy-wide borrowing costs would consume corporate cash flows, posing a risk to the balance sheet repair progress (see Section 4).

Graph 3.1: **Sovereign 10-y yields, Slovenia & Italy**



Source: Bloomberg

The debt is forecast to continue increasing over 2014-15 and may follow unsustainable trajectories under a number of plausible scenarios. The main driver of these trends is the steep increase in ageing-related spending implied by Slovenia's demographics combined with its current social welfare system. For instance, to keep the Pension Fund budget in balance, additional transfers from the central government budget to the Pension Fund increased from 1.8% of GDP in 2008 to around 3.4% of GDP in 2013. A comprehensive reform of long-term care remains at the planning stage. A further pension reform to preserve sustainability of the system beyond 2020 is currently being discussed by the government, with the help of academic experts. To assess the sustainability of public debt under a range of possible economic circumstances, some possible stochastic scenarios for debt developments are presented in the Box 3.3.

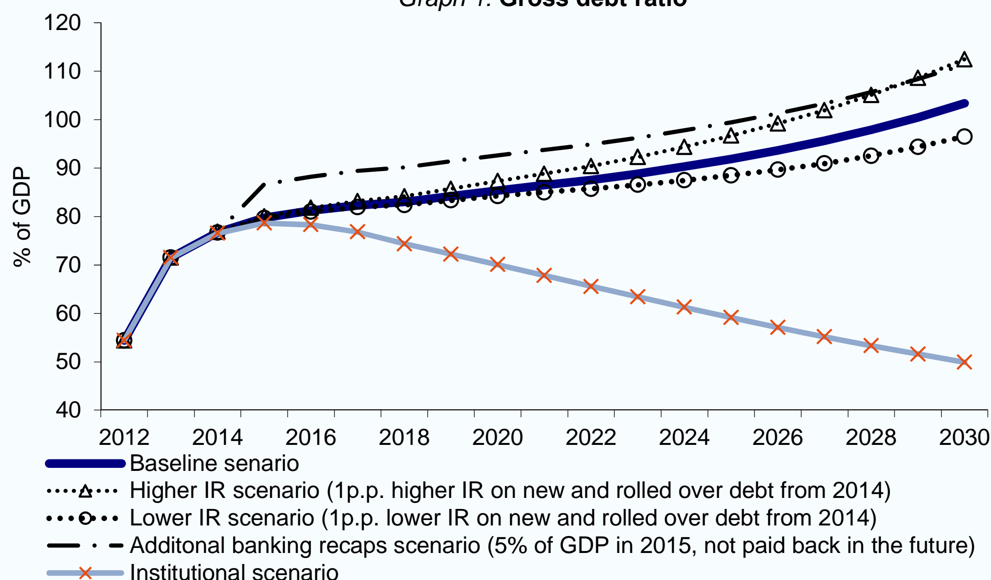
([14]) The correlation coefficient between the two countries' representative 10-year sovereign bonds declined from 0.9 to 0.5 in this period.

Box 3.3: Debt Sustainability Analysis: primary surpluses needed

Five scenarios for debt developments over 2015-30 are considered, built around a common basis represented by the Commission Winter forecast estimates for 2013. The baseline scenario follows the Winter forecast in 2014-15, then converges to the EPC's Ageing Working Group medium/long-term projections with a closure of the output gap over the 3 year period 2016-2018, a GDP deflator that linearly converges to 2% over the same period and interest rates kept constant.

Two scenarios simulate a symmetric permanent 1 pp. shock on the interest rate (entire yield curve). Finally, two very different fiscal patterns are considered, one compliant with the SGP requirements (stemming first from the excessive deficit procedure and then the convergence to and maintenance of the medium-term objective of a structurally balanced budget), a second scenario where new emerging recapitalisation needs of the order of 5% in 2015 impacts both the deficit (one-off) and the debt (permanent). The two latter scenarios entail feedback effects on growth, modelled as a 0.5% impact on real GDP growth for each 1% shock to the structural primary surplus (of opposite sign).

Graph 1: **Gross debt ratio**



Source: European Commission calculations

Given the increasing cost of ageing, the baseline scenario shows an increase in debt throughout the period resulting in an unsustainable debt trajectory. It is worth noting that this happens despite the underlying assumption that GDP grows by 1.4% per year on average and the GDP deflator reverts to 2% as from 2018. Sustainability will improve little with 1 pp. lower interest rates and further worsen in the opposite case. More interesting for our purposes is the scenario with a 5% of GDP fiscal cost due to additional bank recapitalisation needs, as the initial shock to the debt persists throughout the horizon. The impact would be even worse if the two adverse scenarios were combined resulting in a debt to GDP ratio in the region of 120% in 2030.

The only debt trajectory that declines as from 2016 and reverts to below 60% by 2025 underlies the positive scenario in which the government fulfils its commitment to the EDP targets and then abides by the SGP rules, converging to Slovenia's current medium-term objective of a balanced structural budgetary position by 2018 and maintaining it thereafter. This analysis underscores that maintaining fiscal discipline is a prerequisite to debt sustainability.

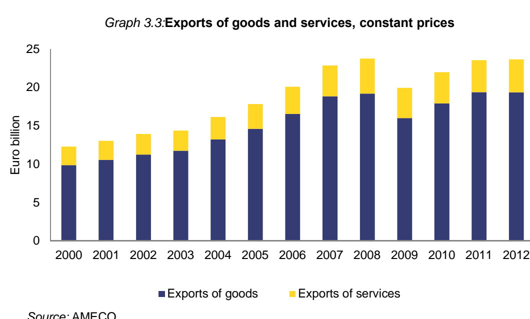
3.3. LOSS OF EXTERNAL COMPETITIVENESS AND EXPORT PERFORMANCE

A substantial loss of export market shares over the past five years indicates Slovenia is not competing effectively in world markets. Although export volumes are returning to the peak levels reached in 2008 ([15]) (see Graph 3.3), they are not growing in line with the expansion in global trade (see Graph 3.2). Other advanced economies are also losing market shares, but the higher level of losses by Slovenia, for both goods and services, is a symptom of underlying problems connected with the loss of competitiveness.

Graph 3.2: **World export market shares, yoy growth rate**

Source: Eurostat

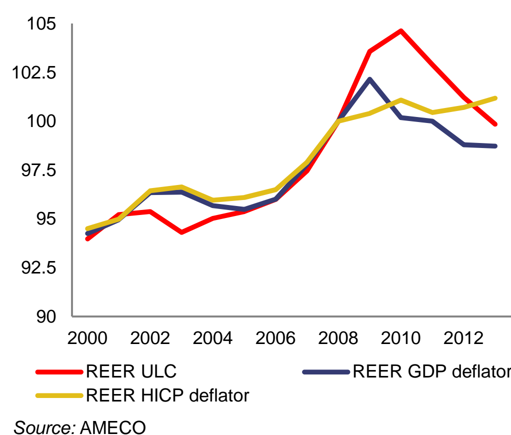
Graph 3.3: **Exports of goods and services, constant prices**



Source: AMECO

Slovenia lost cost-competitiveness, in particular when compared to relevant country groupings. As shown in Graph 3.4, the main real effective exchange rate (REER) indicators against the euro area (EA-17) have appreciated substantially at the wake of the crisis and until 2010. The REER calculated using unit labour costs appreciated the most, as the measures taken at the time to stem the impact of the collapse in economic activity on the labour market, in the form of subsidy schemes for reduced working hours and for workers on forced leave, resulted in labour hoarding and wage inertia. Recent developments vs EA-17 are less clear cut, depending on which REER measure is assessed; the unit labour costs (ULC)-based REER has depreciated the most.

Graph 3.4: **Real effective exchange rates vs EA-17, 2008=100**

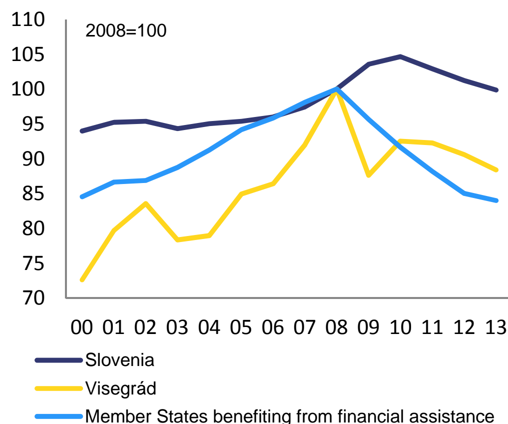


Source: AMECO

As a competing production and FDI location, Slovenia's performance can be usefully compared to that in the Visegrád countries (Hungary, Czech Republic, Poland and Slovakia). In terms of adjustment to macroeconomic imbalances, it can also be compared to rapidly adjusting member states benefiting from financial assistance (Cyprus, Greece, Ireland, Portugal). Graph 3.5 shows that the REER depreciated sharply at the beginning of the crisis in the two comparisons groups, while it was still appreciating in Slovenia.

([15]) According to the latest export data, the exports surpassed the 2008 level in Q3 2013.

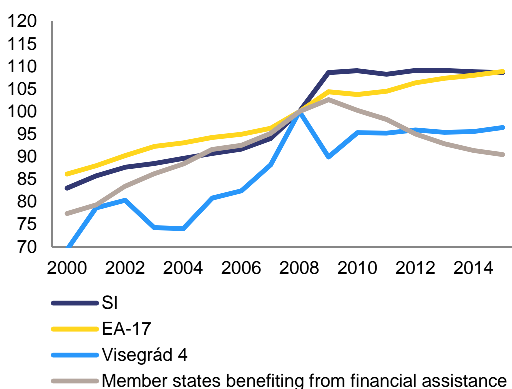
Graph 3.5: **Yearly real effective exchange rates ULC vs EA-17**



Source: AMECO

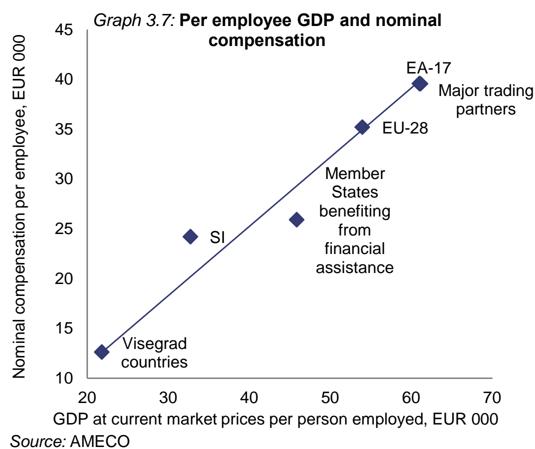
Unit labour costs in Slovenia have increased more than in other benchmark countries. Graph 3.6 shows the hike in nominal unit labour costs (NULC) that Slovenia recorded in the first two years of the crisis. ULC have broadly stabilised since 2010, in spite of some relaxation in employment protection legislation and in the indexation of the minimum wage to inflation (see Box 2.1 in the IDR 2013). Member States benefiting from financial assistance and the Visegrád countries have instead recorded a gradual decline or even a sharp correction of their ULC.

Graph 3.6: **Nominal Unit Labour Costs, 2008=100**



Source: AMECO

Labour costs in Slovenia are somewhat out of line with productivity. The relative importance of the productivity and labour cost trends underlying NULC developments can be assessed by comparing Slovenia with the benchmark groups. Graph 3.10a shows that in Slovenia the sharp increase in nominal compensation per employee between 2008 and 2010 was accompanied by a decline in productivity, as output dropped. The sustained dynamics of nominal compensation in the Visegrád countries was compensated for by a continued productivity increase during and after the crisis (see Graph 3.10b). The reduction of ULC in Member States benefiting from financial assistance has been driven by a decrease in nominal compensation and productivity gains, which occurred at the expense of rising unemployment (see Graph 3.10c). In absolute levels, Slovenian labour costs and productivity are between those of the Visegrád countries and those of the other benchmark groups. Proportionally, Slovenia has made more progress towards European average wage levels than it has made towards average European productivity levels, as can be seen from its position above the line in graph 3.7.



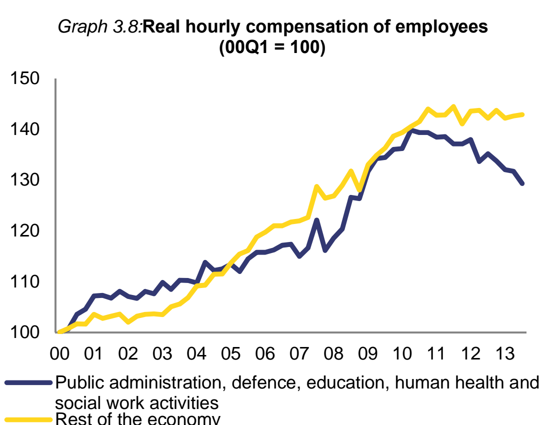
Graph 3.7: **Per employee GDP and nominal compensation**

Source: AMECO

In real terms, wages in public sector have been declining since 2010. Growth in real hourly wages in both the private and public sectors was quite dynamic before the crisis, but slightly more so in the private sector (see Graph 3.8). Wages in the public sector decoupled from those in the private sector in 2010, when they started to decline under the constraint of fiscal consolidation. As policy currently stands, there are in-built dynamics in wages that could reignite adverse trends in the coming years. The minimum wage, which was discretionary increased by 22.9% in March 2010 and adjusted by the inflation rate at the beginning

of 2011, 2012 and 2013 is among the highest in the EU as a percentage of average wages. ([16]) The high level of the minimum wage relative to the average wage in Slovenia could have a significant negative impact on employment, deter FDI, prevent creation of lower productivity jobs and as a consequence delay the employment recovery. Renewed economic growth would also put pressure on wages just above the level of the new minimum wage as employees seek to re-establish differentials that were compressed in 2010.

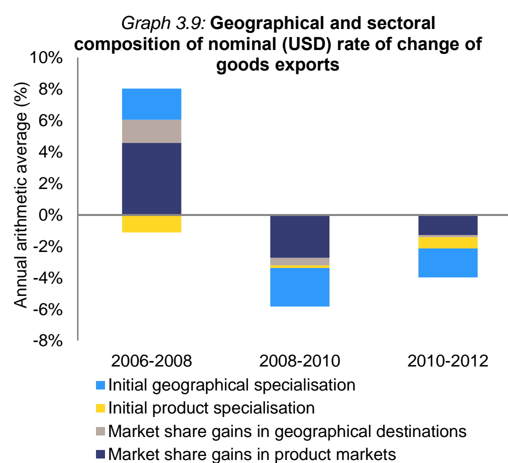
Graph 3.8: **Real hourly compensation of employees (00Q1 = 100)**



Source: Commission services

Slovenia's export performance also suffers from an unfavourable product specialisation and geographical orientation. Graph 3.9 decomposes the growth in nominal goods' export before and during the crisis into two indicators showing the extent to which exports have been geared towards dynamic geographic and product markets, and two performance indicators capturing Slovenia's success in achieving above-market export growth in intial geographic and product markets. The Graph 3.9 shows that before the crisis Slovenia's exports were oriented towards still dynamic destination countries – mainly Italy and the former Yugoslav republics, while it managed to gain considerable market shares in new product markets. However, as the crisis hit Slovenia's key trading partners, the geographical specialisation of Slovenia's exports turned into a disadvantage, and the economy lacked sufficient dynamism and/or competitive advantage to enter new markets. This accounts for approximately half of the decline in goods exports since the crisis. The other half of the decline has occurred through losses of market shares within specific product markets, where Slovenia had an established foothold. Product specialisation remains a drag on export performance, indicating slow adjustment of industrial base.

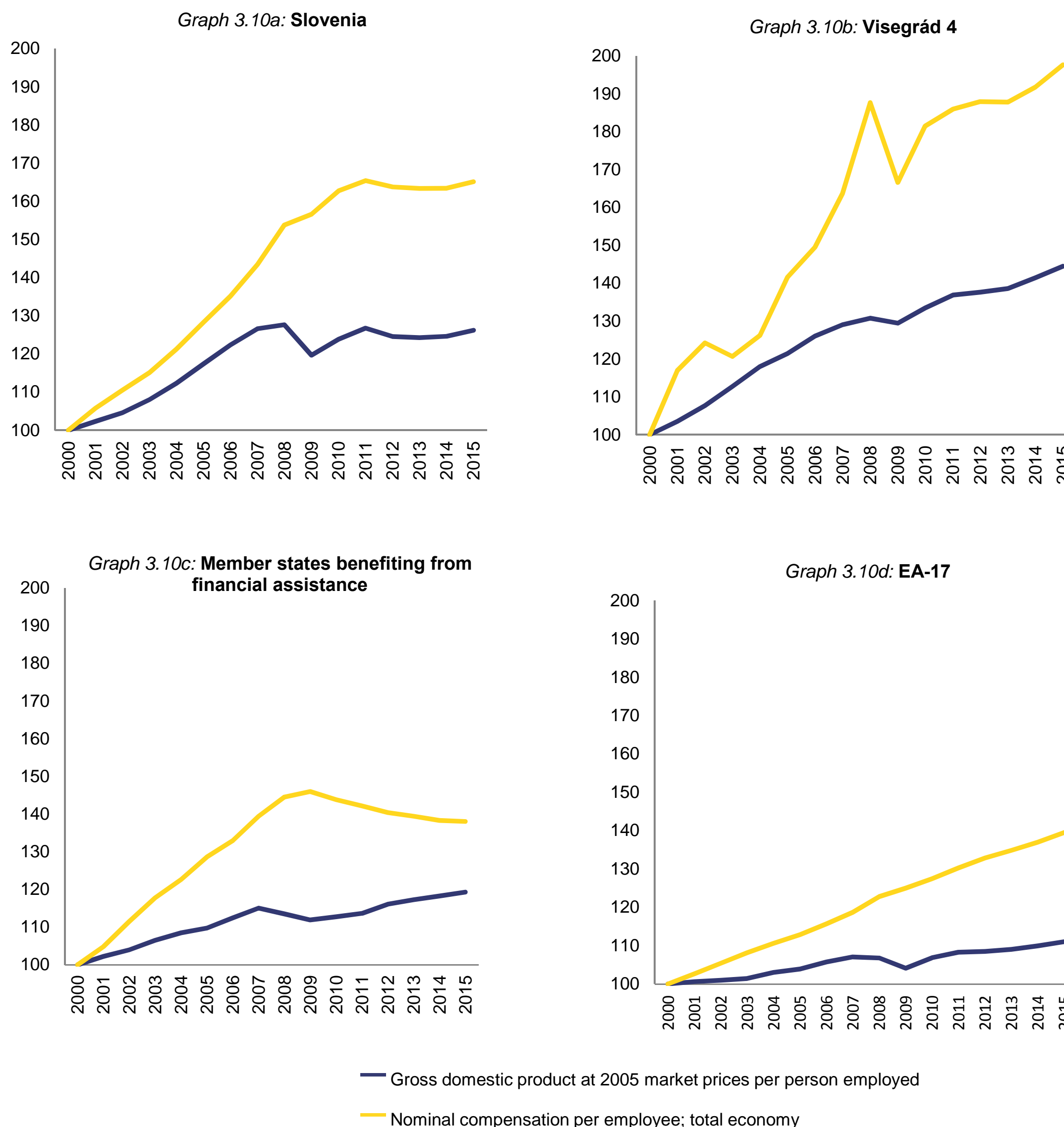
Graph 3.9: **Geographical and sectoral composition of nominal (USD) rate of change of goods exports**



Source: Comtrade data and Commision services caculations.

([16]) See ECFIN Country Focus on minimum wages in Slovenia, June 2013: http://ec.europa.eu/economy_finance/publications/country_focus/2013/pdf/cf_vol10_issue4_en.pdf

Graph 3.10: **Productivity and labour cost (2000=100)**



Source: AMECO

4. SPECIFIC TOPIC - CORPORATE PERFORMANCE AND RESTRUCTURING

4.1. FINANCIAL PERFORMANCE AND DISTRESS IN THE CORPORATE SECTOR(17)

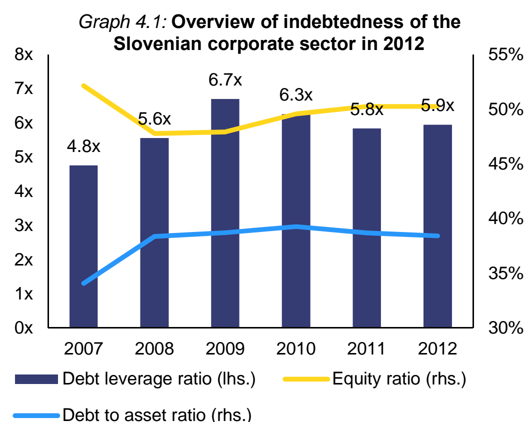
Slovenia's corporate sector has been significantly impacted by the economic downturn. The level of non-performing loans (NPLs) in the Slovenian corporate sector substantially increased during 2013 (from 16% at end December 2012 to 28% at end November 2013). In parallel, profit margins remain squeezed, burdened by high interest costs. The fall in operational profitability of the companies indicates a decrease in efficiency and a loss of competitiveness. This has wider implications for the economy as the corporate sector's contribution in terms of net added value to GDP has deteriorated from pre-crisis levels. Furthermore, the high level of indebtedness has limited the corporate sector capacity to invest and has notably contributed to the 50% decline in investment experienced in Slovenia.

The assessment ([18]) in this Section is based on data from the database of the Bank of Slovenia, which comprises micro data of 2000 - 2012 annual reports for more than 55,000 Slovenian companies. The data is analysed from a bottom-up (company-by-company) and a top-down perspective (consolidated for the entire corporate sector, by industry or by company size). The primary data source is the Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES) ([19]). In addition, a different set of publicly available data from Bureau Van Dijk (Orbis database ([20])) was used in order to allow sectorial and cross-country comparison (see Box 4.1). The data excludes companies in insolvency proceedings and those with negative equity value, thereby improving the quality of the sample base and somewhat overstating the real situation.

4.1.1. Main features of corporate over indebtedness

High debt leverage accumulated in the years preceding the crisis has only been partly corrected. The debt level compared to total assets and to operating profit increased significantly in the period 2007 to 2009 (see Graph 4.1). While deleveraging commenced in 2010, progress to date has been limited and companies' debt leverage ([21]) and debt to assets ([22]) ratios remain elevated.

Graph 4.1: **Overview of indebtedness of the Slovenian corporate sector in 2012**



Source: AJPES, consolidated corporate sector accounts, ECFIN analysis

The accumulation of debt in the past has distorted liability structures. Continued postponement of financial restructuring has considerably weakened companies' balance sheets and reduced their loss absorbing buffers. In 2012,

(17) While the 2013 IDR and 2013 Country focus assessed the performance and economic implications of state-owned and state controlled companies, this section looks at the performance of the non-financial corporate sector in Slovenia more broadly.

(18) Commission services staff assessment

(19) Bank of Slovenia database based on AJPES data: https://www.ajpes.si/?language=english. The companies included in the dataset are limited and unlimited liability companies (including listed companies), economic interest groupings and main offices of foreign business entities. Excluded are companies in insolvency proceedings, banks, insurance companies, stock exchange, investment funds and certain other financial and investment companies which are not using corporate accounting standards. The scope of companies reporting to AJPES is changing every year, which may have an impact on time series analysis and conclusions on long-term trends.

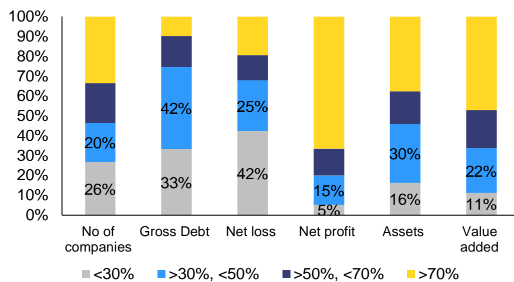
(20) Orbis is a publicly available database https://orbis.bvdinfo.com. It contains information for both listed and non-listed companies.

(21) Debt leverage ratio is defined as total gross debt (long-term and short-term financial liabilities) divided by earnings before interest, tax, depreciation and amortization (EBITDA).

(22) Debt to assets ratio is defined as total gross debt (long-term and short-term financial liabilities) divided by total assets.

the equity ratio ([23]) of 46% of the Slovenian companies was below 50% (see Graph 4.2). While the number of companies in this category has remained relatively stable since 2004 ([24]), their proportion of the cumulated net corporate loss has increased significantly from 30% to 67% in 2012. Similarly, these firms display particularly low profitability and hold 75% of gross debt. Without restructuring the ability of some of these companies to continue to operate is questionable. The reform of the insolvency legislation with the objective to enable financial restructuring at an early stage and rapid resolution is key to facilitating the reallocation of economic resources and recovering value for creditors (see Section 4.2 and Box 4.4). In addition, fresh equity investment, including FDI, will be an important facilitator to reforming capital structures and restoring operational efficiency in the corporate sector.

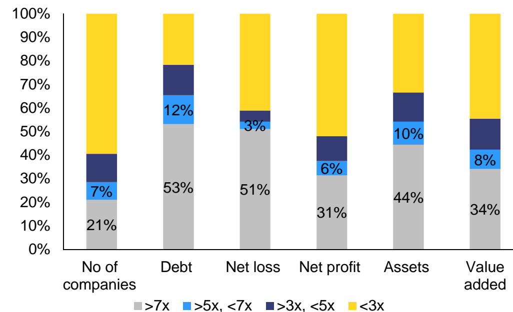
Graph 4.2: **Corporate health indicators for companies classified by share of equity in total liability (2012)**



Source: Data input from Bank of Slovenia, based on raw micro level data (firm-by-firm) from AJPES
Note: Equity ratio is defined as the equity (book value of equity) divided by the total capital (long term and short-term financial liabilities and book value of equity)

The debt overhang ([25]) is concentrated in a small number of vulnerable large and medium sized companies. Highly indebted companies ([26]) account for 65% of the total debt and more than half of the corporate assets in Slovenia (see Graph 4.3), although they represent only 28% of the number of companies (up from 15% in 2000). They contribute to more than half of the total net loss of the corporate sector in 2012.

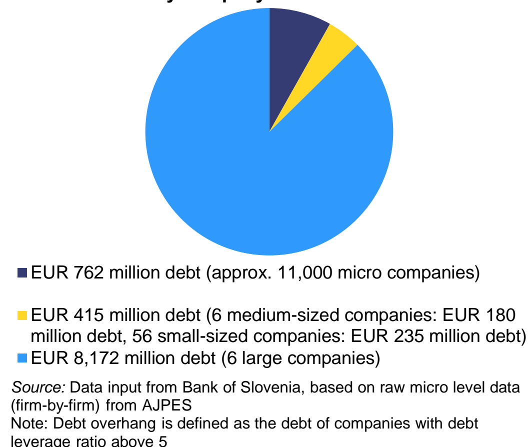
Graph 4.3: **Corporate health indicators for companies classified by debt leverage ratio (2012)**



Source: Data input from Bank of Slovenia, based on raw micro level data (firm-by-firm) from AJPES
Note: Debt leverage ratio is defined as gross debt over earnings before interest, tax, depreciation and amortization (EBITDA)

Only a dozen highly indebted companies ([27]) are liable for 90% of the debt overhang (see Graph 4.4). The remaining 10% is dispersed among a limited number of small companies (2.4% of small companies) and a much wider group of micro companies (18.4% of micro companies). Corporate governance and misallocation of capital may be the underlying reasons for this uneven debt concentration. Consequently, from the economic efficiency perspective, the focus of the financial and operational restructuring should be on the large companies.

Graph 4.4: **Distribution of the debt overhang by company size in 2012**



Source: Data input from Bank of Slovenia, based on raw micro level data (firm-by-firm) from AJPES
Note: Debt overhang is defined as the debt of companies with debt leverage ratio above 5

Corporate debt imbalances affect several sector of the Slovene economy. Unlike in other vulnerable countries, where the economic distress was concentrated in the real estate and

([23]) Equity ratio is defined as the equity (book value of equity) divided by the total liability (long term and short-term financial liabilities and book value of equity).
([24]) Varying between 42% and 48% of companies each year.
([25]) The debt overhang is defined as debt of companies which have high credit risk characteristics with debt leverage ratio above five.
([26]) Companies are considered to be highly indebted if they have a debt leverage ratio above five.
([27]) Majority of them are reporting very high levels of indebtedness with debt leverage ratio above seven.

Table 4.1:

Overview of key ratios and financial indicators by sector (2012)

SECTORS	No OF COMPANIES (AS % OF TOTAL)	NET VALUE ADDED/ EMPLOYEE	DEBT (AS % OF TOTAL)	CONTRIBUTION TO TOTAL NET LOSS (AS % OF THE TOTAL)	EBITDA MARGIN	NET PROFIT MARGIN	DEBT LEVERAGE RATIO (2012)	DEBT LEVERAGE RATIO (2004-2012 median)	SHARE OF EQUITY IN CAP STRUCTURE
Manufacturing	12%	36.4	20%	18.7%	8.6%	1.8%	3.2x	3.2x	61.2%
Electricity, gas, steam and air conditioning supply	1%	103.6	5%	0.6%	7.1%	2.5%	3.5x	1.7x	75.3%
Construction	12%	25.9	5%	8.2%	4.0%	-2.1%	10.4x	5.0x	48.0%
Wholesale and retail trade, repair of motor vehicles and motor	24%	35.8	14%	17.2%	3.5%	0.4%	5.0x	4.1x	57.5%
Transportation and storage	5%	44.8	13%	2.5%	16.0%	3.4%	6.7x	9.2x	50.6%
Accommodation and food service activities	5%	25.4	2%	5.2%	7.6%	-8.7%	10.0x	7.7x	52.5%
Information and communication	6%	63.4	3%	1.9%	16.6%	4.8%	2.3x	2.2x	61.6%
Financial services	2%	69.1	20%	25.4%	9.5%	-41.7%	60.7x	78.1x	36.2%
Real estate activities	3%	86.3	5%	7.9%	15.9%	-16.3%	15.3x	10.7x	40.1%
Professional, scientific and technical activities	21%	40.8	8%	6.3%	8.7%	3.6%	7.5x	7.0x	55.6%
Arts, entertainment and recreation	1%	47.3	1%	2.3%	10.1%	-6.3%	4.4x	4.3x	51.6%
State-owned & state-controlled enterprises (SOEs & SCEs, excluding insurance and energy sectors)	-	-	*27%*	*24%*	*10.0%*	-	*5.0x*	-	*46.9%*
TOTAL (ALL SECTORS)	**100%**	**38.0**	**100%**	**100%**	**7.2%**	**0.4%**	**5.9x**	**5.9x**	**50.3%**

Source: AJPES, consolidated sectoral accounts, ECFIN analysis

Notes: (1) EBITDA MARGIN = (Gross operating retunrs - Operating Expenses + Depreciation)/ Revenue
(2) The SOE assesment is based on micro data of a sample of 31 companies with over 25% state involvement, data is sourced from annual reports. EBITDA margin and debt leverage ratio represent the median of these companies in 2012.
(3) The total for all sectors is calculated based on consolidated data for the entire corporate sector.

construction sectors, in Slovenia the pattern is rather cross-sectorial and likely linked to capital misallocation and inefficient corporate governance. The transport and storage, services and leisure ([28]), as well as wholesale and retail trade sectors are also highly indebted (see Table 4.1) ([29]). These sectors have in recent years generated losses or low profits and their average leverage ratios (2007-2012) are above five. Box 4.1 further examines the level of indebtedness of Slovenian corporates on a sectorial and company-size basis at the end of 2012, using different company-level data ([30]) to allow a comparison to regional peers (Czech Republic and Slovakia).

Financial holdings ([31]) represent a key vulnerability for both the corporate and the banking sector, given the high levels of debt and financial distress concentrated in these entities. Financial holdings participated in a number of debt-driven management buy-out transactions (MBOs) during the period 2005-2007. Many of those transactions were part of the second wave of privatisations in Slovenia, when powerful internal stakeholders consolidated ownership in key industries supported by state-owned banks and funds (see European Commission 2013 IDR and Country Focus). Some of the largest financial holdings (i.e. Zvon) are insolvent while others are currently going through debt restructuring processes (i.e. ACH).

([28]) Including the financial services sector. The financial services sector excludes banks and insurance companies. It is assumed that financial holdings are classified within the financial services sector predominantly as micro or SMEs companies.

([29]) This analysis is based on consolidated data on sector level (and not micro company-by-company data). The retail and the services sectors together comprise more than half of the Slovenian companies in terms of numbers, but only about a quarter of the total debt and approximately 30% of employment. Therefore, it could be concluded that these are primarily small companies (micro or SMEs) such as retail stores and other high street businesses. Given the uneven distribution of indebtedness among large and small companies, it is possible that there are few outliers distorting the analysis.

([30]) The analysis is based on 2012 financial data for 3,070 Slovenian companies obtained from the Bureau Van Dijk Orbis database, in order to allow cross-country comparison. Companies that are known to be majority-controlled subsidiaries are excluded from the analysis to avoid double-counting of their financial data, which are consolidated with the parent companies. For benchmarking purposes a similar regional peer dataset is constructed covering 5,607 Czech and Slovak companies. These two Visegrad countries were chosen because of good data availability and the fact that their NFC debt remained moderate over the 2000s.

([31]) According to data classification by AJPES, financial holdings are classified within the financial services sector (which does not include banks and insurance companies), predominantly as micro or small companies. Financial holdings are therefore analysed based on consolidated data for the financial services sector. They are not included in the micro data analysis on the concentration of debt presented above (Graphs 4.2-4.4), as they are extreme outliers in terms of debt leverage ratios and magnitude of the loss they generate.

Box 4.1: The distribution of corporate debt in Slovenia – a sectoral analysis and cross-country comparison

An analysis of firm-level data from the Bureau Van Dijk Orbis database confirms the conclusions reached regarding the sectorial distribution of indebtedness based on aggregate data (see Section 4.1.1). It compares the level of indebtedness of Slovenian corporates with two Visegrad-4 countries (the Czech Republic and Slovakia).

Indebtedness of Slovenian corporates is heterogeneous across industries. In particular, the construction and real estate sector, but also trade and transport and other services, appear to be highly indebted. In all three cited sectors, the extremely indebted firms (debt/EBITDA ratio above nine) account for a large majority of the total sector debt. In these sectors, at least 80% of the total sector debt is held by firms with a debt/EBITDA ratio above five (Graph 1a). In the trade and transport sector, this pattern is driven by a small number of large firms, while in the construction and real estate, and the other services sectors, SMEs are also highly indebted. As regards the manufacturing sector, over 60% of debt is held by companies with debt/EBITDA above five, but the share of extremely indebted firms (debt/EBITDA ratio above nine) is significantly lower than in other sectors. Furthermore, the construction and real estate and the other services sector have the highest share of their debt (each about 12%) held by companies at risk of insolvency, with negative operating cash flows (proxied by negative EBITDA).

Slovenian firms are highly indebted compared to regional peers, particularly in the construction and real estate, manufacturing and other services sectors. The industry heterogeneity in the typical financing structures and the stronger shock on earnings in Slovenia are controlled for by using the ratio of debt to total capital (i.e. debt plus equity) as a second measure of indebtedness[1] and by comparing this ratio to a regional benchmark[2]. Graph 1b indicates that, in all sectors, a large majority of debt in Slovenia is held by firms which are more indebted than the median firm in the same sector in the benchmark countries. This observation is consistent with the fact that, at the aggregate level, NFC debt in Slovenia is much higher than in the two reference countries. The construction and real estate sector stands out as having a particularly high share of debt held by firms with extremely high indebtedness compared to peers (i.e. exceeding the 90th benchmark percentile). To a certain extent, the same applies to manufacturing, other services sectors, which have notably high shares of debt in the 75th-90th percentile category, and to the information & communication sector, where debt is concentrated in the 50th-75th benchmark.

High indebtedness is not limited to large companies, in particular in construction and real estate. The construction and real estate sector appears to have a higher average indebtedness among small and medium companies, and the distribution shows a high skewness towards high indebtedness (the weighted average is notably above the median). In contrast, the transport and trade sector shows an average indebtedness increasing with size. In the other services and the manufacturing sectors, average and median indebtedness do not seem to vary significantly across size categories.

([1]) Two complementary measures of firm indebtedness are used in this analysis. The debt/EBITDA ratio is used as a measure reflecting solvency. Given the sensitivity of EBITDA to macroeconomic conditions, a second measure of indebtedness is used for the country comparison, namely the share of debt in total capital employed (debt plus equity), reflecting a firm's financial leverage which allows us to distinguish the relative contribution to firm indebtedness between the numerator (i.e. firms which took on excessive amount of debt in the pre-crisis period), and the denominator (i.e. firms' which suffered a stronger than expected adverse shock on earnings during the crisis).

([2]) Slovenian firms are divided into categories by comparing their debt/capital ratio to percentiles of this ratio among Czech and Slovak firms operating in the same sector (using as thresholds the median, the 75th and 90th percentile).

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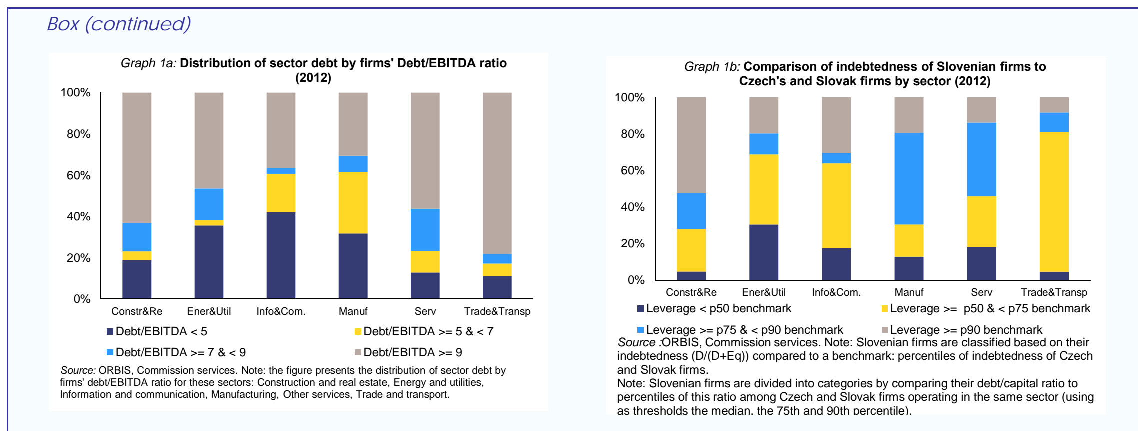
Box (continued)



In 2012, the financial holdings were liable for as much as EUR 6.7 billion or 20% of the total corporate debt, despite the fact that there are relatively few of them and they are insignificant in terms of employment (below 1%). On average financial holdings reported significantly higher losses (-42% net profit margin) and debt levels (leverage of 61x in 2012 and median for 2004-2012 of 78x) than the overall average (see Table 4.1). The specific role of the financial holdings in Slovenia as well as their ownership structure needs to be assessed in view of their very limited contribution to the economy by way of employment and their low profit generation capacity. Their viability is questionable, given the unsustainable levels of debt they hold.

4.1.2. Confirmed weaknesses in SOEs and SCEs

State-Owned and State-Controlled Enterprises (SOEs/ SCEs) in Slovenia continue to generate losses and pose significant risks to the public finances. The 2013 IDR and 2013 Country focus presented key evidence on the nature and extent of state involvement in the economy, focusing on ownership links, the fiscal effects of capital injections and the impact on overall efficiency of the economy through misallocation of resources. Most of the SOEs/ SCEs ([32]) included in last year's review continue to be highly indebted, and as a result their performance has deteriorated further in 2012, with the exception of the insurance sector, which is in good financial health (see Box 4.2 for more detailed assessment of the insurance sector). The number of companies assessed as highly vulnerable has increased from 13 in 2011 to 17 in 2012([33]). Moreover, when compared to other ownership structures, SOEs/ SCEs appear to hold the largest proportion of the corporate capital in Slovenia (27% of total debt and 29% of total assets). SOEs/ SCEs are also responsible for a large share of losses in the corporate sector, contributing almost a quarter of the total net loss in 2012 (see Table 4.1). As discussed in a recent note by the Slovenian Institute of Macroeconomic Analysis and Development (IMAD) ([34]), SOEs are significantly larger than average enterprises and in some cases more capital intensive. Their profitability and productivity in 2012 was lower than the privately and foreign-owned companies in Slovenia, particularly in the agriculture and mining, construction, manufacturing, and in the services sectors (accommodation and food services; professional, scientific and technical activities). Although SOEs appear to be present in most of the sectors of the economy, they are more concentrated in the energy, transport and storage,

([32]) State-owned and state-controlled enterprises (SOEs/ SCEs) are defined in the European Commission's 2013 in-depth review and 2013 Country Focus as companies, where the Republic of Slovenia owns directly or indirectly at least 25% plus one vote of the total capital, thus having an effective blocking minority over most strategic corporate transactions.

([33]) According to the assessment in the 2013 IDR and Country focus, highly vulnerable companies are those which not only have high leverage ratio of over 4 and report negative net profits, and in some cases even negative operating profits (EBITDA).

([34]) The note is based on various data sources to describe trends in the Slovenian corporate sector depending on the ownership structure and it reveals considerable differences among the three ownership categories examined (state-owned, majority foreign-owned and majority domestic-privately-owned), with SOEs/ SCEs being the worst performers based on a number of operating and performance indicators.

Box 4.2: Overview of Insurance Sector

The Slovenian insurance sector comprises 15 insurance companies, 2 reinsurance companies and 3 pension companies, most of which are active in both life and non-life insurance. Total gross insurance premiums written (in 2011) amounted to 5.9% of GDP as compared to 8.7% of GDP for EU 27. Triglav Insurance (66.7% state-owned) is the market leader with respectively 37.5% and 46.7% of the life and non-life gross premiums written in 2012.

The sector is healthy. There is only one (small) non-profitable company. Sector-wide ROE exceeded 10% in 2011 and 2012 respectively. All companies are solvent, both under Solvency I and (the more stringent and risk-sensitive) Solvency II. Under Solvency I, the ratio of available capital to minimum requirement has been steadily increasing to reach 246% in 2012, amounting to a surplus of EUR 500m. Increased competition, lower demand (due to the crisis), low interest rates and transition to Solvency II may put pressure on profitability in the coming years, but there is no immediate risk. The low interest rate environment is a strain particularly for the life insurance segment, in view of its typical asset-liability mismatch.

Neither Triglav nor the sector as a whole, which held a total of EUR 6.1bn in assets at end-2012, is of a size that could be considered material to financial stability. Slovenian insurers held EUR 1.7bn of government bonds in September 2013, most of it domestic. Aside from accentuating the sovereign-financial sector feedback loop, holdings of government bonds could generate more volatility in the solvency position and substantial spread risk with the transition to Solvency II standard. This risk still appears manageable. Slovenian insurers also held EUR 432m of domestic corporate senior debt (24% of its corporate debt exposure). While this debt is of poor quality (rated below BBB or unrated), any losses would be easily absorbed by the sector's capital surplus. Finally, the holders of unit-linked products bear most of the risk of the sector's equity holdings.

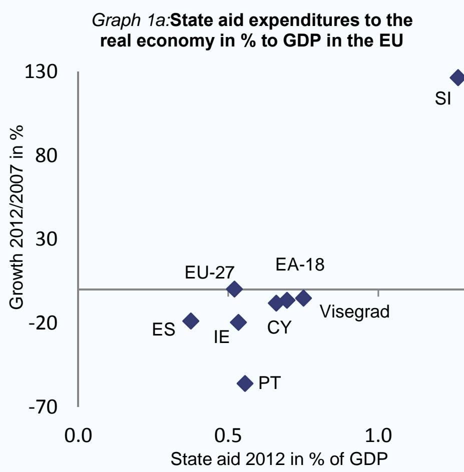
financial services (i.e. financial holdings), and professionals services, which are also amongst the most highly indebted sectors in Slovenia (see Table 4.1).

The high level of state involvement in the economy is one of the factors limiting equity investment and FDI which would support the reform of capital structures. A business environment open to private competition is one of the main prerequisites for FDI. However, the most recent findings by the Slovenian anti-corruption agency (KPK) point at systemic corruption risks, distortion of the allocative function of the banking system, lack of robust risk management and supervision practices. The study, which is based on case-by-case investigations, draws attention to the privileged role of SOEs and SCEs in the Slovenian economy, particularly when it comes to access to finance and investment opportunities. Box 4.3 broadens the scope beyond ownership links to show the extent of subsidies and state aid to companies, irrespective of ownership, which further worsens the investment climate in Slovenia. Distortion of market principles and rent-seeking practices in Slovenia threaten to block the privatisation process which would help to boost productivity, deepen the role of capital markets ([35]) and enhance the potential for technological spill-overs from FDI. Indeed, at only 34% of GDP in 2012, the level of inward FDI stock in Slovenia has remained the lowest among new EU Member States since 2000, with the exception of Romania in 2002-2003 and Lithuania in 2008 when their inward FDI stock relative to GDP edged just below the one of Slovenia.

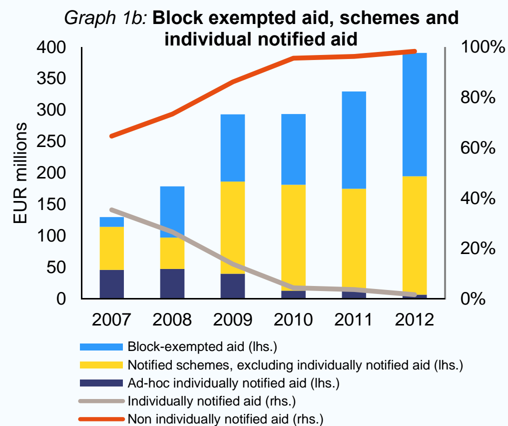
([35]) All 10 companies included in the Ljubljana Stock Exchange's benchmark SBI TOP index are to a greater or lesser degree state-owned or state-controlled, with potentially negative impacts on minority shareholders.

Box 4.3: Increasing Dependence on State Aid

Between 2007 and 2012, Slovenia's expenditures on state aid to the real economy ([1]) more than tripled. This represents the fastest increase in the EU. In 2012, the Slovenian authorities were granting EUR 390.5 million of aid to support the real economy (1.27% of GDP), a level surpassed only by Finland and Malta. Graph 1a shows the extent to which Slovenia is an outlier both in terms of the volumes granted and the increase over time. Notably, State aid expenditures in the EU 27, EA 18, Visegrád countries and member states benefiting from financial assistance have decreased to between 0.35% and 0.8% of GDP since 2007.



Source: DG COMP State aid scoreboard



Source: European Commission - DG COMP state aid scorboard; The information provided by DG COMP is based on the annual reports submitted by Member States pursuant to Article 6(1) of Commission Regulation (EC) 794/2004 and comprises expenditure granted by Member States through existing aid measures which fall into scope of Article 107(1) TFEU.

Only 2% of the state aid granted by the Slovenian authorities in 2012 was individually notified to and approved by the Commission, down from 35% in 2007. The remaining 98% was either block exempted or granted under notified and approved aid schemes (see graph b).

Of the companies in receipt of aid over the past three years, a material number are now in financial difficulties ([2]). This casts doubt on the effectiveness with which Slovenia harnesses these schemes to pursue its development objectives ([3]). This may imply waste and/or suboptimal allocation of scarce budgetary resources and could foster perverse incentives by diverting management attention from commercial goals to subsidy maximisation. Moreover, companies in financial difficulty are in principle not eligible for horizontal aid.

In 2013 the authorities granted rescue aid to Cimos (automotive industry) and Mariborska Livarna Maribor (steel) in the amount of EUR 40 million. The Commission is currently assessing the compatibility of their restructuring plans with the Rescue and Restructuring Guidelines. In addition, the Commission opened a formal procedure in regard to supposed state aid to Adria Airways and started investigations in a series of ex officio state aid cases based on complaints and allegations in the press.

With the business climate remaining depressed and with firms' access to finance remaining problematic, the demand for subsidies is likely to remain strong.

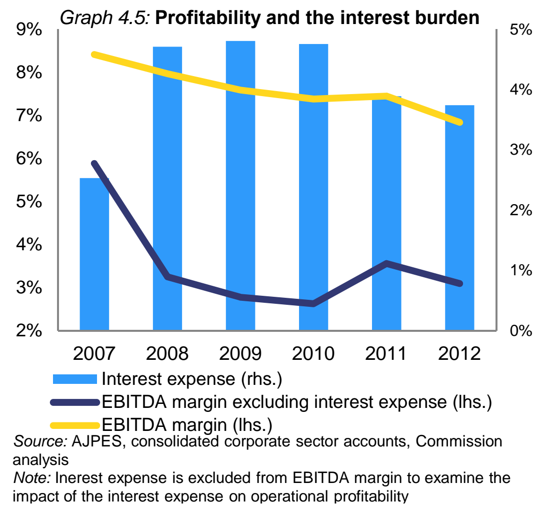
([1]) Comprising all non-crisis-related aid earmarked for horizontal objectives of common interest (e.g. regional aid, environmental aid, aid for research, development and innovation, aid to SMEs) or granted to dedicated sectors of the economy (e.g. coal, transport, or serving a specific objective, e.g. rescue and restructuring, closure aid, but excluding subsidies to railways and to the agricultural sector, which are not reported to the Commission).
([2]) Based on a preliminary review of the annual report submitted by Slovenia.
([3]) Though not included in these figures, the declining performance of Slovenia's heavily subsidised agricultural sector may also confirm this pattern – see IMAD Slovenian Economic Mirror 11/2013 and 5/2011.

Implementation of targeted reforms to reduce the level of state involvement in the economy has been delayed. As a first step in the privatisation process, the authorities identified an initial 15 companies for accelerated privatisation in June 2013, but progress to date has been mixed. One small company (Fotona) and one medium-sized company (Helios) have since been privatised, though the state only had a blocking minority in the latter. In the interim, the state ownership in the banking sector has increased due to state recapitalisations and the state may become owner of a further two domestic banks if private capital is not raised (see Box 3.1). Two key privatisations are expected to be completed by July 2014 and to attract substantial FDI flows, one in the banking and another one in the telecommunication sector. Several of the other assets sales processes appear to be stalled with limited progress, partially due to the intention to firstly undertake debt restructuring, but also in some cases due to difficulties in reaching shareholder agreements for the sale of the company. Moreover, the amendments to the legislation underpinning the Slovenia Sovereign Holding (SSH) and reconstituting it as a vehicle for consolidating the management of direct and indirect ownership stakes of the Republic of Slovenia and the classification of non-core assets for privatisation envisaged by end September in the context of the 2013 CSRs have yet to be adopted.

4.1.3. Deteriorating profitability and low investment capacity (36)

The profitability of the corporate sector has deteriorated considerably due to the loss of competitiveness and the high interest burden. Profit margins have collapsed since the beginning of the crisis and remain squeezed at below pre-crisis level. This has been evident both in terms of operational profitability (EBITDA margin(37)), suggesting decreasing efficiency and loss of competitiveness, as argued in section 3.3, and in terms of net profit margins, revealing the impact of increased interest burden on the debt accumulated during the boom (see Graph 4.5).

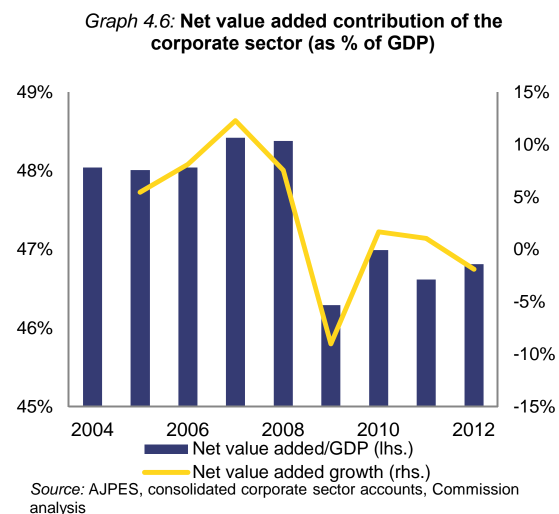
Graph 4.5: **Profitability and the interest burden**



Source: AJPES, consolidated corporate sector accounts, Commission analysis
Note: Inerest expense is excluded from EBITDA margin to examine the impact of the interest expense on operational profitability

The corporate sector contribution to the economy in terms of net added value to GDP deteriorated significantly in 2009 and while it has recovered slightly it remains lower than the pre-crisis levels (see Graph 4.6).

Graph 4.6: **Net value added contribution of the corporate sector (as % of GDP)**

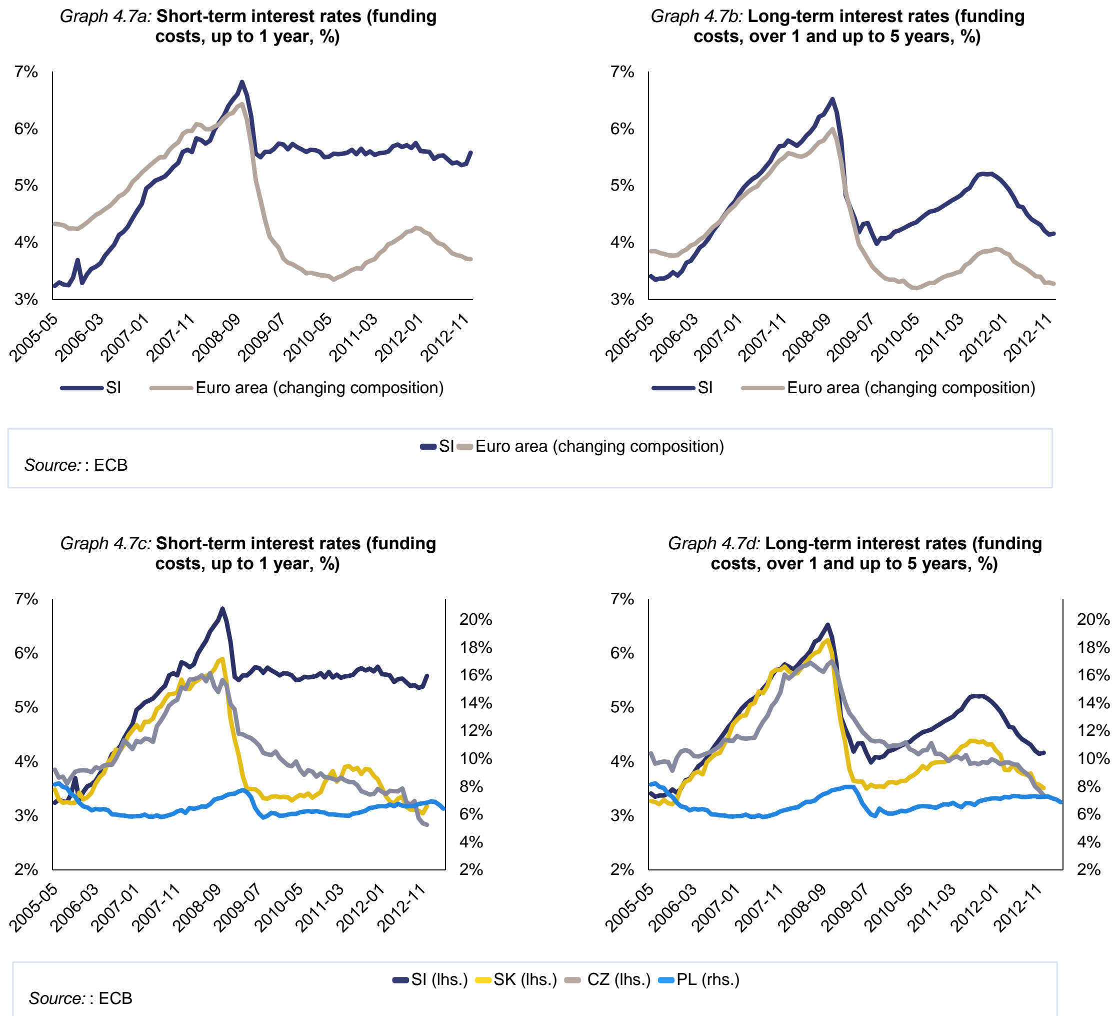


Source: AJPES, consolidated corporate sector accounts, Commission analysis

The funding cost of the Slovenian corporate sector has remained elevated compared to regional peers and to euro area average since the beginning of the crisis. Slovenian companies benefited from lower short- and long-term interest rates before the crisis, compared to regional peers (Slovakia and Czech Republic) and to the euro area average. However, with the start of the crisis in 2008-2009, the gap between corporate funding costs in Slovenia and peers (both regional and the Euro area average) started widening, mirroring the

(36) Please note that analysis in this section is based on aggregate data (consolidated balance sheet and income statement for the entire corporate sector).
(37) EBITDA margin is defined as EBITDA divided by revenues

Graph 4.7: **Funding cost of the Slovenian corporate sector**

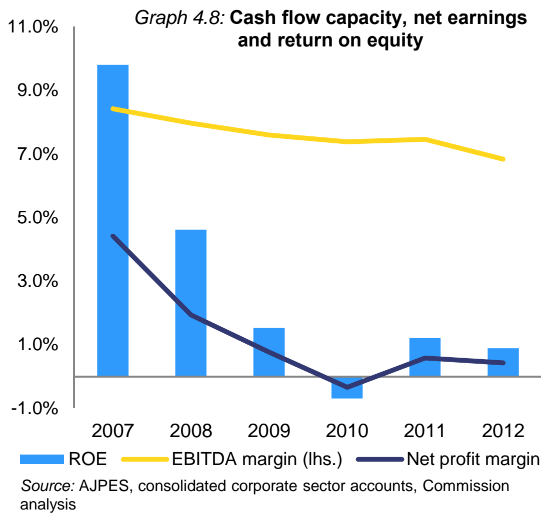


deterioration in their capacity to generate operating cash flows (see Graphs 4.7).

The inefficient capital structures, deteriorating profitability and elevated funding costs have considerably reduced the companies' capacity to invest. While debt levels might have been sustainable during the boom, the high interest burden has wiped out net earnings and return on equity during the crisis (see Graph 4.8). As a consequence, the investment capacity of many companies has been significantly reduced and they have started to underinvest as of 2011([38]). Capital expenditure (CAPEX) ([39]) significantly decreased in 2010 and has not yet recovered to pre-crisis levels. The stronger decline in investment compared to EBITDA reflects the credit contraction and the companies' increased liquidity buffers as a preventive mechanism (see Graph 4.9).

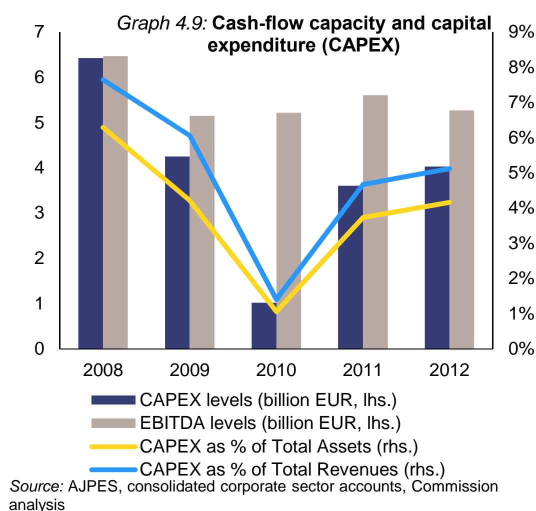
([38]) Product Market Review 2013, DG ECFIN, European Commission.

([39]) CAPEX has been estimated from consolidated balance sheet data for the entire corporate sector as the difference between tangible assets and real estate assets from previous year plus depreciation.



Graph 4.8: **Cash flow capacity, net earnings and return on equity**

Source: AJPES, consolidated corporate sector accounts, Commission analysis



Graph 4.9: **Cash-flow capacity and capital expenditure (CAPEX)**

Source: AJPES, consolidated corporate sector accounts, Commission analysis

High costs of capital, distress in the banking sector and misallocation of resources have impacted viable companies, limiting their sources of financing and damaging overall competitiveness. In addition, cross-ownership, weak corporate governance and vested interests have been a further driver of the squeeze on profitability and the excessive accumulation of debt, leading to delays in restructuring and an increase in insolvencies.

4.2. FINANCIAL RESTRUCTURING AND INSOLVENCY CHALLENGES

The absence of the necessary legislative framework has delayed the necessary deleveraging process. The insolvency framework that was in place until the end of 2013 did not provide for sufficient incentives to stakeholders to promptly and effectively respond to and address emerging solvency issues. Furthermore, it did not allow for effective preventive actions which resulted in many instances, as outlined above, in a further deterioration of the financial situation and reduced prospects of a return to sustainability.

The deficiencies in the insolvency framework made it difficult for creditors to maximize recovery from companies in distress. The authorities recently introduced amendment in the insolvency framework (see Box 4.4) which, if properly implemented should provide a more effective toolset for sustainable debt restructuring and greater opportunity to rehabilitate viable companies with large debt overhangs.

Given the concentration of debt in a small number of large companies, the focus of financial restructuring should be on financial holdings and SOEs/SCEs. Decisive action by creditors in addressing the largest problematic cases first can also assist in restoring insolvency as a credible threat for non-payment of loans, essential for a functioning financial system. Impediments to corporate restructuring arose not only from the out dated legal framework but also from the significant delays experienced of courts processing cases. Recent trends indicate a favourable improvement in the overall processing times (see Box 4.5). If appropriately extended to insolvency disputes, these trends coupled with the new framework could also assist in addressing the debt overhang of corporates in a durable manner.

Box 4.4: Reform of Insolvency proceedings

In December 2013 the Slovenian authorities amended the insolvency law with a view to improving financial restructuring of distressed companies as well as the efficiency of insolvency proceedings in general. The law (i) introduced new preventive restructuring proceeding for large or medium-sized companies (it also covers financial holdings that, irrespective of their size, issue obligatorily consolidated annual reports, as per the Companies Act) that are not yet insolvent but are likely to become insolvent within one year to restructure their obligations, (ii) broadened the scope of simplified compulsory settlement proceedings making them available to both micro companies and small companies and (iii) simplified the prerequisites in the application of those proceedings, streamlined the role of the courts in insolvency proceedings, and further fine-tuned the insolvency framework in various aspects.

Preventive restructuring proceedings – The purpose of these proceedings is to facilitate early restructuring before a company is insolvent. A proposed solution for the work out of the company is agreed between the debtor and creditors; this will include the specific measures to be undertaken, the timeline for these measures and the conditions. The initiation of the preventive restructuring proceedings lies with the Court which decides within 8 days after the debtor files its petition and creditors holding 30% of the overall financial claims must have consented to the proceedings. The debtor is given a 3 - 5 month period (plus a possible extension of up to 3 months), depending on its company's size, to reach an agreement with its creditors. A restructuring agreement is then returned to the Court for ratification when agreement has been reached with creditors holding at least 75% of the total ordinary claims and 75% of the total secured claims (if affected). The Court's decision, which is issued within 8 days after the debtor submits its petition, provides that creditors can be forcefully restructured but secured financial claims are not subject to a reduction of the principal.

Compulsory & simplified compulsory settlement proceedings - Where companies are already insolvent, a restructuring under the compulsory settlement proceedings could be undertaken in order to maximise the recovery values to the creditors if it is considered greater than what would be derived within the context of bankruptcy. The previous condition whereby the debtor had to be able to offer a repayment of at least 50% of debts in order to qualify for these proceedings has been removed. Under the revised framework creditors holding jointly more than 20% of all financial claims are eligible to propose the commencement of compulsory settlement proceedings. In addition, the simplified compulsory settlement proceedings has been extended to small companies whereby debtors have four months to provide the court with the consent of at least 50 or 60% of all creditors (depending on the claims each time concerned) for the proposed restructuring. Restructuring options permitted under the above proceedings include the reduction of the principal, the extension of the maturity, reduction in interest rates and the write-down of collateral to market value with a conversion of the now unsecured elements into unsecured claims.

Streamlining the role of the courts in insolvency proceedings - Court proceedings are made more efficient through several measures including granting judicial assistants the competence to decide on less demanding issues. The insolvency framework underwent further streamlining.

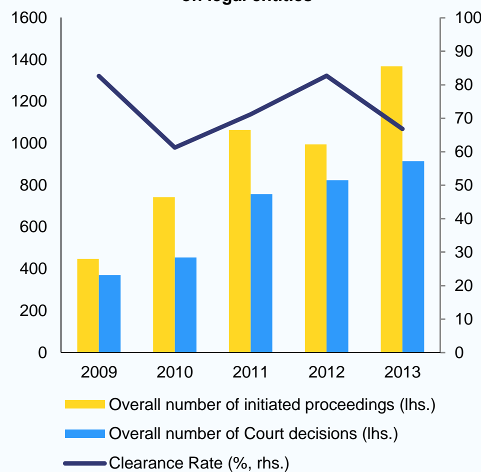
Box 4.5: Enhancing the business environment through improving the effectiveness of commercial and civil justice

The 'Triaža' project focussed on improving the case management in the court system, together with other initiatives, appears to have had a positive impact on reducing case backlogs and the length of court proceedings generally. The number of litigious commercial pending cases at first instance was reduced by almost 19% between 2011 and 2013, with bigger drops at certain district courts. The clearance rate ([1]) in litigious civil and commercial cases (without insolvency) rose to 107,5% in 2012 and 108,7% in 2013, thus reducing case backlogs, whereas the disposition time ([2]) in the same cases fell from 431 days in 2010 to approximately 348 days, in 2013. The reduction in pending enforcement cases has, however, been less dramatic, as at the end of 2013 there were more than 160,000 pending enforcement procedures before local courts, and more than 40,000 pending cases in the electronic system for the enforcement of authentic documents (CoVL), although it should be noted that the incoming CoVL cases are resolved very quickly and efficiently.

Economic recession and corporate financial distress put the Slovenian court system under particular pressure and has translated into an increase in case backlogs in certain areas (see graph1b). There was a tripling in the number of bankruptcy proceedings on legal entities initiated between 2009 and 2013, also due to the introduction of the new tools under the Slovenian Insolvency Act "ZFPPIPP" in May 2013. Close monitoring and assessment of the December 2013 changes to the insolvency framework are required in order to assess their impact on the court system and the effects on the market.

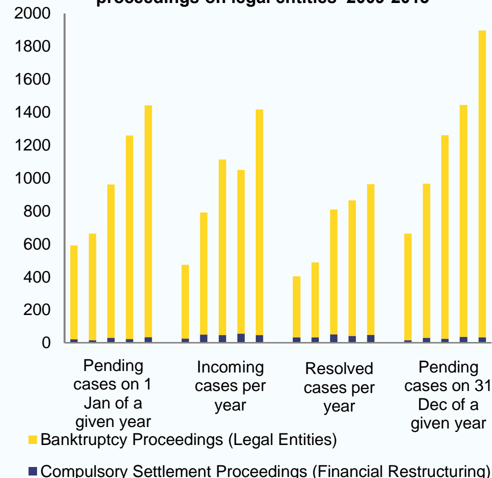
The organizational changes in commercial courts, which also deal with insolvency cases, have not yet resulted in a positive trend towards a 100% clearance rate (see graph 1a). The number of pending compulsory settlement proceedings remains at low levels (see graph 1b). In any case, despite the rising number of incoming petitions, the proportion of bankruptcy proceedings on legal entities resolved within 9 months of filing increased from 57% in 2009 to 63,4% in 2013.

Graph 1a: **Clearance rate for bankruptcy cases on legal entities**



Source: Data from official Court statistics, Republic of Slovenia

Graph 1b: **Court data on bankruptcy proceedings on legal entities 2009-2013**



Source: Data from official Court statistics, Republic of Slovenia

([1]) The clearance rate is the ratio of the number of resolved cases over the number of incoming cases. It measures whether a court is keeping up with its incoming caseload. When the clearance rate is low and the length of proceedings is high, backlog develops in the system (EU Justice Scoreboard).

([2]) The disposition time indicator is the number of unresolved cases divided by the number of resolved cases at the end of a year multiplied by 365 days and is used to express the time (in days) needed to resolve a case in court, that is the time for the court to reach a decision at first instance (EU Justice Scoreboard).

(Continued on the next page)

Box (continued)

Despite the overall improvements graphs 1a and 1b show the significant challenges that remain in the insolvency proceedings given the increasing number of initiated cases and the large backlog of cases that has built up in recent years. Rapid resolution of all cases is the key to recovering value for creditors and reallocating economic resources.

5. POLICY CHALLENGES

This IDR has analysed five main challenges for the Slovenian economy – related to the need for a durable repair of the banking sector, addressing the level of state ownership, bringing the public finances onto a sustainable path, improving export performance and competiveness and enhancing corporate profitability and viability. The discussion of banking sector repair highlights further deleveraging that will continue despite the recently completed asset transfers and recapitalisations. In order to facilitate new lending, in particular to viable companies, a restoration of banks' profitability is essential but this is only feasible through cost rationalisation in the medium term. The analysis of public debt developments quantifies the impact of the increased debt levels on the debt servicing costs and identifies the risk of unsustainable debt trajectories. The analysis of export performance highlights the extent to which labour market rigidities undermine Slovenia's competitiveness. The complex nexus of state ownership limits adjustment and distorts resource allocation, especially as regards new investment. It also appears to deter FDI which is lower than in peer countries. Finally, a focus on corporate debt overhang discusses the factors preventing the appropriate debt restructuring or liquidations that would take companies out of financial distress and unlock new investment. All five challenges will need to be overcome for Slovenia to effectively correct its imbalances and to fully realise its growth potential. Against this background, this section discusses different possible policy avenues that could be explored in order to address the above challenges.

Financial Sector restructuring

Further restructuring and consolidation in the financial sector beyond the progress made in 2013 is required to return to long-term sustainability and profitability. The next phase of the restructuring process will focus on the operational restructuring of banks and could involve further consolidation in the sector. Given declining lending volumes and rather compressed net interest margins, the cost reductions achieved in this phase will be the main tool to improve profitability prospects over the medium term and in turn secure viability and maintain resilience to any potential future shocks. Financial stability in the longer term will also depend on the quality of governance and risk management. Here there is an important role for bank privatisation and rigorous micro and macro supervisory oversight.

Debt sustainability

The sharp increase in government debt in recent years, albeit from a relatively low level, creates new challenges and risks which require durable policy actions to ensure debt sustainability in the medium term. This IDR has detailed how Slovenia faces new challenges due to its substantially increased and still rising general government debt ratio. In particular, the materialisation of a range of risks could push debt onto unstable trajectories. The main risks are further bank recapitalisations and additional funding needs of the BAMC, protracted low nominal GDP growth, failure to curb expenditure dynamics and weak budgetary execution. These risks are further compounded by the projected substantial long term increase in expenditure deriving from demographic ageing.

Minimisation of risks associated with a higher debt level in a low growth environment requires competent and credible policy-making. First and foremost, sustained primary surpluses are needed to bring the debt on to a downward path and compensate for any materialisation of risks. The right fiscal institutions, including an effective fiscal council and fiscal rules can be important anchors for such a fiscal policy. The margin for revenue increases has been largely exploited in the 2014 budget, so expenditure consolidation options will need to be fully explored. A good alternative to damaging linear expenditure cuts would be a more targeted reorganisation of state and local government activities based on credible expenditure reviews. The pension and long term care systems will also need to be reformed in the near term if the overall expenditure envelope is to be stabilised over the medium term. Materialisation of risks from the BAMC needs to be minimised. Losses on some assets may be inevitable, but these should be minimised and the riskiest strategy would be to hold assets for the full lifetime of the BAMC based on expectations of market recovery. This would merely replicate the recent failings of the banks but this time within the general government's balance sheet. Restructuring or insolvency procedures with prompt recovery of

value are the key to minimising this risk. This imperative applies equally to the government's divestment of companies, where swift execution would reduce the fiscal and economic risks arising from further corporate governance failures, while at the same time the proceeds would contribute to debt reduction. Finally, the higher debt level brings greater rollover needs, which increases the importance of skilful debt management and sound economic policies consistent with affordable interest rates.

Restoring competitiveness

Containment of labour costs is essential for restoring cost competitiveness. This IDR identifies labour cost dynamics as one of the key challenges for Slovenia. Labour costs are a particular challenge in industries which are heavily reliant on workers earning the minimum wage or slightly above, industries where productivity growth is not sufficient to bring down unit labour costs and industries which need to adjust their workforce to lower demand but face labour rigidities. Over the medium term, the best way to contain unit labour costs is to generate productivity growth. There are many determinants of productivity growth at the microeconomic level, but it is investment, particularly high quality FDI, where Slovenia appears to face the biggest challenges.

There are ways in which policy makers can address labour cost dynamics so as to ensure that wage developments and labour market institutions support competitiveness and job creation. The minimum wage is set very high in Slovenia, is indexed for inflation, with no link to (sectorial) productivity, and is set at a uniform rate. These parameters could be reviewed and the possibility of introducing separate wage floors for certain categories of workers (such as the young) could be explored.

Corporate sector restructuring

Enhancing governance in the corporate sector and providing the tools to effectively address the debt overhang will help to unlock productivity. This IDR has detailed the extent and nature of the corporate debt overhang in Slovenia. Balance sheet repair is slowed by depressed activity but it is also hindered by frictions, notably in financial and operational restructuring. The delay in decisively addressing this debt overhang has resulted in a further deterioration in the viability of the corporate sector and a large increase in the level of NPLs held by banks.

There has been policy action since May 2013 to overcome barriers to financial restructuring of companies. The insolvency code has been amended to improve the efficiency of procedures and institute new debtor-initiated pre-insolvency procedures for larger companies. There has also been continued improvement to court functioning to address the long case backlog and to process cases faster, which will help preserve recovery values. However, there has been no policy action regarding operational restructuring.

Financial and operational restructuring could start with the most vulnerable companies, financial holdings and the state-owned entities where the majority of the debt overhang is concentrated. Close monitoring will be required to ensure the recently revised insolvency framework and court processes deliver the necessary improvement in the restructuring of distressed companies. Early intervention by both debtors and creditors via the new preventive restructuring procedure could allow for viable businesses to be restructured before they become insolvent. Reinforcement of legal and court capacity may be necessary to fully implement the new legislation and to facilitate the prompt work out of distressed companies.

The state is an important actor in many key restructuring cases, through the BAMC, the state owned banks and state shareholdings. Further policy options which incentivise and provide for the timely restructuring of corporate debt, prioritising the most indebted companies and sectors could be explored and introduced in a manner that does not hinder the ongoing privatisation process. Private restructuring deals concluded between privatised companies and privatised banks are likely to adhere more closely to commercial principles and deliver more durable value than solutions orchestrated by the state. Private ownership, including foreign ownership, would also deliver the productivity and competitiveness boost Slovenian enterprises urgently need. In addition, attracting fresh private capital, including FDI, will be an important prerequisite for reallocating economic resources

and reforming highly indebted capital structures of companies.

Privatisation and state ownership

Encouraging private ownership and a comprehensive strategy for the management of strategic/core assets could improve the adjustment capacity of the real economy The level of state ownership and influence prevalent in Slovenia creates significant risks to the public finances directly and indirectly by way of contingent liabilities from guarantees provided. Furthermore, the high level of state ownership deters FDI and equity financing from playing a full role in Slovenia's recovery. Decisive progress with regard to the privatisation of the 15 state owned entities identified for accelerated privatisation and the adoption of a comprehensive strategy for strategic, core and non-core state assets would provide a clear signal to the market regarding Slovenia's commitment to implementing the necessary reforms and openness to private ownership. Continued divestment of state ownership beyond the initial 15 companies identified is important in order to improve governance and efficiency. The success of the privatisation process would be further enhanced by an improved business environment and the promotion of greater competition in the relevant sectors.

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