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Highlights in this issue:

- **Slovenia started transition with good initial macroeconomic conditions**
- **Stabilisation policies remedied imbalances, keeping the economy remarkably resilient**
- **Important structural challenges have still to be tackled**

Slow is beautiful? Slovenia's approach to transition

*By Mateja Peternelj**

Summary

Slovenia's per capita income, while lagging behind the EU average, is comparable to that of Greece or Portugal: in 2004 the country's GDP per inhabitant measured in PPS, reached around 80% of the EU-25 level. The statistics reflect the fact that throughout the painful regime change prior to EU accession – dismantling the system of economic planning to create a market economy – Slovenia outperformed the other transition countries on nearly every macroeconomic indicator. GDP growth has been steady and robust and the external position strong while the current account has been broadly in equilibrium. However, the economy came under strain towards the end of the nineties as inflationary pressures built up and the fiscal balance turned negative. While good initial conditions helped the country manage the earliest stages of transition at relatively low cost, it was the implementation of effective stabilisation policies that then helped the economy recover its strength. However, structural indicators show that Slovenia is lagging behind in completing the transition. Reforms in the financial sector, labour market and utility reforms are major challenges which still lie ahead.

Catching-up performance determined by initial conditions, stabilisation measures and structural reforms

The transition performance of a country depends on several factors

Three factors appear to significantly influence the catching-up of an economy: initial conditions, stabilisation measures and structural reforms (Berg *et al*., 1999, Falcetti *et al*., 2000, Fisher *et al.*, 2004, World Bank, 2004). First, initial conditions, being intimately related with production factor endowment and the efficiency with which they are processed, determine the level of a country's development. Second, as the country faces an abrupt shock to the system following the breaking down of the prevailing political and economic institutions, stabilisation measures – notably, timely adoption of sound macroeconomic policies – are in order. The success of these measures can be measured by the general government balance relative to GDP and the annual rate of inflation. The third factor with an impact on the catching-up process is structural reforms. While establishing and preserving stability is typically the main focus of policy action, policy-makers also attempt, to varying degrees, to restructure the economy, which is considered to benefit growth in the longer term. Liberalisation and privatisation, in particular, have been judged essential. In its recent study, the EBRD (2004) finds that reforms have a robust, positive influence on growth and that "a sustained commitment to reforms will bring substantial benefits over the longer term" (p.14). The link between a better starting point and

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growth has also been shown to be non-negligible, although its effect withers over time (European Commission, 2004).

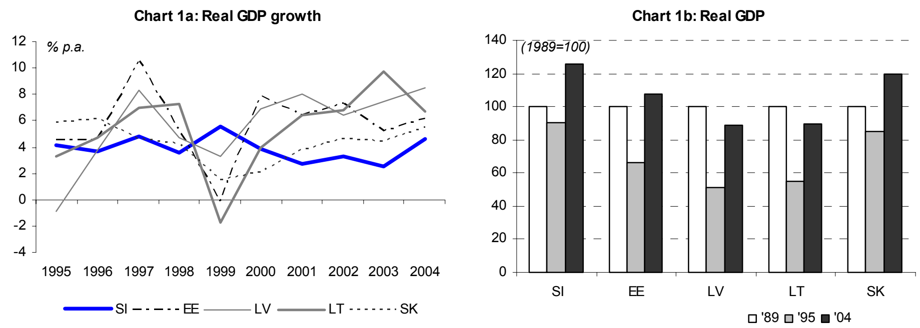
It is possible that as the effect of initial conditions dies away other factors become increasingly important. Moreover, the level of development at the start of transition might very well determine the reform path. Hence, Slovenia may have achieved a good performance due to favourable initial conditions, which has consequently allowed it to rest on its laurels and make less of an effort to reform and restructure the economy ready for EU entry.

Thriving on good initial conditions

Slovenia entered transition as one of the most developed of the new Member States

Following a short recession, which affected all countries at the start of transition, Slovenia regained its strength as real GDP growth picked up in 1993, thereafter remaining steady at 3-5% per annum. Despite being considered a small, open economy, with two million inhabitants, it has managed to offset relatively well the negative consequences of economic downturns in the international environment. Growth stayed impressively stable and robust (Chart 1a) as domestic consumption spurred activity when external demand failed to support it. Note, however, that of the whole subset of comparable transition countries in terms of market size, Slovenia has recorded the lowest growth rates since 2001. On the other hand, some of the countries have yet to regain the real GDP levels attained in the period preceding the transition, whereas Slovenia has fully recovered from the slack period (Chart 1b). Already relatively well developed when it declared its independence, it has succeeded in making further progress in converging to the EU level and achieving a solid economic performance (Table 1).

Chart 1: Slovenia and selected transition countries – catching-up performance



Source: Eurostat, EBRD

Table 1: Slovenia and selected transition countries – macroeconomic indicators

	SI		EE		LV		LT		SK		EUR-15	
	95	**04**	**95**	**04**	**95**	**04**	**95**	**04**	**95**	**04**	**95**	**04**
GDP per capita (in PPS) relative to EU-25	68.4	78.5	33.9	50.7	29.8	43.7	34.1	47.9	44.5	54.0	110.8	108.9
Real GDP growth	4.1	4.6	4.5	6.2	-0.9	8.5	3.3	6.7	5.8	5.5	2.4	2.3
Current account (% of GDP)	-0.4	-0.9	-4.2	-12.9	-0.4	-12.5	-9.6	-8.3	3.0	-3.4	0.5	0.4
Inflation (HICP) (1)	8.3	3.6	9.3	3.0	8.1	6.2	8.8	1.1	6.0	7.4	1.7	2.0
Productivity growth												
Employment rate	66.1	63.6	67.4	65.3	58.5	63.9	61.8	62.1	60.2	57.3	62.1	66.5
Unemployment rate	7.0	6.0	9.7	9.2	18.9	9.8	12.7	10.8	13.3	18.0	10.0	8.0
General government deficit (2)	-3.5	-1.9	-0.6	1.8	-2.8	-0.8	-2.5	-2.5	-12.3	-3.3	1.0	-2.6

(1) year 1997 instead of 1995; (2) year 2000 instead of 1995

Source: European Commission services

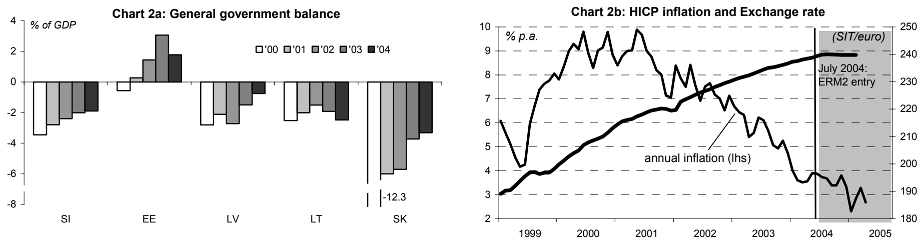
Keeping the economy resilient through stabilisation policies

Public finances

Over the transition, Slovenia managed to keep its public finances broadly in balance. Although the general government balance slipped in 1997 and has since been negative, the deficits have been relatively contained. In December 2001, Slovenia started simultaneously adopting budgets for two consecutive years in an effort to introduce greater certainty into the fiscal planning. For 2003, however, the general government deficit was much higher than initially planned due to lower than expected growth. In order to limit the budgetary impact of this kind of adverse cyclical developments, the implementation bill attached to the 2004 budget introduced a novel measure. The government was given discretionary power to suspend new spending commitments in the event of a revenue shortfall within the limits set in the bill. A revenue undershooting of up to 15 billion tolars (0.25% of GDP) due to unfavourable economic conditions was to be compensated by a proportional reduction of expenditure in the course of the year, without the need to pass a supplementary budget. If unfavourable macroeconomic conditions persisted, a higher budget deficit of up to 10 billion tolar (0.17% of GDP) was nevertheless to be accepted at the end of the year. By invoking the right to refuse claims for further expenditure from October 2004 onwards, the government managed to keep the deficit within the target limit for 2004. The deficit diminished to below 2% of GDP while the gross government debt stabilised at roughly 29.5% of GDP.

Public finance imbalances remained relatively contained throughout the transition period

Chart 2: Slovenia and selected transition countries – indicators of stabilisation



Source: European Commission services

Monetary conditions: prices and exchange rate

Inflation has been a cause for concern since 2000, but strongly declined lately

Still in double-digit numbers until 1996, the annual inflation rate dropped to just above 6% by 1999. External inflationary impulses compounded by the consequences of VAT introduction a year before, disturbed the disinflationary path and took HICP back up to 9% in 2000. Increases in administered prices, taxes and energy prices kept inflation high while the policy of steady exchange rate depreciation further added to inflation inertia. According to the estimates made by both the government (IMAD, 2003) and independent researchers (Coricelli *et al.*, 2004), about half of the price increase was linked to the steady nominal depreciation of the exchange rate with a pass-through of six to nine months. The inflation rate fell after the Bank of Slovenia slowed down the rate of depreciation of the currency in the second half of 2004 before setting it at the central parity of 239.640 tolars per 1 euro with a standard fluctuation band of +/- 15 percent within ERM II on 28 June 2004. This halted a long period of continuous depreciation against the euro and the tolar has remained very stable ever since. The annual increase in consumer prices has declined impressively, dropping from 8.6% in 2001 to 3.7% in 2004.

Reforming slowly, with major challenges still to be faced

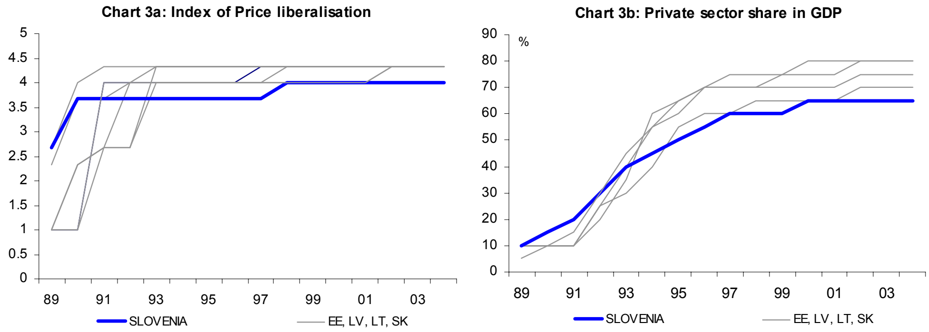
Slovenia advocates a gradualist approach to transition

Slovenia has adopted a gradualist approach towards structural reforms, in particular with respect to liberalisation and privatisation. Advocates of such strategy see major benefits in giving economic agents ample time to adapt to the new setting as it would allow outworn activities to be transformed rather than scrapped.

Indexation mechanisms have been widespread until 2003 …

With a degree of price liberalisation higher than in other transition countries of a similar size, Slovenia was in a more favourable position to start the transition (Chart 3a).[1] Over the past decade, however, inflationary pressures have fed through a lack of competition in various sectors, certain rigidities in the labour market, and widespread indexation. Slovenia succeeded in weakening indexation mechanisms in the economy, starting in 2002. In particular, dismantling backward-looking indexation for wages and social transfers was seen as contributing to the dis-inflationary process. In 2004, a restrictive wage agreement was implemented across the economy. Forward-looking indexation, taking into account expert views on expected rather than actual domestic consumer price movements and projected inflation in the EU as well as the euro/tolar central parity, has been applied consistently in all sectors, public and private. Moreover, the wage increases lagged behind productivity growth by more than one percentage point, in line with the social agreement, resulting in subdued real wage growth.

Chart 3: Slovenia – indicators of liberalisation



Source: EBRD

… but co-ordination between the Central Bank and the Ministry of Finance speeded up the disinflation process

A move toward a general de-indexation of the economy, together with the stabilisation of the exchange rate, was instrumental in combating inflation as it credibly anchored expectations. Simultaneously, the government regulated administered price rises and indirect tax changes in such a way as to not exceed the targeted inflation rate at the end of the year. Moreover, it applied frequent adjustments of excise duties on oil in order to temper the impact of world market price fluctuations. However, although the co-ordinated policy effort in bringing down inflation was considerable, disinflation was partly achieved through administrative means.

The reform process moved forward, albeit slowly and with a mixed progress across different sectors …

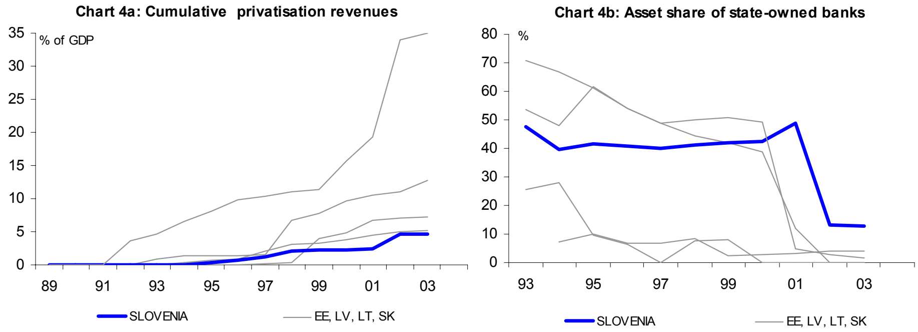
Structural rigidities remain, as evidenced by the low share of the private sector in the economy (Chart 3b). The State still controls almost half of the economy, either directly (through majority ownership of banks, insurance companies, investment funds, utilities and other companies) or indirectly (holding the largest share of a company and thereby influencing the management). By 2004, privatisation revenues in Slovenia had only reached 4.7% of GDP in cumulative terms. While significant liberalisation has occurred in the network industries, State-owned incumbents continue to dominate. The most-extensive privatisation has taken place in the banking sector and foreign-owned institutions have played a major part in the process of banking consolidation; still, the banking sector remains predominantly domestically owned. The high degree of interconnectedness which characterises the financial sector, with a myriad of cross-sectoral shareholdings and significant cross-sectoral financial flows, (IMF, 2001) must continue to be carefully monitored.

… but stalling privatisation inhibited trade incentives

The slow (case-by-case) privatisation (Chart 4a) has kept foreign direct investment (FDI) inflows low (Table 2). In 2003, negative FDI flows – traditionally positive, if small – were registered for the first time as a result of significant outward investment, mainly directed to the countries of former Yugoslavia. This negative result followed a transitory hike in 2002 largely due to one-off privatisation activity in banking and a takeover in pharmaceuticals. Low FDI activity may, in turn, explain the relatively slow growth of Slovenia's trade. Since 2000, the share of exports to EU markets has been falling constantly, shrinking in 2003 to 59% of total exports. Furthermore, the trade deficit with the EU has also been increasing steadily, reflecting the erosion in the competitive position of Slovene firms. After the suspension of favourable free trade agreements following EU accession, the competitiveness of Slovene exports to the former Yugoslav markets is also expected to suffer.

Obstacles in the business environment and the lack of effective competition in some sectors continue to have an impact on the dynamism of enterprises. Lengthy and bureaucratic procedures (Table 2), as well as difficulties in buying land for industrial use, still persist. According to the Commission's analysis of a recent World Bank survey (World Bank, 2005), Slovenia is ranked the second worst country in the EU for "ease of doing business".

Chart 4: Slovenia – indicators of privatisation



Source: EBRD

Table 2: Slovenia and selected transition countries – structural indicators

	SI		EE		LV		LT		SK	
% of GDP unless otherwise indicated	**95**	**03**	**95**	**03**	**95**	**03**	**95**	**03**	**95**	**03**
Share of exports to EU-15 area	66	59	53	58	43	62	35	42	36	62
Share of imports from EU-15 area	66	67	64	52	49	51	36	45	34	54
"Barriers to business" - days duration	-	61	-	72	-	18	-	26	-	52
FDI intensity, (ave '97-'03) *	-	1.6	-	4.6	-	2.4	-	2.2	-	2.9
Share of foreign-owned banks (% foreign/all)	-	27	-	57	-	43	-	54	-	76

** Foreign Direct Investment intensity - Average value of inward and outward FDI flows as % of GDP*

Source: EBRD, World Bank, Eurostat

Restructuring of public finances, on both the expenditure and the revenue side, is under way

Ranking the effect of 22 factors on competitiveness, Slovene firms identified taxation as having the greatest negative impact (Chambers of Commerce, 2004). The rigid tax system is also a deterrent to FDI. On 1 January 2005 the new direct tax regime entered into force but only limited adjustments in the personal income and corporate tax have been introduced. Faced with an uncompetitive tax system, the new government has therefore announced a comprehensive reform package to deal with the erosion of competitiveness of the Slovene economy. Recently, the idea to introduce a flat tax rate has once again become prominent on the policy agenda. And although the two-year budgetary planning horizon is helpful in fostering fiscal discipline the high share of non-flexible spending commitments (more than 80% of total outlays) does not leave much room for manoeuvre, so the fiscal reforms have also anticipated the restructuring of the expenditure side.

Conclusion

The run-up to EU accession brought significant challenges for Slovenia, especially that of negotiating the transition from a centrally planned to a market economy. Slovenia opted for a gradual regime change as it was considered that this would minimise the risk of profound and rapid structural changes ultimately backfiring on the economy. Indeed, shocks have been largely avoided. With stable economic growth and no major macroeconomic imbalances, losses of output and jobs have been kept small and social peace preserved. Economic, social and political stability are considered to be the most prominent advantages of the gradualist approach (Šušteršič, 2004). On the other hand, important opportunities have been wasted. By deterring foreign capital, Slovenia has failed to reap the benefits of technological modernisation, the introduction of technologically demanding products, the transfer of management skills and access to new markets (Oxford Analytica, 2004). Moreover, growth might have been more pronounced if financial markets had been reformed more rapidly, since Coricelli *et al*. (2004) show that the development of credit markets has a significant role in affecting growth. While the prospects for durable, balanced growth over the medium term are solid, Slovenia has been outperformed since 2000 by the other RAMS of similar size. The consistent implementation of structural reform in addition to stability-oriented macroeconomic policies is paramount in securing sound economic conditions for growth and development. However, if economic activity becomes strained due to structural shortcomings, domestic forces for growth may eventually become exhausted and potential growth could back-pedal.

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[1] The EBRD index of price liberalisation ranges from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.
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