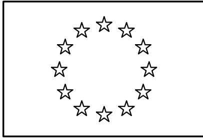

EUROPEAN COMMISSION
DIRECTORATE GENERAL
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CONVERGENCE PROGRAMME OF SLOVENIA (2004-2007)

AN ASSESSMENT

Table of contents

SUMMARY AND CONCLUSIONS 3

1. INTRODUCTION 5

2. MACROECONOMIC DEVELOPMENTS 6

   2.1. Macroeconomic scenario 6

   2.2. External accounts 7

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY 8

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES 10

   4.1. Budgetary developments until 2003 10

   4.2. Programme overview 10

   4.3. Targets and adjustment in 2004 13

   4.4. Targets and adjustment in 2005 and beyond 13

   4.5. Debt ratio 14

5. THE QUALITY OF THE PUBLIC FINANCES 15

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES 16

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME 18

SUMMARY AND CONCLUSIONS[1]

On 14 May 2004, Slovenia submitted its first convergence programme, covering the period 2004-2007. It aspires to an early ERM II entry, by the end of 2004 at the latest, in order to introduce the euro at the beginning of 2007.

The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2].

The macro-economic scenario underlying the convergence programme has been revised downwards since the 2003 pre-accession economic programme but remains slightly more optimistic than the Commission Spring 2004 forecasts until 2005. In particular, projected growth in 2004 appears on the high side of the current forecasting range. For the rest of the period covered the evolution of growth – drawing closer to and from 2006 slightly exceeding potential growth, estimated at 3.7% by the national authorities – seems plausible and is broadly in line with the Commission projections. Forecast to reach 3.3% in 2004 and settle below 3.0% at the end of 2005, the projection for inflation reveals rather favourable expectations of future price developments, while the Commission services take a more cautious view of the disinflation process.

The gradual fall in inflation, which began in 2001, accelerated in the second part of 2003. The annual increase of consumer prices reached 4.6% at year-end, decreasing the annual average to 5.7% from 7.5% a year before. The disinflation continued in 2004; in May, however, the year-on-year consumer price inflation rate was 3.9%, up by 0.3 percentage points compared to a month before. The long-term sustainability of lowering inflation – still relatively high at 4.7% on a 12-month moving average basis – needs to be strengthened. A good coordination of economic policies is regarded as key in bringing down inflation durably. Wage moderation and changes to the wage indexation system, in particular, have been identified as essential in supporting the disinflationary process. The new wage adjustment method for 2004-2005, introducing forward-looking indexation mechanisms – with anticipated rather than actual domestic inflation and also taking into account expectations related to EU inflation and euro/tolar exchange rate – should contain wage increases and ease inflationary pressures thereof. The Bank of Slovenia has price stability as its main objective and conducts monetary policy through a combination of interest rate policy and exchange rate management. Since 2003, the interest rates have been cut by a cumulative 350 basis points – leading to a real short-term interest rate of about 2% at present – while the rate of depreciation of the exchange rate against the euro has now been slowed to some 0.1% per month.

Without explicitly referring to the Stability and Growth Pact, the programme strives at achieving a stable budgetary position of close-to-balance. However, with a projected deficit of 0.9% of GDP in 2007, a close-to-balance position is only approached by the end of the programme period through a gradual reduction of general government deficit.

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[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001. The delimitation of general government has not been applied completely and accrual accounting needs to be further improved.

Tracking a slightly slower path as compared to the 2003 pre-accession programme, the convergence programme envisages a back-loaded fiscal consolidation as it postpones the deficit reduction to the far end of the programme horizon, whereby the adjustment is channelled mostly through a cut in the expenditure ratio.

The consolidation path appears credible but is rather unambitious in setting the budgetary targets. The convergence programme fails to provide the details and, especially, the quantitative impact of the planned budgetary measures is missing. However, compared to the 2003 pre-accession programme, the consolidation strategy seems to have remained largely unchanged. It envisages the restructuring of general government expenditure and revenue so as to enhance budgetary flexibility. In particular, reducing mandatory budget spending is deemed necessary in order to cope with financial commitments of EU and NATO membership, which the authorities seem to regard as the sources of additional pressure on the budget while the share of mandatory expenditure accounts for more than 80% of the budget. The government has committed itself to meet the targets by gradually lowering the cyclically-adjusted deficit and will, in adverse circumstances, allow the working of automatic stabilisers only on a limited scale (in the order of 0.2% of GDP, according to the implementation bill to the 2004 budget). Given that the projected budget deficit is just slightly below 2% of GDP in the period 2004-2005, there may not be a sufficient safety margin against breaching the 3% of GDP deficit threshold should the authorities not succeed in limiting the play of fiscal stabilisers. Assuming potential setbacks related to downside economic developments, similar to the ones in the recent past, the budgetary outcome could be worse than expected.

Gross public debt is relatively low and will remain so over the programme period. In 2003, the debt-to-GDP ratio rose to 28.6% of GDP. Running a persistent primary deficit, the government anticipates a further increase in the debt ratio in the first two years, peaking at 29.5% of GDP in 2005. By 2007, the debt is forecast to return to 28.4% of GDP as nominal GDP growth is projected to be higher than the interest rate thereby facilitating the stabilisation of debt. Furthermore, the authorities consider the maturity and currency structure of debt portfolio appropriate since a long-term repayment profile spreads evenly over time with a growing share of tolar-denominated debt and external debt being predominantly euro-denominated.

The programme briefly reviews the government’s structural reform agenda which focuses on enhancing the competitiveness of the economy by increasing the share of R&D expenditures in the budget. It also announces further measures to sustain economic growth, e.g. promoting job-creation oriented investment and removing structural rigidities in the labour market. However, the programme does not dwell upon the specifics of the restructuring process; policy goals seem fairly general and are only exceptionally accompanied by well elaborated measures. Budgetary implications cannot be unambiguously discerned since no attempt has been made to quantify the planned structural reforms in the projections of the main fiscal aggregates.

Slovenia faces risks of budgetary imbalances in meeting the costs of an ageing population. Implementing thoroughly the pension reform and putting in place a stable health-care system together with securing an adequate primary surplus are essential for placing public finances on a sustainable footing.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**2.3**	**3.6**	**3.7**	**3.8**	**3.9**
	COM	2.3	3.2	3.6	n.a.	n.a.
	PEP	*3.1*	*3.9*	*4.0*	*4.4*	*n.a.*
HICP inflation (%)	**CP**	**5.6**	**3.3**	**3.0**	**2.7**	**2.6**
	COM	5.7	3.6	3.2	n.a.	n.a.
	PEP	*5.5*	*4.3*	*4.2*	*3.7*	*n.a.*
General government balance (% of GDP)	**CP**	**-1.8**	**-1.9**	**-1.8**	**-1.5**	**-0.9**
	COM	-1.8	-1.7	-1.8	n.a.	n.a.
	PEP	*-1.9*	*-1.6*	*-1.6*	*-1.3*	*n.a.*
Primary balance (% of GDP)	**CP**	**-0.3**	**-0.3**	**-0.4**	**-0.2**	**0.4**
	COM	0.1	-0.1	-0.1	n.a.	n.a.
	PEP	*-0.5*	*-0.1*	*-0.1*	*0.0*	*n.a.*
Government gross debt (% of GDP)	**CP**	**28.6**	**29.1**	**29.5**	**29.4**	**28.4**
	COM	27.1	28.3	28.2	n.a.	n.a.
	PEP	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. INTRODUCTION

The convergence programme of Slovenia was submitted on 14 May 2004, a day after having been passed by the government. The Slovene authorities have updated the pre-accession economic programme from August 2003 with respect to early ERM II entry aspirations and in conformity with the supplementary budget for 2004 as well as the 2005 budget, both adopted in December 2003. The programme sets out a medium-term fiscal policy framework for the period 2004-2007. It largely abides by the Code of Conduct regarding the data requirements as it caters for all the required tables in broad compliance with ESA95 standards.[3] Likewise, the content and format of the document broadly conforms to the model structure, suggested in the Code of Conduct. However, the programme text on several points demands recourse to additional sources for background information so as to allow a broader insight into policy strategy. Moreover, it lacks the quantitative impact of the planned budgetary measures.

Seeking to keep public finances sound, especially in view of the EMU participation plans, the convergence programme projects a gradual move toward cyclically-adjusted balance, which, however, is not to be reached during the period covered by the programme. According to the national authorities, sufficient room is created to increase to a limited extent the cyclical deficit under unfavourable economic conditions. The programme aims at reducing the deficit – to 0.9% of GDP by 2007 – but at a slightly slower pace than anticipated in the 2003 pre-accession economic programme. The government is determined to adhere to the targets should an economic downturn provoke

[3] It is noteworthy that the gross public debt levels (as in Tables 3 and 5 of Annex 1) are now fully consistent with the Code of Conduct while still measured as the central government debt according to the national - GFS 1986 methodology in the 2003 pre-accession economic programme. However, the delimitation of general government has not been applied completely and accrual accounting needs to be further improved.

a revenue shortfall. To this end, it has the discretion to cut expenditure proportionally, up to 0.25% of GDP, without having to pass a supplementary budget, as stipulated in the implementation bill to the 2004 supplementary budget. Compared to the 2003 pre-accession programme, the consolidation strategy underlying the convergence programme remains largely unchanged. It focuses on restructuring general government expenditure and revenue so as to enhance budgetary flexibility. Given the problems in sustaining the fiscal resilience to unforeseen developments in the past, adjusting the budget structure is deemed necessary to cope with the financial commitments linked to the EU and NATO membership. The gross public debt is expected to rise until 2005, coming to 29.5% of GDP, and then retract to the 2003 level of around 28.5% of GDP by 2007.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The projections of the main macroeconomic aggregates have been revised downwards since the 2003 pre-accession economic programme. The new growth path remains, however, slightly more optimistic compared to the Commission Spring 2004 forecasts; in particular, projected growth in 2004 appears on the high side. The recent upward trend in the quarterly dynamics of domestic demand confirms the anticipation of a gradual economic recovery in 2004-2005. Both consumption and investment spending are expected to accelerate further, supported by low interest rates and favourable loan conditions through the national housing saving scheme, which could swing the economy into a new expenditure cycle.[4] Investment in particular, is set to grow vigorously, following a boost in construction activity and enterprise restructuring, undertaken to meet revived foreign demand. With exports to the EU now picking up the economic upturn should become even more pronounced. The external economic assumptions broadly correspond to those underlying the Commission Spring 2004 forecasts.[5]

Real GDP is projected to expand steadily to close to 4%, in 2005 equalling but thereafter slightly exceeding potential output growth, which is estimated at 3.7% by the national authorities. Expected to turn marginally negative this year, the current account should balance out by the end of the period provided that competitiveness of the Slovene industry improves as the labour market becomes more flexible. The evolution of growth on the medium-term therefore seems plausible if restructuring process advances without further delays.

In the continuous, albeit slow process of removing the structural rigidities from the economy, the average rate of consumer price increase dropped from 8.6% in 2001 to

[4] The national housing saving scheme is a 5-year saving facility, designed by the government to support new home ownership. With twelve regular monthly instalments an additional, 13th payment is taken in charge by the state housing fund each year. The principal augmented by interest is redeemable after five years. Furthermore, the saver is entitled to claim a loan equal to 2-2.5 times the principal offered at a subsidised interest rate. The first national housing saving scheme was launched in 1999 and arrives at maturity in July 2004.

[5] For 2005, the assumptions are slightly deviant, anticipating a slower economic pick-up in the EU and higher GDP growth for the US economy. But these differences should roughly cancel out. On the other hand, it is noteworthy that the oil price assumption is at the lowest side of the projection range. However, a simulation in the convergence programme indicates that an increase in oil prices by about 4 US$ per barrel would not undermine the programme’s central forecast.

5.7% in 2003, and remained on a declining trend in 2004. In May, however, year-on-year consumer price inflation was 3.9%, 0.3 percentage points higher than a month before. The 12-month moving average rate of inflation in turn decreased to 4.7%, projected in the convergence programme to reach 3.3% by year-end and then settle below 3.0% from 2005 onwards.[6] The Commission Spring 2004 forecasts reflect a more cautious view on the lowering of inflation. Bringing it down sustainably might prove to be challenging as inflationary pressures may continue to persist in the face of only gradual structural reforms in various sectors, certain inflexibilities in labour markets and remaining indexation mechanisms. Furthermore, steady disinflation might be hampered if buoyant domestic demand quickly closed the negative output gap. In addition, household income is being progressively disburdened from reimbursing previous loans, mainly contracted in 1999, when households rushed to purchase durable goods in the anticipation of price increases induced by the introduction of VAT. Moreover, new borrowing might be further stimulated through optimistic business and consumer expectations related to EU membership and in view of early euro adoption, which could provoke a rapid convergence of nominal interest rates. As recognised by the authorities, fiscal policy should be ready to step in since the room for manoeuvre to set interest rates will be significantly reduced as from the entry into ERM II.

2.2. External accounts

Slovenia has a tradition of a positive or only slightly negative current account position, implying a relatively favourable private savings-investment balance. In 2003, the current account moved from a surplus of 1.4% of GDP a year earlier closer to balance as a result of a larger trade deficit and a smaller surplus in services. A further moderate deterioration is projected for 2004 and 2005, when the current account is expected to turn and stay (marginally) negative, according to the Commission Spring forecasts.[7]

However, in catching-up countries like Slovenia, current account developments are surrounded by uncertainties. In particular, a current account deficit could widen markedly due to rallying imports, following a boom in domestic demand. In an environment characterised by financial liberalisation and disinflation, credit growth might accelerate on the back of falling interest rates, thereby exerting pressure on the private savings-investment balance. This in turn could widen the current account deficit further as the planned reduction in general government net borrowing may be insufficient to offset a broader gap in the private sector savings-investment balance.

Should the current account balance deteriorate significantly, the composition of its financing would need to be suitably adjusted. FDI inflows have returned to historically low levels from a transitory hike in 2002 largely due to the privatisation in banking and a take-over in pharmaceuticals, while the outward FDI, mainly directed to the countries of ex-Yugoslavia, has been significant. In 2003, a net outflow of FDI was registered for the first time. Implicitly, the financing of the current account would thus have to considerably rely on short-term capital flows. In this context, developments in domestic

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[6] This forecast assumes that future shocks – including the rise in oil prices – would be manageable.

[7] The convergence programme does not supply a record of the current account forecasts, as it is not indicated as either mandatory or optional information in the Code of Conduct.

credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues could have become important considerations in discussing the public finances situation in the convergence programme.

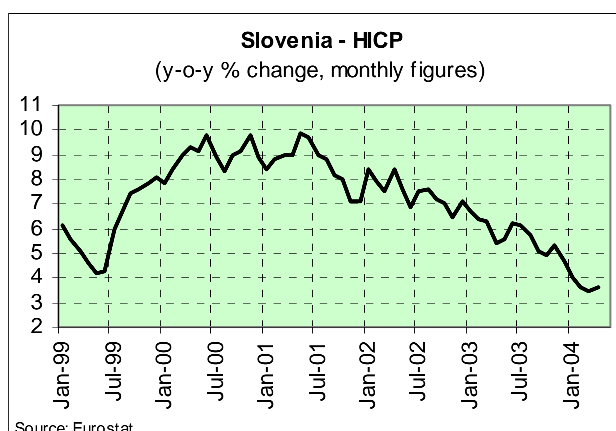
Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	CP	COM	CP	COM	CP	COM	CP	COM	CP
Real GDP (% change)	2.3	2.3	3.2	3.6	3.6	3.7	n.a.	3.8	n.a.	3.9
Contributions:										
- Final domestic demand	3.7	4.3	4.8	4.6	4.6	4.4	n.a.	3.9	n.a.	3.9
- Change in inventories	0.5	0.9	-0.7	0.1	-0.5	0.1	n.a.	0.2	n.a.	0.0
- External balance on g&s	-1.9	-2.0	-0.9	-1.0	-0.6	-0.7	n.a.	-0.1	n.a.	0.0
Employment (% change)	-1.4	-0.2	0.1	0.4	0.4	0.6	n.a.	0.6	n.a.	0.7
HICP inflation (%)	5.7	5.6	3.6	3.3	3.2	3.0	n.a.	2.7	n.a.	2.6
GDP deflator (% change)	5.1	5.1	3.5	3.6	3.4	3.0	n.a.	2.5	n.a.	2.4
Current account (% of GDP)	0.2	0.1	-0.5	n.a.	-0.6	n.a.	n.a.	n.a.	n.a.	n.a.

Note:
The Commission forecast of employment relates to the ILO methodology (based on the Labour Force Survey) while in the convergence programme a domestic concept is used, according to national accounts definition.
Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM)

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Relatively high inflation has for long been an issue of major concern. Inflationary pressures have been fed by lack of competition in various sectors, certain rigidities in the labour market and widespread indexation. Also, increases in administered prices, taxes and energy prices have largely contributed to a rise of consumer prices. In the past, accommodating monetary conditions, especially in terms of a continuous depreciation of the currency in the framework of active exchange rate management have further added to inflation inertia.

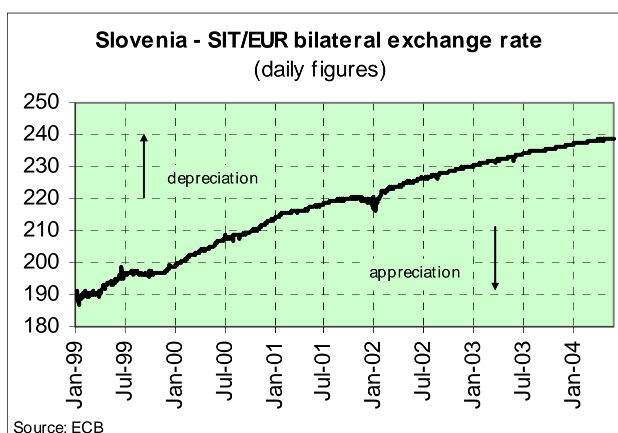


Admittedly, the economic slowdown has now laxed the inflationary pressures and consumer price growth has decreased impressively. Already on a declining trend, inflation has decelerated steeply as of the second half of 2003, helped by the concerted policy action as agreed between the government and the Bank of Slovenia. Having identified bringing down inflation to levels suitable for euro adoption from 2007 as a policy priority, the authorities decided to co-ordinate measures, involving i) a comprehensive price control plan, regulating the administered price increases and tax changes in a way not to exceed the inflation rate at the end of the year, ii) a move towards general de-indexation of the economy by weakening indexation mechanisms of financial contracts

and personal income (wages[8] and certain social transfers), and iii) a deceleration of the exchange rate depreciation (to 1.5% in May 2004). In 2003, the annual increase of consumer prices reached 4.7% at year-end, decreasing the annual average to 5.7% from 7.5% a year before. Continued wage moderation, further de-indexation of the economy and structural reforms aiming at bolstering effective competition in response to the EU integration effects will help to ensure that the disinflationary process becomes durable.

The Bank of Slovenia has price stability as its main objective. To achieve this goal, the Bank conducts monetary policy through a combination of interest rate policy and exchange rate management. In order to prevent interest-rate-sensitive capital flows, the Bank engineers a continuous depreciation of the exchange rate in such a way that the capital loss through the depreciation offsets the higher revenue from the interest rate differential (uncovered interest rate parity). While the Bank describes this exchange rate regime as a managed float, it is generally perceived to be a de facto crawling peg.

In 2004, the Bank of Slovenia lowered the main refinancing rate by 125 basis points in five steps, to 4%, compared to 2% in the euro area. These moves followed several cuts in 2003 that decreased the interest rate by a cumulative 225 basis points. Short-term real interest rates currently stand at about 2% in Slovenia compared to 0.3% in the euro area. In parallel, the rate of depreciation of the exchange rate against the euro was reduced from some .38% per month two years ago (May 2002) to some .12% at present (May 2004).



In the convergence programme, the authorities confirmed intentions to enter into ERM II by the end of 2004 at the latest and to adopt the euro at the beginning of 2007. The present exchange rate regime will be replaced by one in which interest rate policy will primarily focus on stability of the tolar against the euro. The role of monetary policy in ensuring price stability will be restrained as interest rates may not always be at the level required to control domestic demand. The programme therefore recognises that, after ERM II entry, fiscal policy and wage policy as well as strengthened financial supervision, will have a major share in strengthening the sustainability of the disinflation process.

[8] The Social Agreement for 2003-2005, concluded by the social partners in April 2003, stipulates a new wage policy, which should dispense with direct backward-looking indexation while keeping real wages from increasing more than productivity. A new wage adjustment method for 2004-2005 – which will take into account anticipated rather than actual consumer price movements in Slovenia, average inflation in the EU and the euro/tolar exchange rate – has been introduced in both the public and the private sector.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

The Slovene economy has been characterised by broadly sound public finances. Although the general government balance slipped in 1997 and stayed negative since then, deficits have been relatively contained - averaging 2.4% of GDP on an ESA95 basis in the period 2000-2003. The primary balance, on the other hand, recorded only a small deficit. In December 2001, Slovenia started adopting budgets for two consecutive years in an effort to enhance fiscal prudence by bringing greater certainty in the long-term planning of public finance.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

	1998	1999	2000	2001	2002	2003
General government balance	n.a.	n.a.	-3.0	-2.7	-1.9	-1.8
General government gross debt	23.9	25.1	26.7	26.9	27.8	27.1

Note:
Until 2000, general government balance has not been measured according to ESA-95 standards.
Source:
Commission services

Disappointing growth in 2002-2003, however, led to budgets being revised in the middle of the year. In that period, general government expenditure overruns coupled with tax revenue shortfalls led to failures in achieving the deficit targets. The discrepancies were supposedly the result of overly optimistic domestic growth assumptions based on then common expectations of a recovery in the international environment, which failed to occur. On the other hand, timely adjustments have been heavily strained by structural inflexibility: the budget continues to be characterised by a high share of fixed commitments, accounting for more than 80% of overall outlays.

The general government deficit, still standing at 3.0% in 2000, declined to 1.8% of GDP in 2003. The budget balance improved marginally by 0.1 percentage point compared to 2002. This outcome was slightly better than projected in the 2003 pre-accession economic programme (a deficit of 2.0% of GDP) but much higher than what the 2002 pre-accession economic programme targeted at initially (a deficit of 1.3% of GDP). Against the background of faltering growth, this outcome was achieved thanks to a determined fiscal policy. On the revenue side, taxes on profits and capital gains increased markedly, while substantial savings on interest expenditure materialised due to lower than anticipated inflation. On the other hand, the general government gross debt ratio in 2003 further increased to 28.6% of GDP, following a gentle upward trend since 1994.

4.2. Programme overview

The programme aims at maintaining public finances stable and sets out achieving a general government budget position close to balance as the key medium-term policy objective. The fiscal consolidation, however, should remain a challenge beyond the programme horizon since the close-to-balance budgetary position as defined by the Stability and Growth Pact is not reached by 2007. The convergence programme projects a slightly less ambitious trajectory of reducing the general government deficit compared to the 2003 pre-accession programme while retaining the budgetary strategy outlined therein. According to the new consolidation path, the deficit halves over the next four years, reaching 0.9% of GDP in 2007, as a result of a number of fiscal policy measures –

already ongoing or planned – whereby the adjustment feeds mostly through a cut in the expenditure ratio. The authorities claim that such budgetary consolidation will allow for a sufficient safety margin to avoid a breach of the 3% of GDP reference value throughout the programme period. However, this may not be fully guaranteed, especially at the beginning, when the deficit is projected to linger at 2% of GDP. Assuming the downside macroeconomic risks related to an upbeat economic growth forecast in 2004, the budgetary outcome could be worse than expected.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
			General government balance		
CP	**-1.8**	**-1.9**	**-1.8**	**-1.5**	**-0.9**
COM	-1.8	-1.7	-1.8	n.a.	n.a.
PEP	*-1.9*	*-1.6*	*-1.6*	*-1.3*	*n.a.*
			General government expenditure		
CP	**45.8**	**47.0**	**45.7**	**45.1**	**43.6**
COM	41.3	44.0	44.0	n.a.	n.a.
PEP	*43.6*	*43.8*	*44.1*	*43.0*	*n.a.*
			General government revenues		
CP	**44.0**	**45.1**	**44.0**	**43.6**	**42.7**
COM	39.5	42.3	42.3	n.a.	n.a.
PEP	*41.6*	*42.2*	*42.5*	*41.7*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

On the other hand, it is worth noting that the deficit is not planned to be reduced in 2004-2005, when the economy is expected to strengthen. This implies overall fiscal loosening in the first years of the programme period while important restructuring efforts, both on the receipt and expenditure side, are foreseen. A considerable reduction of the general government deficit is foreseen from 2005 onwards due to a declining cyclical deficit as GDP growth accelerates over only slowly expanding potential growth and thereby the negative output gap narrows.

The fiscal consolidation is back-loaded with the measures envisaged in the programme taking full effect in 2006. The authorities are determined to keep the deficit under control by making timely adjustments of spending in order to meet the targets. To this end, a novel measure was included in the implementation bill to a 2004 supplementary budget. It stipulates the government's discretion to reduce expenditure up to 15 billion tolars (0.25% of GDP) in the course of the year, proportional to a revenue shortfall due to an economic downturn, without having to propose the budget to be amended. If unfavourable macroeconomic trends persist, the government is, nevertheless, willing to accept a limited budget deficit overrun (up to 10 billion tolars, i.e. 0.2% of GDP) so as to attenuate the negative effects of the economic cycle. This would obviously lead to a deviation from the targets as provided in the programme.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	Change: 2007-2003
Revenues	44.0	45.1	44.0	43.6	42.7	-1.3
of which:						
- Taxes & social security contributions	41.4	41.3	40.2	39.8	39.6	-1.8
- Other (residual)	2.6	3.8	3.7	3.8	3.1	+0.5
Expenditure	45.8	47.0	45.7	45.1	43.6	-2.2
of which:						
- Primary expenditure	43.9	46.2	44.1	43.6	42.2	-1.7
of which:						
Gross fixed capital formation	2.6	3.3	3.0	3.0	2.8	+0.2
Collective consumption	8.7	8.6	8.2	8.0	7.7	-1.0
Transfers & subsidies	18.7	18.8	18.3	18.4	17.7	-1.0
Other (residual)	13.8	15.5	14.6	14.3	13.9	+0.1
- Interest payments	1.9	1.8	1.6	1.5	1.4	-0.5
Budget balance	-1.8	-1.9	-1.8	-1.5	-0.9	+0.9
Primary balance	-0.3	-0.3	-0.4	-0.2	0.4	+0.7

Note:
Individual consumption expenditure, i.e. social benefits in kind is included in the Transfers & subsidies expenditure item, following the spending breakdown as presented in the convergence programme, which does not discern between social benefits in kind and social benefits other than in kind.
Sources:
Convergence programme; ECFIN calculations

The authorities have argued that public finances stand to incur additional pressures mainly due to the financial implications of EU and NATO membership as well as linked to policy priorities favouring state financing of large infrastructure projects. According to the programme, the high share of mandatory expenditure leaves little space to assume any new "financial obligations"[9], or to cope with co-financing and additionality principles in relation to EU funds. Such attitude, however, seems to disregard the discretion of the authorities to mitigate the pressure by making adequate savings on other expenditures in the budget. Conferring to fiscal policy an important role of contributing to an improved economic performance (bolstering economic growth and competitiveness of the Slovene economy) the programme, on the other hand, appropriately emphasises the need to respond suitably to economic shocks. It states that, in the run-up to EMU participation, moderate general government deficits would give fiscal policy more room for manoeuvre in case of asymmetric shocks.

To this end, the authorities have fixed an agenda for fiscal policy changes to be carried out. On the revenue side, tax restructuring – such as to increase the tax capacity while maintaining the present tax burden on the economy – is underway. Furthermore, policy efforts have duly focused on restructuring public sector expenditure. The government has redesigned the reform package to proceed with cutting the high fixed share of spending commitments. Pursuing de-indexation of public sector wages and social benefits has become paramount.

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[9] The programme fails to explicitly indicate any examples of such deficit-increasing "additional obligations" but one can presume the reference relates to setting up the Schengen border as an EU commitment and professionalisation of the Slovene Army, following the NATO entry, in particular.

4.3. Targets and adjustment in 2004

The Parliament adopted the budget for 2004 together with the amended 2003 budget in December 2002. From December 2003 a supplementary 2004 budget is in force. Although the deficit has now fallen below 2% of GDP and the two-year budgetary planning horizon is said to uphold fiscal discipline, there remain some concerns about the public finances in 2004. Comparing the budgetary objectives to the 2003 pre-accession economic programme, the convergence programme increased both the expenditure and revenue ratios and revised the general government balance from -1.6 to -1.9% of GDP. Despite the anticipation of an economic rebound, this target is slightly worse than last year's outcome and is due to growing deficits of the central government since structural reforms are slow to implement and bear fruit. With expenditure policy geared to reducing the structural deficit, measures in the 2004 budget mostly apply to the restructuring of spending to meet the requirements for drawing from the EU structural funds. Having regard to this, a significant rise in the share of investment expenditure has been projected.

The authorities are determined to adhere to the targets and have the discretion to reduce expenditure proportionally – up to 15 bio tolars (0.25% of GDP) – should an economic downturn provoke a revenue shortfall, as stipulated in the implementation bill to the 2004 supplementary budget for the first time. In case of persistently bleak macroeconomic conditions, the government will let automatic stabilisers operate admittedly to only limited extent (increasing the deficit by maximum 0.2% of GDP). At 1.9% of GDP, the baseline government deficit target for 2004 is broadly in line with the Commission services forecast of 1.7% – although slippages may occur in relation to the European Parliament elections taking place in June and national parliamentary elections scheduled for November.

4.4. Targets and adjustment in 2005 and beyond

Having revised the 2003 pre-accession programme projection upwards by 0.2 percentage points, the government targets a 1.8% of GDP general government deficit in 2005, in line with the Commission services forecast on a no-policy change basis. The deficit is expected to decrease only marginally despite the planned budgetary measures: a change in the revenue policy – reforming the direct taxes as well as improving the tax administration – and expenditure limits. After 2005, deficit is projected to decline at a faster pace to reach 0.9% of GDP by 2007.

In 2004, new personal and corporate income tax legislation was adopted, coming into effect in January 2005. The new personal income tax regime, designed to provide tax relief for the lowest income classes, will reduce government revenues. This is expected to be compensated by an increase in corporate income tax, following a broadening of the tax base and the elimination of loopholes in the legislation. The introduction of the real estate tax planned for 2006, which will replace the current local tax, is expected to have a neutral fiscal effect. Also, further harmonisation of excise duties with the acquis should remain a stable revenue source. The tax reform is such to assure revenue-neutrality, but losses in VAT receipts and customs duties as border controls are replaced by the European declaration system – judged less efficient by the authorities – lead to an overall fall of revenues (estimated at 0.6% of GDP in 2007 by the authorities).

On the expenditure side, the measures enhancing cost effectiveness and flexibility (in particular, moderation of wage rises and social transfer increases through weakened

indexation mechanisms) are expected to result in savings, which will be partly offset by additional spending commitments related to EU accession (e.g. Schengen border). A substantial pressure is to stem from top-up payments related to the farming sector.

The convergence programme contains a sensitivity analysis that explores the potential impact of the changes in key economic variables on general government expenditure and revenue and the overall government deficit. The analysis of the responsiveness of the budget deficit to the changes in GDP levels, nominal interest rates, and inflation reveals only a minor impact – up to 0.2% of GDP.

4.5. Debt ratio

According to the convergence programme, the gross public debt increased to 28.6% of GDP in 2003.[10] Over the programme horizon, the debt ratio will remain relatively low although the government anticipates a further rise in the first two years given the persistent primary deficit. The gross public debt is expected to peak at 29.5% in 2005, when the debt incurred by the health fund is transferred to the state budget. As higher government expenditure, linked to investment in infrastructure, is offset by smaller debt of the pension fund and lower central government deficit, the debt ratio is forecast to retreat to 28.4% by 2007. The Commission Spring 2004 forecast, on the other hand, assumed that new borrowing would increase the debt from 27.1% of GDP to 28.3% this year, and forecast to stabilise around that level in 2005, according to a no-policy change assumption. The Commission projections did not account for the revenue generated by the sale of state property, in the absence of clear plans on how to use privatisation proceeds to retire the public debt.

The debt portfolio is deemed appropriate by the authorities since a long-term repayment profile spreads evenly over time while the currency structure supports a growing share of tolar-denominated debt and a predominantly euro-denominated external debt. For the medium-term, the government plans to enforce a more active policy of debt management and expects to lower the contribution of interest expenditure to the change in gross debt from 1.6% of GDP in 2003 to 1.3 % of GDP by 2007.[11]

A short discussion on debt sustainability in the programme reveals that inflation and exchange rate developments will not significantly affect the debt level over the medium term. Furthermore, the relation between nominal GDP growth and the interest rate should facilitate the stabilisation of debt.

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[10] According to the March 2004 fiscal notification the debt decreased to 27.1% of GDP in 2003 compared to 27.8% in 2002. The discrepancy between the debt figures reported in the fiscal notification and the convergence programme, respectively, is due to different data concerning interest accrued, inclusion of the debt incurred by the railway agency and restitution bonds RS 21and RS 39, pertaining to the latter, as well as the revised GDP data.

[11] In 2003, the first 10-year government bond with nominal, fixed interest rate was issued. This was a necessary step towards establishing a long-term interest rate thereby allowing a quantification of the compliance with the convergence criteria for entering EMU.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	27.1	28.6	28.3	29.1	28.2	29.5	29.4	28.4
Change in debt ratio (1 = 2+3+6)	-0.7	-0.2	1.2	0.5	-0.1	0.4	-0.1	-1.0
Contributions:								
- primary deficit (2)	-0.1	0.3	0.1	0.3	0.1	0.4	0.2	-0.4
- snow-ball effect (3 = 4+5)	-0.2	-0.5	0.1	-0.3	-0.3	-0.4	-0.5	-0.5
- interest expenditure (4)	1.9	1.6	1.7	1.6	1.6	1.4	1.3	1.3
- nominal GDP growth (5)	-2.1	-2.1	-1.6	-1.9	-1.9	-1.9	-1.8	-1.8
- stock-flow adjustment (6)	-0.4	0.1	1.0	0.5	0.1	0.5	0.2	-0.2

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth.
Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM); ECFIN calculations

5. THE QUALITY OF THE PUBLIC FINANCES

The budget is characterised by a high share of fixed commitments, accounting for more than 80% of total budget expenditures. In the past, this feature led to failures in achieving the targets and to the adoption of supplementary budgets. Limiting the high share of nondiscretionary expenditure remains key to increasing fiscal flexibility and reallocating resources. With reference to the goal of enhancing adaptability and effectiveness of public finances in the medium-term the programme announces a number of measures aimed at restructuring general government expenditure and revenue.

On the revenue side, the reform gives priority to changes in direct taxes: the simplification of personal income tax, the modification of corporate income tax and the introduction of a real estate tax. The new tax regime, entering into force in 2005, was designed to cut labour costs and increase taxes on capital. However, in line with the aim to boost economic growth through the promotion of innovation and technological development, investments in research and employment creation will be entitled to tax relief, which should encourage entrepreneurship. Furthermore, the government promised to gradually reduce the payroll taxes to boost competitiveness. In addition, improvements in the collection of tax administration are foreseen. Still, total revenues are expected to diminish slightly as a share of GDP over the programme horizon.

On the expenditure side, explicit measures have been taken for containing the rise in public wages and social benefits through weakened indexation mechanisms. The new wage policy agreement, introducing forward-looking indexation, will help limit wage growth. However, social benefits de-indexation remains to be pursued further. Moreover, with the implementation of the new Public Sector Salaries Act, new employment and promotions will be restricted. Furthermore, the government laid down measures geared to increasing the cost effectiveness of the public administration (enforcing cuts in discretionary spending of individual ministries mainly through rationalisation of material

costs) and an ongoing restructuring of expenditures (i.e. reallocation towards expenditure items favouring investment in education and research and promoting regional cohesion). Assuming all the planned measures are endorsed timely, the share of total expenditure in GDP is expected to fall below 44% by 2007, since expenditure related to cohesion and structural policy has not been accounted for.

The convergence programme suggests a back-loaded fiscal consolidation, postponing the deficit reduction to the far end of the programme horizon. It largely emanates from the ongoing expenditure reform, which has been designed in a way to operate fully from 2006. Starting in 2004, collective consumption should decrease steadily mainly due to wage moderation while social transfers are expected to decline thanks to smaller social benefit expenditure assuming that indexation mechanisms are further weakened. To a minor extent, the budgetary adjustment is to come from revenue restructuring as the net impact of the tax reform on revenues is limited. Total revenue, excluding cohesion and structural funds, is expected to fall by 0.6% of GDP.

The programme briefly reviews the government's structural reform agenda which focuses on enhancing the competitiveness of the economy by increasing the share of R&D expenditures in the budget. It also announces measures to sustain economic growth, e.g. promoting job-creation oriented investment and removing structural rigidities in the labour market. However, budgetary implications remain vague as the intentions regarding structural reforms seem fairly general and are only exceptionally accompanied by well elaborated measures.[12] Moreover, the planned structural reforms have not been quantified in the projections of the main fiscal aggregates.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The programme briefly discusses the long-term sustainability of public finances: based on a set of demographic and macroeconomic assumptions, projections for public expenditures on pensions and health care until 2050 are presented.

According to the programme, the future demographic situation in Slovenia will be characterised by a low fertility rate (currently at the level of 1.2) and rapidly increasing life expectancy. Under such circumstances, the old-age dependency ratio is expected to increase substantially from 23.5% in 2004 to 56.4% in 2050. Despite the expected positive migration balance and the optimistic assumption of a substantial rise in total participation rates from 67.4% in 2005 to 80.0% in 2050, demographic developments entail high budgetary pressures in the future.

In order to contain the budgetary costs of ageing Slovenia has been implementing pension system reform since 2000. Measures such as an increase in the retirement age and the introduction of a voluntary pension scheme are expected to prevent expenditures from increasing significantly in the next two decades. Moreover, a thorough reform of the health care system, with an aim to rationalise it, is being planned – although no decisions have been taken yet the programme nevertheless envisages that measures will be gradually phased in as of 2005. In addition, measures included in the National Programme of Labour Market and Employment Development 2000-2006, coupled with

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[12] For instance, the programme anticipates the reinforcement of active employment policy but does not specify the relevant measures. The fiscal effect remains ambiguous as normally such a policy implies pressures on the budget.

the improvements in the social security systems should promote a rise in the total participation rate. They should temporarily reduce the budgetary burden of ageing and consequently, improve the prospects for the long-term sustainability of public finances.

According to the programme projections, overall age-related expenditures are to increase substantially, by 6.5% of GDP over the period 2005-2050: pension expenditures by 4.3% of GDP (in spite of the measures mentioned above) and health care spending by 2.2%. Particularly significant is the anticipated dynamics of pension and health care spending in the period 2020 – 2040, when the full impact of ageing translates into a rapid increase in the two expenditure items. To put the relatively high budgetary pressures in the future in perspective, it has to be noted, however, that the debt ratio, standing at 28.6% of GDP in 2003, is relatively low. Simultaneously, implicit interest rates on debt are falling, thus pointing to a declining overall debt burden in the programme period. This is supported by the programme's budgetary strategy of further budgetary consolidation over the programme period, which is compatible with improving the long-term sustainability of the public finances.

On the basis of current policies, the risk of budgetary imbalances in the future cannot be ruled out. Although the Pension and Disability Insurance Fund and the Health Insurance Fund are not expected to run deficits after 2005, developments regarding the financing of the two compulsory social insurance funds should be closely monitored. More generally, in view of the sizeable budgetary pressure stemming from the demographic projections and the optimistic underlying assumptions regarding participation and unemployment rates, it is of the utmost importance to continue with the implementation of pension reform and design a financially stable health care system.

Summing up, although the implementation of the pension reform measures has been gradually improving the prospects for the long-run sustainability of public finances, risks remain given the expected unfavourable demographic developments. Currently, Slovenia has a relatively low level of government debt. Securing an adequate primary surplus is important to maintain a low level of debt. In this respect, plans of further budgetary consolidation over the programme period are compatible with strengthening the long-term sustainability of public finances. Nevertheless, an overall strategy that explicitly addresses the projected surge in age-related expenditures is required, including a comprehensive reform of pension- and health care systems. Coupled with the improvements in the social security system further labour market measures should be beneficial for increasing the employment rates.

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ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	2.3	3.6	3.7	3.8	3.9
GDP *level* at *current* market prices, SIT bn.	5,671	6,085	6,502	6,918	7,361
GDP deflator	5.1	3.6	3.0	2.5	2.4
HICP change [1]	5.6	3.3	3.0	2.7	2.6
Employment growth [2]	-0.2	0.4	0.6	0.6	0.7
Labour productivity growth [3]	2.5	3.2	3.1	3.2	3.2
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	3.1	3.5	3.4	3.3	3.3
2. Government consumption expenditure	2.8	3.0	2.6	2.9	2.8
3. Gross fixed capital formation	5.5	7.6	7.0	5.0	5.5
4. Changes in inventories and net acquisition of valuables as a % of GDP [3]	1.2	1.3	1.3	1.4	1.4
5. Exports of goods and services	3.4	5.5	6.0	6.3	6.6
6. Imports of goods and services	6.3	6.8	6.6	6.2	6.3
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	4.3	4.6	4.4	3.9	3.9
8. Change in inventories and net acquisition of valuables (=4) [3]	0.9	0.1	0.1	0.2	0.0
9. External balance of goods and services (5-6)	-2.0	-1.0	-0.7	-0.1	0.0

(1) CPI change - forecasts of the Institute for Macroeconomic Analysis and Development (IMAD)
(2) Employed population, domestic concept, according to national accounts definition.
(3) Growth of GDP at market prices per person employed at constant prices.

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors					
1. General government	-1.8	-1.9	-1.8	-1.5	-0.9
2. Central government	-1.6	-1.6	-1.8	-1.5	-1.0
3. State government	-	-	-	-	-
4. Local government	-0.1	-0.1	0.0	0.0	0.0
5. Social security funds	-0.1	-0.2	0.1	0.1	0.1
General government					
6. Total receipts	44.0	45.1	44.0	43.6	42.7
7. Total expenditures	45.8	47.0	45.7	45.1	43.6
8. Budget balance	-1.8	-1.9	-1.8	-1.5	-0.9
9. Net interest payments	-1.6	-1.6	-1.4	-1.3	-1.3
10. Primary balance	-0.3	-0.3	-0.4	-0.2	0.4
Components of revenues					
11. Taxes	26.4	26.6	25.6	25.2	25.1
12. Social contributions	15.0	14.7	14.7	14.6	14.5
13. Interest income	0.3	0.2	0.2	0.2	0.2
14. Other	2.6	3.8	3.7	3.8	3.1
15. Total receipts	44.0	45.1	44.0	43.6	42.7
Components of expenditures					
16. Collective consumption	8.7	8.6	8.2	8.0	7.7
17. Social transfers in kind [1]	-	-	-	-	-
18. Social transfers other than in kind	17.5	17.3	16.9	16.6	16.2
19. Interest payments	1.9	1.8	1.6	1.5	1.4
20. Subsidies	1.2	1.5	1.4	1.8	1.5
21. Gross fixed capital formation	2.6	3.3	3.0	3.0	2.8
22. Other	13.8	14.5	14.6	14.3	13.9
23. Total expenditures	45.8	47.0	45.7	45.1	43.6

(1) The convergence programme does not provide data for social transfers in kind as they are considered inseparable from social transfers other than in kind.

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	28.6	29.1	29.5	29.4	28.4
Change in gross debt	-0.2	0.5	0.4	-0.1	-1.0
Contributions to change in gross debt					
Primary balance	0.3	0.3	0.4	0.2	-0.4
Interest payments	1.6	1.6	1.4	1.3	1.3
Nominal GDP growth	-0.6	-1.4	-1.5	-1.4	-1.5
Other factors influencing the debt ratio	-1.5	0.0	0.1	-0.2	-0.4
Of which: Privatisation receipts					
p.m. implicit interest rate on debt	6.9	5.9	5.4	5.0	4.9

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007
1. GDP growth at constant prices	2.3	3.6	3.7	3.8	3.9
2. Actual balance	-1.8	-1.9	-1.8	-1.5	-0.9
3. Interest payments	1.9	1.8	1.6	1.5	1.4
4. Potential GDP growth	3.7	3.5	3.6	3.6	3.7
5. Output gap	-1.0	-1.0	-0.8	-0.6	-0.4
6. Cyclical budgetary component	-0.5	-0.6	-0.4	-0.3	-0.2
7. Cyclically-adjusted balance (2-6)	-1.3	-1.4	-1.3	-1.2	-0.7
8. Cyclically-adjusted primary balance (7-3)	0.3	0.2	0.1	0.2	0.6

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	3.1	3.9	4.0	4.4	-
Latest update	2.3	3.6	3.7	3.8	3.9
Difference	-0.8	-0.3	-0.3	-0.6	-
Actual budget balance					
Previous update	-2.0	-1.6	-1.6	-1.3	-
Latest update	-1.8	-1.9	-1.8	-1.5	-0.9
Difference	0.1	-0.3	-0.2	-0.2	-
Gross debt levels					
Previous update	-	-	-	-	-
Latest update	28.6	29.1	29.5	29.4	28.4
Difference	-	-	-	-	-

Table 6. Long-term sustainability of public finances

% of GDP	2005	2010	2020	2030	2040	2050
Total expenditure	42.8	42.0	41.4	42.3	44.5	47.3
Old age pensions	12.5	12.2	13.1	14.6	16.2	16.8
Health care (including care for the elderly)	6.7	6.8	7.2	7.8	8.5	8.9
Interest payments	1.6	1.2	0.4	0.1	0.9	3.5
Total revenues	42.2	42.5	42.6	41.8	40.7	39.0
Of which: from pension contributions	9.5	9.6	9.8	9.7	9.6	9.4
National pension fund assets (if any)	42.8	42.0	41.4	42.3	44.5	47.3
Assumptions						
Labour productivity growth	3.1	3.5	3.0	3.0	3.0	3.0
Real GDP growth	3.7	4.3	2.5	2.4	2.3	2.2
Participation rate males (aged 20-64)	71.3	73.8	76.8	78.8	80.9	84.6
Participation rates females (aged 20-64)	63.4	66.0	69.0	73.0	75.0	75.0
Total participation rates (aged 20-64)	67.4	70.0	73.0	76.0	78.0	80.0
Unemployment rate	6.3	3.6	2.0	2.0	2.0	2.0

Table 7. Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)					
Long-term interest rate (annual average)					
United States: short-term (three-month money market)					
United States: long term (10-year government bonds)					
USD/€exchange rate (annual average)	1.13	1.23	1.22	1.22	1.22
Nominal effective exchange rate (euro area)					
Nominal effective exchange rate (EU)					
SIT/€exchange rate (annual average)	233.7	238.7	239.8	239.8	239.8
World GDP growth, excluding EU	3.7	4.5	4.3		
United States, GDP growth	3.1	4.2	3.7		
Japan, GDP growth	2.7	2.8	1.6		
EU-15 GDP growth	0.8	1.9	2.2		
Growth of relevant foreign markets	4.5	6.4	6.8		
World import volumes, excluding EU	5.6	8.3	7.8		
World import prices (goods, in USD)	12.8	1.7	1.4		
Oil prices (Brent, USD/barrel)	28.8	27.7	26.0		
Non-oil commodity prices (in USD)	9.8	11.3	-4.7		