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**Slovenia and the EU: successes and challenges**

I still remember vividly the envious comments of my US colleague with whom I have studied and worked at the IU School of Business, Bloomington, Indiana before Slovenia became a widely recognized new country. He pointed out that, while he was “confined to ivory tower academic work”, I had the privilege of being deeply involved in “building a new country”.

When enormous political, economic and institutional changes started in Slovenia at the end of the 80s, I was lucky that my knowledge was in the field of (market economy) finance. This was more of a rarity than a common feature in small Slovenia at the time. Hence, I was asked to assist in developing the financial system and institutions needed for the new country, as well as in transitioning from the Yugoslav economic system of self-management with limited need of finance to market economy where finance is playing one of the major roles. Professionally and academically these were exceptionally exciting times for me that came with enormous responsibility and exhausting work.

As it was, “the transition to market economy with democratic political system” began way before Slovenia formally entered the EU in May 2004, some 15 years earlier. It all started with a military conflict that followed the declaration of Slovenia’s independence. A new country could only start functioning with proper institution and capacity building and by getting a worldwide recognition. The positive spirit, the satisfaction and joy to achieve the dream of our own independent country, extremely motivated and professional leaders all contributed to the success of this formidable task.

In my opinion, the main driving forces for reforms were the goals ahead of us: of becoming a member of the EU, adopting Euro as a new currency, entering the Schengen zone, becoming a member of the OECD, … all the elements of joining the club of developed countries with a bright future. In Slovenia, the support for these integrations was amongst the highest in the EU. Even before the formal negotiations have started, the perspective of integration alone was driving the necessary changes.

The fear of failing to complete the formal integration in the first wave forced the leaders of the country to put the most skilled and experienced individuals to top positions. They not only led very prudent and growth enhancing economic policy (monetary as well as fiscal) but also negotiated better terms in integration agreements (i.e. EU Association Agreement) than a number of other transition countries.

In spite of high professionalism, the transition and integration tasks were extremely demanding as there were no established good practices and the structure of the economy was very specific. Opinions on the best course of action differed greatly between the European Commission, the international (financial) organizations, and the Slovenian economists. The views expressed were sometimes coming from opposing angles, many times reflecting vested interests behind the proposals. The most heated disagreements were on how to privatize and on whether to adopt a fixed or flexible exchange rate policy. I was heavily involved in these discussions, not only through my academic work and its dissemination through articles and interviews but also through consultancy to the government as coordinator of many projects (i.e. strategy for the development of financial system, privatization of certain industries,) as a
member of strategic councils, and in delivering the agreed changes through a number of positions I was appointed to (i.e. member of the national bank council, chairman of the Slovenian SEC, minister of finance).

First 15 years of transition (from 1989 to 2004)

This period was analyzed at its end in a paper entitled: “Soft Landing” in the ERM2: Lessons from Slovenia. Written together with Velimir Bole, my economic adviser during my first term as finance minister. We presented the logic of the economic decision-making used in the process of joining the EU and EMU for Slovenia that in our opinion proved successful. Our main observations were the following:

At the beginning of the 1990’s there was a wide discussion among academics and politicians on the sequencing priorities the countries in transition should follow – first, structural changes and then macroeconomic stability, or vice versa; gradualist or «big-bang» approach. Generally, the European transition countries also set the goal of joining the EU, and ultimately, the EMU. Nominal and real convergence was necessary to successfully join the EU and EMU. They required very complex (and difficult) economic decisions. This caused not only additional requirements for structural changes, but also new exogenous shocks and additional constraints in their economic policies.

In this period Slovenia undertook its transition in three phases. Gradualism was the main characteristic of the three, while the priority of macroeconomic stabilization was followed in the first phase until 1995 and structural adjustments in the second phase until 2000. Slovenia needed an additional phase, called the «landing phase» that ended by entering EU in May 2004 and ERM2 less than two months later.

In the period after 1995, structural adjustments were needed to mitigate market distortions. Distortions in the market structure, especially in the non-tradable (versus tradable) sector, distortions (segmentation and lack of flexibility) on the labor market, unsustainable pension system and shallowness of the financial intermediation were among the most important areas of the change.

By 1999 Slovenia achieved a considerable level of macroeconomic stability with quite stable economic growth and low unemployment. At the same time, market structure distortions and a slowly but stubbornly deteriorating fiscal stance were the main macroeconomic drawbacks. Additionally, EU accession commitments and fixed horizon of convergence policy triggered changes in the macroeconomic environment. Capital controls had to be removed, VAT and excises introduced, and several regulated prices adjusted and economic policy constraints increased. Policy goals were changed as well, as short-term nominal convergence to Maastricht criteria came into policy focus. However, to prevent potential high macroeconomic costs (in terms of real convergence) of such enforced nominal convergence, structural as well as macroeconomic policy changes were necessary. Fiscal pressures and

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market structure differences between tradable and non-tradable sector were the main constraints of policy makers in the landing phase.

In the landing phase, during my first term as finance minister, we used two strategic principles of economic policy: the basic principle of not allowing equilibrium in one segment to be achieved by causing or allowing disequilibrium in other main macroeconomic segments, and that of high coordination of the monetary and fiscal policy.

The monetary policy focused on controlling domestic demand to curb prices of non-tradables. To be instrumentally consistent, monetary policy used the flexible exchange rate policy for keeping the interest rate differences between the Slovenian currency, tolar, and foreign exchange denominated financial claims equal to the foreign currency risk premium.

The fiscal policy was active in achieving fiscal convergence criteria and, in coordination with the monetary policy, also in supporting convergence of nominal long-term interest rates and inflation. It activated a series of measures by which de-indexation, lowering of inflation expectations, mitigation of supply side price shocks (triggered by regulated prices and tax policy), government debt restructuring, stricter control, and restructuring of government spending, were implemented.

A well-designed interplay of both policies was essential for mitigating long and short-term threats of slower real convergence because of enforced nominal convergence. Achieving the Maastricht criteria went hand in hand with relatively high economic growth, low unemployment and external equilibrium.

Positive climate in the society with demanding accession commitments on one side, and sound, quite unique economic policy with deep structural changes on the other side, lead to a fast nominal and real conversion process. GDP per capita in PPP as percentage of EU28 average increased by 10 percentage points, from 75% to 85%, in the period from 1995 to 2004 (4th best relative increase among transition countries with maintaining the highest GDP per capita in PPP).

Second 15 years (from 2004 to 2019)

Unfortunately, this period will be recorded completely differently, since the same level of GDP per capita in PPP as percentage of EU28 was achieved in 2017 (the latest data) as in 2004 (85%), and the Czech Republic overtook Slovenia with the highest GDP per capita in PPP as percentage of EU28 among transition countries. This was primarily the consequence of inadequate economic policies before the world financial crises, where the impact of joining the EMU on flexibility of economic policy and a need of increased fiscal policy flexibility was not understood. Also, ill designed methodology of estimating the potential output for the purpose of EA fiscal coordination and led to enormous loss of GDP during the crisis. Further, inability to react swiftly to the crisis after it occurred caused its deepening and prolonging to almost six years.

Abandoning the stability paradigm in 2005 was the key decision that lead to a procyclical economic policy with anti-pension reform, an increase of government spending for public sector wages (+17% in two years), intensive highway program as well as tax cuts (full effect: -2.5% GDP), a switch from domestic to foreign public debt, etc. in the overheated world
economic environment. EC’s economic assessment of Slovenia on the basis of inadequate methodology for estimating structural fiscal deficit did not give the needed warning to change the policy. Hence, Slovenia entered the crisis unprepared with 164% increase of foreign debt since 2004, huge structural fiscal deficit and substantial loss of competitiveness.

In such circumstances the new government in 2009 was unable to unblock political standstill that followed the shock and thus insufficiently reacted to the crisis. Important measures (i.e. recapitalization of banks) were prevented due to political disagreements within the government, in the coalition, and between the institutions (i.e. Bank of Slovenia and Ministry of Finance). Although necessary structural reforms (pension, labour market) were adopted in the parliament they were subsequently blocked by (miss)use of referendum and Constitutional Court’s inconsistent rulings.

The procyclical austerity was the economic orientation of the next 2012 government, again inadequately reacting to the crisis. Its measures and reactions to the crisis included reduced public sector wages, reduced public sector employment by freezing new gross employment and layoffs at the age of 65, frozen pensions, bold announcements of austerity measures that caused the biggest reduction in consumer confidence and consumer spending in Slovenia ever, and statements by the top officials declaring the need for „Troika“ that initiated the extraordinary reduction of business and investor’s confidence, sending interest margins to record levels. However, the pension and the labour market structural reforms were adopted, and State Sovereign Holding (SSH) and the bad bank were established as recommended by the European Commission.

Due to an extremely tense political situation, the next government took over in 2013 for only 1.5 years. Heavily guided by the recommendations within the excessive deficit and macroeconomic imbalances procedures and poor access to financial markets the government successfully focused on the structural reforms to rebuild trust of financial markets and competitiveness. Among them were: the necessary changes of the constitution, bank recapitalization, making the bad bank operational, intensive corporate restructuring and enabling the SSH to start operating and privatizing. Planned austerity measures were not fully implemented thus being less procyclical while extensive drawing (positive net) of the remaining EU funds increased highly needed domestic demand. All these measures enabled the switch of economic growth from negative to positive. It is probably fair to conclude that the recommendations of EU institutions and efforts of Slovenia to follow them closely when in agreement, enabled increase of international competitiveness and exceptional growth of exports even during crisis.

The next government served for almost full 4-year term (2014-2018). Serving as finance minister for the second time in the first half of the term was an overwhelming intellectual challenge. After a thorough economic analysis we opted for counter-cyclical economic policy orientation of stability with growth. The concept was extensively debated with the EC and differences of opinions helped us to avoid important mistakes. The structure of the orientation was:

1. **Fiscal stimulus:**
   - Intensive drawing of a large share (net 2.9% GDP) of the 2007-2013 financial perspective of EU funds still at disposal
   - Public expenditure growth lower than revenue growth but positive
• Mid-term fiscal objective in 2020 (not recommended 2017)
• 2015 – fiscal effort goal only nominal deficit of less than 3%
• 2016, 2017 – EU addressed inappropriate results of structural fiscal deficit estimates and reduced requested fiscal effort for Slovenia

2. **Domestic private demand** - restoring business and consumer confidence with political stability, non-aggressive agreement type decision making, social agreement reached for 2015/16, cover wage agreements with labour unions before each Christmas, continuous system changes for the improvements of business environment, etc.

3. **Improving efficiency of public investments** with channeling public funds into projects with higher GDP multiplier and wit improvement of control.

4. **Structural changes concerning:**
   - Fiscal sustainability
   - Improvement of business environment:
     1. Restoring financing:
        1. Bank recapitalization and restructuring
        2. Restructuring of troubled firms (also through privatization)
     2. Reducing administrative burden
        1. Simplifying construction and environmental permits
        2. Simplifying tax procedures
     3. Improving competitiveness:
        1. Improving efficiency of state owned firms
        2. Improvements in the legal system
        3. Tax shifting

The economic results were outstanding, nevertheless, they required enormous effort as public distrust and negative attitude towards politics after a long hardship during the severe crisis was making policy decisions and delivery very hard work.

**The next 15 years**

The crisis revealed very painfully that EMU (EU) is not designed well for the downturn. For Slovenia and many peripheral EU countries, the costs of misdiagnosis of the situation after 2005 were enormous. To put it mildly, the consequences of the very strange signals of the key European fiscal framework indicators (the potential output, output gap and structural deficit) prepared by the Commission in 2016, could have also been very painful. However, only detecting and avoiding the wrong estimates of the potential output concepts for Slovenia prepared by the European fiscal framework is not enough. National macroeconomic stability, especially in small economies, needs a new logic and implementation of the European stabilization framework.

Especially EA’s peripheral countries were struggling to overcome serious challenges of the crisis, with core countries in most cases designing the solutions. Lessons learned are reflected in current very intense debates on how to deepen the EA and opinions are very diverse. Let me point out one topic that is not only very relevant to non-core, former countries in transition, but also to the EA (EU) as a whole.

The usual starting point in discussions of EA deepening is that the changes should prevent irresponsible behaviour of peripheral countries that affects the whole EA. However, there is
ample evidence that EMU is not weak (shallow) primarily because of irresponsible behaviour of the so called „Periphery”.

First, the EMU’s monetary policy is designed for the needs of the Core and is ill suited for the Periphery - in many cases not active enough. Second, the fiscal rules disable efficient fiscal policy, especially during crisis, and the current fiscal rules are highly procyclical thus detrimental especially for the Periphery. Namely, partly based on my experiences since most research does not study shocks in the Periphery but predominantly in the Core, the Periphery is much more prone to asymmetric shocks than the Core due to a different structure of the economy. Solving the problem of asymmetry with structural reforms that lead to full convergence is an illusion. For example, Slovenia can never reach Germany’s structure of economy for numerous reasons (size, infrastructure, geographies, specialization, labour force ...). Also, shocks in the Periphery are amplified by serving as a shock absorber (i.e. Vienna agreement, real estate investments in Spain, ...) for the Core.

Economic difficulties in one peripheral country immediately cause contagion in other Peripheries, and major ones spread also to the Core. As can be clearly seen from the following table, when Slovenia had all economic policy instruments available, mostly before June 2004 when it entered EU and ERM2 and EU fiscal rules and ECB monetary policy prevailed, its economic policy was much more prudent than that of the core or the whole EA.

<table>
<thead>
<tr>
<th></th>
<th>General gov. balance % of GDP</th>
<th>General gov. debt % of GDP</th>
<th>GDP growth in %</th>
<th>GDP PPP pc EU28 = 100</th>
<th>General gov. balance % of GDP</th>
<th>General gov. debt % of GDP</th>
<th>GDP growth in %</th>
<th>GDP PPP pc EU28 = 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro area 19</td>
<td>-3,0</td>
<td>68,4</td>
<td>2,3</td>
<td>110</td>
<td>Euro area 19</td>
<td>-0,9</td>
<td>86,8</td>
<td>2,4</td>
</tr>
<tr>
<td>Germany</td>
<td>-3,7</td>
<td>64,8</td>
<td>1,2</td>
<td>119</td>
<td>Germany</td>
<td>1,0</td>
<td>63,9</td>
<td>2,2</td>
</tr>
<tr>
<td>France</td>
<td>-3,5</td>
<td>65,7</td>
<td>2,8</td>
<td>109</td>
<td>France</td>
<td>-2,7</td>
<td>98,5</td>
<td>2,2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-2,0</td>
<td>26,8</td>
<td>4,4</td>
<td>85</td>
<td>Slovenia</td>
<td>0,1</td>
<td>73,6</td>
<td>5,0</td>
</tr>
</tbody>
</table>

Source: Eurostat

Thus, the actual problem is that the Periphery is lacking essential economic policy instruments to respond to and neutralize shocks. The solutions should be searched in enabling EMU members to respond pre-emptively or at least immediately with efficient economic policy instruments. The system should be mainly decentralized with the tools available to the members of the EMU for pre-emptive actions to avoid asymmetric shocks. The centralized part should enact a quick (rather automatic) response and not a slow process of conditionality. Also, sometimes the process of conditionality results in a forced privatization of state assets at low prices bought by the Core. Such outcomes are risky also for EU existence.

Instead of a conclusion

I am very proud that Slovenia became a EU country among the first group of transition economies and benefited enormously in the first 15 years during the accession. And even
with the disappointments of the second 15 years, due to our own mistakes and the impact of some inadequate EU arrangements, the pride is still there. And as to the envy of my academic colleagues - no need. There are more than enough intellectual challenges left to enable EU using its full potential for economic prosperity in a peaceful, sustainable and harmonious EU society.