Assessment and recommendations

One of the most advanced transition countries...

Slovenia, a newly independent state from June 1991, occupies a unique place among the economies in transition in Central Europe. In terms of its degree of development, the Slovene economy can in many respects be viewed as closer to Western European countries than to the other former-socialist states of Central Europe. For example, the level of GDP per capita in Slovenia (measured on an exchange rate basis) is currently two to three times that of other Central European states (including the Czech Republic, Hungary and Poland), close to that of Greece and Portugal, and one-third to one-half the level of Austria, France and Germany. The ''lead'' over other countries in Central Europe is substantially smaller when GDP is compared according to purchasing power parities because prices are, in many cases, also comparable with those in Western Europe.

... with long-standing openness to trade and market processes

Many of the distinctive features of Slovenia were already apparent at the time of independence from the former-Yugoslavia. It is therefore crucial to an assessment of Slovenia's *current* performance to understand the country as it *was*, prior to independence and prior to transition to a full market economy. In this regard, two areas seem of particular importance. The first concerns the openness of the economy and the freedom of circulation of people and products across Slovenia's borders. Slovenia was the principal trading arm of former-Yugoslavia, itself the most open economy in Central and Eastern Europe. Moreover, most of this trade was with more advanced market

economies in the West: Germany and Italy were Slovenia's main trading partners in 1990, together taking 40 per cent of exports. Second, enterprises in former-Yugoslavia were characterised by a system of self-management and social capital, the so-called ''market socialism''. This system of decentralised control, where markets were allowed to play a significant role in the allocation of resources throughout the economy, stood in contrast with the much more centralised economic management that prevailed elsewhere in Central and Eastern Europe. As a result of these two characteristics, the overall familiarity with market mechanisms was more developed in Slovenia than in other countries. Consequently, the various aspects of product competitiveness, including quality and variety, were better understood when the transition process started. This made possible a rather rapid catch-up with western standards and practices that has been taking place since the early 1990s. These aspects are visible and striking for a visitor during his or her first contacts with the Slovene economy. Nevertheless, despite this relatively favourable situation, Slovenia can rightly be viewed as an economy in transition. Market socialism, combined with the break-up of former-Yugoslavia and its aftermath, have left a legacy of difficulties at both macroeconomic and structural levels. These will be discussed below.

After the transition shock, growth resumed earlier than in other transition economies. There was a rapid trade re-orientation and the economy was stabilised

Slovenia was among the first transition countries where growth resumed. The recovery started in 1993 with GDP growth of 2.8 per cent, improved to 5.3 per cent growth in 1994 and 3.9 per cent in 1995. In 1996, GDP growth is estimated to have been around 3.5 per cent and Slovenia recovered the GDP level of the pre-transition years. Domestic demand, notably final consumption, has played a large role in recent growth, reflecting in part the large and growing share of the service sector in the economy. The importance of foreign trade becomes much more apparent when industrial output is considered. Indeed, after a deep

contraction from the late 1980s, growth of industrial output accelerated to an impressive 6.4 per cent in 1994. This was made possible by the massive trade re-orientation towards the West, especially Europe. By 1995, the geographic structure of Slovene trade had become dominated by the OECD countries, which account for roughly 80 per cent of trade turnover. Germany is the leading trade partner with 30 per cent of Slovene exports and 23 per cent of imports. This trade re-orientation accentuated the openness of the Slovene economy, where the ratio of exports plus imports of goods and services to GDP reached around 110 per cent in 1995. The current account has been roughly in balance in recent years. At the same time, and consistent with these favourable trade developments, during 1992 and 1993 macroeconomic stabilisation was particularly successful in bringing down inflation from around 300 per cent to just over 20 per cent; then, in late 1995, the inflation rate moved into single digits for the first time since 1976. A main pillar of the stabilisation programme was a prudent fiscal discipline, embodied in a roughly balanced consolidated budget since 1992. Concerning the costs of transition, structural change in the economy has led to a significant rise in unemployment. Nonetheless, when measured by ILO standards, the unemployment rate after peaking at 9.1 per cent in 1993 has declined to just over 7 per cent in 1996.

But, recently, output growth and exports have slowed down and macroeconomic policies for 1997-98 are coming under pressure

After the strong surge in 1994, industrial output was up only by 2 per cent in 1995 and the slowdown continued until the first quarter of 1996. In 1996, output was 1 per cent higher than in 1995. Moreover, total exports of goods (in current US$ terms) were approximately the same in 1996 as in 1995, although they are estimated to have increased by around 2.5 per cent in real terms. Recent output trends may be attributable in part to a lagged effect of a significant and steady deterioration of export competitiveness due to the real exchange rate appreciation (on a

price basis) from mid-94 to mid-95 and nominal wage increases which were not fully compensated by productivity growth. The worsening economic conditions in the EU in general, and Germany in particular, are also likely to have been an important factor explaining this slowdown of industrial output. Given the concentration of trade with EU countries, Slovenia is naturally rather dependent on the economic developments of these trade partners. The slow pace of restructuring in some parts of the economy is also now starting to impinge on the sustainability of economic growth. There are also some signs that macroeconomic policies are progressively losing their impetus in the stabilisation of the economy. For example, retail price inflation increased from 8.6 per cent at end-1995 to above 10 per cent in the first half of 1996 before decreasing again to 8.8 per cent in the year to December 1996. Inflation of around 10 per cent is still far higher than in the OECD economies with which Slovenia is increasingly integrating, and is well above the range where policy-makers should be aiming. On the fiscal side, and despite the fact that the general government budget for 1996 is roughly in balance, the continuation of favourable fiscal outturns in future years will depend on a firm policy stance being implemented towards some areas of structural reform discussed below.

The outlook seems much dependent on the policies to be implemented by the new government

Sustained by improved conditions in foreign markets and competitiveness, exports are picking up again. This should help real activity to strengthen somewhat for 1997 and 1998, with a projected 3.5 to 4 per cent increase in GDP in each of these years. Improved export performance should also maintain a near-balanced position in the current account. However, little change is expected in the inflation rate as there will be upward pressures on prices from further liberalisation of controlled prices (including energy). Moreover, while the precise effect on prices of the proposed introduction of a new value-added tax is still to be

determined, it will presumably contribute to inflationary pressures. Unemployment may decline slowly, but there appear to be substantial structural elements in current unemployment – including concentration of unemployment among the low-skilled and in regions which used to be heavily industrialised. These projections assume that the new government implements a range of proposed fiscal measures and tackles some much-needed areas of spending reform. A firm fiscal position provides the appropriate conditions for the allocation of economic resources to be driven primarily by market mechanisms, so that they flow to the most productive sectors in the economy. In a small open economy like Slovenia, consistency between macro and structural areas of policy reform seems particularly crucial to maximise the chances of sustained growth.

Monetary policy has faced significant pressures from capital inflows, with some unevenness in the pace of disinflation

In the conduct of monetary policy, the Bank of Slovenia's operational emphasis is on the growth rates in the narrow money aggregates. Firm control over monetary growth was instrumental in the rapid disinflation achieved after 1991. While, correspondingly, the exchange rate is allowed to float, its level and direction have nevertheless been influenced at times by various forms of intervention by the Bank in the foreign exchange market. For example, faced with large current account surpluses from 1992 to 1994, the Bank engaged in large-scale intervention and sterilisation in order to limit the impact of these surpluses on the exchange rate and money supply. However, the high costs of these activities subsequently led to their being curtailed. The period from around early-1994 to mid-1995 was marked by general stability in the nominal exchange rate and strong appreciation in the real exchange rate, leading to a further sizeable fall in the inflation rate. With the current account moving into deficit in the second half of 1995, the tolar depreciated sharply – by around 10 per cent against the Deutschemark – in the six months to March 1996, before

stabilising again. This depreciation, along with increases in some controlled prices, contributed to the pick-up in inflation in the first half of 1996.

There is need to make the goal of low inflation more transparent and credible in order to increase confidence in the tolar

The key requirement now facing the monetary authorities is to establish in a transparent manner that low inflation is indeed their main objective, and to demonstrate that policy is clearly and consistently directed towards this goal. In general, the Bank needs to take on a higher profile in order to ''lead'' public opinion and expectations regarding the prospects for further disinflation, and to build confidence in the currency. Persistent uncertainty about inflation and exchange rate developments is suggested by the high level of foreign currency deposits still held at Slovene banks (a development which can be originally explained by the ''memory'' of the hyperinflation period). Currently, around 60 per cent of household deposits are held in this form, and these deposits have been steadily increasing.

Greater publicity for monetary policy operations and objectives would help build credibility

With financial liberalisation, including further opening of the capital account, the need for a broader set of monetary indicators relevant for reaching inflation objectives may arise. This need not imply a departure from the current regime combining money aggregate targets and a floating exchange rate. Nevertheless, given the openness of the economy, exchange rate developments are likely to play an important role in further disinflation. In recent years, lack of transparency in policy operations – including the role of the exchange rate – has at times created room for doubt about whether the Bank's main objective has been to maintain the disinflation process or support external competitiveness. In this regard, the Bank's operational objectives would be more transparent, if published. Such statements could include indicative scenarios or projections for factors expected to influence the inflation outlook, including changes in controlled prices. These scenarios would help to

illustrate the trade-offs involved with different economic choices (such as the implications of higher wage growth), would provide a benchmark for assessing actual monetary conditions, and hence would help financial markets and the public to understand and anticipate policy adjustments. Support is also needed from other areas of policy in winding down inflation. For example, ongoing fiscal restraint would ease the pressure on monetary conditions; de-indexation of wages and interest rates is essential; and further labour market liberalisation would give enterprises greater opportunity to take direct responsibility for maintaining and building their competitiveness.

A budget consolidation strategy is needed to handle the problem of excessive wage growth in the public sector...

As part of the stabilisation package implemented in the early 1990s, a year-to-year balanced budget approach was followed. Looking ahead, however, a more comprehensive medium-term strategy is needed to ensure stability of the macroeconomic environment. In this regard, there are two key areas of reform. The first is related to the increasing wage expenditures. Under social pressures, public sector wage policy has led to the equalisation of wage growth in the so-called economic and non-economic sectors. However, recruitment and retention requirements within overall budget ceilings should be the prime mechanism for setting wages in the public sector. In order to let resources flow to the private sector and achieve better allocative efficiency, the labour market should be allowed to establish firmer links between productivity gains and real wage growth and, in this context, sectoral differences in wage growth should be expected. An excessive focus on average public wage growth has been inducing spill-overs to the rest of the economy and creating budget pressures.

... and to solve the long-run unsustainability of the pension system

A second key area of macro-structural policies is the reform of the pension system. Perhaps also part of the ‘‘closeness’’ of Slovenia to some more advanced Western European economies, the present pension system is unsustainable. In the present system, pensions are provided almost exclusively through a state-run, pay-as-you-go system. Funding comes from social security contributions and transfers from the state budget. These resources will in the future produce a dramatic shortfall compared with the liabilities. The main factors explaining this trend are the rapid ageing of the population and the early retirement policies of the period 1991-92. The elderly dependency ratio is projected to rise from 48 per cent in 1995 to over 90 per cent by 2040. This is also substantially higher than projections for any other OECD country with the exception of Italy. As shown by the simulations presented in the Survey, an increase in the standard retirement age should be considered as part of policy reforms in this area and one of the more direct ways to address this problem. So far, the reform model which seems to be favoured by the authorities would involve a three-pillar pension system, comprising the continuation of a ‘‘slimmed-down’’ version of the current pay-as-you-go scheme, the introduction of compulsory personal pension accounts managed by mutual, public or other forms of funds, and voluntary additional pension savings. These lines of reform seem consistent with recommendations of the major international financial institutions and broadly comparable to reforms currently being implemented in a number of OECD countries. It is important that decisions to reform the pension system take place as soon as possible. Moreover, other policy actions are also needed to ensure the viability of the new system. Among others, an effective regulatory regime has to be put in place to ensure the financial soundness of the pension funds and to promote competition among them. The maintenance of fiscal restraint and low levels of public debt will help provide

greater room for manoeuvre as pressures of the pension system on public sector budgets increase. Finally, further progress toward low inflation and overall monetary policy credibility will encourage growth in long-term financial planning among market institutions and the public in general.

The process of rehabilitation of the banking sector seems in better shape than in most transition countries

Following several years of restructuring, the Slovene banking sector now appears to be in relatively good health compared with other countries in transition. A major rehabilitation programme began in 1993 when the two largest banks were placed under the control of the Bank Rehabilitation Agency. At the time, these banks comprised over half the domestic banking sector and around 45 per cent of their loans were non-performing. Since then, asset quality and financial performance in the sector have significantly improved: the rehabilitated banks now have under 5 per cent of loans which are non-performing, and they along with almost all other banks are currently profitable.

But increased competition and more diversified financial intermediation services are needed as part of the overall restructuring process

However, the need for further development and restructuring is still apparent. While the dominance of the two largest banks has fallen, there are also many small banks which are relatively over-capitalised, but not very efficient. Many of these small banks will probably have to be absorbed by larger banks over the next few years. Despite the large number of banks (28), the financial sector is rather shallow, with the ratios of money aggregates and bank assets to GDP being relatively low in comparison with other countries in Central Europe and with the OECD area. More sophisticated products and services, such as investment banking, are under-developed, and only around 40 per cent of bank assets are in the form of loans to enterprises and other non-financial, non-governmental entities. Moreover, competition in the market for deposits is artificially curtailed through a cartel arrangement – approved by the

anti-monopoly office and the Bank of Slovenia – which sets maximum interest rates on deposits. In addition, close links still appear to exist between some banks and enterprises that are both their owners and clients. This situation, along with state-ownership of the largest banks, raises risks of moral hazard. In most of these areas – with the exception of the deposit cartel – there is little that the government should do in a direct way to produce restructuring and the development of financial services. However, various policy measures should provide more neutral competitive conditions in the sector, and hence encourage market-based reforms. Some of these measures are included in the new Banking Act which is expected in 1997; they include the opening of the sector to branches of foreign banks, and the introduction of a deposit guarantee scheme. A further key step involves the privatisation of the two large banks under the control of the Bank Rehabilitation Agency. Based on their financial performance and condition, these banks now appear ready for privatisation. For Slovenia to receive full value for its investment in these banks, foreign bidders should be encouraged to take part in the privatisation process, a move which should also lead to more rapid growth in domestic banking services and expertise. Finally, while the deposit cartel may have led to short-term reductions in some interest rates, this arrangement is not compatible with longer-run needs to boost competition and innovation, and should be dropped. A ‘‘problem’’ that contributed to the perceived need for such a cartel – apparently the deposit behaviour of certain extra-budgetary funds – would be better dealt with by integrating these funds into the main fiscal monitoring and control regime.

Privatisation has been a complicated process which is near to completion

Transformation of the former ''socially'' owned enterprises into both private and state ownership has been a complicated and slow process which is expected to be finished some time in 1997. By the end of 1996, the share of the private sector in the economy, which has been increasing gradually, passed the 50 per cent mark of value added and employment. At the end of the current privatisation process, the breakdown of value added is expected to be around two-thirds private and one-third public.

However, the conditions for improved corporate governance may not yet be fulfilled

The privatisation of previously socially-owned enterprises does not necessarily, by the very fact of privatisation, change their incentive structure. Indeed, all that the privatisation did was to transfer the ownership rights to a diverse group of institutional investors, insiders, and small (outside) investors, with different interests and areas of expertise. For this reason, there are pending problems with institution building and corporate governance. Insiders tend to be averse to external control (both foreign and domestic), slowing the process of change in the short-run. More dynamic, market-based restructuring may nevertheless occur in the longer-term, including increased foreign investment, but will need support from other areas. For example, it is important for the proposed law on take-over and merger actions to be passed and implemented. While it is well understood that there is the need to liberalise capital and labour markets, firmer policy action in these areas is needed.

After the boom in the early years of transition, the process of enterprise creation did not gain momentum...

Given the more favourable starting conditions of Slovenia, as already mentioned, enterprise characteristics appear to be better than in other countries in Central Europe. For example, Slovenia already has a high proportion of small enterprises, which makes the enterprise structure close to the EU average. In addition, the role of very large enterprises (*i.e.* with 5 000 or more employees), generally with major

re-structuring problems, is also less significant in Slovenia. The number of ''dormant'' or ''dead'' enterprises is also under 10 per cent in Slovenia – by far the lowest among the central and eastern European countries. However, the creation and development of new enterprises is crucial for the restructuring process, and as important as the privatisation process itself. Indeed, some evidence gathered for other transition countries tends to show that, in many aspects, the performance of (still) state-owned and privatised companies tends to be comparable whereas the *ex novo* firms stand out both in terms of productivity and employment creation. In this regard, there are some signs that the pace of enterprise creation in Slovenia slowed down in recent years. A simple relation between income levels and enterprise density estimated for a group of transition countries suggests that there is scope for further enterprise creation in Slovenia. Despite a favourable economic climate and legal environment, the high level of real interest rates does not support investment and the creation of new firms. This illustrates the need for macroeconomic policy to be consistent with and reinforce structural polices.

... and some big loss-making companies are crowding-out resources from the new private sector

Concerning the degree to which hard budget constraints are ensured at the enterprise level, the evidence in aggregate is that most commercial companies are currently earning profits, but there is still a core group of large, loss-making enterprises. These are probably the main recipients of support provided by the state via some extra-budgetary funds and through subsidies from state and local budgets. While such support may find justification in the adjustment ''shocks'' faced by these firms and the local communities in which they operate, it is essential that assistance be of limited duration and directed at restructuring the operations of these companies, preserving the viable parts (if any) of their activities and eliminating unprofitable areas. It is striking that among the top 20 Slovene enterprises, only roughly

half are displaying significant returns to capital. This also suggests limited progress in restructuring the core of large Slovene enterprises. This transition process can be painful because many of these unrestructured enterprises are also among the largest employers. However, this should not block the restructuring process itself. The risk otherwise is that these companies would be a long-term drain on public resources, and the emergence of new, potentially profitable firms would be crowded out.

Economic restructuring could be enhanced by increased participation of foreign capital

In per capita terms, Slovenia already has – by central and eastern European standards – significant foreign capital participation. Nevertheless, the involvement of foreign investors in the economy could be more important, especially because during the privatisation process there has been some hesitancy to accept foreign capital in Slovene enterprises. Available evidence on the performance of firms having foreign investment participation compared with firms having exclusively domestic capital points out a positive association between foreign capital participation and enterprise performance. Even if foreign investors would naturally have been attracted to companies which were strong to begin with, the indicators such as those relating to financial structure and asset utilisation in these enterprises suggest the sort of standards applying in more advanced economies, and which should therefore signal the direction of restructuring that should be expected of Slovene enterprises. Slovene policy-makers endorse the principle that direct state intervention in the activities of FDI units should be avoided. Nevertheless, Slovenia has to make further progress in the liberalisation of capital movements and financial sector reform in order to open the economy to foreign direct investment. This should be based on stable macroeconomic conditions and transparent regulations, notably equal treatment of foreign investors and domestic enterprises.

Industrial policy should not distort the comparative advantages of the Slovene economy, which appear to be light industries with a relatively high content of R&D and product differentiation

Analysis of trade specialisation shows that Slovenia possesses the advantages of a skilled and productive work force combined with a relatively high degree of product differentiation. These characteristics enable firms operating in product niches to be competitive in rather sophisticated segments of the manufacturing sector. Industries relying merely on cost advantages are in the medium and long-term threatened by the potentially strong competition of neighbouring transition countries, whose industries still have a substantial competitive edge in a context of rapidly increasing productivity. Therefore, the competitive advantages of Slovenia seem to be situated more in terms of quality or product differentiation than in terms of prices. Policies that would aim to restructure heavy loss-making enterprises in traditional industrial sectors would seem to be in contradiction with the structural characteristics of the Slovene economy and, in the end, could only impinge negatively on the overall restructuring process. Some suggestions to target the promotion of fast growing enterprises do not seem appropriate. Even with the aim of favouring light industries and sectors with a high degree of product differentiation, policies have to be horizontal. Only continued openness to international markets and a good diffusion of technology and information can ensure the economic restructuring which is needed in Slovenia.

The unemployment benefit system needs to be more firmly administered

The labour force and employment fell sharply in the early years of transition but (according to survey data) have generally been increasing since around 1993. Some decline was evident in 1996, however, reflecting the broader economic slowdown at least in the earlier part of last year. Encouraging trends in employment growth of recent years have included the re-orientation of employment away from industry and towards services, and the growing importance of the small business sector. Surveyed unemployment is around 7 per cent at present. Registered unemployment is

nearly double this level and is usually the policy target, although this measure includes a large number of people who are either working, or not seeking or available for work. Only around one-third of the registered unemployed receive unemployment benefits. However, there is also a large increase in the ''escape rate'' to employment near the point of benefit exhaustion. This suggests that there is scope for tightening the administration of benefits – for example, to ensure that recipients comply with eligibility requirements including job search, work-readiness and limits on additional income.

Wage setting should be more decentralised and indexation mechanisms should be phased out

Real wages declined between 1989 and 1992, but since then have increased rather rapidly. In 1996, real wage growth is estimated to have been 5.0 per cent, including 6.6 per cent in the non-market sector. There is also extensive indexation of wages to past inflation. Recent wage growth is well above the level agreed to in the tri-partite Social Agreement, which *inter alia* targeted real wage growth in 1996 at 2 per cent below the rise in GDP. Wage restraint and rapid productivity growth are important if Slovenia is to maintain its international competitiveness and provide owners with the resources needed for restructuring and investment. The high level of non-wage labour costs is also of concern. Overall, gross labour costs are nearly double net earnings, a situation which risks impairing employment growth and competitiveness. Recent reductions in employer social security contribution rates are therefore welcome, and ongoing spending restraint in this area, leading to further reductions in contribution rates, should be sought. Other elements of labour costs, including wages themselves and the range of allowances and bonuses currently in place, should be subject to negotiation between the parties directly affected by these bargaining processes. In this regard, current bargaining arrangements appear to comprise an awkward mix of centralised and decentralised

elements in which no party takes full responsibility for the outcomes. Further decentralisation of bargaining to the enterprise level would encourage the owners, managers and employees of each firm to take its financial performance and competitive requirements directly into account in labour negotiations. It is important for current indexation provisions to be progressively phased out from wage-setting arrangements. Such a step would support the disinflationary stance of monetary policy.

Wrap-up: are reforms sufficiently active to put Slovenia on a convergence path with more advanced economies?

In summary, the transition process to this point has been marked by a largely successful programme of macroeconomic stabilisation, coupled with substantial reform of trade relations and the banking sector and progress in enterprise restructuring. Contributing to these developments has been the relatively favourable starting point of Slovenia compared with other transition economies in terms of familiarity with market processes and external trade. The challenge now is to build on this strong base that has been established. In this respect, Slovenia can be viewed as at a threshold where policies implemented in the next two or three years will be crucial for maintaining the pace of economic transformation. Clear progress towards further lowering of inflation and containing fiscal pressure is needed, and these measures need to be integrated with the labour market, social, and financial reforms outlined above. Consistency between these macroeconomic and structural reforms provides the best prospect of ensuring sustainable improvements in external competitiveness and reductions in domestic interest rates, elements which are essential for ongoing enterprise development and overall economic growth.