The wiiw Balkan Observatory

Working Papers | 043 | May 2004

Mojmir Mrak, Peter Stanovnik and Franjo Štiblar

Slovenia – Understanding Reforms

The wiiw Balkan Observatory

www.balkan-observatory.net

About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

The wiiw Balkan Observatory

Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

For additional information see www.balkan-observatory.net, www.wiiw.ac.at and www.gdnet.org

Slovenia: Understanding Reforms

1 Introduction

During its 12 years of existence as an independent state, Slovenia has been undergoing a process of two-fold transition. In addition to the process of transition from a socialist to a market economy, similar to all other transition economies, it has been also faced with a transition from a regional economy as part of the SFR Yugoslavia to a national economy. In recent years, transition towards a well performing market economy has been carried out simultaneously with the process of accession to the EU

The process of transition from a socialist economy with a dominant share of social ownership to a market economy based on a private ownership basically comprises of two large sets of reforms. The first set relates to macroeconomic stabilization, and internal and external liberalization. Their main objective is to create stable economic environment that is an absolute prerequisite for a sustainable economic growth and development. Macro-economic measures and reforms alone, although necessary, do not lead automatically to supply responses that are needed for a comprehensive transformation to a market economy. These reforms, namely, do not deal systematically with structural weaknesses of the country's economy. To address these weaknesses, a clearly defined second set of reforms – structural and institutional reforms associated with various micro-economic policies – is needed. These reforms are in fact a transition *per se* and are therefore much more long-term in their character. Structural and institutional reforms will help to develop a strong economy that will be better prepared to absorb shocks and will contribute towards maintaining macro-economic stability in the country.

In Slovenia, transition to a well performing market economy has been carried out simultaneously with two other processes and both of them have had significant influence not only on the design of reforms and their implementation but also on their sequencing. In the period that followed the independence, i.e., in the first half of the 1990s, a significant proportion of Slovenian efforts was focused on reforms and policy measures that had one common denominator – to establish Slovenia as an independent state in the areas of politics, economy, and finance. Some of these "state-building" policy measures and reforms have included introduction of the Slovenian currency, establishment of customs and tax authorities, negotiations for separate agreements with foreign creditors of the former SFR Yugoslavia, etc.

In the second half of the 1990s, the transition process in Slovenia was closely interrelated with the country's process of accession to the EU. Already in 1995, the first full-fledged document – *Strategy for Economic Development* – that has clearly outlined strategic objectives of Slovenia's economic and social development was adopted. The Strategy's

central objectives were defined as follows: (i) to achieve higher growth rates than that in the EU in order to bridge the income gap with this group of countries, (ii) to enhance international competitiveness of the Slovenian economy, (iii) to integrate the country into European integrations, and (iv) to promote long-term economic growth that is environmentally, regionally, socially and ethnically sustainable (Štiblar, and others, 1995). Although this Strategy – and the same pattern is followed in some other related documents[1] – has defined its objectives rather clearly, it remained short in designing both, policy measures required to reach these objectives as well as their timing and sequencing. Both issues represent the core of the *Strategy for the Accession of the Republic of Slovenia to the EU* adopted in January 1998 (Mrak, and others, 1998). This policy document defines and outlines a consistent set of medium-term economic and social policy measures required to complete the economic transformation of the country into a market economy and to prepared its economy for accession to the EU.

The main objective of this country case study is to provide an overview and analysis of reform experience in Slovenia. It discusses the content, the sequencing and the outcome of major reforms carried out in the country since early 1990s. In addition to this *Introduction*, the study consists of four major parts. The *second chapter* provides an overview of specifics in Slovenian transition. It first discusses conditions that have made possible for Slovenia to embark on the rather specific process of transition. Later on, specific features of this process are presented. The *third chapter* provides the macroeconomic and growth framework. It begins with a discussion of monetary policy and foreign exchange policy required for stabilizing the economy. The chapter continues with an analysis of the fiscal policy carried out by Slovenia throughout the transition period and of the challenges to be faced by the country in this area in the years to come. The *fourth chapter* is provides an overview of main features of structural and institutional reforms introduced in Slovenia. The common denominator of all these reforms has been to increase the country's competitiveness and to make the economic development socially and economically sustainable. The text focuses on two segments of reforms, namely on enterprise and financial sector reforms. In *the fifth chapter*, the role of EU and EMU accession process as an instrument of strengthening transition reforms is discussed in some details. The chapter begins with key features of the EU accession process for Slovenia, and continues with a presentation of the financial package that has been agreed between Slovenia and the EU in the final round of its EU accession negotiations. At the end of the chapter some major challenges for Slovenia after accession to the EU and prior introduction of the euro are discussed.

[1] See, for example the Strategy for International Economic Relatiuons of Slovenia (1996) and the Straegy for Increasing the Competitiveness Capabilities of Slovenian Industry (1996),

2 Specifics in Slovenia's transition process

Slovenia's success in economic and social transition during recent 13 years of independence was to a significant extent a consequence of special conditions under which the transition was made. Only recently, the appropriateness of the country's *sui generis* approach was widely recognized by various international institutions, including most important international financial institutions.

In this chapter, two issues will be briefly presented. First, specific framework that enabled Slovenia to design and implement special approach (procedure) to the transition process. Second, special solutions in some key areas of economic reform (substance).

2.1 Specific framework of Slovenian transition

There have been several particularities that enabled *sui generis* approach of Slovenia to transition. This approach was frequently in defiance with advises and statements of major international financial institutions and foreign advisors.

At the beginning of the 1990s, i.e., at the starting point of the transition process, Slovenia was faced with the following facts:

– After its declaration of independence in June 1991, Slovenia was for several months not politically recognized. The country became an UN member only in May 1992, and a member of international finance institutions later on in 1992 and in early 1993. Slovenia had no need to enter into an IMF sponsored arrangement that would through conditionality clauses impose its views on the overall transition process. Taking into account a complete cut of links with the Belgrade, the newly independent Slovenia had practically no foreign exchange reserves at the time of introduction of its currency. It is for this reason that floating exchange rate regime was the only possible solution to generate forex reserves.

– The following underlying pattern of Slovenia's transition is related to the fact that it is one of many countries where the transition from a socialist to a market economy has been accompanied by a transition from a regional economy to a national economy. When Slovenia became independent, its first tasks were not related exclusively to economic transition issues, but also included issues of key importance for creating a sovereign state. One of these tasks was the creation of the institutions of a sovereign state, which had not existed before independence, such as a central bank and a national currency, customs systems, and a worldwide diplomatic network under the direction of a ministry of foreign affairs. Another was the creation of economic

conditions conducive to compensating for the loss of the larger part of the internal market of the former SFR Yugoslavia.

– Legacy of the pre-transition period, including much stronger market orientation and democracy in comparison to other transition economies, has strongly influenced the concept of transition in Slovenia. On the one hand, this legacy bequeathed some important benefits to Slovenia as it embarked on its transition. The country inherited a strong tradition of a quasi-market system with relatively independent enterprise management structures. On the other hand, the legacy of the former SFR Yugoslavia's economic system also had some strong negative effects. Two issues deserve special mention here. First, the tradition of self-management system influenced the approach that Slovenia took to privatization, in which a very important role was assigned to workers. Second, Slovenia inherited huge internal and external imbalanced from the former Yugoslavia.

Slovenia was characterized with a relatively high level of economic development in comparison to other transition countries. Higher volume of domestic financial resources has enabled the country to embark on a different path of the transition process than most of other transition countries and to adopt different sequencing of the transformation activities. Its main characteristic has been a strong preference of the gradualist approach over shock therapy[2]. Slovenia opted for a gradualist approach in its transition from a planned to a market economy for several reasons, of which the following are some of the most important. One was the endogenous origin of Slovenia's transition, in which the old elites not only anticipated the transition but, by introducing important changes already in the pre-transition period, also influenced their own future position in the society and economy in the aftermath of transition. Another reason was the already mentioned relatively high level of development, which allowed a more cautious approach to the transition and which introduced into the cost-benefit analysis the consideration that it was important not to undermine some of the positive developments that had preceded the transition. A third reason was the generally cautious attitude of Slovenians toward economic reform, accompanied by a tradition of consensus building in the face of any major collective decision. Finally, the shock to the economy caused by the loss of the Yugoslav market, together with the unstable political situation in Slovenia itself during the early independence period, argued against a "big bang" approach to the transition.

The main argument in favour of a gradualist approach to transition has been articulated as a counterargument against the big bang approach. Big bang reforms in other countries have typically been accompanied by large shocks to the economy, leading many times to temporary but severe losses of output and growing unemployment, and consequently to

[2] See for details Mrak et others, 2004.

the threat of social instability and ultimately reversal of the reforms. A more gradualist approach gives economic agents more room to adapt, although it can also lead to a halt in the reform process. Gradualists believe that their approach is better because it allows some economic activity and some jobs to be reallocated between firms or industries rather than lost altogether.

Strong political consensus and a tradition of economic and political reform were the main reasons why it was natural to choose a gradual approach in the early stage of transition. This approach was, however, not without its drawbacks, one of which was a stalemate between interest groups, leading to postponed decisions and less-than-optimal compromises, which delayed some crucial structural reforms. Recent developments have warned that the continuation of the gradualist approach might seriously hamper economic competitiveness and even backfire on a macroeconomic performance that has so far been remarkably stable.

2.2 Specific solutions applied in the Slovenian transition

Three strongholds of Slovenia's successful transformation in financial and fiscal sector (thus supporting transition of enterprise sector) were (i) independent central bank and prudent monetary policy with strong supervision of banks, (ii) successful bank rehabilitation with domestic financial resources (similar to this exercise in developed countries), and (iii) prudent fiscal policy with budget close to equilibrium during the past period.

In the following paragraphs, these specific features are explained in some more details.

– Managed floating exchange rate regime was introduced from the early beginning. It enabled accumulation of foreign reserves in the early post-independence. An important vehicle for generating foreign exchange reserve was selling – for foreign exchange – of socially owned apartments to population for foreign exchange. The selling was made at highly discounted value around 17% of market price.

– Quickly liberalized trade of goods accompanied by slower liberalization of trade of services. Capital flows were liberalized gradually, more intensively from 1999 on, what protected Slovenia from financial crises in many emerging economies in 1997 and 1998.

– Creation of fully independent central bank responsible only to Parliament, which led successful monetary policy: (i) introduction of new domestic currency Tolar in October 1991, (ii) moderately restrictive money growth, (iii) conservative approach to creation of new banks (their number only doubled after independence from 16 to 35 at the peak, but later declined to 19 in 2004), (iv) two-tier banking system existed in Slovenia,

being a part of the former Yugoslavia, already from the 1960s. Slovenian central bank is being known for inventive policy of monetization and sterilization of net inflow of forex in connection with managed floating exchange rate regime In early stages, it was using open market policy instruments, while later on, i.e., since 1999, discount rate was applied as a main instrument.

– All costs of transition depression and of the dissolution of the former Yugoslavia have been accumulated in the banking sector (as »black hole«). To rehabilitate two largest banks (being under several and joint liability clause for all ex-Yugoslav external debt due) the Government replaced bad assets of these banks with government bonds (in the size of 12% of GDP), financed by the budget. With the constitutional law adopted in 1994, claims and liabilities to other ex-Yugoslav republics were placed in two largest old banks, while with all other assets and liabilities two new banks were established inn 1994. These new banks obtained international ratings after Slovenia reached agreement with foreign creditors to service part of ex-Yugoslav debt.

– Fiscal policy was prudent from the beginning of independence in 1991. In the first half of 1990s the country had budget surplus. After tax burden was partly lifted from enterprise for reasons of higher competitiveness in the second part of 1990s budget started to create deficit of around 1-2% of GDP. Public debt is below 30% of GDP, external debt manageable and net external position close to equilibrium.

– *Sui generis* economic policy did not give priority to stability over growth (as in many other transition economies dependent on IMF through conditionality), but tried to give both goals equal importance. Thus, average growth rate in the past 12 years was rather stable at an average annual level of around 4%. Inflation was for several years higher than in some other transition countries. After mid-2003, however, the trend of inflation is quickly decreasing to reach 3.5% at in 2004. Decreasing inflation is due to nominal convergence as country intends to enter the ERM2 regime until the end of 2004. Changed priority of economic policy led to declining GDP growth rate (below 3% in 2003), stagnating unemployment rate (at 6.8%), but Slovenia succeeded to retain external and internal equilibrium (current account slightly positive, budget deficit only 1.5% of GDP). Sustainability of growth had always priority over its overly and unsustainable stimulation as economic policy goal.

– Twin deficit was never a problem for Slovenia. Therefore foreign exchange was not urgently needed (managed floating) and therefore selling of domestic assets to foreigners was not a priority. Slovenia tries to retain some of blue chips in real and financial sector in domestic hands (the only country among developing countries with the chance for that), thus following example of all "old" EU-15 members. Such attitude towards inward oriented FDI was criticized by international finance institutions.

Liberalization is gradual, and the goal of Slovenia is, if country wants to become equal partner in the enlarged EU-25, to become net exporter of capital in the future. Outward oriented FDI (mostly towards East and South East of Europe) should be larger than inward oriented FDI from the West. Information capital was retained in domestic hands with such approach to FDI.

- In the real sector, privatization of enterprises was gradual (thus Slovenia was learning from mistakes front-runners made in the process) and in the form of compromise. Several possibilities were given and choice of privatization model remained with workers and government. As privatization could not be fast, efficient and just at the same time, the compromise among these three goals was found so that inequalities among citizens did not explode. Slovenia retains income (and wealth) distribution close to Scandinavian countries and is among the most equal among the transition economies.

- Solid GDP growth rate was obtained in the past 12 years by strong orientation to export (supported from managed floating) and by domestic orientation to infrastructure investment (building highways).

- Special feature of Slovenia was that it was able to retain a strong middle class (practically the only one among transition economies) as foundation for political stability. Elections are in regular terms of 4 years (only one exception in 2000). Proportional election system prevented overly polarization of political forces. Both potential candidates for poverty (and social problems) were well protected in Slovenia. Peasants used their strong political lobby (party) to obtain subsidies, pensioners their lobby to keep growth of pensions in relation to wage growth (or even faster).

All in all, closeness to the Western Europe, tradition of social and economic contacts with developed world gave Slovenia advantage over other transition economies in transforming economy and society into standards required by EU, of which country became a member in May 2004.

3 Macroeconomic policies: stabilization and liberalization

Macroeconomic performance of Slovenia in the period 1994 – 2002 is summarized in the Table 3.1. For 2003, estimated macroeconomic figures are the following: 2.8% GDP growth, 5.3% average inflation, current account in equilibrium, budget deficit around 1.3% of GDP and 6.6% unemployment rate.

Table 3.1

Main macroeconomic indicators, 1994 to 2002

	1994	1995	1996	1997	1998	1999	2000	2001	2002
GDP growth	5.3	4.1	3.5	4.6	3.8	5.2	4.6	3.0	3.3
Inflation (average)	12.3	8.6	8.8	9.4	7.9	6.1	8.9	8.4	7.0
BoP (million US$)	573	-99	31	11	-148	-783	-594	30	200
Unemployment rate (%)	14.5	14.0	13.9	14.4	14.4	13.0	12.0	11.8	11.6
Unemployment rate ILO standard (%)			7.3	7.4	7.9	7.6	7.0	6.4	6.0
Budget balance / GDP (%)	-0.2	0.0	0.3	-1.2	-0.8	-0.6	-1.4	-1.4	-2.5

Sources: National Statistical Office, Bank of Slovenia, Institute of Macroeconomic Analysis and Development, EIPF,

3.1 Monetary and foreign exchange policy and reforms

Slovenia opted for gradual approach to transition which includes, among other things, specific solutions in transformation of monetary and banking (wider financial) sector and sui generis design of monetary and banking (financial) policy. Critics of this approach from abroad and inside the country are wrong in agitating for the shock s in system changes and policy solutions of generally prescribed type. They do not take into account specific conditions under which system and policy design is executed in Slovenia. If shock is applied, this prescription would lead to sub-optimal results and will produce problems, experienced in the past and presently in other advanced transition countries, which did not have a courage and ability to choose their own way to transformation.

It is becoming increasingly obvious that adjustment for the formal EU membership is completed, but entering the ERM2 regime and the EMU requires fulfilment of preconditions regarding appropriate competitive structure of the economy and that rus hing with fulfilment of Maastricht criteria before structural transformation is made leads to sub optimal and unsustainable economic growth damaging the long-run nominal and real convergence of the country. Slovenia is aware of that in applying its gradualism (including, for instance, specific monetary policy with managed floating and banking structure with retaining some banks in domestic majority ownership), which was and still is sometimes criticized at home and abroad. But such policy produced the best results among all transition countries in the past 12 years giving Slovenia solid foundations for becoming equal economic partner to present (less developed) members of the EU, which is not the case for other accessing countries.

2.1.1 Monetary sector and design of the monetary policy[3]

Overview of monetary aggregates and instruments; Independent central bank and monetary policy were strongholds of Slovenian successful financial transition in addition to successful bank restructuring and prudent fiscal policy. Basic monetary aggregates and parameters are presented in Table 3.2.

Table 3.2

Money aggregates and financial parameters of Slovenia, 1991 to 2003

	M0	M1	M2	M3	GDP	INFL	DISC	SIT/	CA	RESER	DEBT
			billion SIT			%	%	EUR	mn USD	mn USD	mn USD
1991		39	74	137	349						
1992		81	186	314	1018	201.3		105.1	926		
1993		116	303	513	1435	32.3	20.3	132.3	192		
1994		170	490	735	1853	19.8	16.0	152.4	574	2763	
1995		204	617	942	2221	12.6	11.5	153.1	-75	3464	
1996		235	750	1135	2555	9.7	10.0	169.5	56	4124	
1997	139	271	1007	1411	2907	9.1	10.0	180.4	51	4377	4123
1998	171	333	1262	1690	3254	8.6	10.0	186.3	-118	4781	4915
1999	199	400	1415	1913	3648	6.6	8.0	193.6	-698	4115	5400
2000	209	424	1543	2206	4036	8.9	8.7	205.0	-547	4376	6217
2001	246	502	1954	2877	4741	8.4	10.8	217.2	31	5746	6717
2002	275	563	2388	3372	5285	7.5	9.8	226.2	375	8152	8799
2003					5712	5.4		233.0			

Sources: BS Bulletin, SURS, EIPF

The main instruments of monetary policy applied in Slovenia include (Bole, 1999): (i) foreign exchange bills of Bank of Slovenia (BS), (ii) tolar bills of BS, (iii) twin bills, (iv) short term loans to banks, (v) liquidity loans, (vi) repurchase of foreign exchange or forex bills of BS, (vii) central government deposits, (viii) minimum reserve requirements. Their relative importance is presented in Table 3.3.

Short history and developments in monetary policy; From proclamation of independence in 1991 Slovenia opted for *sui generis* monetary and exchange rate policy under specific conditions in the country. Moderately restrictive money growth and managed floating exchange rate were basic solutions. From mid-1999 the design of monetary policy (with the primary goal to battle inflation) changed substantially under pressure of three major structural changes which happened in Slovene economic mechanism.

[3] The section is drawn on works of Velimir Bole, Ivan Ribnikar and Tomaž Košak.

October 8 1991 is the official date of birth of Slovenia's central bank (the Bank of Slovenia: BS), its currency (tolar) and its monetary system. The origins of today's Bank of Slovenia stem from 1976, when the National Bank of Slovenia was founded as part of central bank system in former Yugoslavia.

Table 3.3

Volume of monetary policy instruments
(in per cent of balance sheet of the Bank of Slovenia)

	Liquidity providing instruments	Liquidity loans	Repo vrednostnih papirjev	Required reserves and short term bills	Required reserves	Short term tolar bills	Overnight deposits
	1	2	3	4	6	7	8
1992	16%	1%	15%	10%	7%	2%	0%
1993	11%	2%	10%	10%	8%	2%	0%
1994	12%	7%	6%	17%	12%	5%	0%
1995	14%	11%	2%	13%	11%	2%	0%
1996	4%	4%	0.3%	17%	12%	4%	0%
1997	3%	3%	0%	22%	10%	13%	0%
1998	1%	1%	0%	23%	10%	13%	0%
1999	3%	3%	0.3%	13%	9%	4%	0%
2000	1%	1%	0%	10%	9%	1%	0%
2001	0%	0%	0%	21%	7%	11%	3%
2002	0.1%	0.1%	0%	30%	5%	23%	1%

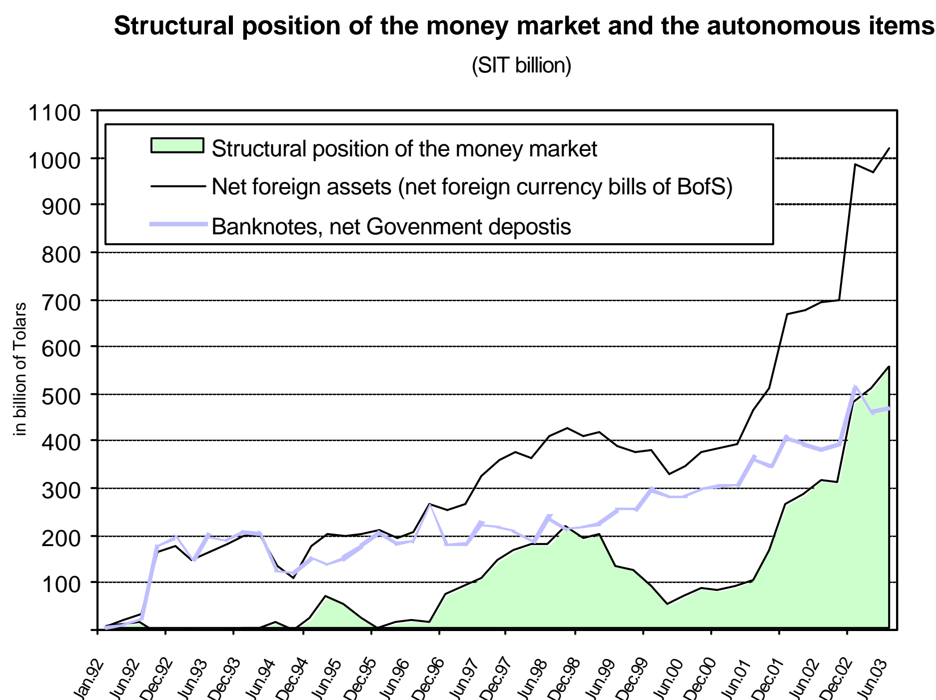
Sources: BS Bulletin

After independence the relationship with the NBY involved the claims and debts of banks and others in Slovenia towards the NBY. It was to be expected that the claims would not balance. Claims (bank reserves, deposits, securities, notes in circulation) amounted to SIT 21,231 million while the debts amounted to only SIT 12,581 million. Had there been an agreement on the separation of the monetary system, then the difference of SIT 8,650 million would have been paid in foreign currency by the NBY or through the NBY by the newly independent states of former Yugoslavia. Since the separation or disintegration of the Yugoslav monetary system was hardly amicable, the BS showed among assets in its balance sheet claims on the Republic of Slovenia or through the BS on five former republics of Yugoslavia an amount of these net claims. The BS could not start or open a balance sheet with more debts than claims. Another category of peculiar relationships among banks and the NBY were "negative exchange rate differences", caused by forex deposits to banks, which were not loanable.

Starting with almost no international reserves, after few years they became almost the only assets in the balance sheet of the BS, while short term bills were the most important liabilities. By eliminating those foreign currency liabilities and making so the surplus of the structural position of the money market smaller, items, that are somehow strange, not

necessarily a part of the central bank balance sheet at all - the same goal, as will be seen later, could have been achieved otherwise - disappear. And what is more important, for absorbing too great liquidity from banks we come into situation that usual or at least almost usual instrument of monetary policy are being used.

Chart 3.1



From Chart 3.1.fluctuation of structural position of the money market is in accordance with the fluctuation in the net foreign currency assets and net foreign currency assets depend on the current account of the balance of payments and international financial flows, i. e. in the first place inflow of foreign capital.

By extracting from banks more liquidity, than the BS was obliged to do, the BS put the banks in the position that they had not enough liquidity. Only in such a way the BS was able to make space for ordinary instruments of monetary policy, i. e. for instruments through which it provides liquidity to banks. As can be seen from Chart 2, from the year 1996 that important space for liquidity providing instruments of monetary policy has been shrinking and after 2000 it almost disappeared.

Instruments applied; By adapting definition of the structural position of the money market to Slovenia, we can come to three kinds of instrument of monetary policy: (a) required reserves, (b) issue and/or sale of short term bills, denominated in tolars, to banks, and (c) various instruments via which liquidity is provided to banks.

– *required reserves;* They were used from 1991 as major instrument of monetary policy. In 1998 the required reserves amounted to 2% of GDP and after that they fell to 1.6% in 2002. Expressed as proportion of the Bank of Slovenia's total assets, they varied between 5% and 12% (Table 3.1). With gradually decreasing reserve ratios scale the Bank of Slovenia tried to stimulate long-term savings with the banks and also to reduce the opportunity costs burden arising due to the bellow the money market rate remuneration of banking assets.

In 2002 the Bank of Slovenia started to gradually adopt the principle of the Eurosystem's reserve requirement. The main reserve ratio was set at 2% meanwhile the 7% reserve ratio was used for liabilities in domestic currency with maturity of up to three months.

Bank of Slovenia short term bills (sterilized purchases of foreign exchange); The surplus structural position in the Slovene money market, which has reached up to 30% of Bank of Slovenia's total assets, required a net withdrawal of liquidity from the banking system or a more intensive use of the instruments, which made it possible to turn the structural position of the money market in a short position. Already in 1994 required reserves were not enough to withdraw the excess liquidity from the banking system. The Bank of Slovenia was constrained to issue different short term bills to sterilize foreign exchange surplus at the market.

Table 3.4

The volume of extended monetary policy instruments (in per cent of the balance sheet of the Bank of Slovenia)

	Liquidity providing instruments	Liquidity loans	Repo vrednostnih papirjev	Required reserves and short term bills	Required reserves	Short term tolar bills	Overnight deposits
	1	2	3	4	6	7	8
1992	16%	1%	15%	10%	7%	2%	0%
1993	11%	2%	10%	10%	8%	2%	0%
1994	12%	7%	6%	17%	12%	5%	0%
1995	14%	11%	2%	13%	11%	2%	0%
1996	4%	4%	0.3%	17%	12%	4%	0%
1997	3%	3%	0%	22%	10%	13%	0%
1998	1%	1%	0%	23%	10%	13%	0%
1999	3%	3%	0.3%	13%	9%	4%	0%
2000	1%	1%	0%	10%	9%	1%	0%
2001	0%	0%	0%	21%	7%	11%	3%
2002	0.1%	0.1%	0%	30%	5%	23%	1%

Source: Bank of Slovenia

- Liquidity providing instruments;
  - *Open market operations;* The repurchase agreement has been the most frequently applied instrument of monetary policy since 1994. With this instrument the Bank ensured a stable and reliable source of liquidity for the banks, especially in the period of low supply of foreign currency in the market.
  - *Standing facilities;* The next group of liquidity providing instruments is lending facilities. Lombard loans were introduced already at the end of 1991 as one of the first instruments, which were offered by the Bank of Slovenia. The standing facilities comprise also various liquidity loans that primarily serve as instruments for balancing short-term liquidity in domestic currency of the banking system.

After the abolition of rediscount quotas in the first quarter of 1992, the Bank of Slovenia performed a care for maintenance of a general liquidity of the banking system through the liquidity loans window. All liquidity loans have been granted by the Banks against the collateral in the form of Bank of Slovenia's bills or government bonds.

For banks undergoing pre-rehabilitation and rehabilitation process from 1993 till 1997, there were available special liquidity loans with maturities of up to two weeks or exceptionally up to one month. Also in 1992 the Bank of Slovenia opened an offer for overnight liquidity loans. They were available to all banks, which were net debtors in inter-bank money market and the banks were obliged to use the funds for meeting their obligations.

After 1995 the extended volume of liquidity loans decreased substantially, from 11% of Bank of Slovenia's total assets to the 4%. At the end of 1996 the liquidity facilities of last resort and a special facility for banks with liquidity problems were introduced at the highest interest rates of the Bank of Slovenia's monetary policy instruments available to the banks in case of unexpected liquidity constraints for performance the payments under due or fulfilment of required reserves.

Interest rates and monetary development; In October 1991, when Slovenia introduced a new currency, tolar, the economy was facing with a galloping inflation rate at around 22% per month. Beside the tremendous need to build up appropriate foreign exchange reserves, which amounted for only four days imports at that time, the Bank of Slovenia was obliged to reduce inflation rate. As the banking system was super liquid at the end of year 1991, the central bank stepwise shrank the base money towards the estimated amount demanded by the economy. The liquidity loans of the Bank of Slovenia to banks were reduced to minimum till the beginning of 1992. The governing board of central bank set the discount rate at 24% per year, which was an explicit target for inflation of 2% per month for

the first half of 1992.The Bank of Slovenia conducted a monetary policy in accordance with exogenous money supply and floating exchange rate in early 1990s.

Such successful concept of monetary policy in first period after achieved political independence contributed to a rapid fall of the inflation rate from 22% in October 1991 to 2% per month in the middle of 1992 and to 0.5% by 1995. In the beginning of the year 1995 the process of decreasing the interest rates ceased, due to the price competition among the banks for the large depositors. At that time the Bank of Slovenia prevented such unhealthy and uncontrolled competition with the administrative action, which penalized the banks with uncommonly high deposit rates. That causes an Interbank Agreement on deposit interest rates, which determined their maximum level in the banking sector and it was in force from 1995 to 1999. After 1999, the Agreement was replaced by a Recommendation on deposit interest rates, which was prepared by the Bank Association of Slovenia and was in force until the end of 2000. By the Agreement and later by the Recommendation, commercial banks committed themselves not to exceed the agreed maximum deposit interest rates in order to prevent an unfair and uncontrolled price competition among banks for large clients. Although such agreement contributed to reduction of the real interest rates, it also hampered the normal development of the interest rate channel of the transmission mechanism.

The transmission of the monetary policy changes through the interest rate channel proved empirically to be weak and long lasting in the Slovenian economy in the entire period till 2000. Its effectiveness was diminished by a widespread use of indexation mechanism in financial contracts, which was a consequence of high inflation recorded already in former Yugoslavia. The indexation factor for short-term financial instruments was abolished in July 2002; meanwhile, long-term instruments have been still indexed by the average inflation rate in past twelve months.

The Bank of Slovenia focused on a reserve money-based anchor to achieve its overall goal of price stability in the 90's. In 1997, the Bank of Slovenia assessed that there was a closer relationship between its final objective of price stability and the broader M3 monetary aggregate that caused the monetary policy framework change. This change increased the transparency of its monetary policy.

Chart 3.2

Interest rates of the BS' tolar bills, interest rates of the banking loans, money market interest rates and indexation factor in percentage

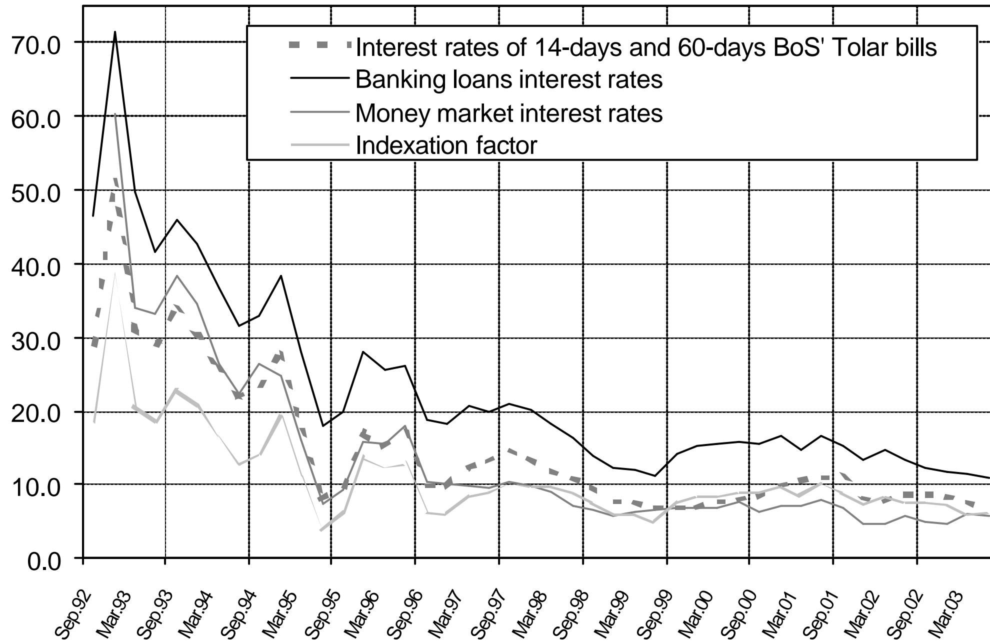
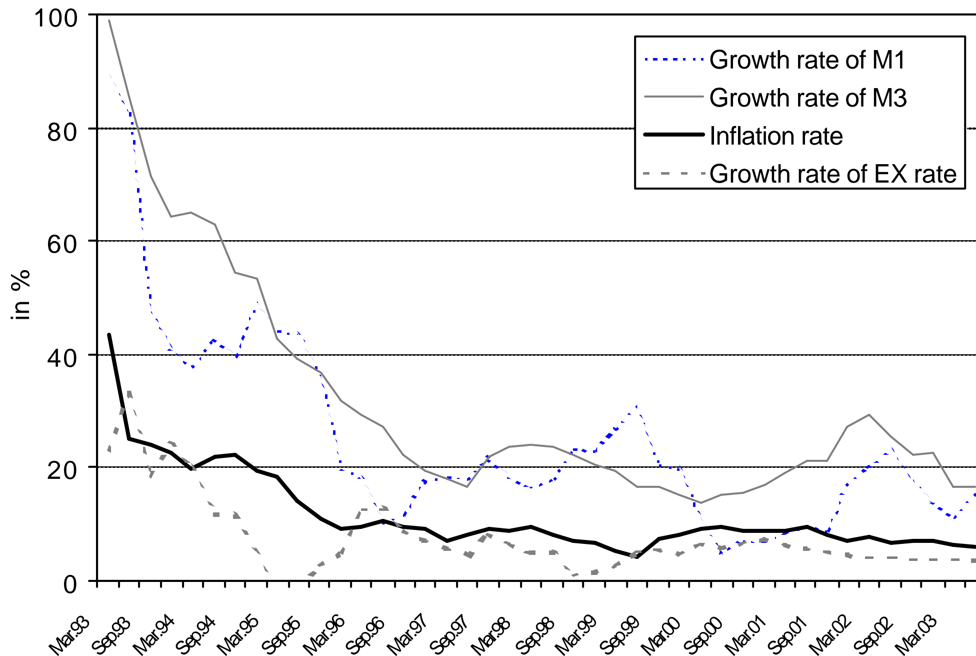


Chart 3.3

Some indicators of monetary development (inflation rate, growth rate of monetary aggregates and growth rate of foreign exchange)



3.1.2 Exchange rate regimes and policies

Slovenia uses managed floating from independence in 1991, when lack of foreign exchange reserves determined choice for floating exchange rate regime. Central bank influences exchange rate through active intervention in forex market without specifying or pre-announcing exchange rate path. Three mechanisms in place were non-sterilized and sterilized purchases of foreign exchanges, and the minimum amount of liquid foreign currency assets that banks have been obliged to have for their foreign currency liabilities. The base money has been predominantly created by monetization of foreign currencies. Therefore there has been permanent demand for foreign exchanges from the part of the BS almost in the amount of increase in the base money.

History of exchange rate regime in Slovenia consists of: (i) pure floating from the launching domestic currency tolar in 1991,when foreign exchange reserves did not exist at all and international financial markets were closed for Slovenia; and (ii) managed floating in three phases (types) when foreign exchange reserves increased and capital inflows increased due to fall of currency and country risk.

In the period September 2001 to mid-1995 net foreign assets of central bank were smaller than money base, so that central bank could influence money base just by changing supply of its lending instruments. Basic instruments were: forex bills, credits collateralized by central bank foreign exchange (forex) and repurchase operation of central bank forex bills.

In the period mid-1995 to mid-1999, however, net foreign assets of central bank were already higher then base money. Central bank still targeted base money, but capital inflows were sterilized by sterilization instruments. Direct capital controls were enacted to enable central bank to tolerate at least short term independence of exchange rate and interest rate paths. In addition to previous instruments, central bank offered bills in domestic currency which became crucial new instrument. Costs of sterilization in peak did not exceed 0.5% of GDP.

In the period since mid 1999, the removal of capital controls worked against even short-term targeting of money base became impossible and long-term financial inflows increased substantially. Central bank introduced two changes in intervening. In the short term it started to target real interest rate and sticking to the base money target only on the long term. At the same time, to make effective real interest rate targeting possible it started to tightly manage exchange rate dynamics to prevent swings in expected rate of return difference. Commitment to interest rate parity was made credible through contracts with banks, where central bank offers swap (on a permanent basis) as a crucial instrument for managing exchange rate dynamics. This change in monetary policy stance resulted in

stabilization of interest rate, lower and less volatile ratio M1/GDP and almost constant expected rate of return differences between tolar and forex instruments

What the BS has been trying to do by monetary and exchange rate policy from 1999 has been to prevent that the difference between the expected return on domestic and foreign currency (euro) assets becomes greater (or smaller) than the risk premium on the domestic currency assets. In the mid-1999, when inflation was already below 5% yearly rate after four years of successful calming down of inflationary expectations, three changes caused change in design of monetary (and exchange rate) policy): (i) introduction of value added tax changing relative prices of goods and services, (ii) changes in management of public sector finances (wage pressures took over the leading role from pressures of transfers on expenditure side, rises in taxes on goods and services including excises to replace squeezed budget revenues; and (iii) in mid-1999 all remaining restrictions on Slovenia's financial flows with the rest of the world were abolished under commitment to EU as part of accession process (they were important for sterilizing foreign exchange interventions).

All these changes accelerated the growth of relative prices of non-tradable goods and services in comparison to tradables, although they had already been far in excess of corresponding relative prices in other advanced transition countries (50% higher than in Hungary, Poland), and to the level of economic development of Slovenia before 1999.Changing relative prices after 1999 induced acceleration of inflation. Monetary policy should be directed towards prices in non-tradable sector. But, how to restrict money growth under abolition of capital restrictions ? And what is the role of exchange rate in such design of optimal monetary policy ?

Since 1999 large, interest rate relative insensitive (caused by foreign acquisitions in privatization of Slovene companies as for instance Lek, NLB; and in introduction of EUR) financial inflows strongly increased money supply through monetization. By operational targeting real interest rate central bank adjusts the restrictiveness of monetary policy, namely the degree of restrictiveness on domestic demand (private consumption and investment) with ultimate goal to curb growth of prices in non-tradable sector. On the basis of estimated and for central bank given inflation expectations the central bank must equalize expected nominal returns on foreign exchange and tolar nominated deposits as foreign exchange deposits would otherwise permit lesser degree of restrictiveness than tolar deposits thus making monetary policy over-expansive. Because interest rate on foreign deposits was almost identical in domestic and foreign banks since 1999 due to arbitrage, central bank must control the expected movement of exchange rate in such a way that it equalizes the expected nominal returns on comparable tolar-denominated and foreign exchange denominated deposits and loans (instruments). As an illustration, when in 2002 the expected depreciation was slightly too small, the volume of foreign exchange

borrowing grew faster than tolar nominated borrowing, while deposits of tolar increased more than deposits of foreign exchange.

Under these circumstances the managed floating is the only remaining instrument available to central bank for preventing large-scale financial inflows from abroad. Large financial inflows are neutralized by adequately restrictive monetary policy: with high enough real interest rates which invite to time deposits and thus increase depth of intermediation, at the same time curbing consumption and investment.

In such monetary policy design central bank can reduce nominal interest rates on tolar deposits only if it assesses that inflation expectations (given externally) are falling, which in fact happened already twice in 2003, in March and at the end of September. Otherwise too low real interest rate on tolar deposits would be overly expansionistic fuelling domestic demand causing inflation, first in non-tradable sector, next overall.

3.2 Fiscal policy and reforms

The sub-chapter on public finance policy and reforms addresses three issues. It first presents the main characteristics of the Slovenian public budget and its fiscal policy reforms implemented throughout the transition. The text continues with an overview of the public debt position of Slovenia. At the end, a brief overview of fiscal implications of the EU membership on Slovenia is made.

3.2.1 Public sector budget

Despite institutional differences the scope of the public finance sector in Slovenia does not differ considerably from its scope in the countries of the EU regarding the size and the structure of public expenditures. The sector consists of four major components: (i) central government budget, (ii) Pension and Disability Insurance Fund, (iii) Health Insurance Fund, and (iv) budgets of municipalities. The reforms of public financing and fiscal policy in Slovenia since independence in 1991 are characterized by gradual rather than radical changes. They by and large corresponded to a general gradualist transition, which has its explanations in a heritage of the previous systemic changes, in rather favourable initial economic conditions of the country, and in its consensus building approach in taking decisions about major economic reforms.

The transition of the public finance sector in Slovenia was also rather smooth taking into account drastic political and economic challenges that the country was faced with in the beginning of the 90s. In the years following the independence, the development of the public finance was burdened by an enormous decline in real GDP due to the loss of the

Yugoslav market and transition. Recession badly affected budget revenues and increased the need for budget expenditures to large industrial enterprises, and for social transfers to unemployed and retired. Independence of the Bank of Slovenia put a stop to the ability to borrow money from the central bank that had been the practice in SFR Yugoslavia. The government had to balance its growing budget expenditure by raising taxes and / or by internal and external borrowing. In spite of thes e developments, Slovenia has succeeded to keep aggregate public expenditures under control in spite of some deterioration in recent years.

Two sub-periods can be distinguished in the development of Slovenian public financing: (i) the sub-period until 1996, and (ii) the sub-period afterwards. In the former, the government designed and implemented different policy measures aimed at preserving potentially vital parts of the economy and at easing social effects of transformational depression. Issuance of government bonds (for bank rehabilitation and for some large industrial companies, guarantees on loans for highly indebted firms, subsidies, capital transfers, tax arrears, extra budgetary funds, and early retirement schemes were among economic policy measures used to alleviate the collapse of the economy. In this sub-period, the government was entirely successful in keeping public finances in balance and in reducing public expenditures from 43,6 per cent of GDP in 1992 to 42,2 per cent of GDP in 1996 (see Table 3.5).

Table 3.5

Budget revenues and expenditures (as percentage of GDP)

Year	Revenues	Expenditures	Surplus / Deficit
1992	43.1	41.9	1.2
1993	44.5	43.6	0.9
1994	43.3	43.3	0.0
1995	43.1	43.1	0.0
1996	42.7	42.4	0.3
1997	42.1	43.2	-1.2
1998	43.0	43.7	-0.8
1999	43.6	44.2	-0.6
2000	40.9	42.2	-1.3
2001	41.5	42.8	-1.3
2002	39.4	42.4	-3.0

Source: Mencinger and Mrak, 2003

When after 1996, the necessity for extraordinary policy measures emerging from the post-transition" shock lessened, but transition related transfers were being quickly replaced by other transfers. As a result, the share of public expenditure in GDP remained rather constant though output returned to its pre-transition annual levels and despite constant

political proclamations that fiscal burden should be lowered. As a result the general government budget was pushed into deficit mainly due to the falling share of public revenues in GDP (see Table 3.5). Custom duties representing 15 percent of tax revenues diminished due to accession agreement while replacement of sales tax with VAT in 1999 has lowered revenues of taxes on goods and services. Indeed, decreased revenues since 1997 reflect weakness on the revenue side of the budget. The correlation between fiscal balance and revenues is much stronger than correlation between balance and expenditures.

3.2.2 Public debt

Evolution of public debt position of Slovenia during the transition has to be evaluated taking into account two different, but closely connected, factors: (i) first, consolidated general government budget position and (ii) second, restructuring measures in the financial sector and negotiation with foreign creditors (linked with the SFR Yugoslavia succession issues).

Most of the debt accumulated in the period before 1996 was due to restructuring of financial sector institution (mainly banks) and some big enterprises (steel mills). Besides that the Government started issuing state guarantees for the private sector institutions to lower excessive credit risk being present because of still unsuitable macroeconomic environment in that period. For the same reason – high real interest rates on domestic markets and lack of domestic resources – most of the borrowing by the state had been realized in the foreign currency or based on indexed instruments on domestic market.

By the end of 1995, public sector total debt exposure was still below 20 per cent of GDP, i.e. a sum of direct government debt and government issued guarantees. As government primary budget position was either in surplus or balanced during this sub-period, current transactions did not contributed to further accumulation of public debt. Since 1996 onwards, the public debt position of Slovenia has worsened. There have been two sets of reasons for the deterioration. On the one hand, the budget situation of the country worsened substantially. On the other hand, Slovenia had to take part over a part of the so-called non-allocated external debt of the SFR Yugoslavia foreign debt vis-à-vis the London and Paris Club creditors. In addition, the government also switched its policies toward supporting developments of public infrastructure (energy sector, highway network, railways network, utilities at local level, etc.) with issuance of additional guarantees. As a consequence of all these development, total public debt, i.e. outstanding and potential, started to grow and reached 34 percent of GDP in 2002.

Relatively higher public debt did not represent a strong fiscal burden due to the fact that the structure of debt improved significantly (more nominal-fixed instruments, more in domestic currency and lower interest rates) and that high privatization receipts (from banking sector

and in principle other shareholding position of the Government) were by Public Finance Act earmarked for repayment of public debt in period 2003-2005.

Today, Slovenia is considered, by any international standard, as relatively modestly indebted country and being in position to fulfil Maastricht debt criteria. Having said that a very important proposition shall be observed in the forthcoming period. Situation will stay stable and sustainable, only based on the assumption that budget situation will be under control, i.e. primary budget balance shall remained in constant surplus and that public sector investments shall be financed more than before from private sources and that the macroeconomic stability in Slovenia will prevail once exchange rate regime will have to be adjusted to the ERM and EMU conditions.

3.2.3 Fiscal effects of EU accession on Slovenia

Within the framework of its EU accession negotiations an agreement was reached whereby, Slovenia will have a net inflow of funds from the EU at a level of around 0.5 per cent of GDP in the years 2004 and 2005. In addition to these direct fiscal effects of EU accession – they will be a result of intra-budgetary financial flows between the EU budget and the budget of the Republic of Slovenia – the country will be exposed to other, indirect fiscal effects of its accession to the EU.

When assessing these indirect fiscal effects of the EU accession on Slovenia, one has to distinguish between two sub-groups. The first one, the »pre-accession build-in fiscal effects«, incorporates fiscal effects associated with the *acquis* steaming from the single market and other EU benchmarks. This sub-group of fiscal effects has been present in the Slovenian budgets for several years. In the pre-accession years, Slovenia (and other candidate countries) have namely increased their budget expenditures aimed at reaching *acquis* requirements. In Slovenia, they are estimated at an annual level of around 1 per cent of GDP and they will not contribute to changes in the fiscal position if compared the post-accession period to the pre-accession period.

The second sub-group or pure »post-accession fiscal effects« – consists of those which will cause a substantial change in the state's fiscal position after the accession. On the budget revenues side, they will occur due to likely worsening of VAT collection efficiency and the decline of customs duties, while on the budget expenditures side, they are associated with the Schengen-related costs, »top-up« mechanism of direct payment, and contributions to the EU institutions. For the years 2004 and 2005, the total volume of "post-accession fiscal effects" is estimated at an annual level of around 0.5 per cent of GDP

In addition to fiscal effects accession has on the overall balance of national budgets in new EU member states, this process is associated also with another important implication for

public finances of these countries. Accession to the EU namely involves drastic changes in the structure of national budget items if the country wants to keep overall budget balance under control, and to draw the committed resources from the EU budget.

There are several reasons for drastic adjustments in the structure of national budgets of new EU member states. The first one lies in the difference between the character of the contributions to the EU budget and the allocation of EU budget expenditures. According to the *acquis*, each EU member is obliged to make annual contributions to the EU budget. These contributions constitute a new budget expenditure item in the national budget. Member countries are also eligible to receive funds from the EU budget and these funds represent budget revenue item for the national budget. However, EU budget funds may be used only for funding eligible expenses associated with two economic policy items carried out at the EU level, namely the CAP and the cohesion policy.

The problem of budget restructuring states is further because a large majority of expenditures funded from the EU budget require co-financing from national resources. Obligation to provide national co-financing and application of the »additionality principle« in fact imply that a country has to channel additional national budget resources for those expenditures – mainly agriculture and structural operations. If, however, the country does not provide funds for co-financing then also the EU funding cannot be used.

To conclude, overall fiscal effects of the EU accession will be more or less neutral in the years 2004 and 2005 if the calculation takes into account only the following two elements. First, *calculated net inflow* from the EU budget. This inflow is estimated at an annual level of around 0.5 per cent of GDP (see sub-chapter 4.3). Second, other negative fiscal effects of EU membership to be experienced exclusively in the post-accession period, especially reduced budget revenues from VAT and customs duties. The magnitude of these effects is estimated again at an annual level of 0.5 per cent of GDP. If, however, those EU related expenditures that have been introduced into the budget already in the pre-accession period, like top up payments in agriculture and Schengen related expenditures, are introduced into the calculation then the overall fiscal effects of Slovenia's accession to the EU will be negative at a level of around 1 per cent of GDP. The outcome may be even more negative in case that the country would not be successful in absorbing EU budget funds committed to the country during the EU accession negotiations.

4 Micro-economic policies and structural reforms

4.1 Reform of productive enterprise sector

This sub-chapter deals with the transformation and restructuring of Slovenian productive enterprise sector comprising agriculture, manufacturing and service industries. Public

services (health care, education, social security system, government services) have not been taken into consideration. After the shock caused by the dissolution from former Yugoslavia and the loss of the markets in South Eastern Europe the privatization and reform of the socially owned business sector was the prime goal for the government authorities and for the political elite. However, it became obvious already in the 90's that the reforms of the public sector should accompany the reforms in the privatized business sector and both reforms should become the integral part of the transformation process in view of EU integration and in view of increasing overall competitiveness of Slovenia. In the context of meeting Maastricht fiscal and monetary criteria Slovenian government decided in 2002 to a launch health care reform, tax reform and the reform of public administration.

4.1.1 Different forms of privatization and restructuring the enterprise sector during the transition period

Slovenia implemented a gradualist approach to enterprise restructuring and privatization, ensuring a consensus among the main stakeholders and distribution of the financial burden between governmental, semigovernmental, and private subjects. The main stakeholders in the process were coalition government, directors and employees of the socially owned companies, trade unions, privatized companies, non-governmental organizations. Enterprises were essentially divided into three groups: (a) large loss-making enterprises owned and under the responsibility of the Development Fund. The restructuring of these enterprises was closely related to privatization and was indeed a readying process for sale to the private sector; (b) enterprises in social ownership, to be privatized under the provisions of the Ownership Transformation Act; and (c) enterprises under direct supervision of the government – such as public utility companies (telecommunications, water, electricity and gas supply, steel works and other communal services) that were supposed to remain in the domain of the government (Simoneti, Rojec, Gregoric, 2003).

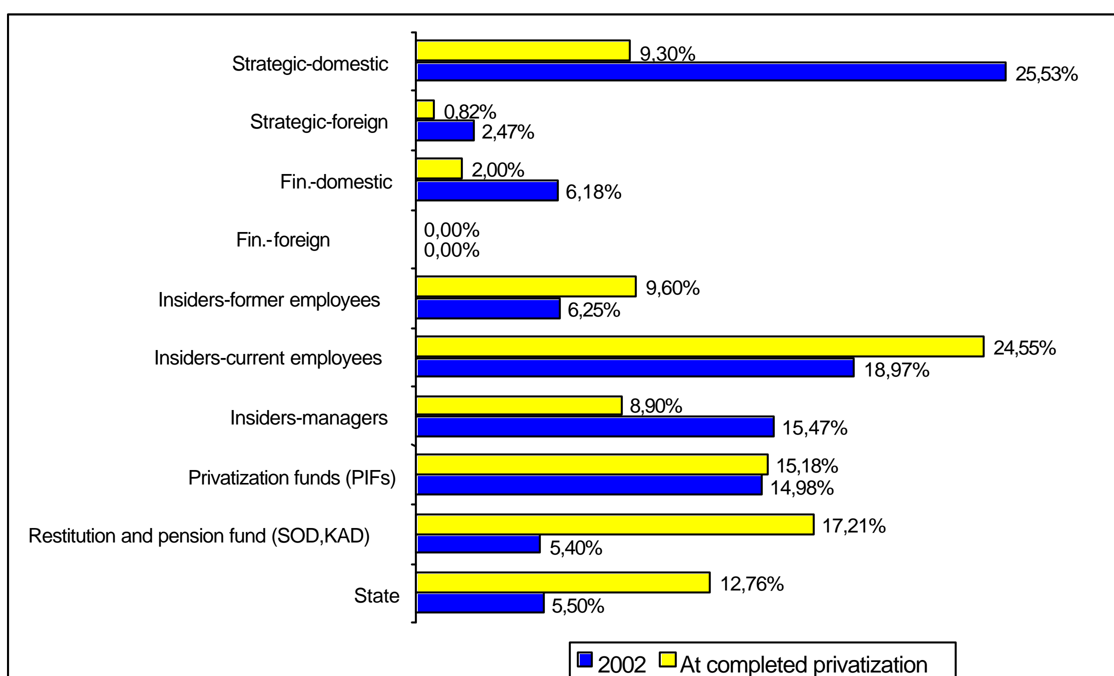
The coalition government tried to solve the problem of numerous loss making enterprises through temporary ownership by Development Fund which was established in 1992. The objectives of this restructuring were to install appropriate corporate governance, downsize the labour force, to negotiate workouts for old debt with creditors, to divest and privatize. Out of 220 companies, which applied for such kind of restructuring process, 98 were chosen. These companies were employing about 10% of the total labour force in the business enterprise sector and accounted nearly half of total nonpublic utility losses. The main goal of the Development Fund operations was to liquidate or sell companies through trade sales, debt-to-equity swaps and joint-ventures. During the process encountered with severe constraints, there were in the first 2 years achieved very good results: losses were reduced by 80%, labour force by 20% and one third of the companies was shortly privatized. At the end of 90's and in 2000/2002 period the programme became softer

providing various forms of state aids. The Development Fund was abolished in 2002 after the requirement of EU state aid regulations. Most of Fund's portfolio companies were transferred to privatization state funds.

Companies which implemented their programmes of ownership transformation under the provisions of Ownership Transformation Act (OTA) and under the supervision and upon two compulsory approvals of the Agency for Restructuring and Privatization. The process of ownership change lasted more than six years, during which 1,381 (96.2 percent) of the companies obtained approval for privatization and inscription in the Court Register.[4] The remaining 55 companies did not end the privatization programme and were either transferred to the Development Fund or liquidated. The social capital subject to ownership transformation represented only 68 percent of existing social capital. Most of the remaining 32 percent stayed under the ownership of the state (Agencija RS za prestrukturiranje in privatizacijo, 1999).

Chart 4.1

Ownership structure of privatizes companies at the time of completed privatization at the end of 2002 (in per cent by types of owners)



Source: CEEPN, Survey 2002.

Most companies were privatized through free distribution of vouchers that could be exchanged for privatizing shares by citizens either directly or indirectly via privatization

[4] The agency gave its first approval of a program of the ownership transformation on July 29, 1993, and its last approval on October 30, 1998.

investment funds. In addition, 20 percent of shares of each company were transferred to the para-state pension fund and the restitution fund with the objective of covering future state liabilities toward the underfunded social pension system and former owners of nationalized property. These artificially created privately managed and state managed funds, in fact, became the new major owners of the entire Slovenian enterprise sector, while the rest of the privatizing shares were mostly taken up by insiders – employees, former employees, managers (see Figure 4.1.). Although internal ownership prevailed in smaller, labour-intensive companies, insiders ended up holding only about 40 percent of capital subject to ownership transformation. On the one hand, workers and management obtained more than 50 percent of shares in 802 companies (61.3 percent), but accounted for only 22.9 percent of total capital. On the other hand, in 150 companies (11.5 percent) accounting for nearly 45 percent of the total capital, insiders did not obtain more than 20 percent of companies' shares (Simoneti, Rojec, Gregoric, 2003).

4.1.2 Structural change in the productive sector

Slovenian productive sector has in the past 12 years undergone significant structural changes due to the privatization process, marketization of the sector and due to the shift to Western markets.

Agriculture, forestry and fishing which had at the beginning of the transition generated relatively small gross domestic product and value added and employed small proportion of working population have in the period 1991-2001 lost additional 2.6 per cent in value added and 3.1% in employment. The role of agriculture in 2002 reached similar importance as in developed EU countries with specific characteristic of very small farms (average size of the farm is 5.7 hectares).

The most important changes occurred in manufacturing and service sectors. Manufacturing sector which has in 1991 generated 35.9% of total value added dropped to 27.7%. On the other side, service sector (not including electricity, water and gas supply and construction) increased the share from 50.2% in 1991 to 60.1% in 2001. Accordingly, the employment in services increased from 43.3% to 55.5%. Labour productivity measured by value added per employee has been constantly increasing but it still lagged behind the EU average by 40-70% in 2000. In the period 1996-2001 the best improvements were achieved in tourism, wholesale and retail trade, business services, telecommunications services and catering.

Table 4.1

Structural change in the Slovenian economy by sectors, 1991 to 2001 (value added in current prices and employment, %)

	1991		1996		2001	
	VA	Employ-ment	VA	Employ-ment	VA	Employ-ment
Agriculture	5.7	8.3	4.4	6.3	3.1	5.2
Manufacturing, mining	35.9	40.6	29.1	33.9	27.7	30.0
Electricity, water, gas supply, construction	8.2	7.8	8.9	8.6	9.1	9.3
Services	50.2	43.3	57.6	51.2	60.1	55.5
	100.0	100.0	100.0	100.0	100.0	100.0

Source: Kuzmin (2003), pages 7-13.

In spite of gradual deindustrialization, the importance of industry in Slovenia remains much higher than the EU average; in fact in 1995-2001 the difference, measured by share in GDP, increased from 6,0 to 6,8 structural points. Within industry, the importance of the manufacturing sector shows the fastest decline. The manufacturing sector is the predominant exporter and consequently its restructuring is of critical importance for Slovenia's international competitiveness. In 1991-2001, the manufacturing sector achieved a positive restructuring process, characterized by the increased importance of above-average capital intensive, innovative and export-orientated activities such as chemicals, metals, engineering and the production of electrical and optical equipment, while the importance of traditional labour-intensive activities, such as the textile industry and footwear manufacturing, dropped. With these changes Slovenia reduced the discrepancies between its own structure and that of the manufacturing sectors in EU countries with a similar industries structure (e.g. Austria, Italy, Belgium, and Denmark). However, the pace of structural changes in the Slovene manufacturing sector, measured by changes in the structure of value added and employees, was continuously slowing down in the 1990's. In the second half of the 1990's, the intensity of structural changes in the Slovene manufacturing sector was higher than in the EU countries, with the exception of Finland and Denmark, but slower than in comparable transition countries (UMAR, 2003).

Due to the fact that manufacturing industries in Slovenia generate about 80% of the country's export it is appropriate to analyze the structural change within manufacturing sector. During the whole transition period "textiles", "leather", "vehicles" and "metal products" branches have lost important shares in value added and employment. These declining branches were the main losers in the period 1991-2002 having the highest negative yearly growth rates (from -6.0% to -4.4% per year). The employment in these three branches dropped by 20.000 jobs and thus contributed to the overall registered unemployment rate 11.6% (by ILO definition the unemployment rate in 2003 was only 6.4%). Despite increased competition on domestic market Slovenian manufacturing still

shows very broad unspecialized and diversified branch structure. Compared with EU countries Herfindahl-Harschman concentration index for Slovenian manufacturing shows very low concentration rates (Bešter, 2002) regarding the employment, total revenues and gross value added. The share of high-tech industries in the total output of manufacturing industries is also very low. The main exemption are pharmaceuticals and electronic components. The lags behind EU average value added per employee in 2000 were from 1.9 to 4,5 times. The majority of manufacturing branches are lagging behind EU by 2-2.5 times despite the fact that productivity grew during the transition by. In the period 1998-2001 the most successful branches were the following: bureau machines and computers.

Table 4.2

Employment change within Slovenian manufacturing industries, 1991 to 2002

	Average growth rates 1991-2002
Food, beverages, tobacco	-2.3
Textile, apparel	-5.6
Leather, leather products	-6.0
Wood processing	-4.1
Pulp, paper, printing	-2.5
Coke, oil derivates	-5.0
Chemicals, chemicals products	-1.9
Rubber, plastics	+0.7
Mineral products	-3.8
Metal, metal products	-4.4
Machinery, equipment	-2.6
Electro industry, optical equipment	-2.1
Vehicles	-6.2
Furniture and other industries	-2.3
Manufacturing total	-3.5

Source: Kuzmin, 2003.

4.1.3 Structural reforms in service sectors

What appears to be critical for enterprises and their competitiveness are reforms designed to improve the effectiveness of the institutional regulatory framework and public administration, including measures to improve the business environment for technology based companies. In competition policy Slovenia has adopted legislation covering the main principles of the acquis communautaire (both in anti-trust and state aid sector). Legislation in the field of public administration has mostly been modernized and is in the process of implementation. Computerization of public administration is progressing and is also supported by regulations regarding the work practice. The key weakness of the public administration in Slovenia is the long lasting processing of certain administrative

procedures which affects economic competitiveness of the companies on international scale.

In service sectors (comprising trade, hotels and restaurants, transport, storage and communication, financial intermediation , real estate and business services, public administration, defence, social insurance, education, health care and personal services security) market services generated in 2002 71% of value added while the number of people in employment was somewhat lower (67%). Compared to the EU average the share of market services in Slovenia is still somewhat lower (Eurostat yearbook 2000, pp. 222-223). Despite extremely high growth rates of market services, the ratio between market and non-market services changed little from 1995-2001, as non-market services also showed above average fast growth. In the final phase of the transition period Slovenia has started to liberalize the service industries and this should result in a higher number of competitors as well of wider and better choice to consumers. Liberalization contributed, first of all, to the lowering of prices, to the rationalization process within the companies and to the improvement of provided services. The effects of liberalization are not to be seen in all sectors and with the same intensity as the process only started few years ago but the positive results are obvious. (Report on structural reforms, 2003)

In this section, we analyse briefly the market reforms undergoing in the telecommunications, postal services, public utilities, energy and transport sectors.

The Slovenian telecommunication market has developed quickly in recent years and reached about 600 million EUR in 2002. The share of mobile telephony users in 2002 was 77% while in fixed telephony there were 47 connections per hundred residents and 90 connections per hundred households. Competition exists in all segments of the telecommunication market, with the exception of fixed telephony for inland calls. Prices in the telecommunication sector have fallen due to the increased competition in mobile telephony while in fixed telephony price distortions still exist. Liberalization of the telecommunications market and ensuring appropriate price ratios for services are realized through independent regulator ATRP which introduced certain changes :unbundling of local loops, pre-selection of operators for mobile and fixed telephony for long distance mad international calls. Besides the network of the main fixed operator Telekom, two other networks were established.

In the postal services Post of Slovenia is the provider of universal postal services accompanied by 5 small providers of courier services. The new Postal services act removes the monopoly in the area of these services.

The local municipalities are in charge of providing public services for environment protection. The majority of them are organized as public companies, owned entirely by

municipalities or by mixed private public ownership. The present organization of public environmental services with excessive number of local providers is inappropriate. The prices for these services are controlled by the state . The future reform of these services envisages more competition and more incentives for the private providers to invest in environmental infrastructure.

In 1999 there were set the grounds for liberalization of energy markets in line with the EU practice. The energy agency as the regulator body was founded in 2000 and is fully carrying out its tasks of issuing licenses, regulating system tariffs, and taking decisions in case of denial of access to electricity and gas market. Deregulation of the electricity sector has brought about the unbundling of production, transmission, distribution and supply activities. Energy companies that still perform monopolistic services (transmission and distribution) must keep separate accounts for market services and for the regulated services. In 2003 the right of eligible customers to choose suppliers abroad was already non-discriminatorily regulated along the rules for cross-border transmission. However, the government has limited the scope of international exchange of 20% of total electricity consumption in Slovenia. The liberalization of electricity market has so far resulted in lower prices for the large consumers, but the positive effects for the rest of the industry have not been achieved.

Functional unbundling of natural gas transmission and other market activities are in the process of legalization. In line with the opening of the growing natural gas market the vulnerable customers will be protected .

Rail, road, air and maritime transport comprise important part of the deregulated market services in Slovenia. National freight transport accounted in 2002 about 68% of freight carried by road, and international road transport accounting for the rest. 19% of road freight is carried out by foreign freight operators, all of it as a part of international transport. In order to promote passenger transport Slovenia uses a system of subsidies for public city passenger transport. However, in the near future this form of transport is supposed to be performed as a public service and concessions will be awarded to best bidders.

4.1.4 Challenges for technological upgrading and human capital formation

In the process of accomplishment of transition, EU accession and shift to new development and knowledge-based paradigm Slovenian economy will have to substantially increase its overall competitiveness. The national competitiveness in defined as a capacity to sell products and services on international markets under free and fair conditions in such a way that ensures sustainable development and sufficiently high living standards (OECD, 2001). As Slovenia doesn't possess any significant domestic natural resources (wood is the only exception), it has to rely mainly on its own human resources

and technological development induced either by domestic innovation efforts either by technology transfer and diffusion from abroad.

In comparison with other CEE transition countries Slovenia inherited some advantageous features of the former science and technology (S&T) system. Under self-management, decentralized research institutions and universities were not organizationally linked to the academy of sciences and government bodies. Institutes were open for contractual co-operation with the business sector, and had many contacts with neighbouring Western research institutions. In the system of social ownership business sector possessed relatively strong intramural R&D capacities.

The latest innovation survey for the years 1999 and 2000 in Slovenia covered almost 3000 companies in manufacturing and service sectors. The rate of innovative firms introducing new or improved products or processes slightly decreased over the last years. Innovative companies (21.6% of the total sample) represent a competitive advantage of economy because better and more functional products and services attract consumers, expand companies' potential markets and give companies first mover's advantage. Internally, innovations reduce specific material consumption, rule out costly machining, reduce machining and assembling time, improve space utilization and machinery placement. The average percentage of total revenues coming from new or renewed products (19%) is slightly lower than in European Union (20.4%), but it still surpasses the Austrian and Irish ratio.

There are huge differences among companies in the innovation rate regarding the size of the companies. Large companies (with over 250 employees) tend to be more innovative (58.8% performed innovation) than medium (32.6%) and small (12.4%) sized firms. This tendency is in line with the findings of innovation survey in West European countries. Intramural and external R&D expenditures represent the largest share (44.9%) of the total innovation costs in Slovenian economy, followed by the expenditures for acquiring machinery and equipment (32.6%), for the preparation of production (11.1%), purchase of external expertise, marketing, education and training of employees.

Companies in manufacturing sector (having nearly 70% of total workforce in innovative companies) employ relatively smaller share of highly educated people. Despite smaller innovation investment (compared to service sector) the manufacturing sector earned in the year 2000 much higher revenues based on innovation (1.5 billion SIT in relation to 0.9 billion in the service sector). The most innovative manufacturing branches are machinery, metal products and chemical products while in the service branches: telecommunications, insurance and electricity supply. The revenues obtained from technically new or improved products (services) represent in Slovenian economy only 19% of total revenues. In this respect there is a slight difference between manufacturing and service sector. The most

profitable branches regarding the innovation revenues are data processing, electronics, oil derivatives, telecommunications, motor vehicles, and garment and fur.

Analyses indicate that industry oriented government, technology and innovation measures are very modest (0.1% of GDP) in scope and distributed proportionally, i.e. relatively evenly across different objectives. This represents lack of priorities and lack of clear orientation of national science, technology and innovation policy.

In the case of Slovenia we would expect more orientation on imitation (policy measures oriented primarily to diffusion and absorption), due to its smallness, technological gap and catching–up towards the EU. However, data show that in Slovenia innovation-oriented and imitation-oriented measures (though insufficient in their scope) are understood as supporting and complementing each other (Stanovnik, Mrak, Štiblar, 2003).

Slovenia devotes significant public resources into education, also in comparison to EU and OECD countries (in period 1995-2000 the total expenditures including pre-primary level amounted between 5.5% and 5.7% of GDP).

Despite improvements in raising human capital in the last decade the educational system is facing severe problems: low average functional literary of adults, low participation rate of adults in education and low average years of schooling (16 years). Special laggings are to be found in shares of those with tertiary education (13%) and those with at least upper secondary education (60%). There are too many drop-outs in tertiary education and a certain disproportion between graduates in engineering, natural sciences and medicine compared to graduates in social sciences and humanities. The data on those who participate in life long learning (5.1% of adult population in Slovenia) show a certain lag behind EU countries (8.9%).

Technology and innovation policy in Slovenia should focus on the following key objectives:

- *Building an innovative culture and entrepreneurship:* Due to the short period of established market economy there is a necessity to conduct a broad based awareness campaign about importance of product, process and organizational innovations. Strategies on the part of firms and government should overcome the inability of many companies especially SMEs to cope with technical progress due to inappropriate work organization, poor management and techniques incorporating new technologies.

- *Leveraging R&D:* There is a need to new approaches to stimulate market driven research that provide greater scope and incentives to private initiative and are less dependent on government financial support. On the other side support for enterprise R&D, for R&D co-operation by firms and improvement of absorptive capacity should

be increased. Science system should adjust to the entrepreneurial model of knowledge generation and diffusion. The government objective for GERD in 2010 is aimed at 3% of GDP. The composition of R&D expenditures should be 2/3 in business enterprise sector and 1/3 in public institutions (universities and research institutes).

– *Enhancing technology diffusion*: Slovenian government needs to make balance between support to the integrated basic research in universities and other public research organizations, support to the "technology" intensive part of the industrial sector and support aimed at fostering innovation and technology diffusion throughout the whole economy. In this context measures addressing the mismatches in risk capital markets and improving framework conditions for high-tech spin offs and start-ups are badly needed.

– *Promoting networking and clustering in the business enterprise sector*: research and technology development and innovation policy should focus on the research organizations' and firms' ability to interact with other EU enterprises and organizations. Positive experiences from 5th FP should be used in the 6th FP, especially to support knowledge diffusion, labour mobility and improving exploitation of public knowledge.

The key measures to be taken in the field of education and investment into human capital are:

– Increase in total (public and private) investments in education and training, especially in the field of adult education, also by introducing individual education accounts and appropriate employment policy programmes.

– Providing high quality education and training at all levels of the education process. Development of the certification system on the principle of acquiring publicly recognized education in different ways. Particularly at the university or graduate level, the flexibility of education, international mobility and comparability of results should be increased.

– Raising the education level of adults and implementing the lifelong learning concept. Development of counselling services for adult education in every region, including for education for personal and other needs not related to work activity. Orientation of measures for stimulating the attendance of adults in education programmes especially towards the unemployed, to inactive persons and those with a negative attitude towards education, and to potentially active persons who would take part in education programmes if certain conditions were met.

– Improving the writing skills of the entire population and their more uniform regional distribution via a selective system of financing education and consulting services for adult education in regions and via regional strategies for raising the level of such skills, and increasing the participation of adults in education and training.

– Increasing the level of responsibility and motivation of employers for the education and development of employees through diverse mechanisms (preparation of long-term and medium-term employee education plans, set the company's education goals, organize education and training consulting for the employees, establish self-learning centres, inter-corporate education centres).

4.2 Financial sector reform

4.2.1 Overview of the financial sector

Financial sector is described by three elements: (i) the size of the sector, (ii) number of institutions, and (iii) market concentration.

– *The size of the financial sector;* At the end of 2002 *total financial resources* in Slovene financial sector were 7259.1 Billion SIT (31 Billion EUR) or 137.4% of GDP in 2002. As shown in Table 3.3, the share of banking sector's assets in the overall financial sector is 63%, of insurance companies 7% and other financial institutions 30%.[5] The size indicates relatively shallow financial structure of new developing country, if 250% of banking assets in GDP of EU members is taken into account, or, if ratio for GDP: total wealth of 1:3 (for developing countries) or 1:5 (for mature market economies) is taken as benchmark. With an additional assumption that half of wealth is kept in financial assets the calculated share for Slovenia should be 1.5 of GDP in financial assets. Relatively large 63% share of banking in total financial assets indicates the shallow financial structure and continental direct financing as predominant feature of Slovene approach.

As shown in Table 4.3, the share of banking sector's assets in the overall financial sector is 63%, of insurance companies 7% and other financial institutions 30%.[6] The size indicates relatively shallow financial structure of new developing country, if 250% of banking assets in GDP of EU members is taken into account, or, if ratio for GDP: total wealth of 1:3 (for developing countries) or 1:5 (for mature market economies) is taken as benchmark. With an additional assumption that half of wealth is kept in financial assets the calculated share for Slovenia should be 1.5 of GDP in financial assets. Relatively large 63% share of banking in total financial assets indicates the shallow financial structure and continental direct financing as predominant feature of Slovene approach.

[5] All financial resources include both, their own assets and assets in management of financial institutions.

[6] All financial resources include both, their own assets and assets in management of financial institutions.

Table 4.3

The size of the financial sector in Slovenia, 2002 (in billion tolars, 1 EUR = 230 SIT)

	ASSETS	**Share:**
A.BANKING INSTITUTIONS		
- 20 banks	4556.6	
- 2 savings houses	15.0	
- 15 savings and loans	51.6	
Total	4623.2	
		63.5%
B.INSURANCE INSTITUTIONS		
11 insurance companies	441.0	
2 re-insurance companies	60.6	
Total	501.6	6.9%
C. OTHER FINANCIAL INSTITUTIONS		
28 brokerage houses	1606.8	
- own assets	356.7	
- assets in management	34.5	
- assets in brokerage	1215.6	
investment companies, managed assets	521.7	
- 19 companies manage 29 privatization inv. funds	328.0	
- 4 investment companies	138.3	
- 18 mutual funds	55.4	
5 mutual pension funds	5.8	
TOTAL (A + B + C)	2134.3	29.4%
ALL FINANCIAL INSTITUTIONS	7259.1	100%

Alternatively, the share of banking assets in GDP was 87.4%, the share of insurance sector assets 9.5% and market capitalization in stock exchange is 41%, which gives total sum of 135.3% of GDP, close to the above calculation.

The stock of financial resources (wealth) was calculated above. The net increase in the form of portfolio of bank deposits, insurance premiums and securities calculated for 2002 indicates increase in financial savings[7]:

- net deposits in banks (deposits minus withdrawals)	385 billion SIT	48%
- net insurance premiums (256 gross premiums-164 claims)	192 billion SIT	12%
- turnover in stock exchange	322 billion SIT	40%
TOTAL	799 billion SIT	100%

7 Not all of this is by domestic residents, although the share offoreigners was very small.

Financial savings in three major forms thus counted for 154.1% of GDP in 2002. The share of savings (net) in the form of bank deposits declined to 48%, 12% was put in net insurance premiums and almost 40% were sells / buys of securities in stock exchange. Again, the latter is not totally comparable to the first two forms of financial savings, but the indication for redirection of savings from bank deposits towards securities due to difference in returns is appropriate as bank passive interest rates declined by 0.5 to 1.5% percentage points, while Ljubljana stock exchange index increased by 55% in 2002.

– *The number of financial institutions.* Number of financial institutions almost halved (decreased by 45%) from 1997. All types of institutions decreased their number in last five years except mutual funds. Some new institutions are appearing recently. Green field FDIs in financial sector are not present while domestic institutions are in consolidation process (M&A). In 2002 the share of banking institutions is only 25% (with 63% share in volume of total financial resources in Slovenia they control), institutions in insurance 8% (with 6.9% share in volume), while other financial institutions have 67% in number, but only 29.4% share in volume of financial resources. Taking into account different services they offer comparison indicates that further consolidation will be needed especially in other financial institutions.

Table 4.4

Number of financial institutions, 1997, 2001 and 2002

	1.12.1997	**31.12.2001**	**31.12.2002**	**% v 2002**
A.BANKING INSTITUTIONS				
banks	28	21	20	14%
savings houses	6	3	2	1.4%
savings and loans	70	45	15	10%
B.INSURANCE INSTITUTIONS				
insurance companies	13	11	11	7%
reinsurance companies	2	2	2	1.4%
C.OTHER FINANCIAL INSTITUTIONS				
stock broking houses *	43	32	28	20%
management companies	26	20	19	13%
privatization companies	60	37	29	21%
mutual funds	15	18	18	12%
TOTAL	**237**	**189**	**144**	**100%**

* Including 11 banks in stock market

Source: ZBS in BoS

– *The concentration in financial market.* Competition in the market is defined not only by number of existing players, but level of concentration. For three sub-sectors of Slovene

financial sector market concentration indicators are calculated: Hirsman-Hirfendal Index (minimum value 0% if equal distribution of market shares among infinity of market players; maximum value of 10.000, if only 1 institution controls 100% of market) and K-5 coefficient)as a sum of shares of five largest institutions in the market). Availability of data confines representation of other financial institutions only by leasing companies as special sub-market.

Table 4.5

The H-H Index and K-5 Coefficient for Slovene financial market concentration, 2002

	H–H Index	K-5 Coefficient
Banks in 2002	1651	69.0%
Insurance companies in 2002	2560	91.7%
- life	3244	94.5%
- non-life	2635	94.7%
Leasing companies, 2002	1545	66.0%

Source: BoS, SZZ, own calculations

Concentration is not too large. In banking it declined from over 1800 in mid-1990s and remains below the level of some mid-size EU economies (Netherlands). It is larger in insurance sector (especially if life and non-life insurance is analyzed separately), smaller in market of leasing (and probable all other financial institutions) indicating again where further consolidation will take place.

4.2.2 Banking sector reforms

Slovenian banking sector did not suffer banking crisis in the 1990s, the only one among all transition countries. Rehabilitation of banking sector after independence was made by the model for developed countries, using budget resources and intervention of Government. It was successfully completed in 1997, so that banking sector reform is one of the three pillars of the successful financial transformation of Slovene economy (other two being independent Central bank with its monetary policy and prudent fiscal policy with budget close to equilibrium).

Slovenia opted for universal banking system with indirect financing as predominant feature of the entire financial sector. Stock exchange, despite the fact that it is technically well developed, plays a minor role, and insurance sector lags behind banking in transformation.

History of the banking sector. Slovenia has a good banking tradition in the history. In the past, first incorporated domestic bank Ljubljanska banka was established in 1900 when Slovenian territory was part of Austro-Hungarian Empire. Domestic banks proved to be much more stubborn against crisis after the World War I. They were strongholds in the economic boom of the region in early 1920s, survived a crisis of early 1930s, operated during World War II, but were abolished as independent commercial banks during 1945-1960 period of SFR Yugoslavia. In 1960s they re-emerged becoming at first profit oriented financial institutions during period of economic reform of 1965, but later, in the system of associated labour, they were converted into servic e of self-managed enterprises. Only later in 1980s banks increasingly regained the role of financial institutions with profit motive.

From early 1990s, the economy of Slovenia is experiencing major changes due to the dissolution of the SFR Yugoslavia and transformation from socialist labour self-management to the capitalist market economy. These changes had profound effect on large "old" banks that had been formally owned by enterprises. Smaller new banks started to emerge from 1989, even before the proclamation of independence of Slovenia in June 1991. "Old banks" suffered enormously (I) from loosing assets in other parts of the former SFR Yugoslavia, (ii) from retaining "joint and several liability" obligations against foreign creditors of the SFR Yugoslavia, and (iii) from increasing share of non-performing loans to enterprises hit by the dissolution of the country and by the transformation depression.

Salient features of Slovene banking including early introduction of two-tier banking system in late 1950s, ownership of banks by enterprises, openness to the world, led to specific starting situation in banking at the beginning of transition in 1990s and to specific solutions for bank restructuring later.

Banking sector rehabilitation and privatization. In all EU member states at least 80 percent of leading banks are in domestic ownership, while in transition countries this share is close to zero, with exception of Slovenia which still has a possibility to decide which way to go. In restructuring of banking sector, Slovenia tries to follow the strategy of less developed EU countries: consolidate first to retain international competitiveness and privatize gradually after so that there is enough domestic capital to retain at least some banks in majority domestic ownership to execute own development strategy.

Rehabilitation of major Slovene banks as a central element of bank restructuring was needed due to losses, liquidity and solvency problems. Namely, most of the costs of independence and transition of Slovenia were finally concentrated as a "black hole" in banking sector. Two largest "old" banks were put under formal rehabilitation status at the beginning of 1993 and the third bank followed at the beginning of 1994. They counted for more than half of the banking sector, which made the bank restructuring in Slovenia an un-precedent venture.

The main objectives of bank rehabilitation were to achieve capital adequacy according to international standards, positive cash flow and current operational income, reduction of banking interest rate, regaining credibility in international financial markets and introducing basic principles of prudential behaviour of banks.

Specific Slovene initial conditions on macro (newly established open economy and small monetary area) and micro banking level led to the choice of specific mix of centralized-decentralized approach to bank rehabilitation. The state swapped bad assets of banks for government bonds through the state Bank Rehabilitation Agency (BRA), which became owner of banks, but not in their total amount thus forcing banks to engage in intensive internal rehabilitation as well. BRA, established in 1991, played a major role in supervision of banks in rehabilitation, management of bad assets and management of the part of public debt (servicing government bonds swapped for bad assets of banks).

The rehabilitation procedure for banks included four steps: (i) write-off current losses, (ii) swap of bad assets for BRA/state bonds, (iii) transfer of bad assets to BRA, and (iv) BRA engagement as temporary owner (supervisor) of banks delegated by the decree of Government. In the process of rehabilitation five key State rehabilitation transactions were adopted: (i) a swap of bad assets for rehabilitation bonds in January 1993,[8] (ii) establishment of Nova Ljubljanska banka (NLB) and Nova Kreditna Banka Maribor (NKBM) in July 1994 whereby old banks had retained claims and liabilities associated with the succession to the former SFR Yugoslavia; (iii) exchange of rehabilitation bonds in October 1995 (from foreign into domestically denominated), (iv) resolving the issue of un-confirmed debt swaps under "New Financial Agreement" with foreign commercial banks in February 1996, and (v) conclusion of the rehabilitation status in June 1997.

By the end of 1996, these banks were successfully rehabilitated and their rehabilitation status was abolished in mid-1997. Slovenia succeeded to stabilize the economy and rehabilitate banks (and insurance sector later) without any formal involvement of international financial institutions. There was no IMF arrangement. Thus, strict external conditionality were not imposed regarding restructuring of banking sector and later also bank privatization, of which the second part was delayed several times by the government.

Major results of the bank rehabilitation, as observed at the end of the process in 1997, were the following: (i) public debt of the country increased for the amount of DM 1.8 billion[9] (less than 10 percent of GDP); later on it was partly reduced through bad loan recovery by BRA, (ii) entire banking sector reduced share of bad assets from 10 percent to less than 4 percent of their total loan portfolio (increasing share of A-classified loans from less than 80

[8] The state became owner of banks by re-capitalization, as former owners (several thousand of enterprises from the system of associated labour, where banks were "service of labour organizations in real sector) did not want to do it.

[9] 1 EUR today is 1.95583 DEM.

percent to 89 percent, producing profits instead of losses in banking sector and achieving more normal structure of balance sheet, and (iii) banks in rehabilitation managed with the positive capital of DM 850 million instead of negative capital of DM 1,500 million and with the capital adequacy ratio CAR over 12 percent, positive profits with return on equity ROE and return on assets ROA above the average of banking sector; significant institutional and organizational improvements and better management of human resources.

Privatization process for two rehabilitated banks started after completion of the rehabilitation process with preparatory steps which included: (i) transfer of the ownership of banks from BRA back to the State (Government), (ii) appointment of interim professional supervisory board and (iii) clarification of the legal framework (legislation and decrees for privatization).

Slovenia has decided that privatization should be done gradually as all other institutional reforms in transition in the country. Because country's budget is not in urgent need for receipts from privatization, it will be executed only if and when a proper offer from proper foreign institutions appears.

Major objectives of privatization are to find active owners, to be quick and just, to generate cash (for decreasing public debt) and to be transparent. Privatization was made by tender for two state owned banks, NLB and NKBM, of which only the one for NLB was partially successful. The largest banking group NLB thus obtained partly foreign owners: Belgian KBC by 34 percent and EBRD by 5 percent, the rest being in private hands (17 percent) or state and quasi state hands. Tender for the second largest bank, NKBM, was not successful in 2002, so that it remains for the time being in 100 percent state ownership.

Performance of Slovene banking sector. All basic laws on banking were enacted in the package of "constitutional laws" on the day of independence of Slovenia on June 25, 1991. New legislation was closer than previous to modern banking regulation. A step further in approximation to the EU Acquis was made by new banking law adopted in February 1999. Its provisions related to the EU Second Banking Directive regarding single passport and home banking control will enter into force from the formal start of the Slovenian membership in the EU in May 2004.

The Slovene banking regulatory framework became gradually liberal, sector opened to foreign banks, which can establish subsidiary and from 1999 also a branch (only one Austrian bank used the possibility to open a branch until now). There are 4 banks with majority foreign capital, 1 foreign branch and over half of Slovenian banks have some foreign ownership participation. Until May 2004 licensing of foreign bank is based on discretionary decision of the Bank of Slovenia, which rely on reciprocity treatment with foreign country and positive report of home country regulator for the foreign bank –

investor. At present, foreigners control around one third of the banking sector in Slovenia, the only case among transition countries where banking is not yet majority foreign owned.

Table 4.6

Basic facts about the Slovene banking, 1992-2002 (SIT billion)

Year end	Banks	Employees	Capital K	Assets A	Costs C	Profit R	Exchange rate SIT/USD	SIT/EUR
1991	26		63	327			27.57	
1992	30		103	628	16.261	-15.516	81.29	105.07
1993	32		142	937	22.180	0.338	113.24	132.28
1994	33		220	1174	36.828	4.672	128.81	152.36
1995	31		263	1493	44.689	15.168	118.52	153.1
1996	30	10317	285	1799	52.029	15.754	135.37	169.51
1997	29	10417	320	2094	60.216	19.596	159.69	180.40
1998	24	10386	355	2412	73.708	21.907	166.13	186.27
1999	24	10445	392	2763	84.791	17.662	181.77	193.63
2000	24	10929	444	3270	98.848	31.045	222.68	205.03
2001	20	11258	481	4041	110.508	9.911	242.75	217.19
2002	19		530	4586	132.386	47.220	240.24	226.22

Source: Bank of Slovenia, SURS, NLB different sources

Over the last twelve years of independence, Slovene banking experienced slow but continuous growth and deepening. For illustration some basic facts are presented in Table 4.6. Number of banks before independence was 16. It more than doubled to 35 at the peak in mid-1994 and later declined steadily to only 19 at the end of 2002. Four of them are members of NLB Group, so that the actual number of independent banks is only 15, close to the number planned by the Bank of Slovenia as optimal at the beginning of 1990s. Contrary to general trends in developed economies, the number of employees in Slovene banking sector surprisingly and probable only transitory increased at the beginning of 2000s after stagnating at 10.000 employees through 1990s (see Table 4.7.). Modern e-banking is apparently only in an early stage of introduction.

As table 4.6. indicates bank capital increased 8.4-times and assets of banking sector 14-times in nominal terms between 1991 and 2002. At the same time, between 1992 and 2002 operating costs of banking sector increased 8.2-times and income and loss account (profits) improved from –15 to +47 billion SIT. In EUR terms capital increased from EUR 1 billion in 1992 to EUR 2.34 billion in 2002, while assets increased from EUR 6 billion to EUR 20 billion, operating costs from EUR 150 million to EUR 580 million; the loss of EUR 140 million in 1992 became profit of EUR 208 million in 2002

Table 4.7

Number of employees, units and assets in the Slovene banking sector

	31.12.1995	31.12.2001
number of units	558	643
number of employees	10.137	11.258
assets in Million SIT	1,497,544	3,962,822
assets / employees, in Million SIT	147.7	352.0

As Table 4.7. shows, the income efficiency of banks continuously increased in 1992-2002 period (exceptions being 1999 and especially 2001 with losses in SKB bank), with ROE exceeding 10 percent in 2002 and ROA obtaining close to 1 percent value in recent years. The cost efficiency worsen in the first half of the period and improved towards numbers from the beginning in the second half of observation period. It is below 3 percent, but not all costs are included, so that the true cost-to-assets ratio is 3.22 percent in 2002. Asset-to-capital multiplier increased moderately from 6.1 to 8.7, and accordingly, CAR declined from 17.8 percent to 12.8 percent reason being fulfilment of high founding capital requirement of Bank of Slovenia in the first half of 1990s. Present bank assets-to GDP ratio of over 80 percent indicates still very shallow banking structure in which further financial deepening can be expected, if 250 % ratio in EU is taken as a benchmark.

If EUR 10 billion of assets is taken as a provisional minimum required size of bank prepared for international competition (economy of scale), EUR 18 billion of total assets of banks in Slovenia enable less than 2 such large banking groups in Slovenia. Therefore, expansion abroad is necessary for Slovenian banks as it is also needed for other financial institutions and real sector blue chips in order to survive as independent (domestic) legal units with their final business decisions made in Slovenia. In fact, to execute Slovenian economic strategy, for blue chips having head office in Slovenia with final decision made here is more important for that purpose than their Slovenian ownership. The proper direction for bank expansion is South-East Europe because of comparative advantages there (existing links, language, common history, culture). Other solution is diversification of financial services (economy of scope) including development of bank assurance, investment and private banking and para-banking services in banking groups. International comparison shows that in 2000 Slovene banking was relatively efficient in comparison with 7 members of EU and 6 transition countries, more than the later group, and less than the former group (author, 2001). Comparative data (24 banks were divided into 4 foreign owned, 4 state owned and 16 private domestic owned) show that in 2000 4 majority foreign owned banks were less income efficient and paid less taxes, and they were a little better in cost efficiency. Foreign owned banks had less provisions and higher secondary multiplication. State banks lacked capital and together with foreign banks experienced higher ownership concentration. Private domestic banks with dispersed ownership were more profitable despite their lower interest rate margins.

Table 4.8

Basic financial indicators for Slovene banking sector (in per cent)

Year	ROE	ROA	A/K	CAR	Costs/A	A/GDP	K-5: 5 Banks in Total Assets
1991							73.6
1992	-15.1	-2.5	6.1		2.59		69.1
1993	0.2	0.0	6.6		2.37		66.9
1994	2.7	0.4	6.9	17.8	3.14		56.9
1995	7.2	1.0	7.0	19.5	2.99	67	59.1
1996	6.3	0.9	7.3	18.2	2.89	70	59.9
1997	7.1	1.0	7.6	17.6	2.11	72	60.0
1998	7.5	1.0	6.8	15.6	3.06	74	61.4
1999	5.5	0.7	7.0	14.0	3.07	75	61.3
2000	8.8	1.1	7.4	12.6	3.02	75	60.8
2001	2.5	0.3	8.4	12.8	2.74	85	67.4
2002	11.5	1.1	8.7		2.89	87	68.4

Legend: ROE = return on equity, ROA = return on assets, CAR = capital adequacy ration, A = assets; K-5% = the share of five largest banks in total assets of banking sector

Source: Bank of Slovenia internal materials, authors calculations

In June 2003 total bank assets were 4863 Billion € (20.7 Billion €). In six months of 2003 deposits of non-bank costumers grew by 2.4%, loans by 6.7%; aggregate pre-tax profits were 25.5 Billion SIT (110 Million €), ratio of operating costs to assets declined from 3.2% to 3.0%, but ROE and ROA (1.1%) were lower than in the first half of 2002. Total bank exposure was 5826 Billion SIT, of which 1011 Billion of balance. Average risk level of claims improved to 5.8%. Capital adequacy was 11.6%, down from 11.9% at the end of 2002.

4.2.3 Insurance sector reform

First domestic insurance company was incorporated in Slovenia as part of Austro-Hungarian Empire in 1900, the same year as the first bank. Insurance sector was financial stronghold for economic expansion of Slovenia between the Wars. After 1945 all insurance was nationalized. In former Yugoslavia insurance companies were made independent legal entities but given the role of service of the associated labour, similar to the experience with banks.

After independence of Slovenia in 1991 the major open question was the ownership status of the largest insurance company Triglav and the re-insurance company Sava. The claim

that it is mutual company of insurees was rejected in favour of state ownership of it only in 2002. That enables its further restructuring and potential future privatization.

Most of the old insurance companies (branches of the Triglav Group which became independent legal entities at the beginning of 1990s) successfully executed self-rehabilitation with additional capital investments of owners and with re-allocating surplus of premiums over claims towards assets. Development of insurance sector in independent Slovenia is indicated next.

Table 4.9

Premiums of insurance sector in Slovenia (Billion of SIT, nominal and real)

Year					
	Gross premium	**Growth rates**		**life**	**non-life**
	nominal	nominal	real		
1991	12	.	.	1	10
1992	33	186	-21	3	30
1993	47	44	11	5	42
1994	63	33	12	9	54
1995	102	63	49	15	87
1996	122	19	9	20	102
1997	130	7	-2	23	107
1998	154	19	11	26	128
1999	171	11	5	31	141
2000	193	13	4	37	156
2001	230	19	11	49	181
2002	266				
Prediction	**Mc Kinsey**	**author**			
2003	288	294			
2004	345	347			
2005	410	409			
2006	480	483			
2007	521	570			

Source: Report, Slovene Insurance Association, 2002; Mc Kinsey Report; author's calculations

Slovenia lags behind developed market economies with regard to insurance deepening, but leads the less developed economies, especially in the field of non-life insurance. Income elasticity of insurance is above 1.

Both insurance and reinsurance companies have premiums well above damage claims thus earning profits which are channelled to their re-capitalization, creation of reserves.

Table 4.10

Basic indicators for insurance in Slovenia, 1992-2002

	real growth gross premiums, %	density (premium per capita) $	EUR	penetration (premiums/BDP, %)	income elasticity (growth premium/growth income)
1992	-1.9	203	157	3.23	1.369
1993	8.9	210	180	3.30	1.016
1994	10.6	246	208	3.40	1.022
1995	44.4	435	337	4.61	1.357
1996	8.5	452	361	4.77	1.040
1997	-2.5	409	360	4.46	0.933
1998	10.2	467	417	4.25	1.058
1999	4.9	475	446	4.73	1.001
2000	8.8	436	474	4.78	1.019
2001	10.2	477	534	5.07	1.065
2002	7.6	607	578	5.03	1.046

Sources:SZZ, EIPF, SURS, Internal data

Table 4.11

Relation of insurance versus re-insurance in Slovenia, in %

	PREMIUMS reinsur / insur, %	CLAIMS reinsur / insur, %	CLAIMS/PREMIUMS reinsurance	insurance
1991	20.3	23.8	83	71
1992	18.3	24.1	83	63
1993	12.1	15.3	81	64
1994	11.7	11.3	64	67
1995	8.5	7.8	59	64
1996	8.1 min	7.7 min	61	64
1997	8.9	8.2	63	68
1998	8.6	9.2	67	63
1999	10.4	9.7	57	61
2000	9.8	12.6	85	65
2001	9.4	11.2	74	63
2002	10.7	9.1	51	60

Source Internal data SZZ, 2002

According to Mc Kinsey study (2003), Slovene insurance market is already deregulated in accordance with EU standards, except pension insurance, which has only partial second pillar; restrictions on investments; stricter capital adequacy requirements, which are not yet fully fulfilled.

Further consolidation is necessary in Slovene insurance industry for several reasons: (i) efficiency improvement, (ii) economy of scale and scope, (iii) better use of existing network, (iv) development of life insurance, (v) development of pension insurance and mutual funds, (vi) improved international ratings and cheaper external financial resources, and (vii) retaining re-insurance premiums in the country. Financial deepening in Slovenia will consist in the period of next five years of growth of banking assets by 12% yearly, insurance assets of 15% yearly and growth of market capitalization and turnover in stock exchange at the rate of 10%-20% yearly.

Slovenia has majority of insurance institutions in domestic ownership as the only remaining country among countries in transition. Together with banks and blue chips in real sector they should form a economic foundation for equal opposition of Slovenia in future enlarged EU, where present members all still keep majority of blue chips in domestic ownership.

4.2.4 Capital market reform[10]

Probable the opportunity for the capital market to become the key part of the Slovenian financial system has been lost. However, the potential competitive advantage of the capital market was not fully exploited and in fact was largely unexplored during the initial restructuring of the banking system at the end of the 1980s and the beginning of the 1990s. Banks were very inefficient, with interest margins exceeding 10 percent and little trust in them. Now that the restructuring of the banking system has been completed, interest margins are falling, and public opinion polls have been showing that banks are enjoying increasing trust. At the same time, the extreme short-term orientation of key players in the capital market is being viewed very negatively by the general public. Capital markets in Slovenia will not play the central role in its financial system as in Anglo-Saxon systems but with a complementary role in such fields as the management of pension and life insurance savings they will resemble the solutions from continental Europe.

The development of the capital market in Slovenia started in former Yugoslavia in 1988/89. At the beginning, its the main purpose was to provide new financial services and facilitate the flow of a growing amount of savings into productive investments both before and after privatization. Public issuance of stocks and bonds, the commencement of stock exchange operations, and the creation of mutual funds all preceded mass privatization schemes, which became operational in 1994. Privatization provided important momentum for its development but also caused extensive instabilities of the capital market in the post privatization period, reducing the general trust in it and in this way delaying its development as a normal part of the Slovenian financial system.

---

[10] Drawn on Jašovic, Mramor (2003)

The former Yugoslav legislation from the late 1980s regulating the capital market was replaced by the Slovenian Securities Markets Act and the Investment Funds Act in 1994, while the Take-overs Act was enacted in 1997. Amendments were adopted and new Investment Funds Act was passed in 2002. All changes adopted EU capital market directives. The independent Securities Market Agency (SMA) was established in March 1994.

Slovene capital market developed in past twelve years to market capitalization over 40% of GDP and turnover to over 9% of GDP. In 2003 historical maximums are achieved in domestic capital market with regard to stock exchange indices although the volume of transactions lags behind 2002, when major privatization transactions and foreign acquisitions of Slovene companies were made.

Table 4.12

The primary and secondary market in Slovenia, 1995-2002

	1995	1996	1997	1998
New public offerings* (million EUR)	40,5	57,2	52,7	27,4
Market capitalization (billion EUR)	0,7	1,0	2,2	3,8
Market capitalization (% of GDP)	5,0	6,9	13,7	21,8
SBI (Slovenian Stock Exchange Index)	1.390	1.183	1.405	1.706
Number of securities traded	48	82	129	173
Turnover (billion EUR)	0,6	0,5	0,6	0,9
Turnover (% of GDP)	4,0	3,4	3,7	5,3
Turnover/MC (shares)**	1,12	0,54	0,28	0,28
Turnover/MC (bonds)**	0,38	0,25	0,14	0,15

	1999	2000	2001	2002
New public offerings* (million EUR)	35,1	57,6	10,1	13,3
Market capitalization (billion EUR)	4,7	5,6	6,4	9,6
Market capitalization (% of GDP)	25,2	27,0	29,1	41,1
SBI (Slovenian Stock Exchange Index)	1.806	1.808	2.152	3.340
Number of securities traded	236	266	270	264
Turnover (billion EUR)	1,4	1,3	1,6	2,1
Turnover (% of GDP)	7,3	6,4	7,4	9,1
Turnover/MC (shares)**	0,30	0,21	0,28	0,23
Turnover/MC (bonds)**	0,16	0,22	0,14	0,16

* Public offerings due to the privatization process are excluded as well as issues of government and central bank securities. The figures consist of new issues of stocks and bonds.

** Turnover/MC is calculated as the ratio between trading volume and market capitalization.

Sources: Ljubljana Stock Exchange Annual Report 2002, Securities Market Agency of Slovenia Annual Report 2002, and Bank of Slovenia Monthly Bulletin (May 2003).

Primary market was depressed by privatization. But, after privatization is completed pension reform could give new impetus to the market. At the same time, insurance industry needs to find the proper way to invest their assets. There are many open questions regarding further development of Slovenian capital market.

The status and development of the capital market of a country is usually measured by such data as has been presented in Table 4.12. Slovenia has made considerable progress, and if we also consider the status of the legal environment, its enforcement, and other elements of well organized capital markets, then the picture is even brighter. Slovenia is a country in transition, however, and during the transition period, some other questions have become even more important when assessing the capital market's prospects for further development. The major question is the role of the capital market in the privatization process, especially when voucher privatization has been chosen as the major method. It is important for the development of the capital market that its role in privatization remains a small as possible and that the essential rules of a safe, transparent, low-cost, liquid, stable and well-organized capital market would be strictly followed in the future. Due to the transition environment, this can not be achieved only with the usual regulatory and supervisory tools used in developed market economies, especially when a satisfactory level of stability is in question.

5 EU and EMU accession process as an instrument of speeding up transition

5.1 EU accession negotiation process

The EU enlargement process – the fifth so far – of which Slovenia is a part differs in many aspects from the previous enlargements. First, the number of countries joining the European Union is this time much higher. Second, the systemic differences between the present and future Member States are much wider. In previous enlargements the countries joining the European Union had well-established market economy. This time the acceding countries are still undergoing the process of transition to a developed market economy. Third, the extent of the *acquis communautaire,* i.e. the EU legislation that has to be transposed and implemented is much larger, and includes a number of entirely new areas, for example, accession of new member states to the European monetary system. And last but not least, the enlargement takes place at a rather unfavourable time from the financial point of view. Many Member States are namely affected with serious fiscal problems and have much more limited possibilities for financing new Member States, which are in addition at a relatively low level of economic development than was the case in previous enlargements.

In order to join the EU, Slovenia, as all other applicants, has had to meet a set of accession requirements. In this regard, the European Council in Copenhagen in June 1993 stated

that: "the associated countries in Central and Eastern Europe that so desire shall become members of the Union. Accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions. Membership requires: (i) that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, (ii) the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the EU, and (iii) the ability to take on obligations of membership, including adherence to the aims of political, economic and monetary union." Membership in the EU requires from the candidate countries to incorporate EU legislation, the so-called *acquis communautaire,*. into national legislation and to implement this legislation effectively by using appropriate administrative structures and judiciary.

Accession negotiations with Slovenia and the other five countries of the so-called Luxembourg group started in spring 1998. The negotiations covered cover both the political and economic aspects of the Copenhagen criteria. They also focused on the incorporation of the EU legislation and on implementation of this legislation. In technical sense, the negotiations were organized in 31 chapter, with each of them covering a precisely determined segment of the EU legislation. Most of the chapters address economic issues related to the four freedoms, i.e., free movement of goods, services, capital and persons.

As part of its preparations for EU accession negotiations, Slovenia prepared the *Strategy for the Accession of the Republic of Slovenia to the EU* (Mrak, and others, 1998). Table 5.1. presents key structural reforms that Slovenia had planned to implement by the end of 2001 as well as their sequencing. In retrospective, one can assess the strategy was by and large implemented and also the sequencing of reforms was more or less respected.

Responsibility for assessing the extent to which the candidate countries have fulfilled the Copenhagen criteria was with the European Commission. In November of each year, it issued a report assessing to what extent individual candidate countries meet the political and economic criteria set in Copenhagen in 1993. The reports have also summarized how successful have individual candidate countries been in incorporating the *acquis.* By the end of 2001, Slovenia has closed all but those negotiation chapters that are financially the most intensive and are usually negotiated at the very end of the EU accession negotiation process. Negotiations for the financial package – they involve negotiations about the volume and structure of funds Slovenia will get from the EU budget under the common economic policies of the EU in the 2004 – 2006 period and about the volume of Slovenia's contributions to the EU budget – are discussed in the following sub-chapter.

Table 5.1

Major components of main reforms and their schedule

	1997		1998		1999		2000		2001	
	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2
Reform of the tax system										
Approbation of legislation (VAT and excise) by Parliament			■							
Preparation of implementation of VAT and excise tax	■	■	■	■	■					
Implementation of VAT and excise tax						■				
Reform of the pension system										
Prepare a White Paper on pension reform	■	■								
Discuss White Paper		■	■							
Submit proposed legislation to Parliament			■							
Adoption of the legislation by the Parliament				■						
Preparation of the reform	■	■	■	■						
Start implementation of first phase of reform					■					
Continue implementation of successive phases						■	■	■	■	■
Financial sector reform										
Opening market to branch offices of foreign banks			■	■						
Abolish inter-bank agreement on max. deposit rates and					■	■				
tolar deposits on foreign credits					■	■				
Privatization of NLB & NKBM										
Adopt legislation on bank privatization			■	■						
Preparation of privatization and divestiture			■	■	■	■	■	■		
Introduce new payment system			■	■						
Complete ownership transformation of insurance companies			■	■						
Rehabilitation and privatization of insurance companies					■	■	■	■	■	
Opening of insuranc e market to foreign capital					■	■	■	■	■	■
Broaden and deepen capital market	■	■	■	■	■	■	■	■	■	■
Develop/ improve legal/regul. framework (all fin. Sectors)	■	■	■	■	■	■	■	■	■	■
Harmonize with EU essential legislation in the sector	■	■	■	■	■	■	■	■	■	■
Reform of public utilities										
Price liberalization	■	■	■	■	■	■	■	■		
Liberalization and competition, including privatization			■	■	■	■	■	■	■	■
Regulation, including the introduction of public	■	■	■	■	■	■	■	■	■	■
procurement system	■	■	■	■	■	■	■	■	■	■
Price liberalization										
Announce full programme of price liberalization with dates			■							
Implementation according to announced plan	■	■	■	■	■	■	■	■		
Enterprise sector reform										
Rehabilitation & privatization via Sloven. Develop. Comp.		■	■	■	■	■	■			
Replace distortive subsidies with transparent measures		■	■	■						
Reducing subsidies to the level compatible with Europe			■	■	■	■	■	■	■	■
Agreement			■	■	■	■	■	■	■	■
Develop horizontal mechan. to stimulate competitiveness		■	■	■	■	■	■	■	■	■
Develop institutional and legal framework (take-over etc.)		■	■	■	■	■	■	■	■	■
Stimulate FDI and capital restructuring in privatized sectors		■	■	■	■	■	■	■	■	■

Source: Mrak et al 1998.

5.2 Financial package for accession of Slovenia to the European Union

As by far the most developed of the all candidate countries – apart from Cyprus – Slovenia has had an extremely unfavourable starting position for the negotiations about the financial package associated with its accession to the EU. Being aware of this problem, the country has clearly defined the following two strategic objectives for this segment of the accession negotiations: *First,* the final agreement with the EU should allow Slovenia to continue the process of real convergence, that is the process of further reducing Slovenia's development lag behind the EU average. *Second,* the agreement should not deteriorate Slovenia's public finance position and as a consequence it should not cause additional difficulties in achieving the fiscal part of the Maastricht criteria.

The results of the financial package negotiations in terms of meeting the development and public finance goals may be assessed from two points of view. First is the short-term perspective, that is the period from the time when Slovenia becomes a EU Member State (in May 2004) to the end of the present financial perspective (the end of 2006). Second is the long-term perspective, that is the period of the next seven-year financial perspective.

The negotiations on the financial package in fact began in January 2002 with the European Commission publishing the document "Common Financial Perspective 2004 - 2006", whereby it defined the basic framework for discussion about the financial aspects of accession of candidate countries to the European Union, that is about agriculture, structural funds and regional policy and the contributions to the EU Budget. In fact, this part of the negotiations has proceeded through three phases. The *first phase* lasted from the issue of the above Commission's document in January 2002 to the Brussels European Council at the end of October 2002. The *second phase* of financial-package negotiations took place in November 2002, i.e. in the period from the Brussels European Council to the first proposal of the Danish Presidency at the end of November. The *third and the last phase* of negotiations took place in the period from the first Danish Presidency proposal and the European Council in Copenhagen in mid-December 2002.

The agreed financial package solutions as presented in Table 5.2 can be assessed as a balanced for Slovenia both, in the short as well as in the long term. The agreements made in the area of agriculture, funds for co-financing the Schengen border as well as the agreement about Slovenia's possibility for regionalization at NUTS 2 level are all the elements of the financial package which clearly indicate its long-term orientation. These elements will not only have important effects on Slovenia's development but will provide a solid basis for our country to remain a net recipient of the funds from the EU Budget also in the period of the next financial perspective, i.e. from 2007 to 2013. Undoubtedly, this would be an adequate solution for Slovenia, given its level of development in comparison with other Member States of the enlarged European Union and would in addition contribute to long-term public finance stability of our country.

Table 5.2

Financial package for Slovenia, 2004 to 2006 (in EUR million)

Calculated pre-accession aid 2003 (EUR 45 million)				
	2004	**2005**	**2006**	**Total**
A. Calculated inflows from EU budget into Slovenian budget	**224**	**285**	**324**	**833**
- Pre-accession aid	51	43	27	121
- Agriculture	43	124	157	324
- Structural actions	27	59	73	159
- »Schengen facility« and other	38	38	38	114
- Internal actions	12	21	28	61
- Cashflow lump sum compensations	52	-	-	52
B. Calculated outflow from Slovenian budget into EU budget	**-187**	**-288**	**-296**	**-771**
- Traditional own resources	-18	-29	-29	-76
- VAT resource	-22	-35	-36	-93
- GNP resource	-129	-198	-203	-530
- UK rebate	-17	-27	-28	-72
C. Calculated net balance before budgetary lump sum compensation	**37**	**-3**	**28**	**62**
D. Budgetary compensation	**43**	**85**	**54**	**182**
E. Calculated net balance after budgetary lump sum compensation	**80**	**82**	**82**	**244**
F. Calculated net balance after budgetary lump sum compensation (% of GDP)	**0,4**	**0,4**	**0,4**	

Source: EU Commission, 17 December 2002

The financial package agreed upon with the European Union is relatively favourable also in its short-term perspective. Following the conclusions of the Brussels Economic Council already, Slovenia would be a net beneficiary of funds from the EU Budget in the period 2004 - 2006. However, the increased amount of lump sum payments agreed upon in the final phase of the negotiations even strengthened the foreseen positive net budgetary position of Slovenia *vis-à-vis* the European Union in this period and consequently also reduced potential public finance risks.

5.3 Key macroeconomic challenges after accession to the EU

5.3.1 Adopted plan for introduction of the euro and fulfilment of Maastricht criteria

In October 2003, the government of the Republic of Slovenian and the Bank of Slovenia took a decision about the fast-track accession of the country to the eurozone. The two institutions have come the conclusion that taking into account the existing macro-economic stability in the country – fiscal Maastricht criteria are fully met, inflation is on a strong downward trend, current account is in equilibrium – and the achieved level of structural

reforms it is in the best interest of Slovenia to introduce the euro as quickly as possible. More specifically, the two institutions have agreed that Slovenia will try to enter the ERM2 mechanism by the end of 2004and to introduce the euro in 2007.

Conditions for entering ERM2 are matter of negotiations (date of entrance, exit, parity exchange rate and its band). Criteria of both, nominal and real convergence, need to be fulfilled to enter the EMU and at least 2-year participation in ERM2 regime is just one of the nominal convergence criteria.[11] For Slovenia, among the latter, fiscal and long term interest rate criteria are already fulfilled. What remains is the exchange rate stability (ERM2) and decreasing of the inflation rate. For real convergence closing the GDP per capita gap (faster GDP growth and productivity improvement) will take time to be fulfilled, which will not prevent entry into EMU.

Consequences of entering the ERM2 regime will be significant for all sectors of the economy: (i) *macroeconomic environment:* lower inflation, interest rates and wage growth, aggravation of current account and ambivalent impact on GDP growth (depending on changes in consumption, investment, government spending); (ii) *enterprise sector*: will get cheaper financing abroad, income of exporters will suffer, competition will increase; labour market rigidities will play a role; (iii) *banks:* lower interest margins and savings rates, changes in structure of balance (open external position), quality of loan portfolio will suffer, capital inflows will increase.

Regarding fulfilment of Maastricht criteria, in 2003 Slovenia already fulfils 4 out of five nominal criteria:

	EU convergence criteria	**Slovenia**
- inflation	2.9%	5.0%
- long term interest rates	6.7%	5.6%-5.9%
- public deficit, GDP%	3.0%	1.8%
- public debt, GDP%	60%	28%

For real convergence, the GDP growth rate of Slovenia should be more than 50% higher than for the EU average to close the development gap (with population growth assumed equal, although Slovenia has negative natural growth, and the EU positive; but difference in migration should be taken into account too). If the EU average GDP growth for 2003 is 0.5% and Slovenia's 2.8%, real convergence requirement is more than satisfied (author, 2003).

[11] This criteria need to be fulfilled at the time of entry to ERM2 or EMU and not before. It is important not to rush with early fulfilling these criteria, as structural reforms should be made first (even with criteria not fulfilled), so that the nominal and real convergence will then be sustainable.

5.3.2 Need for strong coordination of economic policies

The process of euro introduction will request a close coordination between the government and the central bank in running their macroeconomic policies. By joining the EMR2, Slovenia is going to loose its monetary policy, which has been one of the pillars of Slovenia's economic policy over the last ten years. Transferring the monetary policy on a supra-national level is going to narrow Slovenia's room for manoeuvre for reaching its economic goals and thereby enhance relative importance of other economic policies, which will remain on the national level or will only have to be co-ordinated with the EU, especially fiscal policy, and also structural policies. Should these policies not be efficiently prepared and functional at the time of the EU accession, Slovenia's ability to effectively manage the risks related to becoming a new EU Member State will be severely compromised.

Key challenges of macroeconomic policy immediately after the EU accession, namely public finance reform and preparation and implementation of structural policies, are explained in more details below.

Public finance. Since 1996 and 1997 when the country was by and large in fiscal balance, there has been an evident trend of growing problems in public finance (increasing budget deficit, worsening of the expenditure side structure, etc.). Even though fiscal problems in the country are by no means alarming, their trend raises concerns, especially in light of further pressures for budgetary expenditures expected in the future. One group of these pressures is of a general character and can be observed in majority of European countries. A clear example of this kind is ageing of the population and its effects on budget through increased expenses for pensions and health care. The second group of pressures is more country specific and includes fiscal effects of the country's joining the NATO and the EU. Integration to these two institutions will not only increase the pressure on budget expenditures but will give an impetus to restructure the budget in respect of allocating a bigger portion of expenses for investments, a trend which has already been noticed.

Slovenia is expected to start paying full contributions to the EU budget in 2007 and at the same time gain the access to all funds which the EU distributes to its members. Unless Slovenia is thoroughly prepared for drawing on funds from the part of the EU budget reserved for agriculture and regional policies (altogether amounting to 85% of the EU budget), it will become a net payer to the EU budget after 2007. In order to obtain these funds Slovenia must institutionally and financially prepare itself and *first*, put in place an efficient organizational and institutional support for preparation and management of projects, and *second*, ensure sufficient funds from national budget or other domestic sources to co-finance the projects. As of funds from EU budget may not substitutive domestic investment funds – "additionality" principle – Slovenia will have to increase the

amount of expenditure for investment, which could be achieved either by reallocating budget expenditures or increasing budget deficit.

Taking into account that alternatives for increasing budget revenues in near future are rather limited, an objective a balance in public finance can be reached only through budget expenditure reform or more precisely through cutting budget expenditures. Therefore, a thorough, integral public finance reform based is needed in order to resolve problems in public finance system. Such reform should be carefully structured so that its costs would be equally distributed among all social classes of the population. To achieve this objective, the reform should include all segments of public finance and not only central budget. Some important elements of integral public finance reform are the following: (i) limiting rules on entitlement to funds and some other rights, thereby reducing budget expenditures to a long-term sustainable level, (ii) increasing available budget revenues, (iii) accelerating healthcare system reform, (iv) supplementing pension insurance reforms, and (v) limiting public sector borrowing and promoting non-traditional, alternative sources of financing.

Structural policies. One of important weaknesses of the transition process in Slovenia has been that the country is not yet adequately prepared for poorly and insufficiently prepared for quality and efficient structural policymaking. Some of the main problems or deficiencies are the following: (i) inconsistency between development and investment priorities determined in strategic documents and investment priorities determined in annual budgets, (ii) inadequate institutional structure for designing and carrying out structural policies of the country, and (iii) weaknesses in preparations of projects which would comply with EU requirements or criteria.

If Slovenia wants to improve policy making in the field of structural policies, including efficient use of resources from the EU budget, weaknesses identified above should be eliminated. Various activities aimed at raising the quality of preparation and realization of investments in Slovenia would at the same time ensure higher level of harmonization and transparency of development programme in the country, while ensuring more active participation of relevant ministries in the process of planning and realization of investment programmes. Last, but not least, such activities would enable the Government and the country to conduct sustain best support public finance stability.

Literature

Autumn Report, Institute for Macroeconomic Analysis and Development, Ljubljana, 2003

Bank of Slovenia, Montlhy Bulletin, several issues

Bešter J.: Analiza konkurencnosti po dejavnostih glede na slovensko povprecje in v primerjavi z državami EU, IER, Ljubljana, 2002

Bole V.: Monetary Transmission Mechanism in Slovenia, EIPF Working Papers, Ljubljana 1999

Domadenik P., Prašnikar J: On the Path toward the EU; an Overview of Enterprise Restructuring in the last Decade. In Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.

Eurostat yearbook, 2000.

Kuzmin F.: Strukturni premiki v zaposlenosti v slovenskem gospodarstvu, 1991-2002, Inštitut za ekonomska raziskovanja, Ljubljana, 2003

Mencinger J., Mrak M.: Fiscal Policy, Public Debt and EU Fiscal Implications, November 2003, mimeo.

Mrak M., Rojec M., Jauregui, C..S.(editors): Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.

Mrak M., Stanovnik P, Štiblar F.: Slovenia: Past Trends, Current Issues and Future Challenges, Peace Foundation, Cavtat 2003

Mrak M., Potocnik J., Rojec M.: Strategy of the Republic of Slovenia for Accession to the EU, Ljubljana, 1998.

Mramor D., Jašovic B.: Capital Markets Development. In Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.

OECD: Science, Technology and Economic Outlook, Paris, 2001

Republic of Slovenia: Single Programming Document 2004-2006, Ljubljana 2003

Ribnikar I., Košak T.: Monetary System and Monetary Policy. In Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.

Simoneti M., Rojec M., Gregoric A.: Privatization, restructuring and corporate governance of the enterprise sector. In Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.

Stanovnik P.: Competitiveness of Slovenian economy before EU accession, Slovenski Svetovni Kongres, Ljubljana, 2003

Štiblar F., Voljc M.: Banking Sector in Slovenia. In Slovenia: From Yugoslavia to the European Union. World Bank, Washington, D.C. 2004.