



COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION
CONVERGENCE REPORT 2006 ON SLOVENIA

(prepared in accordance with Article 122(2) of the Treaty at the request of Slovenia)

[SEC(2006) 615]

1. PURPOSE OF THE REPORT

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union.

This report has been prepared at the request of Slovenia, submitted on 2 March 2006. A more detailed assessment of the state of convergence in Slovenia is provided in a technical annex to this report (SEC(2006) xxx).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires that the reports include an examination of the compatibility of national legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB. The reports also have to examine the achievement of a high degree of sustainable convergence in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and take account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

2. LEGAL COMPATIBILITY

In its 2004 Convergence Report (COM(2004) 690), the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act, was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular with respect to the Bank's objectives as well as in the field of personal and institutional independence.

The incompatibilities have been removed by an amendment to the Bank of Slovenia Act adopted by the Slovenian Parliament on 30 March 2006. In particular, the amendment clarifies that the Bank of Slovenia competences in the area of monetary functions, operations and instruments shall be transferred to the ESCB as from the date of the introduction of the euro in Slovenia. Moreover, the possibility for the Government of being involved in the management of the Bank's foreign exchange assets has been removed. With respect to the identified imperfections, the grounds for dismissal of the members of the Governing Board of the Bank of Slovenia have been aligned with those stipulated in the ESCB/ECB Statute. Finally, the objectives of the Bank of Slovenia have been amended and reflect the wording of Article 105(1) of the EC Treaty more accurately. In particular, the Bank's secondary objective (supporting the general economic policy in accordance with the objectives set in the EC Treaty) is now clearly subordinated to the primary one (price stability). However, the third objective (linked to financial stability in line with the principles of an open market economy and free competition) is not clearly subordinated to the primary and secondary ones, which constitutes a residual imperfection.

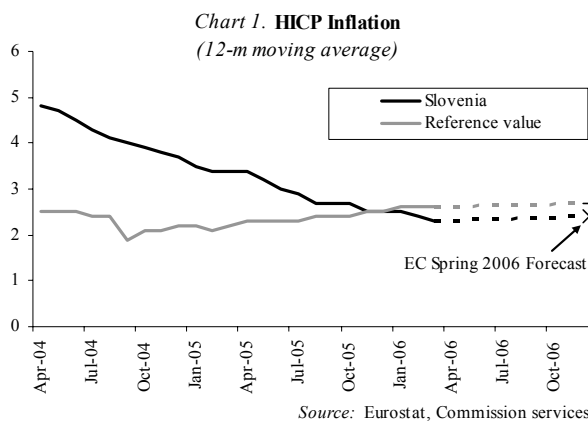
Legislation in Slovenia, in particular the Bank of Slovenia Act, is compatible with the requirements of the EC Treaty and the ESCB/ECB Statute.

3. PRICE STABILITY

Evolution of the reference value

Slovenia did not fulfil the criterion on price stability in the 2004 Convergence Report. The average inflation rate in Slovenia during the 12 months to August 2004 was 4.1 percent, above the reference value of 2.4 percent.

The 12-month average inflation, which is used for the convergence assessment, declined from 8.6 percent in 2001 to 2.3 percent in March 2006. As a result, it progressively approached the reference value and reached it for the first time in November 2005. The 12-month average inflation was below the reference value since January 2006. In March 2006, the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Slovenia was 2.3 percent, 0.3 percentage points below the reference value.



Underlying factors and sustainability

Inflation in Slovenia increased to around 9 percent between mid-1999 and mid-2000, mainly due to the impact of the introduction of the value-added tax. Inflation started to fall again in the second half of 2001, when also a new medium-term monetary policy framework was adopted by the Bank of Slovenia. Its main objective was to secure an early euro area entry by decreasing inflation and progressively stabilizing the exchange rate. Since 2003, the disinflation process has been underpinned by a coordinated policy approach of the Slovenian Government and the Bank of Slovenia. An effective control of administered prices, wage moderation in the public sector and a stabilisation of the exchange rate since mid-2004 reinforced the credibility of the disinflation process, which in turn translated into wage moderation in the private sector. Disinflation in recent years was also supported by a prudent policy mix and by growth below potential between 2001 and 2003. However, the progressive lowering of unemployment rates since 2003, in line with the economic upturn, was not associated with increased wage and price pressures, which signals that the decrease in inflation was rather driven by factors which should be expected to underpin a low inflationary environment also in the medium term.

Inflation performance in 2005 was affected by a favourable development of prices of certain categories of goods, mostly reflecting a favourable impact of EU accession, which helped to outweigh a large negative impact of the increase of oil prices on the

world markets. While EU accession also contributed to increasing the level of competition on the domestic markets with permanent effects on inflation, part at least of the favourable impact on price developments is expected to progressively fade out.

In spite of this, the outlook for inflation in the remainder of 2006 remains favourable. The expected easing of the negative effects of the external environment on energy prices will be broadly compensated by a slow pick-up in non-energy related inflation from exceptionally low levels in 2005. At the same time, the decline in the growth rate of unit labour costs observed since 2002 is expected to continue also in 2006 and average inflation is forecast to slightly decrease from 2.5 percent in 2005 to 2.4 percent in 2006.

In a longer-term perspective, the final convergence of domestic interest rates to the euro area level and the possibility of an increase of the value-added tax rate envisaged in 2007 represent risk factors to inflation. Slovenia therefore needs to remain vigilant to protect its low inflationary environment and a favourable competitiveness position. A more ambitious fiscal policy stance would help to mitigate risks to inflation and wage moderation should be continued beyond 2006.

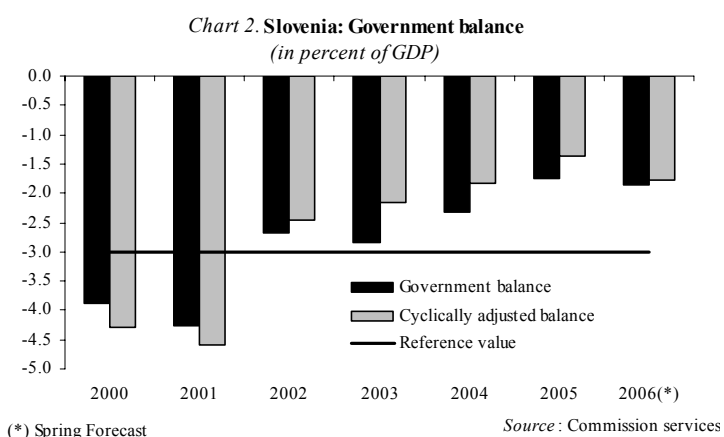
Slovenia has respected the reference value for inflation since November 2005 and is likely to continue to do so in the months ahead. Slovenia fulfils the criterion on price stability.

4. GOVERNMENT BUDGETARY POSITION

In the 2004 Convergence Report, the Commission stated that Slovenia was not subject to a Council decision on the existence of an excessive deficit and that it fulfilled the criterion on the government budgetary position.

Public finances in Slovenia worsened in 2000-2001 and the 2001 general government deficit reached a high of 4.3 percent of GDP. Following a correction in 2002-2003, the general government deficit has stayed below the 3 percent of GDP threshold since 2002.

A reinforced commitment to fiscal discipline and economic recovery since 2004 underpinned a further reduction of the general government deficit to 2.3 and 1.8 percent of GDP, respectively, in 2004 and 2005. The commitment of the government to a sound budgetary policy was most apparent in 2004 when a shortfall from value-added tax resources prompted cuts in expenditures in order to respect the deficit target.



Slovenia targets a general government deficit of 1.8 percent of GDP in 2006, somewhat below the Commission services' spring 2006 forecast. No deficit reduction compared to 2005 is planned. On the contrary, in view of the expected favourable economic environment, the structural deficit, which stood at 1.4 percent of GDP in 2005, is expected to deteriorate to 1.8 percent of GDP. At the same time, it is expected to stay below the minimal benchmark of 1.9 percent set in the Stability and Growth Pact for providing a safety margin against breaching the 3 percent of GDP reference value under normal macroeconomic fluctuations.

The general government debt has been lingering at slightly below 30 percent of GDP since 2000. At the end of 2005, the gross debt accounted for 29.1 percent of GDP, down from 29.5 percent in 2004. The general government debt is expected to stay below 30 percent of GDP over the medium term.

According to the December 2005 convergence programme, the budgetary strategy is to gradually reduce the general government deficit to 1 percent of GDP in 2008. The programme announced tax reform measures leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and expenditure cuts, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP. Some concrete measures that would underpin this consolidation have been specified in the latest update of the Convergence programme, while further measures are being considered.

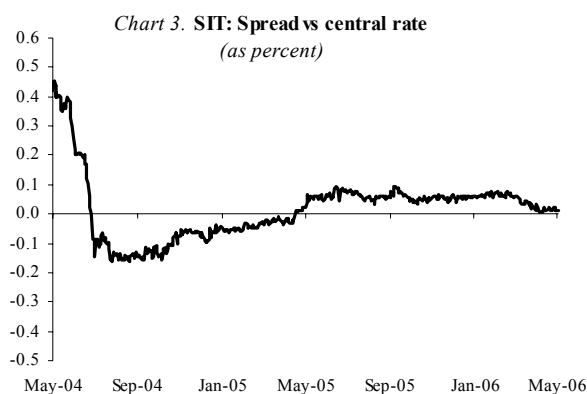
The Council examined the updated convergence programme of Slovenia on 14 February 2006. It regarded the budgetary strategy as having set plausible targets and saw the risks to the budgetary projections in the programme to be broadly balanced. Slovenia is, however, considered to be at high risk as regards long-term sustainability. According to the current projections based on existing measures, Slovenia appears at high risk with regard to the long-term sustainability of public finance due to a substantial rise in age-related expenditures. The Council therefore invited Slovenia to step-up the budgetary consolidation, especially by frontloading the adjustment effort and to undertake measures to improve the long-term sustainability of public finances.

Slovenia is not subject to a Council decision on the existence of an excessive deficit and fulfils the criterion on the government budgetary position.

5. EXCHANGE RATE STABILITY

In the 2004 Convergence Report Slovenia was assessed not to fulfil the exchange rate criterion. By the time of the examination, the country had been participating in ERM II for two months.

The two-year period relevant for the assessment of exchange rate stability extends from May 2004 to April 2006. Slovenia entered ERM II on 28 June 2004 and has so far spent 22 months in ERM II. The ERM II central parity retained for the tolar corresponds to the market



Source: ECB, Commission services

exchange rate on the last trading date before the decision on ERM II entry. As the long-standing policy of continuous tolar depreciation went on until ERM II entry, the tolar-euro exchange rate in the two months prior to ERM II entry moved from 0.45 percent above the future central rate at the beginning of May 2004 to the central rate on 25 June 2004. Inside ERM II, the tolar-euro exchange rate has stayed close to the central rate with maximum deviations of 0.16 percent on the depreciation side and 0.10 percent on the appreciation side of the fluctuation band. The average absolute deviation of the tolar-euro exchange rate from the central parity in the period covered by this assessment was 0.08 percent.

Exchange rate stability within ERM II has been achieved in the presence of a stable interest rate differential vis-à-vis the euro area slightly below 2 percentage points for most of the period under examination. Following policy rates increases by the ECB since December 2005 and interest rate cuts by the Bank of Slovenia since January 2006, the differential recently decreased to below 1 percentage point. Together with a likely decrease in the risk premium of Slovenian assets in ERM II, the positive interest rate differential helped to underpin the strength of the tolar.

The stability of the tolar-euro exchange rate has been supported by an agreement concluded in 2001 between the Bank of Slovenia and most of the commercial banks on co-operation in interventions on the foreign exchange market. The Bank of Slovenia has in particular used the foreign exchange swap facility to maintain the remarkable stability of the tolar-euro exchange rate inside ERM II. As the ERM II central parity played well its role of anchoring financial markets expectations, the "price interventions" also inherent to this agreement (when the central bank sets the base exchange rate at which the commercial banks participating in the agreement are obliged to trade) have not been used since the first month following ERM II entry. The transition to the new system did require a temporary direct intervention in the foreign exchange markets in order to signal the effective change to the exchange rate regime. As the tolar stabilized in early July 2004, no further direct interventions have been necessary inside ERM II.

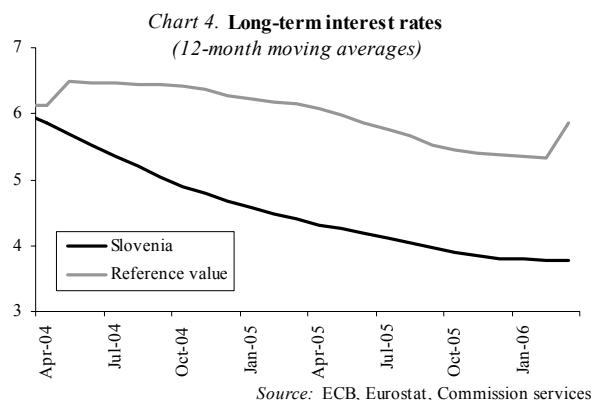
The tolar has remained very close to the ERM II central rate for the two years covered by this assessment. There has been no devaluation of the tolar's central parity inside ERM II on the initiative of Slovenia. By the time of a possible Council decision in July 2006, the tolar will have participated in ERM II for more than 24 months. Slovenia fulfils the exchange rate criterion.

6. LONG-TERM INTEREST RATES

In the 2004 Convergence Report Slovenia fulfilled the criterion on the convergence of interest rates. The average long-term interest rate in Slovenia in the year to August 2004 was 5.1 percent, below the reference value of 6.4 percent.

The spread vis-à-vis euro area average long-term interest rates had been declining markedly between mid-2002 and end-2004 mainly reflecting a gradual decrease in Slovenian inflation rates accompanied by a reduction in short-term policy rates, decreasing country-risk premia and the perspective of euro area accession. Since ERM II entry in June 2004, the spread has remained between 10 and 70 basis points.

The twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period. In March 2006, the latest date for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Slovenian benchmark bond stood at 3.8 percent, below the reference value. Slovenia fulfils the criterion on long-term interest rate convergence.



7. ADDITIONAL FACTORS

Slovenia's financial system has substantially integrated into the broader EU financial system. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan. The size of the financial system remains somewhat smaller than would be implied by the relatively high level of development of the economy. While competition via cross-border services provided by other EU financial institutions is increasing, Slovenia's financial system is not fully privatised with a level of foreign ownership close to the one of euro area Member States but lower than in other new Member States. Strong economic growth and convergence in interest rates have stimulated a progressive pick-up in the growth rate of bank lending to the private sector, notably to households. The share of foreign currency loans to household in particular has started to expand from negligible levels in 2003 to nearly 50 percent of new loans in 2005.

The Slovene economy is highly open to trade but it is relatively little receptive to foreign direct investment (FDI) inflows. Slovenia has also adopted a relatively gradual approach to structural reforms particularly with respect to liberalisation and privatisation. At the same time, Slovenia has an industrial structure similar to that of the euro area. The relatively low level of inward FDI is related to the privatisation process, which has been less receptive to the participation of foreign investors. The low intensity of FDI may limit competitive pressures in the domestic market. Also further progress on the transposition and application of EU-wide directives is important for the smooth functioning of the Internal Market in Slovenia.

Slovenia has a tradition of a broadly balanced current account, principally reflecting equilibrium between the deficit in trade in goods on one side and a surplus in trade in services together with a positive balance of current transfers on the other side. The Slovenian current account balance in 2005 recorded a deficit of 1.1 percent of GDP, down from 2.1 percent in 2004. This improvement mainly reflected the reversal of the trend of a progressive deterioration of the balance of trade in goods since the second quarter of 2005 and an accelerated improvement of the balance of trade in services. This suggests that the 2004 current account deterioration was most likely a

temporary phenomenon and does not signal competitiveness problems for the Slovene economy or potential exchange rate pressures. The main challenge for Slovenia in the near future will be to safeguard a healthy competitiveness position, for which wage moderation will be essential. At the same time, despite a high domestic saving rate, Slovenia may have scope for a more extensive use of foreign savings for increasing domestic investment and productivity.

In the light of its assessment on the fulfilment of the convergence criteria, the Commission considers that Slovenia has achieved a high degree of sustainable convergence.