



Flash report

23. 05. 2006

Slovenia: 13th member of the euro area...

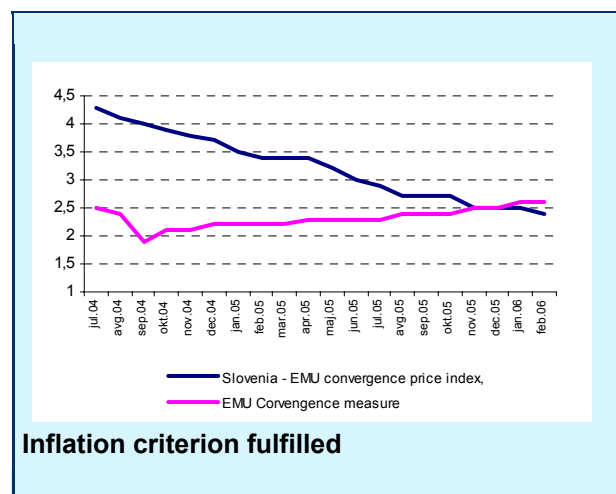


Summary

The story about Slovenia and the adoption of the euro reads like a fairy tale. Indeed, the Slovene authorities made a detailed EMU road map a few years ago and even a government change didn't affect the meticulous execution of the plan. As a consequence, all the forecasts have been realised. The ECB and EU Commission concluded in their May 17 convergence report that the country satisfies all Maastricht criteria and is fit to join the euro area and adopt the euro as of January 1 2007. The EMU entry will still be discussed in the EU parliament and at the June summit of EU leaders before the ECOFIN Council will formally approve entry at their July 11 meeting when also the EUR/SIT conversion rate will be fixed. This allows Slovenia to make the changeover to the euro as planned on 1 January 2007. **The EUR/SIT conversion rate will to all likelihood be the central parity rate (239.64).**

Inflation is under control

In April, HICP inflation rose by 0.8% M/M and 2.8% Y/Y, up from 2% Y/Y previously. More importantly, the average Y/Y HICP rate for the last 12 months compared to that of the previous 12 months, amounted to 2.3%, or below the 2.6% rate of the average inflation of the three countries with the lowest inflation. Slovenia therefore satisfies the inflation criterion. We expect inflation to remain close to the EMU inflation level in the near future.



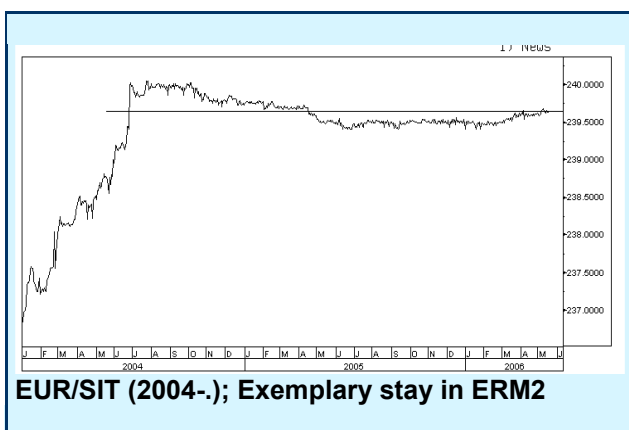
The EUR/SIT exchange rate

The stay of the tolar in the ERM-2 system has been quiet and exemplary by any standard. **The EUR/SIT rate has deviated at most by 0.12 percent from the central parity level and trades currently at the central rate of EUR/SIT 239.64.**

The key question left is the EUR/SIT conversion rate. Past conversions (Greece in 2001) and current developments suggest that the adoption rate will be very close to, we think even at the central parity rate of EUR/SIT 239.64.

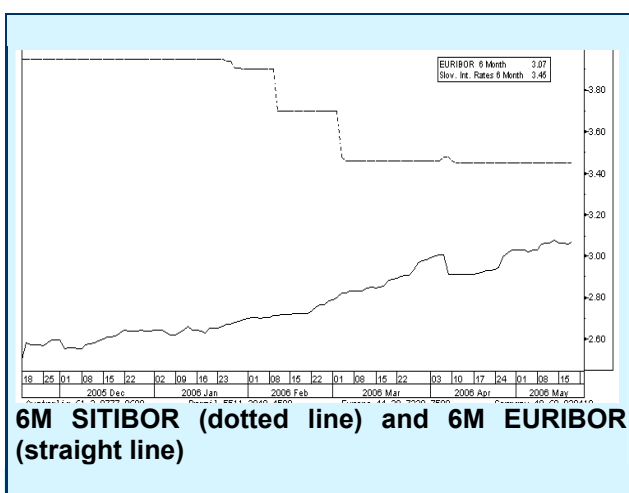
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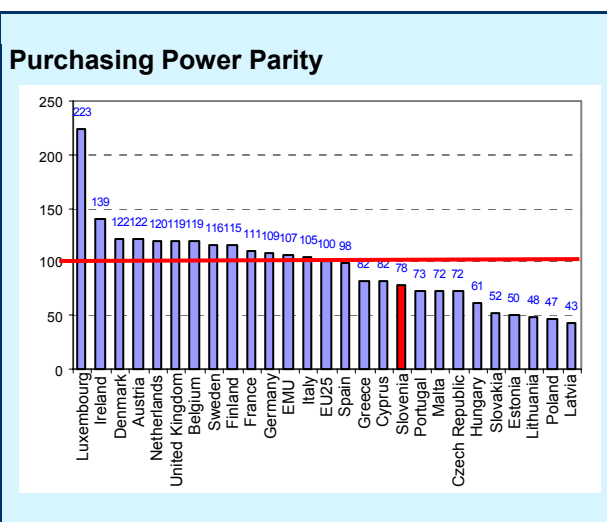
The BoS anticipates euro adoption

The Slovenian central bank has already cut its interest rates twice this year, as it started the convergence process of the official rates. Both times it cut rates by 25 bps (some instruments by 50 bps). At the same time, the ECB lifted its rates by 25 bps, meaning that the interest rate difference shrank by at least 75 bps. The Slovenian central bank does not have a monetary instrument directly comparable to the ECB minimum bid rate, but Slovenian central bank rates are currently approximately 1 percentage point above those of the ECB. The convergence of money market rates is illustrated in the graph below. Further convergence of the BoS and ECB rates is already expected in H1, when we take the expected ECB rate increase(s) in June into account. Also the BoS might help the convergence process by cutting its rates (in June?).



Slovenian GDP growth still exceeds growth for the whole EU

In 2005, Slovenian GDP growth amounted to 3.9%, marginally down from 4.2% in 2004, but still about 2.5% above EMU growth. The main difference between the growth in 2004 and 2005 lies in the positive contribution of the external trade balance (2.3 percentage points), while gross investments dropped 3% points, a rather less positive development. In the next two years, we do not expect any essential change in growth rates. IMAD forecasts 4.2% and 4.0% growth in 2006 and 2007. In 2004, GDP per capita in Slovenia measured by purchasing power parity amounted to 78% of the EU-25 average. The Slovenian government's goal is to achieve the average EU level within ten years. We think this goal is achievable, especially if Slovenia adopts the reforms that have been announced.



Improvement in the external balance

Thanks to improving economic conditions in the European Union, Slovenia maintained its positive foreign trade trends in 2005. Export growth again exceeded import growth. In 2005, Slovenia had its most lively trade with the EU-25 countries, generating up to 68% of the total value of exports and 81% of the total value of imports with this group of countries.

Favourable developments in the trade balance in 2005 had a very positive impact on the current account deficit, which narrowed to around 1.2-1.5% of GDP in 2005 (2.1% in 2004). In the future, we anticipate that the current account deficit will not exceed 2% of GDP.

Budget position

Slovenia meets the government financial criterion in terms of both the government deficit and general government debt. The general government deficit has fallen significantly in recent times, from 3.8% of GDP in 2000 to 1.8% of GDP in 2005. According to the updated Convergence Programme, the deficit measured by the ESA95 methodology should amount to 1.8% in 2006 and 1.1% in 2007. Public finance developments in the coming years will depend on the announced tax reforms, while further uncertainty stems from the incomplete negotiations on the European financial perspective for the 2007-2013 period. **General government debt as a proportion of GDP has been stable and slightly below 30%.** Current developments suggest a stabilisation in the years ahead. The biggest risk factor for a budget deficit could be the pension and health insurance budget. Last year, the Slovenian government adopted a law linking pension growth to wage growth and no longer to consumer price growth. This should increase pension costs.

Structural reforms announced

In late 2005, the Slovenian government adopted a programme of broad structural reforms for the period up to 2007. The government established a Ministry for Development to implement these reforms. The aim of the reforms is to create a business-friendly environment that will make Slovenia more competitive, allow it to grow more rapidly and subsequently catch up with the most developed countries in the world. The core of the planned reforms involves simplifying the tax legislation, with a proposal for a flat-rate tax. At the same time, the government also wants to adopt a new wage model and social agreement. The trade unions have indicated their strong disagreement, especially with the proposed flat-rate tax. Hence, in the next few months we expect an interesting debate on the reforms and how far the government will go with them.

Rating upgraded to AA (S&P)

Following the positive EMU-entry assessment of the country by ECB and EU Commission, S&P rating agency upgraded the LT foreign currency credit rating of Slovenia to AA from AA- (outlook stable). The agency praised the impressive achievement in reducing inflation and its healthy government finances, while at the same time its economy grew strongly. The euro adoption shields the country from potential balance-of payments

pressures. Fitch rating agency already said it will intend raising the country's AA- rating towards AA once the EMU entry is officially confirmed by the ECOFIN Council. We expect Moody's to follow the decisions of the other agencies. Currently, it rates the country at Aa3, one notch below the other agencies.

S&P rates the country 3 notches above Slovakia and four above Czech republic and Hungary.

Slovenia is also rated (by S&P) higher than current EMU members Italy (AA-), Portugal (AA-) and Greece (A), though one notch below Belgium (AA+).

Conclusion

Slovenia will adopt the euro on 1 January 2007. The EUR/SIT ERM-2 central rate of 239.64 will be more than likely also the EUR/SIT conversion rate. In the remaining months, the gap between official CB rates and market rates will be closed further. The Slovenian economy is looking good and is well placed to make more progress on the road to prosperity. However, it should not let the reform momentum slip, now that entry is secured, but refocus away from issues concerning the euro to issues relating to wealth, growth and a modernisation of its economy.

Appendix: Key data

	2001	2002	2003	2004	2005	2006F	2007F
GDP growth (%)	2.7	3.4	2.5	4.2	3.9	4.2	4.0
Inflation Y/Y(%)	7.0	7.2	4.6	3.2	2.3	2.0	2.1
Budget deficit (% of GDP)	-3.9	-2.7	-2.7	-2.1	-2.1	-1.8	-1.1
Unemployment- ILO (registered) (%)	6.4 (11.2)	6.4 (11.3)	6.7 (10.9)	6.3 (10.3)	6.1 (10.0)	6.6 (9.8)	6.7 (9.6)
Public debt (% of GDP)	28.1	29.8	29.4	29.8	29.3	30.9	29.7

Sources: data BoS, IMAD. Forecasts NLB

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