Investing in the Future of the Republic of Slovenia

By

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Abstract

This policy analysis examines the Republic of Slovenia’s recent macroeconomic experience and corresponding impact on international trade and financial markets. Based on past successes in controlling inflation, sustaining real economic growth, and maintaining considerable progress toward achieving the European Union’s *acquis communautaire*, we argue that Slovenia should pursue expansionary fiscal policies that address two major domestic policy concerns (the aging population and vast unemployment among young and unskilled laborers). Furthermore, we suggest that the Bank of Slovenia should maintain tight monetary policy that continues to reduce the rate of inflation and attempts to appreciate the tolar/euro exchange rate. Recognizing the possible limitations that our policy recommendations contain, we highlight potential political and market-driven obstacles that our policy suggestions might encounter.

Our analysis first provides some background on the recent macroeconomic trends that Slovenia has experienced and then moves to identifying three significant disturbances in the data. Each individual section identifies the policy problem at hand, then offers a policy change to correct (or alleviate) the problem, and concludes with a short discussion of the policy’s limitations. The paper’s final section addresses some limitations of our aggregate policy recommendations and offers some closing remarks.
Background: Macroeconomic Data

Overview
Almost a decade after the break up of the former Yugoslavia, the Republic of Slovenia is the most successful of its Yugoslav counterparts and the one of the most successful countries in the former Communist bloc. Slovenia has consistently proven to have strong economic growth, steady inflation and employment numbers, disciplined fiscal policy, and good relations with the European Union. Preliminary forecasts suggest that these trends will continue into the future.

Growth
Slovenia has had positive economic growth since 1993. Although GDP growth fell in 1998, it was much more robust in both 1999 and 2000 at 5 percent and 4.9 percent, respectively, as Table 1 shows. Since the country’s population has been the same at approximately two million for at least seven years (IMF), per capita growth has stayed roughly the same as GDP growth.

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</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>5.3</td>
<td>4.1</td>
<td>3.5</td>
<td>4.6</td>
<td>3.8</td>
<td>5.0</td>
<td>4.9i</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>9.0</td>
<td>7.4</td>
<td>7.3</td>
<td>7.1</td>
<td>7.9</td>
<td>7.6</td>
<td>6.7ii</td>
</tr>
<tr>
<td>Unemployment Rate (of persons &lt; 25)</td>
<td>.</td>
<td>18.8</td>
<td>18.8</td>
<td>17.6</td>
<td>18.6</td>
<td>18.1</td>
<td>.</td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td>21.0</td>
<td>13.6</td>
<td>9.7</td>
<td>9.1</td>
<td>8.5</td>
<td>6.6</td>
<td>10.9iii</td>
</tr>
<tr>
<td>Government Balance</td>
<td>-0.6</td>
<td>-0.9</td>
<td>0.3</td>
<td>-1.2</td>
<td>-0.8</td>
<td>-0.6</td>
<td>-1.0iv</td>
</tr>
<tr>
<td>Current Account (millions of dollars)</td>
<td>573.1</td>
<td>-99.4</td>
<td>31.4</td>
<td>11.4</td>
<td>-147.3</td>
<td>-782.4</td>
<td>-384.2v</td>
</tr>
<tr>
<td>Exchange Rate (tolar per dollar)</td>
<td>128.81</td>
<td>118.52</td>
<td>135.36</td>
<td>159.69</td>
<td>166.13</td>
<td>181.77</td>
<td>222.66</td>
</tr>
<tr>
<td>M1 (1000 mioECU/euro)</td>
<td>.</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
<td>1.8</td>
<td>2.0</td>
<td>.</td>
</tr>
<tr>
<td>M2 (1000 mioECU/euro)</td>
<td>.</td>
<td>5.7</td>
<td>4.2</td>
<td>5.4</td>
<td>6.7</td>
<td>7.1</td>
<td>.</td>
</tr>
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Table 1 (compiled from data in International Financial Statistics (IMF), Slovenia Country Investment Profile (EBRD), and 2000 Regular Report on Slovenia (EU Commission)

ii Third quarter of 2000
iv Projection from Slovenia Country Investment Profile, European Bank for Reconstruction and Development
v Data through the third quarter of 2000

Unemployment
Slovenia’s unemployment rate steadily decreased for much of the mid-1990s before increasing slightly in 1998. However, since 1998, unemployment has resumed its downward path, and in the third quarter of 2000, it reached a post-transition low of 6.7 percent. Although the overall unemployment rate is at this relatively low level, unemployment among younger workers is
much higher. As of 1999, the unemployment rate of persons under the age of 25 was disturbingly high—18.1 percent (EU).

**Inflation**
The inflation rate fell steadily during the course of the 1990s before increasing sharply in 2000. This spike in inflation, however, is not as problematic as a cursory examination of the data might suggest.

**Government Finance**
From the mid-1990s onward, the Slovenian government has typically run fairly small budget deficits, with the exception of 1996 when it ran a surplus.

<table>
<thead>
<tr>
<th>Government Revenues</th>
<th>Government Expenditures</th>
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</thead>
<tbody>
<tr>
<td>1994 768.50</td>
<td>1995 926.42</td>
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<tr>
<td>1995 926.42</td>
<td>1996 1041.65</td>
</tr>
<tr>
<td>1996 1041.65</td>
<td>1997 1163.40</td>
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<td>1997 1163.40</td>
<td>1998 1330.58</td>
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<td>1998 1330.58</td>
<td>1999 1445.54</td>
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<td>1999 1445.54</td>
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</tbody>
</table>

*Table 2*

As Table 2 shows, both government expenditures and revenues have been growing in recent years; however, expenditures have grown at a faster pace. Nevertheless, these deficits are small by Western standards and are no cause for concern. In addition, Slovenia’s debt to GDP ratio remains low at 0.25 as of the end of 1999, so the national debt is not a problem either at this point in time.

**Current Account**
The current account was in surplus until 1995 when it fell into a small deficit. However, in 1998, the current account went into deficit again before skyrocketing to $784.2 million in 1999. In 2000, the current account deficit appeared to be going down again, although it was still quite high by historical standards.

<table>
<thead>
<tr>
<th>Exports</th>
<th>Imports</th>
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<tbody>
<tr>
<td>1994 6,828</td>
<td>7,304</td>
</tr>
<tr>
<td>1995 8,316</td>
<td>9,492</td>
</tr>
<tr>
<td>1996 8,312</td>
<td>9,423</td>
</tr>
<tr>
<td>1997 8,372</td>
<td>9,357</td>
</tr>
<tr>
<td>1998 9,048</td>
<td>10,110</td>
</tr>
<tr>
<td>1999 8,604</td>
<td>9,952</td>
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</table>

*Table 3*
As Table 3 shows, Slovenia’s trade increased dramatically in 1995, coinciding with Slovenia’s entry into the World Trade Organization. Since this initial increase, both imports and exports have increased, but imports have grown at a more rapid pace.

*Exchange rate*
Slovenia’s currency, the tolar, has steadily lost value for the past decade with 1995 being the only year in which the tolar appreciated. In 1999, the nominal depreciation of the currency accelerated as the tolar’s value decreased by 9.4 percent. This more rapid depreciation continued through 2000.

*Money Supply*
Between 1995 and 1999, M1 grew at a fairly constant pace, although M1 grew considerably more rapidly in 1998. During the same five-year span, M2 was more volatile with a sharp decline in 1996 and significant increases in 1997 and 1998. Although M2 increased by a substantial amount during both years, the tolar’s depreciation was much higher during the second of these years.

**Problems and Policy Recommendations**

**Problem 1: Maintaining Fiscal Discipline in the Face of an Aging Population**

As the data in the previous section show, the Slovenian government has been able to keep its budget deficits relatively low in recent years. In addition, the population has remained at approximately the same level for at least seven years at 1.99 million, while GDP growth and per capita income growth have remained relatively equal. This trend indicates that fewer young people are entering the workforce to fund the pensions of workers who will be retiring in the coming years. This demographic fact poses a problem for keeping budget deficits low, as expenditures on pensions will rise while the lack of younger workers will negatively affect total government revenues. The effect of this change is already beginning. In 1994, the ratio of pension payments to pension fund contributions was 1.13, whereas in 1998, the ratio had increased to 1.48 (EIU). So far, the government has been able to divert other budget resources to pension payments, and the ratio of pension payments to total government revenue has remained constant for the most part. However, if the economy enters into recession as the country’s population ages, total government revenues will be lower. In the face of lower revenues and higher pension obligations, the government would likely find itself creating large deficits to fund pensions, which already make up 29.6 percent of all government expenditure (EIU).

If these deficits mount up, the government will either have to divert resources from other parts of the budget or increase taxes to pay off the accumulated debt. If the government initiates pension reform just as pension obligations become a drain on the treasury, this policy would have an adverse effect on output and employment. As Figure 1 shows, output would fall from $Y_0$ to $Y_1$. If the government does not change the pension system at all and increases taxes permanently to fund pensions, income will return to its original level in the long-run, but the currency will depreciate from $S_0$ to $S_1$, as Figure 1 shows. Given the fact that Slovenia depends on imports, especially for capital goods, this depreciation would not be desirable, because it would make imports more expensive, raising both consumer prices and producer costs.
Proposed Solution
To mitigate this problem of changing demographics, the Slovenian government ought to take the following measures:

- Increase the retirement age by two years. The positive effects of this measure are twofold. First, it will increase the revenue stream into the country’s pension fund, and second, it will lower the government’s pension obligations for any given year.
- Reduce the number of pensioners in the active population by limiting pension payments to those people who are actually retired. In recent years, proportionally more active workers have been receiving pension payments (EIU), which has increased the government’s financial obligations. Restricting access to those workers who are retired will limit the government’s pension burden.

With these measures, a large tax increase would not be as necessary since revenue would be higher while financial obligations would be lower.

Limitation
The main limitation of these proposed changes is that they may not suffice. The government might still find itself with higher obligations than revenues. However, if Slovenia implements the measures proposed here, any necessary tax increase will be smaller than otherwise would be needed.

Problem 2: Creating Prosperity Among Unskilled and Young Laborers

The recent trend in the Slovenian labor market indicates that a shortage of young skilled labor exists in the economy. According to the Economist Intelligence Unit Report on Slovenia for 1999-2000, over 47% of registered job-seekers in 1998 were over 40. This group also made up 62% of those unemployed for more than one year. Nearly half of the unemployed was registered without qualifications. Considering these statistics and the transition favoring higher productivity, the jobless total is more likely to rise than decline in the near future (EIU).
Overall trends have indicated that there is less of an emphasis on the traditional, agricultural, and manufacturing base in the economy. During socialism, manufacturing reached its peak. The introduction of a free market, however, spurred a move toward expanding the service sector. Services have tended to be more profitable rather than manufacturing, and as the service sector expands, it now accounts for approximately 57% of Slovenian GDP (EIU).

Serious efforts to expand the tourism industry within the country have occurred as well. To encourage foreign tourists, the country’s VAT was introduced at the low rate of 8% (the higher rate is 19%) for hotel stays and public passenger transportation. In Slovenia, the EIU expects tourism expansion to be a significant source of foreign exchange (EIU).

Proposed Solution and Limitation
All of these recent trends indicate that the nation is moving toward a service sector that can cater to the needs of the residents and foreigners. These jobs will require a young and skilled labor force to support the service markets and tap further economic growth potential. To this end, the Slovenian government must invest in job training and education as part of a larger fiscal expansion. Investment in education infrastructure (teachers, administrators, school facilities) and in funding opportunities (government-backed educational loans and research grants) will provide the skills that the younger generation of Slovenes need to compete within Slovenia and eventually within the European Union. In addition, the creation of programs that teach technical and computing skills would enrich the current workforce that is unable (or unwilling) to return to school. These programs, while having considerable up-front costs, will result in much higher returns in the long-run, as the economy and country grows.

Problem 3: Fighting Inflation and Depreciation En Route to the Euro

Significant inflationary pressures are often the harbinger of a bleak economic future. Central banks in Europe have made reducing inflation rates their primary objective since Germany’s hyperinflation in the interwar period. The success of the Bank of Slovenia in reducing its country’s inflation rate since 1994 strongly suggests that Slovenia is no different. The accompanying tight monetary policy has surprisingly done little to impact the real economic growth of Slovenia, as its GDP growth rates have averaged between 4 and 5 percent. On the other hand, elementary money supply theory tells us this strong growth cannot continue without sufficient liquidity in the financial markets. Therefore, the sharp price rise in 2000 (resulting from the introduction of the VAT and increasing oil prices) might concern Slovenian central bankers. With inflation rising and the pressure to keep economic expansion going, decisions on monetary policy might seem contradicting. Fortunately, decision-makers in small open economies like Slovenia can look to international finance theory for assistance.

Clearly, Slovenia is a small open country, as its GDP is no larger than US$20 billion and imports of goods and services consist of about 58 percent of GDP (World Bank). With such a high exposure to trade, the exchange rate becomes an important tool in economic analysis. The tolar has depreciated steadily against both the U.S. dollar and the euro/ecu since 1995, much to the delight of exporters and to the chagrin of importers. By 1998-99, however, imports had risen sharply while the tolar continued to depreciate—an odd combination. In addition, monetary
policy remained somewhat tight, suggesting an appreciation of the tolar should have occurred. By 2000, the current account deficit had become significantly high, due to higher consumer demand (through higher consumption and investment from VAT expectations), while inflation had risen for the first time since 1994. Monetary policy, therefore, should address both the potential contagion effects of inflation and the steadily depreciating currency.

*Proposed Solution*

Low inflation and a steady exchange rate are natural goals for the Bank of Slovenia. To achieve these goals, the Bank must implement a tight monetary policy that continues to force downwardly inflation expectations and counterbalance fiscal expansions that might depreciate the currency. This policy should also attract more foreign direct investment (with higher domestic interest rates) and accumulate some additional capital. These results are acceptable, considering the current account deficit is relatively low compared to GDP and should spur future long-term economic growth possibilities (EIU). This constraint on monetary policy should help stabilize the important tolar-euro exchange rate and prepare Slovenia for European Union entry and, equally as important, entry into the economic and monetary union.

*Aggregate Economic Policy Recommendations*

As delineated in Problems 1 and 2, Slovenia must correct two chief domestic policy considerations to prepare for economic prosperity in the long-run. The results of these recommendations will expand fiscal policy and create a larger fiscal deficit than Slovenia currently has. In the short-run, the Bank of Slovenia should also maintain tight monetary policy to attract foreign capital, fight inflationary pressures, and keep appreciative pressure on the tolar. In terms of a DD-AA diagram, we suggest an outward shift of the DD curve in the short-run (resulting in long-term increases in Y) and a stable AA curve to maintain appreciative pressure on the exchange rate.

*Policy Limitations*

Any policy recommended in this report will be subject to various limitations. The recent decade has shown a serious depreciation of the tolar. Even if the Bank of Slovenia decides to keep the money supply tight and maintain interest rates with the hope of appreciating the currency, the country will continue to face the impact of global market expectations. World demand for the tolar is relatively low. With little demand to hold the tolar, investors are likely to sell it regardless of expectations about the Bank of Slovenia’s monetary policy decision. This continued selling limits the ability of central bank to control expectations greatly; however, if the Bank of Slovenia makes a concerted and public effort to appreciate or maintain the tolar-euro exchange rate, it might make an impact. This result is highly uncertain.

Another external factor impacting the tolar is the fluctuations in the euro. Until Slovenia can join the ranks of the EU, its currency will have less value relative to the euro. If the European Central Bank is successful in strengthening the euro, the tolar will depreciate relative to the euro. Recently, we have evidence of the ECB’s intentions to strengthen the euro, as it has tried to bring the euro stronger relative to the US dollar.
Furthermore, any fiscal policy recommendations introduced would be subject to political scrutiny and legislative gridlock. Internal factors, such as elections, will impact the government’s ability to implement certain policies. For example, legislation that constrains the parliament’s ability to run large fiscal deficits would hinder our ability to implement aggressive expansionary policy. In addition, Slovenian government bonds may not be sufficient to fund these programs, depending on the country’s bond rating.

In addition, the purchasing trends of the country may also limit policy changes from being implemented. A country like Slovenia that has not had access to Western goods in the past, with the additional disposable income, may see its consumers’ preferences change. This change could fundamentally exacerbate the current account deficit to a point where it becomes risky for Slovenia.

Finally, volatility in the region may offset any policy recommendations that we may propose. For example, if the conflict in Yugoslavia were to occur again, or if internal strife began in a neighboring country, the Slovenian economy will likely suffer a shock through the current account, investment in military defense, or a potential refugee influx across borders. Though this may appear unlikely in the near future, it is a possible factor impacting policy implementation success. Similarly, in the long run, if Slovenia enters EMU, they will have to forgo any monetary policy autonomy. The result could be a pan-European policy that does not match closely with the needs of the local Slovenian economy.

**Final Thoughts**

As the macroeconomic data suggest, Slovenia has a considerably healthy economy. General trends suggest that real economic growth is strong, inflation is falling, and the unemployment rate is steady. For the most part, the government and central bank have coordinated their policies well, and economic prosperity should continue in the short-run. On the other hand, our analysis reveals weaknesses in the government’s policy toward the aging population and its ability to maintain growth in the long-run. We highly suggest that the government and central bank of Slovenia begin examining how they will maintain economic growth even after what seems to be an inevitable accession into the European Union. After the loss of monetary policy as a significant policy instrument, Slovenia will need to be prepared to use its fiscal policy effectively and efficiently.

**Cited Sources**