71st East Jour Fixe[1]

Slovenia: The First Five Years in Monetary Union

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Introduction

The 71st East Jour Fixe, hosted by the OeNB on July 9, 2012, dealt with the Slovenian experience of euro adoption and the possible effects of euro area membership on Slovenia's ability to cope with the recent crisis. Five years of membership in monetary union, almost coinciding with five years since the onset of the crisis, provided an opportunity for stocktaking, for evaluating Slovenia's successes, possible mistakes and future challenges. The lessons could prove useful for other CESEE countries planning to join the euro area.

In his opening statement, *Peter Mooslechner,* Director of the OeNB's Economic Analysis and Research Department, recalled that Slovenia had long been regarded an "eminent pupil" of the CESEE region, with its high relative per capita income level, sound economic structures and institutions, and a fairly swift establishment of broad macroeconomic stability. He posed the question whether euro adoption and the expectations it created might not have contributed to an unsustainable cyclical boom in Slovenia in 2006 to 2007, e.g. by the convergence of interest rates to lower levels, helping stimulate a credit boom. Moreover, the crisis uncovered several structural weaknesses of the economy that have yet to be addressed by policymakers.

Slovenia in Monetary Union: Still a Lot Work to Be Done

In her keynote address, *Mejra Festić,* Vice Governor of the Bank of Slovenia, provided a comprehensive overview of macroeconomic developments in Slovenia in recent years and described the main structural issues and policy challenges. Slovenia's boom before the crisis had been fueled by strong credit growth supported by low real interest rates. After the introduction of the euro, inflation accelerated, mainly due to commodity price developments, which led to an erosion of real wages and increasing wage growth pressures. The consequent sharp rise of nominal wages throughout the economy, combined with a fall in productivity, then led to a deterioration of Slovenian cost competitiveness. Due to the high exposure to the construction sector, the share of nonperforming loans of Slovenian banks spiked in 2009; since banks' dependence on wholesale funding is high, both they and the corporate sector are now facing a lack of funding. Systemically important banks had to be recapitalized in 2011 and 2012, which contributed to the ongoing post-crisis deterioration of public finances. Festić stressed that fiscal credibility needed to be restored, structural reforms should be sped up and the capital position of both the banks and the corporate sector had to be strengthened in order to revive growth in the Slovenian economy.

Coping with Macroeconomic Challenges

The speakers of the first session, chaired by *Doris Ritzberger-Grünwald,* Head of the OeNB's Foreign Research Division, examined macroeconomic developments in Slovenia during the recent economic downturn, providing an outlook for the near future and emphasizing implications for the fiscal policy in particular. The session

[1] *The presentations and the workshop program are available at http://ceec.oenb.at (Events).*

shed light on how Slovenia is performing among CESEE countries and compared various economic scenarios modeled for Slovenia.

Hermine Vidovic, Senior Researcher at The Vienna Institute for International Economic Studies (wiiw), opened the session, contrasting Slovenian macroeconomic developments before and after the crisis and comparing them to those of the country's regional peers. Her presentation aimed to identify reasons why Slovenia – unlike other CESEE countries – has not yet started to recover from the recession. In particular, Vidovic drew attention to Slovenia's private corporate indebtedness ratio, which is one of the highest among CESEE countries, the sudden stop of bank credit availability, the low capital adequacy of the Slovenian banking system, relatively high gross foreign debt (115% of GDP in 2011) resulting in part from the current account deterioration during the crisis as well as recent political instability. The speaker also presented the most up-to-date wiiw forecast for the Slovenian economy, according to which stagnation or even further contraction was likely in 2013, with upward pressure on the unemployment rate and subdued household consumption. The ailing banking sector remained the greatest downside risk to this outlook.

Reinhard Neck, professor of economics at Klagenfurt University, presented a study describing the macroeconomic model of the Slovenian economy, SLOPOL, based on quarterly macroeconomic and demographic data for 1995 to 2011. The model simulations shown during the presentation suggested that external trade developments could explain about two-thirds of the drop in Slovenian GDP during the crisis and that an extremely, in fact unrealistically expansionary fiscal policy, i.e. a public deficit of 30% of GDP, would have been needed to prevent the output contraction. Investigating optimal policies within the model, the study authors found that the optimal fiscal policy for Slovenia would be countercyclical and not strongly expansionary. With long-term simulation results, Neck also demonstrated that none of the three possible remedies of the aging problem (increase of the retirement age, decrease of the pension replacement rate and increase in the social security contribution rate) alone would suffice to keep Slovenian public finances sustainable in the long run.

Mitja Košmrl, desk officer for Slovenia at the European Commission (DG ECFIN), provided an overview of the fiscal challenges in Slovenia. He argued that the seeming gradual improvement of the general government balance before the crisis had only been due to the business cycle, as the underlying structural balance had been deteriorating. Therefore, successful implementation of the recently adopted 2012 austerity package was of utmost importance. However, additional measures were likely to be needed for 2013 and beyond. Košmrl also pointed out as the main structural fiscal issues to be addressed the aging problem affecting pension system sustainability, an insufficient medium-term budgetary framework and risks stemming from the interlinkages between the sovereign and the banking sector.

The Euro – A Catalyst for Structural Change?

The second session, chaired by *Peter Backé,* Deputy Head of the Foreign Research Division at the OeNB, looked at structural issues of the Slovenian economy in more depth. The speakers addressed the question of what particular reforms need to be implemented in Slovenian labor, product and banking markets to better

equip the Slovenian economy to handle economic downturns such as the recent one.

Rafał Kierzenkowski, Head of the Slovenia and Hungary Desk at the Economics Department of the OECD, presented recent research results which demonstrated potential gains for Slovenia from adopting labor market and product market reforms. He argued that potential growth in Slovenia in recent years had been almost solely related to developments in labor productivity, whereas potential employment growth had been stagnating. Moreover, according to Kierzenkowski, there is a need to increase the share of tradable sectors in the economy, as well as to restore cost competitiveness by curbing unit labor costs. The speaker showed that in the medium-term, Slovenia could benefit from increasing spending on active labor market policies, and also from addressing labor market dualism by equalizing the protection of regular and temporary employment contracts. These measures as well as the reduction of coverage rates of collective agreements and pension system reform could boost Slovenian labor supply. Refraining from further increases of the minimum wage would not only help improve cost competitiveness but would also impact positively on the unemployment of the young and the low-skilled. There is also room for easing regulation in professional services, telecommunications and transport, and for privatization.

Reiner Martin, Deputy Head of the ECB's Financial Stability Assessment Division, focused his presentation on the Slovenian banking sector. His analysis inferred that the problems the Slovenian banking sector is coping with today are structural or induced by the crisis, rather than being related to the country's participation in the euro area. He showed that the share of foreign ownership, or the relative size of the banking sector expressed as the assets-to-GDP ratio, have barely changed in recent years. The loan-to-deposit ratio, however, had been rising quite sharply until it reached 160% in 2009 and has declined only marginally since. Credit growth came to a halt in 2010, in line with that of Slovenia's regional peers, and has even been negative since, whereas the share of nonperforming loans has risen rapidly to about 12%. Profitability of the banking sector has plunged, aggravating the already low capital adequacy of the sector. According to Martin, reconsideration of the funding model and of the role of the state in the Slovenian banking sector is needed to overcome the structural problems uncovered by the crisis.

The Slovene Experience: Any Lessons for Euro Aspirants?

In his concluding statement, *Damjan Kozamernik,* Director of the Analysis and Research Department at the Bank of Slovenia, addressed possible reasons for an insufficient policy counteraction of the boom-bust cycle preceding the recent crisis in Slovenia. In doing so, he drew the following lessons: The correct identification of the source of macroeconomic imbalances (i.e. supply versus demand shocks) is crucial for an effective policy reaction. Furthermore, it is key to build up fiscal buffers "in good times" and to bolster the credibility of the policy mix, which also should include macroprudential and financial supervision measures. Moreover, under a regime with irrevocably fixed exchange rates, the flexibility of the economy should be enhanced to withstand shocks better. For Slovenia in particular, this would have meant and still means the introduction of a forward-looking wage-setting rule to ensure that the labor costs growth do not exceed productivity growth.