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In-depth review for SLOVENIA

**in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and
correction of macroeconomic imbalances**

Accompanying the document

**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT AND THE COUNCIL AND TO THE EUROGROUP**

**Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and
correction of macroeconomic imbalances**

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EXECUTIVE SUMMARY AND CONCLUSIONS

In May 2012, the Commission concluded that Slovenia was experiencing macroeconomic imbalances, in particular as regards developments related to corporate sector deleveraging, banking stability and to some extent also external competitiveness. It highlighted the necessity of a prompt and thorough policy response to minimise the risk of existing imbalances becoming excessive. In the Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found it useful, also taking into account the serious imbalances identified in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this In-Depth Review (IDR) takes a broad view of the Slovenian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are that the negative economic trends and imbalances identified in the 2012 IDR have aggravated. Notably:

- The levels of total private debt are below the euro area average and the alert thresholds of the scoreboard, but many corporates remain over-indebted, leading to further rises in non-performing loans. 23.7% of this segment of bank credit is now in arrears of 90 days or over.
- The size of the Slovenian banking sector is relatively small and less than half the euro area average, but major domestic banks face continued deterioration of their credit portfolios, which puts sustained pressure on capital buffers, which remain low in regional comparison. Further recapitalisations are likely to be needed.
- Credit is contracting and the interaction between weak banks and the sovereign has intensified. The nominal stock of bank credit to the private, non-banking sector is shrinking at an annual rate of more than 5%. The state has *de facto* become the main source of capital and remains a sizeable, though declining, source of deposits for the banking sector. At the same time, the state itself has to consolidate and yields on government bonds remain elevated. Public debt amounted to 54% of GDP in 2012 and is forecast to exceed the 60%-of-GDP threshold by 2014.
- The deleveraging challenge is accentuated by a double-dip recession and growth forecasts have been revised downwards. Real GDP is now 8% below the peak reached in 2008 and this situation is forecast to persist through to 2014. Economic contraction hinders corporate balance sheet repair and makes it difficult for new firms to grow, inevitably leaving banks increasingly exposed to legacy portfolios.
- Net external debt is relatively contained and the current account has turned into surplus. However, this is due to reduced imports from lower economic activity and employment, while cost-competitiveness losses have not been reversed. Export market shares have been lost and export performance is substantially weaker than in peer countries.
- Policies to address the limited adjustment capacity of the economy have yet to fully develop. Important positive steps have been the enactment of a partial pension reform in the final weeks of 2012 as well as the labour market reform adopted early March.
- The complex nexus of state ownership limits adjustment and distorts resource allocation, especially as regards new investment. It also seems to keep foreign-direct

investment lower than in peer countries. State-controlled funds and enterprises also impact public finances through the interaction of elevated debt levels, recapitalisation needs and significant government guarantees.

- Framework legislation for bank restructuring and privatisation was passed but still needs to be implemented effectively.

Periods of policy uncertainty and legal obstacles to reforms have prevented Slovenia from addressing its imbalances adequately and enhancing its adjustment capacity, thus increasing its vulnerability at a time of heightened sovereign funding stress in Europe.

A comprehensive reform strategy accompanied by a credible implementation path would stabilise the financial sector, unleash Slovenia's growth potential and increase employment. The IDR thus also discusses the policy challenges stemming from these developments and possible policy responses. A number of elements can be considered:

- the credible repair of the banking system through a balanced set of measures and maintenance of financial stability through prudent supervision and improved governance structures, including the eventual privatisation of state-owned banks;
- a sounder financing of the net international investment positions (NIIP) and growth through foreign direct investment (FDI) facilitated by an improvement of the business environment;
- cost-competitiveness developments supportive of adjustment and helping to avoid the re-emergence of external imbalances through continued public sector wage restraint, adaptation of minimum wage setting and a set of labour market reforms;
- the enhancement of adjustment capacity at the microeconomic level, particularly in relation to state-ownership and labour market institutions.

1. INTRODUCTION

On 28 November 2012, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of follow-up it will recommend to the Council.

This is the second IDR for Slovenia. The previous IDR was published on 30 May 2012 on the basis of which the Commission concluded that Slovenia was experiencing severe macroeconomic imbalances, in particular as regards developments related to corporate sector deleveraging, banking stability and to some extent also external competitiveness. It highlighted the necessity of a prompt and thorough policy response to minimise the risk of existing imbalances becoming excessive. Overall, in the AMR the Commission found it useful, also taking into account the serious imbalances identified in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this IDR takes a broad view of the Slovenian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 of this IDR looks more in detail into these developments covering both the external and internal dimensions. This is followed by a specific focus updating the assessment of the banking sector in Section 3.1 and a specific focus on the special position of state-owned enterprises in Section 3.2, which has been a recurring issue since pre-accession negotiations.¹ Section 4 discusses policy considerations.

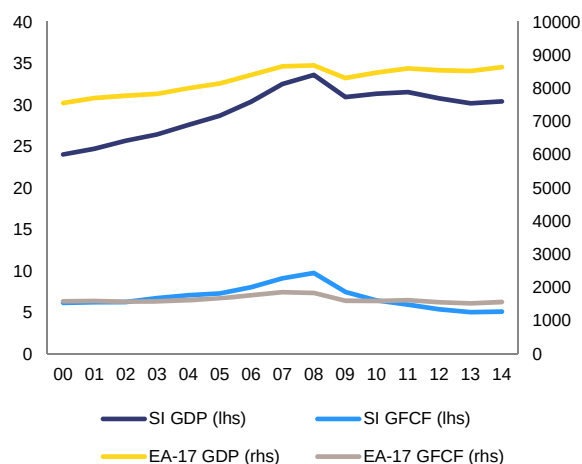
2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. Macroeconomic scene setter

Slovenia is experiencing a double-dip recession. Real GDP contracted by 2.3% in 2012 and will contract by 2% in 2013 according to the Commission services’ 2013 Winter Forecast. As a result, GDP is about 8 pps. below the peak reached in 2008 and this gap is not expected to close over the forecast horizon; the corresponding gap for the euro area as a whole is about 1½ pps. in 2012, closing to zero in 2014. As a consequence, and in contrast to most other European economies, the recovery in 2010-11 was so short-lived and modest in Slovenia that real GDP has now fallen below the previous trough.

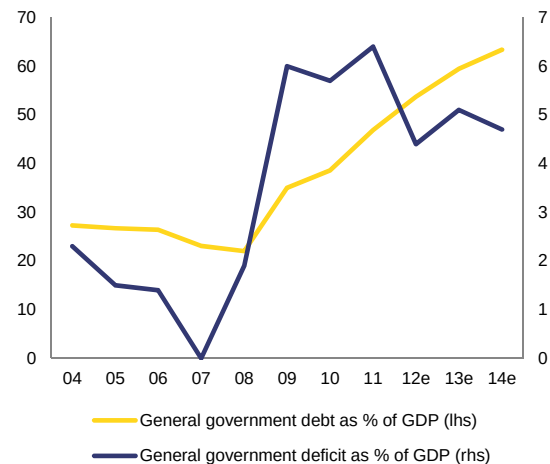
¹ See European Commission (2000), p. 58 and p.81, European Commission (2003), pp. 5-9 and p. 59, and also Lindstrom and Piroška (2004), pp. 6-7.

Graph 1: Gross domestic product and gross fixed capital formation, €bn at constant 2005 prices



Source: Eurostat and Commission services' 2013 Winter Forecast

Graph 2: General government deficit and debt, % of GDP



Source: Eurostat and Commission services' 2013 Winter Forecast

Demand remains weak, employment is still in decline and the financial situation of firm continues to deteriorate. Weak demand and capital support measures continue to drive the deterioration of Slovenia's public finances. The excessive deficit will probably not be corrected in 2013, the deadline set by the Council, according to the Commission services' 2013 Winter Forecast, which foresees a deficit of 5.1% of GDP. Debt is expected to approach the 60% of GDP threshold by 2013, even without including additional measures necessary to stabilise the financial sector. Employment is still contracting and is forecast to remain on a downward path until 2014, the period covered by the Commission services' 2013 Winter Forecast. Many companies, especially those oriented to the domestic market, struggle to service debts. The transmission of financial distress from firms to banks has intensified, leading to substantial further loan losses.

Slovenia's accessed sovereign debt markets in 2012. Slovenia has maintained an investment grade rating (Moody's Baa2, S&P A-, Fitch A-), despite a downgrade, whereas throughout most of the year yields on Slovenian government bonds rose in tandem with those for Italy and Spain. Market access was eventually reconfirmed through a sizeable US-dollar issue in October. Nevertheless, funding vulnerabilities remain as reform progress is uneven. Uncertainty as to the true scale of contingent fiscal liabilities in the banking sector and possible further downgrades² have the potential to make Slovenia's re-financing programme more challenging in 2013, with potential knock-on implications especially for the banking sector.

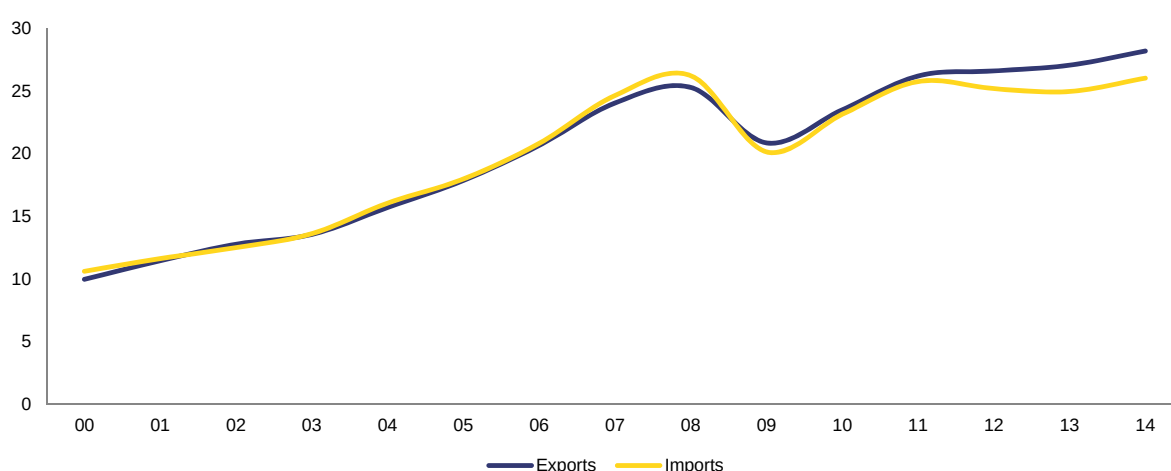
2.2. Sustainability of external positions

Weak domestic demand has allowed the current account to move into surplus. Final data for 2011 show the impact of the trade surplus on reducing net borrowing. Despite the sizeable

² The ratings outlooks of Moody's and Fitch remain negative.

general government deficit, the current account has moved from balance in 2011 to a surplus of 2% of GDP in 2012, according to the Commission services' 2013 Winter Forecast. It is expected to remain in surplus over the forecast horizon, even once adjusted for the very weak stage in the cycle, whereas the current account norm for Slovenia is a slight deficit according to Commission internal estimates.³ This development can be attributed primarily to weak domestic demand, with a secondary role through the income balance for profits and earnings of foreign workers. The role of weak domestic demand since 2009 is driving a gap between imports and exports. Indeed, internal estimates suggest that Slovenia may be one of the relatively few EU Member States where current account improvement can primarily be attributed to cyclical factors.⁴ While these estimates are sensitive to the specific calculation methodology adopted, they nonetheless point to underlying structural weaknesses.

Graph 3: Imports and exports of goods and services, €bn at current prices



Source: AMECO and Commission services' 2013 Winter Forecast

The relatively benign level of the net international investment position (NIIP) hides underlying weaknesses. Historical NIIP data have been revised, leaving Slovenia slightly above the 35% of GDP NIIP threshold in the AMR scoreboard – still the lowest reading for a new Member State. As this is primarily due to the very low FDI stock, it is in fact a consequence of features of Slovenia's business environment and history of state-ownership. Consequently, the structure of Slovenia's external debt, comprising essentially portfolio and other investment,⁵ makes this position more vulnerable to abrupt changes in investor confidence than the headline indicators would suggest. The need for rapid repayment of wholesale borrowing by domestic banks, which has contributed to deleveraging, exemplifies this vulnerability (see section 3.1). The 2012 IDR analysis in this respect remains valid. More

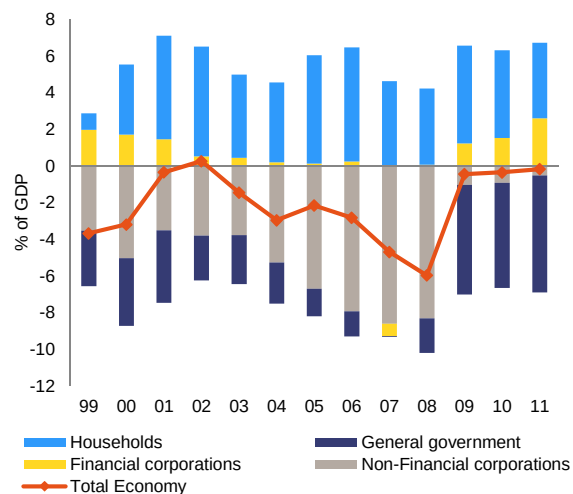
³ The current account norm describes the 'average' current account balance that would prevail in a country with similar structural characteristics such as ageing profile, fiscal deficit, degree of energy dependence, etc. A comparison of a country's business-cycle-adjusted current account balance with the current account norm indicates in how far the former deviates from the 'norm'. Estimated current account norms are based on a panel regression of 68 countries and available data for the period 1970 to 2012. For details on the methodology, see Salto and Turrini (2010).

⁴ See Salto and Turrini (2010).

⁵ The structure of this has changed over the past two years, with a shift from wholesale funding to ECB lending.

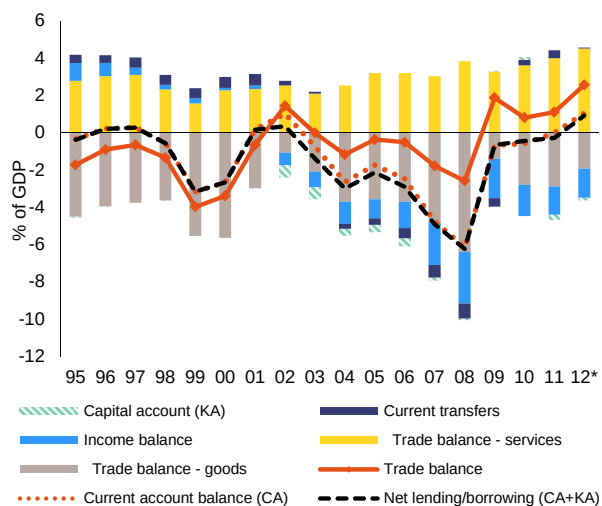
success in attracting FDI to finance Slovenia's catching-up process would initially imply current account deficits and in the longer run a more negative but more sustainable NIIP.

Graph 4: Net lending/borrowing by sector (% of GDP)



Source: EUROSTAT

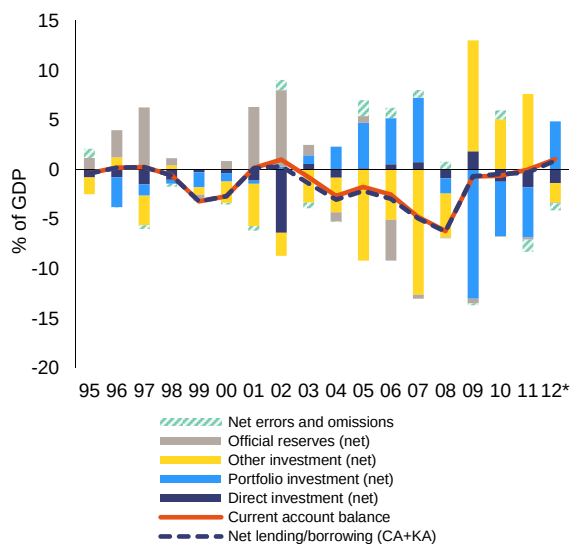
Graph 5: Components of net lending/borrowing (% of GDP)



Source: EUROSTAT

* indicates estimated figure using quarterly data.

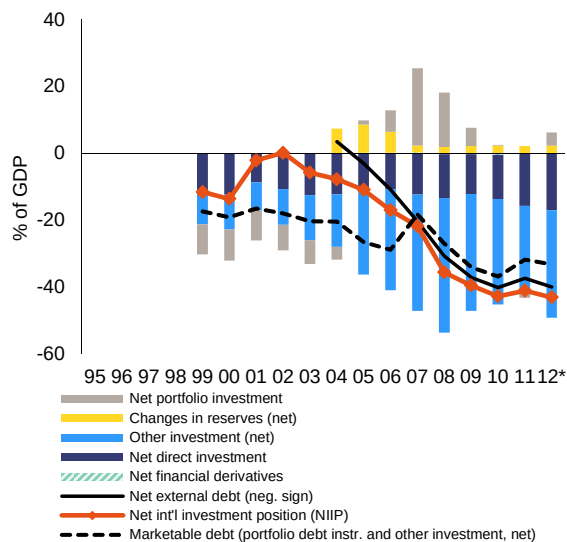
Graph 6: Financing of net lending/borrowing (% of GDP)



Source: EUROSTAT

* indicates estimated figure using quarterly data.

Graph 7: Net external debt and composition of Net International Investment Position (% of GDP)



Source: EUROSTAT

* indicates estimated figure using quarterly data.

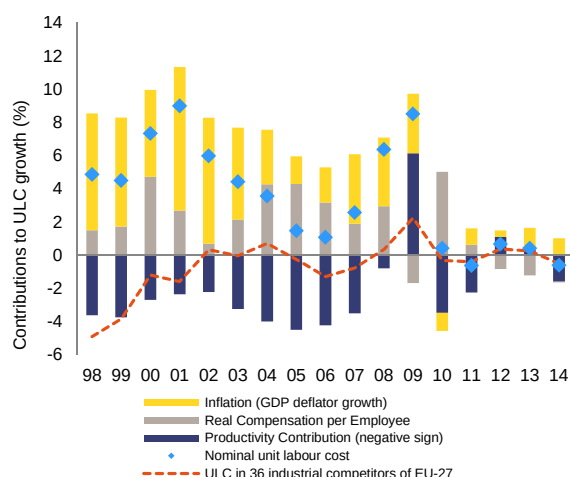
Creating a good investment climate, including for FDI in productive sectors, would reduce external vulnerabilities by promoting a beneficial shift towards equity and less volatile debt in Slovenia's overall financing. Despite its high-quality workforce and location close to main EU markets, Slovenia's inward FDI stock stood at only 31% when the crisis hit in 2009, compared to 78% in Hungary and 58% in Slovakia. Slovenia scores "below expectations" on the basis of comparison of the FDI Attraction Index with the FDI Potential Index.⁶ This confirms it is among the catching-up economies that have received less FDI than would be expected based on economic determinants. Significantly increased FDI would be beneficial, for growth and external sustainability. FDI in productive activities could provide much-needed equity to the real sector and bring fresh capital and improved risk management to banks, thereby allowing credit growth to resume in the future. FDI could also reinforce corporate governance and promote external balance by bringing higher technology content manufacturing, strengthening integration into international supply chains and opening up access to growth or niche markets. Finally, FDI is a key portfolio diversification tool for a small open economy such as Slovenia, allowing a wider range of investors to shoulder Slovenia-specific risks and opening up space for diversification of Slovenian balance sheets.

2.3. Competitiveness and export performance

Slovenia's competitiveness remains to be re-established. This is in line with the 2012 IDR assessment. With wage growth still low, nominal unit labour cost (NULC) growth has decreased, with the indicator falling below the scoreboard threshold. This is reflected in a slight depreciation in the ULC-based measure of the real effective exchange rate (REER ULC). However, sustained NULC and price growth below that of Slovenia's trading partners will be necessary to repair previous cost-competitiveness losses, especially from the 2007-09 period. Necessary corporate balance sheet repair could also absorb initial labour cost reductions by improved profitability, thus helping in the sectoral allocation of capital. Lack of competitiveness will hold back exports and disincentivise FDI. Moreover, as policy currently stands, there are strong built-in dynamics in both public and minimum wages that could reignite adverse trends in the coming years. Pressure on wages is to be expected once economic growth resumes as employees seek to re-establish differentials that were compressed in 2010 by a hike in minimum wages and by its subsequent inflation-indexation based increases.

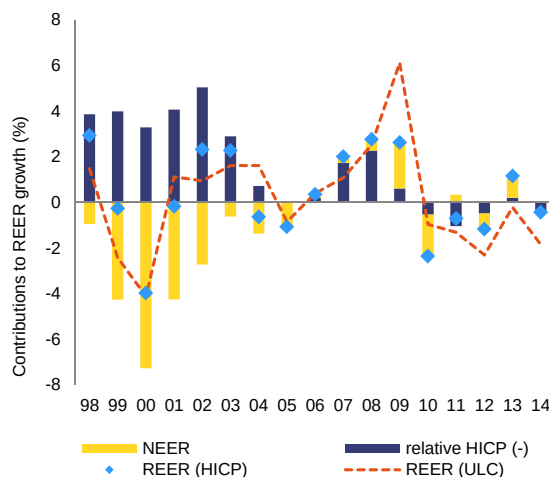
⁶ UNCTAD (2012).

Graph 8: Decomposition of developments in ULCs



Source: Eurostat & Commission services 2013 WF

Graph 9: Developments in Real Effective Exchange Rates



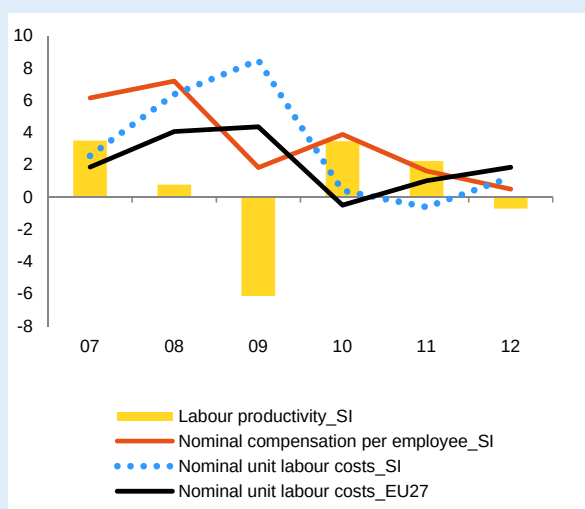
Source: Eurostat & Commission services 2013 WF

Improving cost competitiveness, notably in terms of labour costs, could make a key difference in preventing the return of external imbalances. Competitive labour cost levels would contribute to positive trade and current account developments and help Slovenia become a more attractive investment location. The government has cut nominal public sector wages by around 3% in net terms in 2012 and has envisaged cutting the wage bill by 5% in 2013. Although this only indirectly affects the tradable sector, this is one of the government's main levers in containing wage costs. There are currently no plans to pull the other main lever available – alteration of minimum wage adjustment (see Box 1).

Box 1: The minimum wage in Slovenia⁷

A hike of the minimum wage in 2010 contributed to the loss in price competitiveness and was ill-timed given rising unemployment. In March 2010, the minimum wage increased by about one quarter, from 597 to 734 Euros per month. At the same time, the number of minimum wage recipients more than doubled. The large discretionary adjustment in the minimum wage coincided with the period of economic slowdown and interrupted the ongoing deceleration in the wage growth.⁸ The increase in the minimum wage was exceptionally high not only compared to its developments in the last decade but also compared to average yearly increases in inflation and labour productivity over the same period. The minimum wage was also pushed well above the basic wages negotiated in some sectoral collective agreements, even for tasks requiring medium education. At the beginning of 2011, 2012 and 2013 the minimum wage was adjusted by the inflation rate in the previous year, resulting in a further increase of the minimum wage by 6.7% to the level of 784 Euros per month in 2013. In 2011, Slovenia was placed among the EU countries with the most expensive minimum wage workers compared to the average wage workers, measured both in gross terms and in terms of the labour costs. The high level of the minimum wage is estimated to have a significant negative impact on employment and to delay employment recovery.⁹

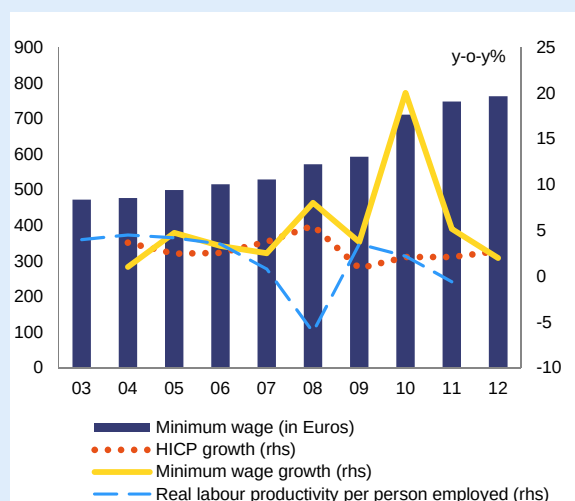
Graph 10: Unit labour costs, compensation per employee, labour productivity, y-o-y growth rate



Source: AMECO

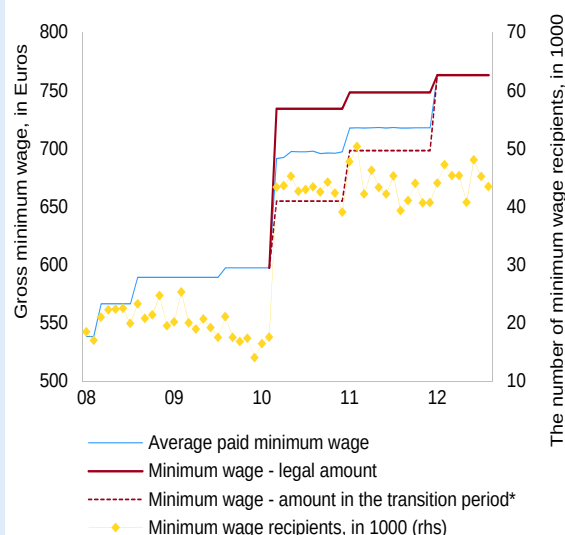
Graph 12: Minimum wage and the number of minimum wage recipients

Graph 11: Minimum wage, inflation and labour productivity, y-o-y growth rate



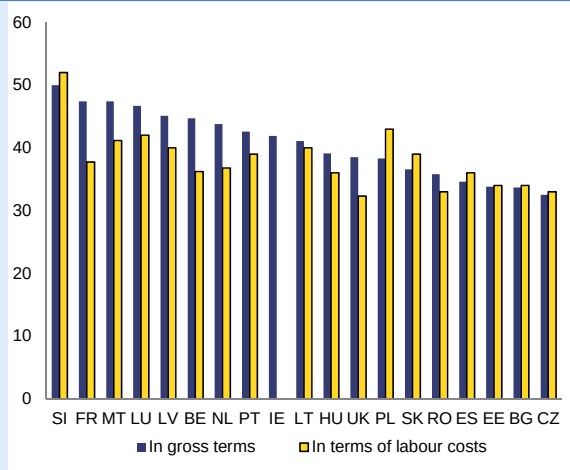
Source: Ministry of Labour, Family and Social Affairs

Graph 13: Costs of the minimum wage worker compared to the average wage worker, 2011



*The lowest amount set in the legislation

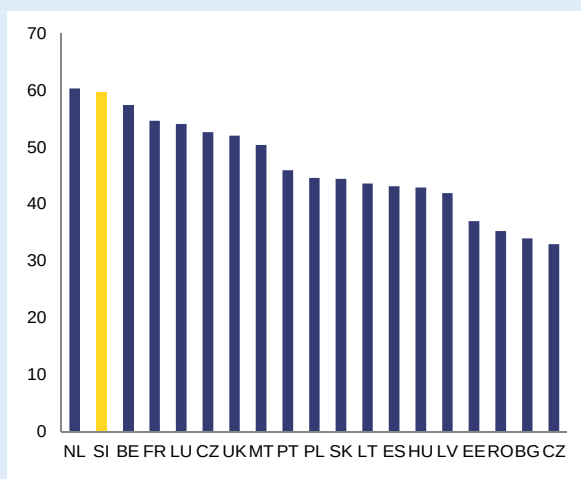
Source: Institute of Macroeconomic Analysis and Development (2012).



Source: Eurostat (wages in gross terms); Commission services; Joint European Commission-OECD project, using OECD Tax-Benefits models (labour costs)

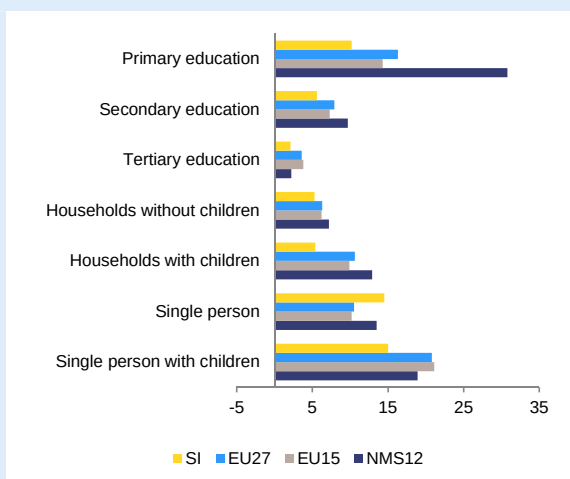
Although the minimum wage is below the relative poverty threshold, the risk of poverty among the employed is low. Net income of minimum wage workers is not sufficient to reach the relative poverty threshold (60% of median equivalised disposable household income); however, net income of minimum wage workers is among the highest in the EU when compared with average wage workers. The at-risk-of-poverty rate of employed persons is low in Slovenia compared to other EU countries, including of the workers with primary education who tend to be low-paid. The main cause of poverty is unemployment, thus increases in unemployment as a result of inadequately high minimum wages may actually increase overall poverty.

Graph 14: Net income of the minimum wage worker as a % of net income of the average- wage worker, 2011



Source: Commission services; Joint European Commission-OECD project, using OECD Tax-Benefits models, Eurostat

Graph 15: In-work at-risk-of-poverty rate, 2010

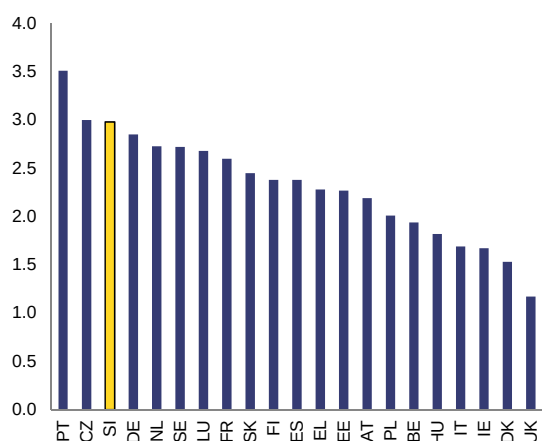


Source: Eurostat, Commission services

Employment protection legislation in Slovenia used to be among the most rigid in the EU, which may also have limited the attractiveness of Slovenia as a production location

and imply upward pressure on wages. Using the OECD indicator, Slovenia stood out in its tight regulation of permanent contracts, notably in case of individual dismissals. In addition, outcomes on the labour market point at labour market segmentation, above all among the young, stemming from a very high and increasing share of newly concluded contracts for a definite period and relatively low transition rates from temporary to permanent contracts.

Graph 16: Employment protection legislation, individual dismissals, 2008

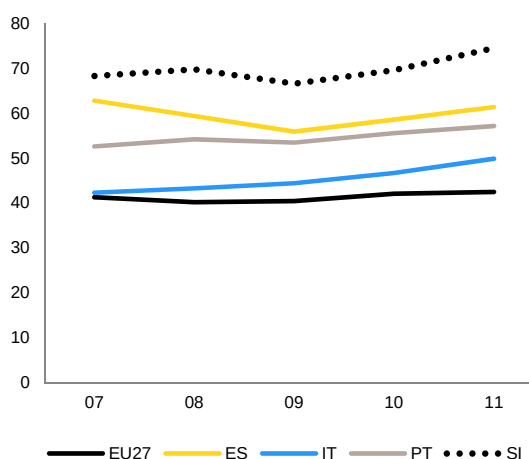


Note: Scale from 0 (least stringent) to 6 (most restrictive)

Effects of reforms after 2008 are not taken into account.

Source: OECD, Commission services

Graph 17: The share of temporary employees in total number of employees aged 15-24



Source: Eurostat, Commission services

Strict employment protection legislation reduces the adjustment capacity of the economy and causes labour market segmentation. Rigid employment protection legislation may have hampered the necessary re-allocation of labour across firms and sectors, including away from state-owned enterprises. By hindering adjustment in the quantity of labour inputs, strict employment protection also transmitted output falls during recessions into falling labour productivity. In contrast, when labour demand recovers, it will favour wage growth over employment growth. By reducing labour turnover and by boosting the wage bargaining power of insiders, rigid employment protection legislation may accentuated wage pressures throughout the economic cycle. Furthermore, to the extent that employment protection legislation increased the effective labour costs borne by employers, it could also have translated into a loss of price competitiveness and reduce investment, including FDI.

Slovenia recently revised employment protection legislation with a view to fostering job creation, tackling segmentation, and enhancing the adjustment capacity of the economy.

The key measures aim at strengthening incentives for firms to use permanent contracts as a rule. To this end, the regulation of permanent contracts has been relaxed by streamlining dismissal procedures in case of individual and collective dismissals, and reducing dismissal costs for workers with longer tenures. Conversely, protection of fixed term contracts is increased to curb abuse. The reform also introduces temporary/mini jobs for retired persons and financial support to both employers and employees during the notice period in case of consensual dismissals. While the reform goes in the right direction, it may not be sufficiently ambitious to have a substantial impact on the labour market and flexibility. In addition, new restrictions on the chaining of fixed term contracts may have a negative impact on job

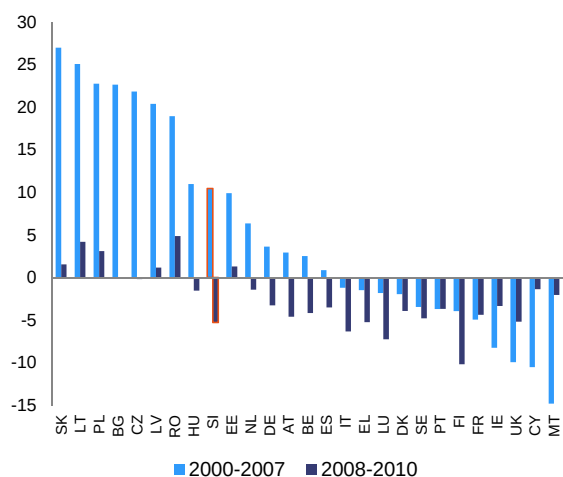
creation. Finally, the reform does not address the problems associated with the extensively used and under-regulated “student work” status.

Over burdensome regulation of professional services has been identified as detrimental to the business environment. Slovenia has over 300 regulated professions (the EU average per country is below 200). Slovenia is also among the member states which relatively frequently impose specific qualification requirements not linked to professional titles (notably in the areas of tourism and security services). Unjustified qualification-related entry barriers in professional services, such as reserves of activity, can hinder competition and increase costs for businesses and households. A reform process was launched in 2012, with legislative changes foreseen for the craft, tourism and construction sectors in early 2013 and other sectors due to follow. In parallel as a tool for improving the overall business environment, efforts are being made to develop a fully operational Point of Single Contact for online completion of administrative procedures in the services sector by 2015.

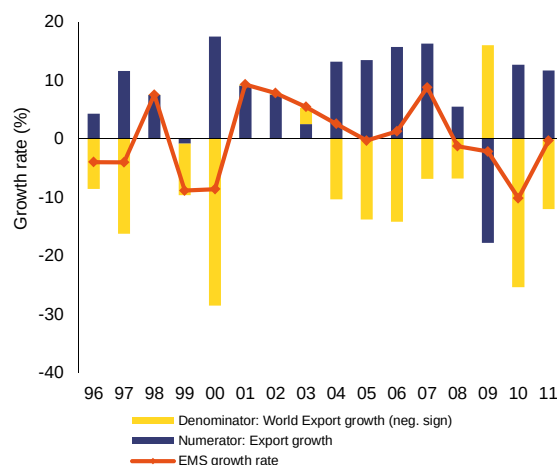
Slovenia has not yet adopted a plan for the transition to e-procurement and is one of the EU Member States with the least developed infrastructure in this area. This means that the significant economic benefits of e-procurement (including greater transparency, faster procedures and more competition) are currently not being fully exploited in Slovenia.

After years in which Slovenia did not keep up with the gains in export market shares of other catching-up economies, adverse cost trends have coincided with a decline in export market shares. Slovenia now breaches the AMR scoreboard threshold with a cumulative three-year loss of market shares of 6.4%, principally because of losses incurred in 2010. In that year the country failed to benefit proportionally from the sharp rebound in world trade and the minimum wage saw a large upward adjustment. The overall pattern of trade has remained similar in 2012, with early signs of some strengthening of exports beyond the EU which have previously been weak. Modest gains in export market shares are forecast until 2014, the period covered by the Commission services’ 2013 Winter Forecast. The impact of weak export performance, including on account of losses in competitiveness, is significant as exports are the largest demand component in the Slovenian economy, amounting to over 75% of GDP. As a result, even if economic reforms were to lead to only small increases in exports, these can have significant positive effects on external balance, growth and employment.

Graph 18: Export growth net of global import growth (in pps.)



Graph 19: Export market share growth (% y-o-y)



Source: Commission services' calculations based on UN COMTRADE data Source: EUROSTAT

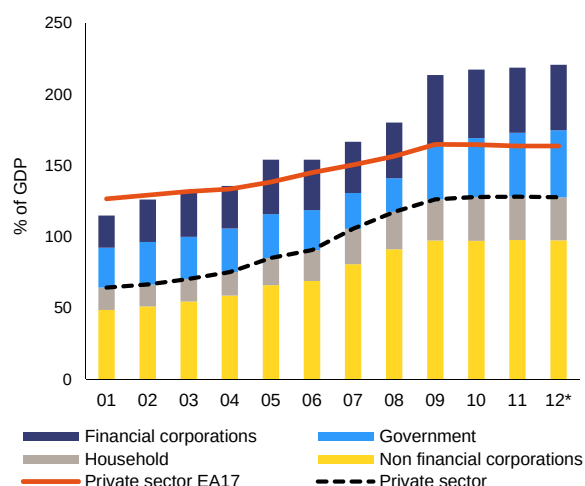
Weak export performance also reflects weaknesses in non-cost competitiveness. As described in the 2012 IDR, Slovenia's industrial structure is still largely dominated by low-to-medium technology and labour intensive products. There is also a structural services surplus based on tourism and road haulage. Relevant factors that may play a role in non-cost competitiveness are Slovenia's niche in global supply chains together with other factors such as product marketing and quality. ECFIN estimates for exports and imports disaggregated by product show no strong trend in Slovenia compared to other countries during the interval 1995-2007; there has been neither a substantial increase in the success of exports in foreign markets nor a substantial increase in the proportion of domestic production seriously challenged by imports.¹⁰ This may indicate a failure to capitalise sufficiently on European integration and the catching-up potential. New ECFIN estimates¹¹ indicate that Slovenia ranks relatively high in the EU in terms of the import content of exports and of investment, as might be expected from a small manufacturing-oriented country with limited natural resources and a sizeable intermediate goods sector. This is especially the case as regards goods. Given Slovenia's position in the supply chain, cost-competitiveness and adjustment capacity are key to responding to demand shocks.

2.4. Private sector indebtedness

Private sector debt levels (as a percentage of GDP) remain below the euro area average, but still contribute disproportionately to the weakness and adjustment needs of the Slovenian economy. As described in the 2012 IDR, debt levels increased fast during the boom but remained below the AMR scoreboard threshold given the low starting level as well as the stalling credit growth since 2009. Slovenian households have only moderately participated in the credit boom. Lending to households for housing purchases continued to

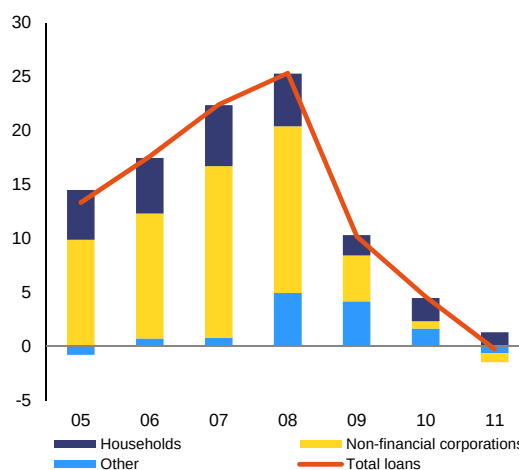
grow in 2009-10 but has since faded. In contrast, the indebtedness accumulated by non-financial corporations in only a few short years before the crisis was frequently out of proportion with their debt-service capacity. Commission estimates of deleveraging pressures based on corporate assets confirm that Slovenia is in the group of countries where rapid corporate debt build-up has led to deleveraging pressures even in the absence of high debt-levels in absolute terms.¹²

Graph 20: Decomposition of debt (% of GDP)



Source: EUROSTAT

Graph 21: Sectoral contributions to credit growth (%)



Source: ECB

Slovenia continues to face corporate and bank over-indebtedness and the deterioration in asset quality triggered by the recessionary environment. While these imbalances are not signalled in the AMR scoreboard, where no indicator exceeds the threshold, the 2012 IDR diagnosis remains valid. The fallout from the 2009 recession continues to put the balance sheets of thinly capitalised banks under considerable strain. The state has already had to step in several times to recapitalise the banks it owns. The fact that the economy is in a double-dip recession is aggravating these trends. The economy is therefore undergoing a necessary but difficult deleveraging process, with the stock of non-financial, private sector credit shrinking at around 5% on an annual basis in nominal terms. Credit to non-financial corporations continues to fall, as banks write down loans and readjust their lending volumes to their domestic deposits base. Despite this, corporate debt-to-equity ratios remain high at 144%. Composite indicators rank Slovenia alongside countries where strong deleveraging pressures arise from both lending supply and demand factors.¹³ The in-depth analysis in section 3.1 provides an update on the situation in the banking sector and the state-of-play of the policy response.

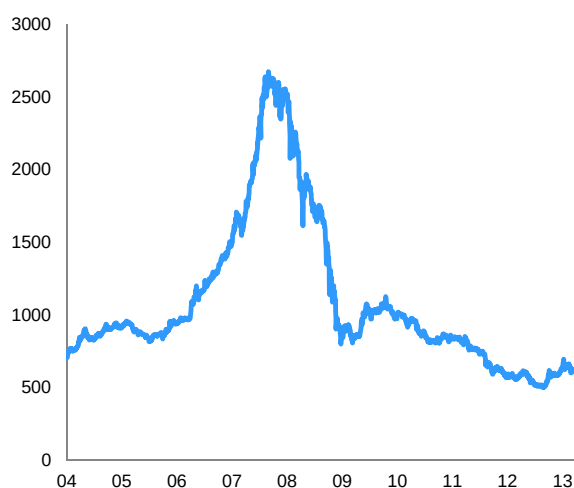
Access to credit from Slovenian banks has deteriorated for non-financial corporations. Credit to non-financial corporations declined by 10.2% in 2012. Corporate credit (for loans above EUR 1m) is more than 2 pps. more expensive in Slovenia than in the euro area as a whole and this margin has increased again in 2012. Non-financial corporations' demand for loans has amounted to around 130% of new loan volumes over the last two and a half years according to the Bank of Slovenia (BoS survey results). However, the same source reports a decrease in creditworthy demand, which can be related to the poor financial prospects of the

corporate sector. Credit transactions fail to be concluded mainly due to banks' stricter credit standards and corporations' rejections of credit conditions. For these reasons, some non-financial corporations have resorted to issuances of short-term commercial papers. This replaces long-term corporate bonds and credits from abroad, although the latter funding source has stabilised recently.

2.5. Asset market developments

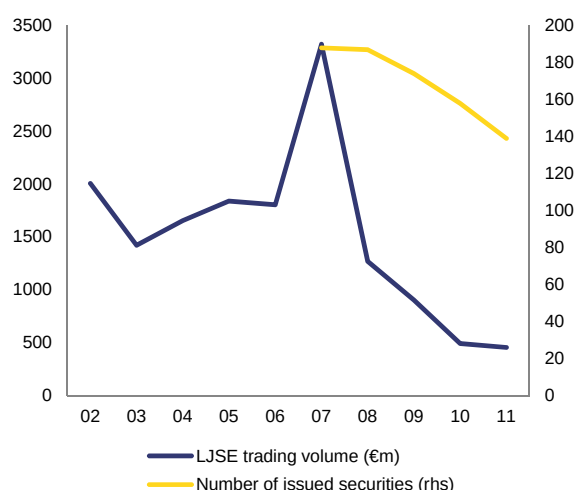
Activity on financial asset markets remains very subdued with little issuance of bonds or shares. Stock market valuations remain depressed and liquidity at the Ljubljana stock exchange remains limited. Corporate bond issuances, which had provided a measure of relief from the credit crunch for larger companies, are down from EUR 77m in 2009 to zero as of October 2012.

Graph 22: Slovenian blue-chip stock market index (SBITOP)



Source: Bloomberg

Graph 23: Activity on the Ljubljana stock exchange

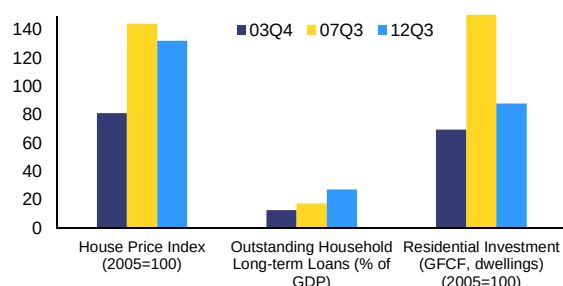


Source: Bank of Slovenia

Note: All companies in the index are at least partially state controlled.

House prices, which had seen only a small correction since the crisis, may now be falling in a more sustained manner. As of 2012Q3 Slovenian house prices were about 24% below the 2008 peak in inflation-adjusted terms. About half of this adjustment came from a nominal reduction, while the rest was due to consumer price inflation. The inflation-adjusted house-price fall is moderate compared to other new Member States (e.g., -31% in Hungary and Poland, -44% in Estonia, -64% in Romania). The nominal adjustment continues to be volatile: a slight nominal increase in Q2 followed a fall in Q1. Transaction volumes on the real estate market in Q2 were significantly reduced relative to the 2007 average, down 59% for newly built dwellings and down 30% for existing dwellings. This reduced housing market liquidity could suggest that any ongoing price adjustment is slowed down by institutional and behavioural frictions. Such frictions could arise when banks opt against disposal of their property holdings at market-clearing prices that would imply recognition of significant losses.

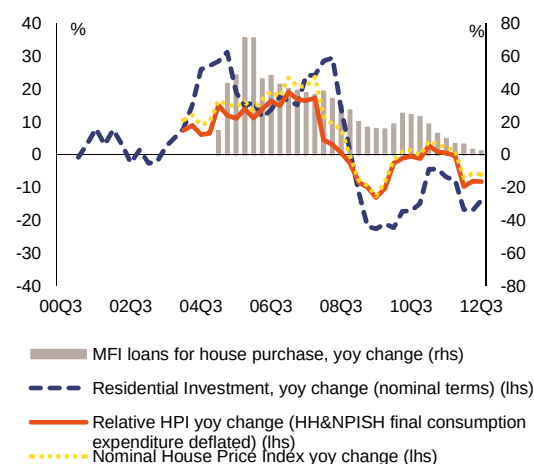
Graph 24: Housing and Mortgage Market (levels)



Note: The three indicators / bars convey different messages and their value or calculation formulae should not be strictly contrasted across the panel. The comparison is interesting from inter-temporal perspective as well as in terms of general dynamics with a view to concluding whether risks related to house prices, household indebtedness and housing investment have accumulated or cleared in coordinated manner over time.

Source: EUROSTAT, ECB, OECD

Graph 25: Housing and Mortgage Market (growth)



Source: EUROSTAT, ECB, OECD

House price valuation methods signal a substantial additional correction potential.¹⁴ As of 2011Q4 the price-to-rental and the price-to-income ratios were above their averages over the period 2003-11 (by about 8% and 7%, respectively). However, the effective overvaluation might be higher, as the sample available for calculating the Slovenian long-term average does not cover one full cycle. The corresponding bias is probably above 11%, approximated by the average of the price-to-rental ratio for the euro area over the period 2003-11 compared with the long-term average over 1996-2011. Given that the pre-crisis upturn in the euro area as a whole was probably more moderate than in the new Member States, this estimate would be a conservative lower bound for the bias. An adjustment potential is also signalled from a fundamental model of relative house prices.¹⁵ Based on the Commission services' forecast for GDP growth, the current long-term trend for house prices is about 10% below 2011 levels, and could drop further if fundamentals continue to deteriorate in 2013. A caveat due to the short data history applies here as well, and leads probably to an underestimation of the gap.. This has potential implications for loan collateral values and banks' soundness.

Characteristics of the housing market, such as Slovenia's high home ownership rate, do not explain house price resilience, since potential buyers are likely to be affected by credit constraints. Arguably, the home-ownership rate is high, at around 81%. In the Slovenian housing market price resilience could point to the fact that marginal transactions on the market rely on specific parts of the population, such as younger, first-time buyers, that could be particularly sensitive to developments in the credit market. Credit tightness, coupled with stocks of dwellings that might ultimately need to get on the market, is therefore increasing the chances of a housing price correction and corresponding adjustments to real estate collateral.

Housing investment has receded significantly, but adjustment is not such as to lower pressure on house prices. The current fall of 33% below 2007 levels (40% in real terms) does not seem to fully reflect the fall in transactions in new homes (as discussed above). It is thus likely that some of the newly built dwellings are currently kept out of the market as a

result of various institutional and behavioural mechanisms at play (e.g. strategy of developers, relationships between banks and construction sector borrowers). Building permits are down about 70% from the 2007 level and have thus fallen considerably deeper. This sharp fall possibly reflects the absorption of the backlog of old permits and suggests that the pipeline will be adjusting over the coming period.

3. IN-DEPTH ANALYSES

3.1. Banking sector vulnerabilities

Slovenian banks face increasing challenges. The large, state-owned banks, and possibly some other banks, need additional capital again. The necessary deleveraging process is accelerating as wholesale lenders are repaid and the deposit base has reduced.¹⁶ Credit quality has deteriorated further, leading to higher loan-losses now and, due to the lagged booking of impairments, also in 2013. Downward revisions of economic forecasts imply an additional deterioration of loan portfolios also in the future. Newly available estimates of stress loan losses point to possible additional recapitalisation needs. Work-out of bad and doubtful assets remains challenging.

Repeated and increasing recapitalisation needs are concentrated in state-owned banks, Some of the smaller, privately owned domestic banks also face challenges. Additional capital would strengthen confidence in the banking sector. If required for regulatory reasons, as already repeatedly done in the past (see Box 2) the state is likely to provide this at least for the largest three banks which are majority state-owned.¹⁷ A durable return of confidence would benefit from banks resolving distressed loans and demonstrating a viable business model, including solving the governance challenges in state-owned banks (see section 3.2 for the implications of continued state ownership of the three largest banks).

Box 2: Recapitalisation of NLB, NKBM and Abanka

The Nova Ljubljanska bank (NLB) continues to generate substantial fiscal costs. NLB Group is by far the biggest banking group in Slovenia, with assets amounting to around 23% of the total assets of the banking system and (25% for total loans and advances to non-banks) as of the end of 2012, down from 29% at the end of 2009. NLB Group is experiencing sustained deterioration of the quality of its loan book, which resulted in a net loss for the fourth consecutive year in 2012. NLB Group's insufficient capital base was identified by European Banking Authority (EBA) in 2011. To address the situation, further strengthening of the core Tier I base was recommended.

On 2 July 2012 the Commission temporarily approved, under EU state aid rules, an additional capital injection to the NLB for reasons of financial stability. A contingent convertible bond (CoCo) worth EUR 320m, direct cash injections worth EUR 63m from state-owned funds and restructuring of existing subordinated instruments yielded a capital increase of around €500m. This increase, together with some restructuring of risk weighted assets, increased the Core Tier 1 capital ratio to 9.5% to comply with the EBA recommendation of autumn 2011. The state's share (direct and indirect) increased by 5pps. to around 64%, while the share of erstwhile strategic investor KBC declined to 22%. At the end of 2012, KBC sold

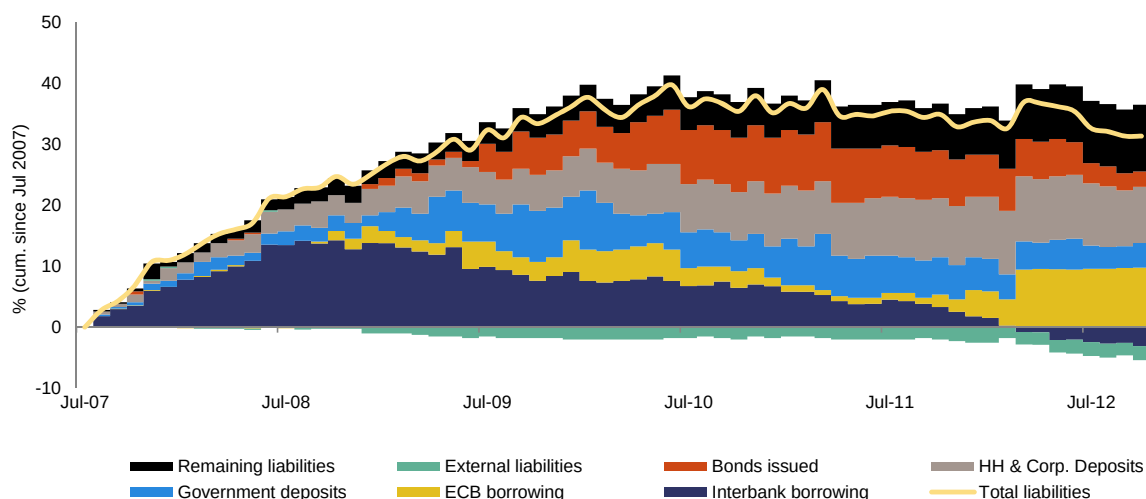
its remaining shares to the Slovenian state at a substantially reduced price (less than 1% of what it paid in 2002) as part of its restructuring under state-aid rules.¹⁸ Losses recognised since the recapitalisation brought Core Tier 1 capital excluding the CoCo below 7% thus triggering conversion¹⁹. Further capital needs would be exposed in the process of transferring assets to a Bank Asset Management Company (BAMC, see below). Moody's downgraded NLB's credit ratings with negative outlook on 12 March, citing capital needs, ongoing material losses and the expectation of further losses in 2013.

Recapitalisation needs also emerged for NKBM and Abanka, banks whose shares trade at low price-to-book ratios. NKBM, the second biggest bank in the country and majority state-owned, raised fresh capital of EUR 104m in April 2011, which allowed it to successfully pass the EBA stress test of summer 2011. Nevertheless, after posting losses as a result of further deterioration of its asset quality, the need for fresh capital re-emerged in 2012. In October a further increase was launched, producing a net positive effect of EUR 182m on capital position for regulatory purposes through a mix of measures including the sale of a subsidiary insurance company (see also Box 3), buy-back of subordinated instruments, the sale of assets pledged as collateral and further scaling down of risk-weighted assets. With a hybrid loan by the government,²⁰ the Core Tier 1 ratio reached 9%, thus meeting the requirement by the EBA, before the end of 2012. On 18 March 2013 NKBM announced it would trigger conversion of this instrument, subject to the approval of the supervisory board in April.²¹ Meanwhile, Abanka, the third biggest and also majority state-owned bank,²² is also looking to raise new capital. An initial attempt to issue new shares in summer 2012 failed due to insufficient interest at the high asking price. The exercise was re-launched in December at a significantly lower asking price, but again failed to attract sufficient investor interest. After these two failed-attempts, the BoS has accorded Abanka a further extension to raise the required capital by 31 July 2013. There are also long-standing merger talks with Gorenjska banka, a somewhat smaller but better capitalised, majority privately-owned bank in which the state holds a blocking minority share. The viability of such a merger would need to be assessed by the owners of both banks.

The shift away from foreign wholesale funding has continued, but further deleveraging will be needed in the absence of new sources of replacement funding. After the onset of the crisis, banks issued bonds, some of which were backed by government guarantees, and competed to attract more deposits. Help from the government and from the ECB, whose LTROs now amount to 8.5% of the sector balance sheet,²³ together with cumulative deleveraging of around 10% over 2009-2012, have enabled banks to repay around half of their foreign liabilities. However, other sources of replacement financing will be difficult to mobilise. Banks under majority foreign ownership previously reliant upon funding from their parent institutions intensify competition for retail deposits.²⁴ As a result, interest margins are being squeezed, raising risks to profitability. Furthermore, in a new development since the 2012 IDR, domestic deposits have started contracting on aggregate, declining 4.8% in nominal terms in the first nine months of 2012.²⁵ This development is principally observed at domestically-owned banks. It has so far been explained by one-off factors, notably the contraction of government deposits,²⁶ but still requires close monitoring, particularly on a bank-by-bank level. Finally, the balance sheet of the development bank SID, which was used to partially offset deleveraging over the past three years, has been significantly expanded. With wholesale funding opportunities unlikely to return and given the time limits on the ECB's extraordinary LTRO policy, funding pressures are likely to push the sector into further

deleveraging on an aggregate level and potentially also rationalisation such that, bank-by-bank, funding needs and funding sources (particularly deposits) come closer into alignment.

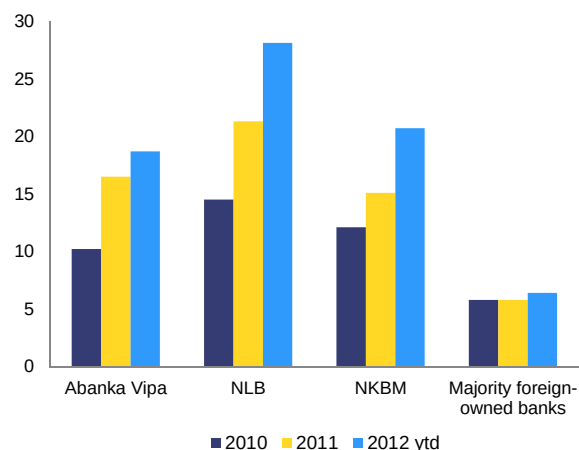
Graph 26: Financing of the Slovenian banking sector



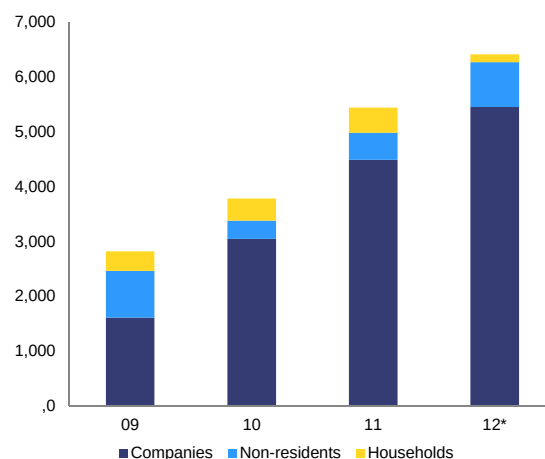
Source: ECB, Commission services calculations

Credit quality has deteriorated further since spring 2012 with the decline concentrated in the impaired balance sheets of the state-owned banks. Non-performing loans (NPLs), defined as arrears over 90 days, ran at a rate of 5.4% at the end of 2009. By the end of 2011 this had risen to 11.2% and by the end of 2012 still further to 14.4%. In the corporate segment, NPLs were at 24% by the end of 2012, up from 18.5% a year earlier. NPL trends have remained the most negative in the large state-owned banks. The construction sector remains the most afflicted, with NPLs now standing at 61%, but the increase in NPLs from 11.1% to 17.4% for the manufacturing sector also has a large impact as the sector accounts for over a quarter of the non-financial corporate sector (NFC) portfolio. NPL ratios pertaining to smaller segments such as financial services and real estate activities have also continued rising. Indeed, all sectors now show NPL ratios in excess of 10% with the exception of primary industries and utilities. These ratios are understated, to the extent that they are reported in proportion to total exposures²⁷ rather than total loans. Furthermore, some of the loans classified as performing have formally been restructured or rescheduled, and the data on households have not been refreshed since end-2011.²⁸

Graph 27: Non-performing loans, % of gross loans



Graph 28: Overdue 90 days+ classified claims by sector, €m



Notes:

NPL ratio definitions vary between banks and between annual reports and statistical returns to the Bank of Slovenia (which compares NPLs to classified claims, which is a broader concept than gross loans)

Abanka Vipra: from Annual Reports, 2012 H1 from semi-annual report

NLB: from Annual Reports, 2012 H1 from Fitch

NKBM: from Annual reports, 2012 Q3 from interim report

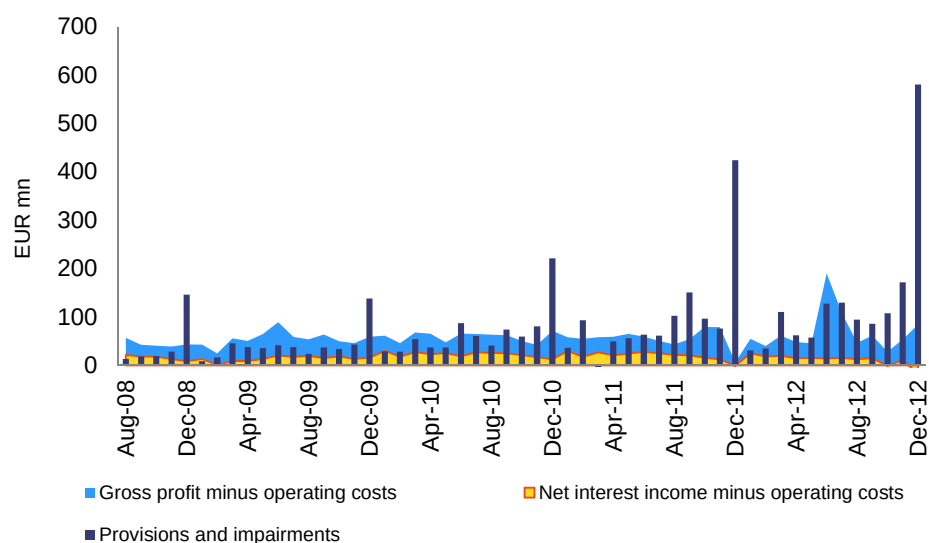
Majority foreign-owned: from Bank of Slovenia (classified claims concept)

*Includes sole traders but other households not yet available

Source: Bank of Slovenia reports, Commission services calculations

Credit quality deterioration has led to a further acceleration of losses. Impairment costs of EUR 1,206m in 2011 drove a before-tax loss of EUR 539m. The trend continued in 2012, with impairment costs up by around 32% according to unaudited figures, driven by a 32% increase at NLB and a 92% increase at NKBM. This led to losses in 2012 over 40% larger than in 2011, despite one-off factors boosting income.²⁹ As discussed in the 2012 IDR, loan losses are recognised with a significant lag after the materialisation of loan arrears. In part, this is due to how provisioning rules are specified. In this respect, NPL increases observed in 2012 would drive the recognition of further losses in 2013 and 2014. At the same time, the scope for banks realise one-off profits seems to be largely exhausted after the discounted buy-back of hybrid instruments in 2012.

Graph 29: Banking system P&L (€m)



Note: Pre-impairment profit is calculated as gross income minus operating expenses. 2012 gross income is boosted by one-off profits on buy-back of hybrid instruments, so the graph also shows pre-impairment profit arising from net interest income (calculated as net interest income minus operating expenses) to strip out these one-off effects.

Source: Bank of Slovenia reports, Commission services calculations

The key question for the Slovenian banking system is how far credit quality deterioration and loss increases will go given the worsened economic climate. Banks are deleveraging by scaling back new lending, which is partly demand-driven, so they are increasingly reliant only on legacy portfolios. Furthermore, migration matrix analysis based on Slovenia's A-E classification system reported by the Bank of Slovenia (BoS) shows a distinct negative trend in loan ratings in the year to September 2012. 15.9% of doubtful, so-called C-classified, loans became non-performing (D classified), with ratings downgrades outweighing upgrades by a balance of 22.7%. For non-performing D claims, the trend was even more distinct, with 44.9% of them migrating to the E category, which usually corresponds to write-off – with downgrades outweighing upgrades by a balance of 40%.³⁰ Credit quality in the corporate segment will either improve or deteriorate depending on the balance of two effects: (i) a mechanical reduction of the NPL ratio as loans to the main corporate casualties of the 2009 recession are written off³¹ and (ii) a second wave of defaults caused by the double dip. A second wave could involve previously stronger firms that fully used their shock absorbers in 2009-2011 (cost cutting, bank forbearance and lower interest rates) and therefore can be tipped into default more easily compared with the previous downturn.³²

Several new assessments point to potential future losses. The BoS and the IMF performed stress tests in April 2012 as part of the Financial Sector Assessment Programme (published only in December, and therefore not available in time for the 2012 IDR, IMF 2012a). These estimates pointed to a Core Tier 1 capital shortfall of approximately 3½% of GDP by 2013 in the baseline scenario, rising to around 5% in an adverse scenario (with slight variations depending on methodology). For the subset of large, domestically-owned banks, the stress scenario suggested a shortfall of approximately 4½% of GDP under an adverse scenario to reach the EBA threshold of 9% core equity tier 1 set by the 2011 Recapitalization exercise.

Separately in mid-2012, third-party due diligence exercises were conducted in the three main state-owned banks which constitute the bulk of the domestically-owned, large banks. This corresponded to the country specific recommendation to obtain third-party verification of stress-loan-loss estimates. The government subsequently earmarked EUR 1bn for recapitalisations (around 2¾% of GDP) in the Act on Measures of the Republic of Slovenia to Strengthen Bank Stability. This is understood to correspond to the need for write-downs identified in the due diligence reports, net of the July 2012 NLB recapitalisation of slightly below 1½% of GDP (see Box 2). The due diligence-based figure of 2¾% of GDP and the IMF/BoS figure of 4½% of GDP for large domestic banks can therefore be usefully compared and seem to point to additional capital needs of a similar order of magnitude. While some recapitalisation has taken place since these alternative estimates were produced (also in NKBM), the underlying macroeconomic outcomes and forecasts have also been revised significantly downwards.

Asset work-out is at the heart of a solution for the banking sector. The factors highlighted in the 2012 IDR remain problematic, notably dealing with bankrupted construction and holding companies and their associated real estate and share collateral, managing loans in arrears and enforcing claims, if necessary through frequently unsatisfactory insolvency proceedings. After previous attempts to co-ordinate the resolution of claims and shareholdings within bank consortia stalled, the government has legislated to create legal instruments allowing the removal of problematic legacy assets from the banking system.³³

The Stability of Banks Act came into force in December 2012. It provides a framework for issuing state-guaranteed securities to fund the transfer of legacy assets from banks to an asset management company (BAMC) or a special purpose vehicle (SPV) together with recapitalisations to address the losses crystallised as a result of transferring assets at long-term economic value (generally below book value). In line with state-aid rules on asset valuations, the transfer of these troubled assets into a state-guaranteed fund would crystallise a capital shortfall in participating banks which the government intends to simultaneously cover through cash recapitalisations. After transfer of these assets, the BAMC would be responsible for asset work-out until 2017 when the assets would revert to the Slovenian Sovereign Holding (SSH). The BAMC would aim to consolidate claims and shareholdings and achieve substantial financial restructuring of the corporate sector. The government currently foresees funding the transfer of assets with up to EUR 4bn of government-guaranteed bonds and making good any capital shortfalls with up to EUR 1bn of cash contributions.

Implementation of the BAMC (or separate special-purpose vehicles, SPVs) is at an early stage, with challenges lying ahead. The by-law adopted on 13 March 2013 specifies some operational processes, particularly around the modalities of asset selection and granting of government guarantees. Furthermore, it provides a methodology for determining the long-term economic value of loans and some criteria for admissible valuations for other risk items. It lists the types of assets that can be transferred: besides standard loans, the by-law specifies capital stakes and real assets acquired through enforcing collateral rights; capital stakes that together with loans form a business whole for the transferring bank; a wide range of off-balance-sheet risk items; and any other assets that may reduce the participating bank's ability to meet its capital adequacy requirements. The wide range of types of risk item eligible for transfer means significant flexibility and discretion are retained. The selection of participating banks and the basis for opting between transfer to the BAMC and transfer to an SPV also remain subject to administrative discretion. It is anticipated that guidelines will be issued providing additional details pertinent to a more complete economic assessment of the policy

and it may well be that the policy, its costs and its effects become clear only after selection and valuation of specific assets has occurred. Some of the important open questions pertain to: (i) the nature of the assets actually to be transferred (as opposed to just eligible to be transferred), (ii) impairments accounted for to-date on these assets, (iii) which banks will be involved, and when, (iv) the number and frequency of transfers planned, (v) the structure of debt instruments to be issued by the BAMC, and (vi) the BAMC business plan on maximising recovery value and asset management solutions.

In the short term, the BAMC (or SPVs) can strengthen banks' balance sheets. It aims to achieve this through purging a lot of risky assets from bank balance sheets, replacing them with potentially ECB-eligible BAMC debt instruments, thus easing funding pressure on the banks.³⁴

The transfer of assets to the BAMC would also crystallise losses, thus bringing forward and revealing capital shortfalls. The transfer value may, according to the bylaw approved mid-March, also be reduced by up to 3% of the asset value to cover the administrative and operational costs of the BAMC for managing the assets. Bank profits and losses would further be affected going forward, losing the revenue streams associated with transferred assets in return for interest on BAMC bonds and possible further remunerations to the BAMC to cover costs.³⁵

In all cases, the sovereign-bank feedback loop is maintained or strengthened. Banks retain government bonds (in all cases), gain state-guaranteed assets and contingent claims on the state (in case the BAMC or the APS is applied) while the government increases its substantial direct and indirect ownership stakes in the sector (in all cases). Banks will also be subject to restructuring requirements under state-aid rules.

In the medium-to-long term, recapitalised banks with cleaned (or guaranteed) balance sheets could become more attractive to potential investors. The attractiveness is crucially contingent on a wider set of factors, including the will of the government to reduce ownership below the "blocking minority" threshold of 25%+1 share as well as Slovenia's growth prospects and the appetite of investors for European banks more generally. Whether banks sustainably return to profit will also depend on improved management while the Stability of Banks Act gives the Ministry of Finance strong powers to shape the business planning of banks transferring their legacy assets. These powers could be used to strengthen the banks but it should be avoided to use these powers to promote credit flows to favoured categories of borrowers with inadequate creditworthiness.

The success of the work-out phase will depend inter alia on the speed at which the BAMC can become fully operational. The BAMC will need to quickly ensure key operational prerequisites including skilled staff, the availability of banks' restructuring plans, IT infrastructure, asset documentation and legal prerogatives. The more numerous the assets, the more critical these institutional underpinnings will be. The practicalities of substituting for in-bank management of what might be a very diverse corporate portfolio finally selected for transfer adds to the magnitude of the challenge facing the Slovenian BAMC. The BAMC's ability to break even will ultimately reflect the realism of transfer prices, market conditions, the efficiency of the BAMC and the trade-off between minimising losses to the taxpayer and exercising forbearance to keep companies in business. Given the lifespan of the BAMC and the potential shortfall of realisable values below long-term economic value within this period, policymakers face a choice between actively running off the portfolio, even at the cost of

realising losses, or transferring a sizeable rump of legacy assets to the SSH³⁶ in five years' time.

Fiscal costs for recapitalisations could exceed EUR 1bn over time and will likely be deficit-increasing. The EUR 1 billion currently earmarked for recapitalisations (which can be increased if necessary), according to the explanatory memorandum, may well be needed in its entirety given the potential capital shortfalls discussed above. To recapitalise with cash, Slovenia will need to raise the corresponding amounts on financial markets. The government-guaranteed bonds that would be used to pay for transfers are likely to be debt-increasing, subject to a Eurostat decision. If the BAMC makes losses during its lifetime (or losses are incurred on guaranteed assets in an APS), the guarantees could also generate future deficits.

The adequate use of the new supervision and resolution powers of the BoS are key to ensure stabilisation of the financial system. The bank supervision framework has been modernised. Changes to the Act on Banking entered into force in December 2012. The wide powers of the BoS (the supervisor) had not been extensively used previously as they were considered blunt, ineffective and lacking in credibility. In addition to addressing drafting defects, the changes allow the BoS to intervene faster, with more of a forward-looking justification. The BoS also gets new powers termed 'extraordinary measures', including the power to transfer a bank's assets. The amendments to the Act on Banking, together with legacy asset measures described above give policymakers in Slovenia new tools to intervene in failing banks.

3.2. State-owned enterprises: a key source of macroeconomic imbalances and impediment to private investment

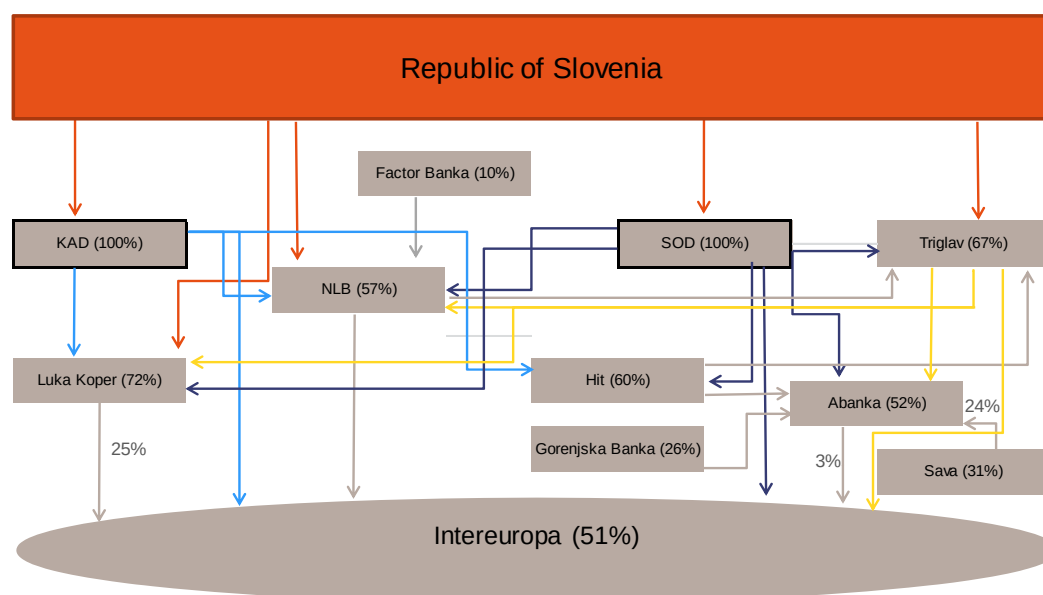
State ownership has a significant role in the Slovenian economy with many features remaining unchanged since the transition period of the 90s. The privatisation and corporate restructuring tools adopted during the 1990s resulted in the state remaining dominant, especially in the financial sector. This is particularly evident in the area of large-scale privatisations and corporate governance, where Slovenia has fallen considerably behind its peers. Compared with other EU and euro-area Member States in Central and Eastern Europe for the period 2004-2010, Slovenia has generated around 75% less in privatisation revenues. Moreover, the state's share of the banking sector is now around three times as large as the average for this comparison group.³⁷ European Commission pre-accession reports on Slovenia already highlighted the role of these features in holding back development and competition, and hindering FDI inflows.³⁸ This in-depth section draws on publicly available information to provide a fresh analysis of the state-owned segment³⁹ of the Slovenian economy, from the perspective of economic performance and contingent fiscal liabilities.⁴⁰

The size and weakness of the state-owned enterprise (SOE) sector hold back economic development and contribute to existing imbalances. State dominance and frequently malfunctioning governance of state assets impede private domestic and foreign investment. Cross-ownership of financial institutions and corporates limits the adjustment capacity of the economy and delays the restructuring process. A number of SOEs classified both inside and outside general government accounts are facing challenging financial conditions. These might even aggravate given the expected continued economic downturn.⁴¹ Several are accumulating losses and reducing equity value. Most companies are highly levered and total debt of non-bank SOEs amounts to over 30% of the Slovenian GDP. Recapitalisations of SOEs in 2011

weighed on government's budget by close to EUR 0.5bn (1.4% of GDP, a large portion of which arose in the banking sector) and SOEs and funds classified within the general government have gross debt amounting to 5.4% of GDP on a non-consolidated basis. Also going forward, SOE's subdued performance and delayed restructuring result in fiscal risks related to further state recapitalisations and government guaranteed debt of SOEs.

The cross-ownership of SOEs in the non-financial sector with state-owned financial institutions creates contagion risks and prevents the economy from adjusting. State ownership encompasses a complex matrix of frequently financially-troubled and debt-burdened banks, insurance groups and non-financial corporations, which own each other. Some of these companies emerged weakened from the recent economic and financial crisis and contribute to the increase of impaired assets in the banking sector. Debt-to-equity conversions enforced on SOEs' defaulted obligations strengthen the fiscal loops with the banking sector and the sovereign. The density of these inter-linkages is manifested in the state-bank-corporate nexus, with reciprocal risks for SOEs reliant upon loss-making banks and banks exposed to loss-making SOEs.⁴² Furthermore, cross-ownership, cross-subsidy and cross-recapitalisation of SOEs and state-owned banks combined with state influence and frequently sub-optimal corporate governance soften budget constraints and create a business environment where the normal allocative function of capital markets is distorted. This impedes the deleveraging of banks and the required restructuring of the corporate sector. Graph 30 illustrates the complex cross ownership of SOEs and financial institutions.

Graph 30: State ownership shares (%) – the example of Intereuropa



Notes:

The companies inside the general government (KAD and SOD) are shown with a solid border line.

The computation of state ownership (shown in brackets) may not be fully exhaustive due to complexity of shareholding structures and lack of publicly available data. See also footnote 40.

Source: 2011 AUKN report, 2011 Annual company reports, Commission services calculations

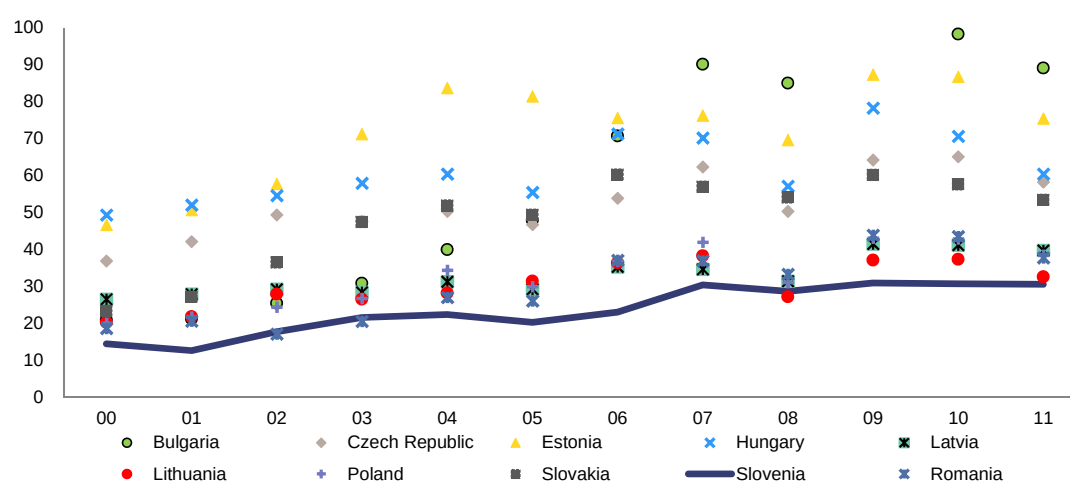
The origin of these inter-linkages can be traced back to the transition of Slovenia from planned to market economy in the 1990s. Privatisation in Slovenia was gradual and allowed for both paid and non-equivalent (i.e. voucher-based) privatisation with the intention to start the development of capital markets in the economy (Simoneti, 2001). The distribution of the shares followed the envisaged final split as stipulated in the Ownership Transformation Act⁴³ (see Table 1). However, the overall bias in favour of insiders' control, which could be explained by the business culture existent at the time, predetermined considerable influence of managers and employees and left ownership in the hands of highly fragmented but collectively powerful internal groups with little incentives to improve profitability and restructure companies. A secondary privatisation at a later stage aimed to consolidate ownership interest over time and increase the share of strategic investors. However, given the existence of powerful internal owners, strategic external investors (both foreign and domestic) had difficulty in acquiring a controlling share. The emphasis was instead on internal management buy-outs supported by high levels of debt provided mainly by the state-owned banks, and on distributing the remaining shares to state-owned funds. Thus, neither primary nor secondary privatization attracted enough strategic investors or foreign participation to allow for the restructuring of financially troubled companies during the transition.⁴⁴

Table 1: Split of privatisation shares in Slovenia according to the Ownership Transformation Act

Entity entitled to receive shares	Share to be received (% of total)	Way of transfer	Reasoning
KAD	10%	Free transfer	KAD and SOD were initially envisaged as portfolio investors which would use profits on investments to fund pensions and other state liabilities in relation to the restitution process under the Denationalisation Act.
SOD	10%		
Privately managed privatisation funds	20%	In exchange for vouchers purchased from citizens	Created with the intention to offset influence of insiders and to monitor management performance as an external shareholder.
Internal owners	20%	In exchange for vouchers	To give priority to employees and management to acquire shares in the company they work for at favourable conditions.
Optional	40%	Sell/ in exchange for vouchers	The use of the remaining 40% was optional: for buy-outs by internal owners, in exchange for vouchers by the public or the private investment funds, or for sell to strategic investors.

Source: Simoneti et al. (2001)

State dominance in key sectors such as finance, energy and transport is not conducive to FDI, thereby delaying required internal rebalancing of the economy. All 10 companies included in the Ljubljana Stock Exchange's benchmark SBI TOP index are to a greater or lesser degree state-owned or state-controlled, with potentially negative impacts on minority shareholders. This dissuades investment and prevents equity financing from playing its full role in Slovenia's development. A market environment open for private competition and welcoming for investment is one of the main prerequisites for FDI. Instead, in Slovenia, state ownership and influence on those SOEs that are relatively strong performing are used to reshuffle assets and indirectly recapitalise other SOEs in economic difficulties (e.g. banks, see Box 3 and 4 for a recent examples). This thwarts the privatisation process required to boost productivity, deepen capital markets and enhance technological spill-overs from FDI. Indeed, under 31% of GDP, the Slovenian inward FDI stock is one of the lowest among new EU Member States (Graph 31 and section 2.2). Bulgaria, for example, has attracted 3 times as much FDI as Slovenia.

Graph 31: Inward FDI stock comparison across countries (% of GDP)

Source: United Nations

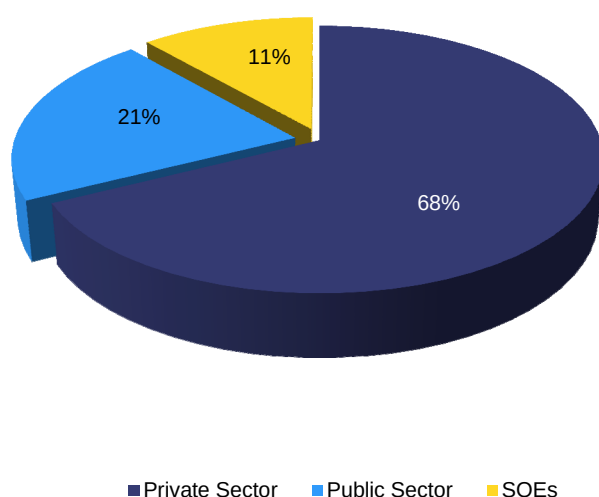
Box 3: An example of maintaining state ownership

Recent consolidations in the insurance sector may provide an insight into how access to the resources of better-performing SOEs can potentially be used to reshuffle assets among state-owned entities, to indirectly recapitalise state-owned banks under strain, and to maintain state ownership.

NKBM, the second largest bank in Slovenia and 51.2% state owned, tried in autumn 2012 to sell its 51% share of the insurer Zavarovalnica Maribor (ZM) to reach a sufficient capital adequacy level. According to numerous reports various private, including foreign investors were interested in buying these ZM shares. One of these offers seem to have been higher than the successful bid but was conditioned on taking over at least 75% of ZM, i.e. reducing the public ownership below the blocking minority threshold, implying that reinsurer Sava Re (47.1% state-owned) would sell part of its 49% share.⁴⁵ However, Sava Re, instead of selling own shares in ZM, made also an offer for the NKBM share in ZM. In order to arrive at a sufficient amount Sava Re made this offer together with SOD (100% state-owned restitution fund, recapitalised by the Republic of Slovenia in 2011 and 2013 and itself one of Sava Re's owners). In the end, Sava Re purchased 11.8% of ZM for EUR 15m and SOD spent EUR 50m for a 39.2% stake. SOD aims at withdrawing from ownership and Sava Re intends to buy the share from SOD after its IPO planned for spring 2013⁴⁶.

With a share of at least 11% of total employment, SOEs have a material effect on labour productivity and competitiveness of the Slovenian economy overall.⁴⁷ Taking into account employment shares in the public and private sector (21% and 68%, respectively), at least one out of eight employees in the corporate sector is employed by SOEs.

Graph 32: Employees in private, public and SOEs sectors, December 2011



Notes: Employment in SOEs captures employees in the 46 largest SOEs analysed so far plus those in the state-owned banks. Public sector employees are those who are employed in the government administration, health and education sector. Private sector employees are calculated as a residual (total employment net of those employed in the SOEs and in the public sector).

Source: National Statistical Office of Slovenia, 2011 AUKN report, 2011 Annual company reports, Commission services calculations.

A number of SOEs are accumulating losses and debt, reducing their equity value and will face viability risks if they are not restructured and recapitalised.⁴⁸ Debt and losses of the four entities consolidated within the GGA (three funds and part of the railway holding) have a direct negative impact on public finances. All four of these SOEs are highly levered and with gross debt equivalent to over 1% of GDP each, with the exception of DSU, whose debt is lower in absolute terms but equivalent to over 20 times its 2011 earnings. KAD reported both negative EBITDA⁴⁹ and a net loss in 2011 due to impairments on its portfolio companies. The Railway holding also had to report a loss in 2011 following a prolonged period of underperformance. These losses reduce equity and may raise recapitalisation needs in the future. The negative or low levels of return-on equity (ROE) reported by KAD, the Railway holding and D.S.U. suggest poor investment returns for the state.

About half of the non-bank SOEs outside GGA are assessed as highly indebted. About one quarter reports negative EBITDA and double digit negative return on equity. Some have already been recapitalised by the state and several may need to be recapitalised (again), absent an improved outlook. A further half of these companies report net losses and negative ROEs. The remainder of these highly indebted companies report low earnings and return on equity, which could indicate either a general squeeze in profitability margins in the relevant industry possibly due to the economic crisis, an inefficient management of the underlying businesses, or debt-burdened capital structures (i.e. high interest expenses). Conversely, the companies with relatively high ROEs may operate in environments where firm-level efficiency is not the only determinant of profitability.⁵⁰ Furthermore, some of these firms may be less exposed to cyclical developments.

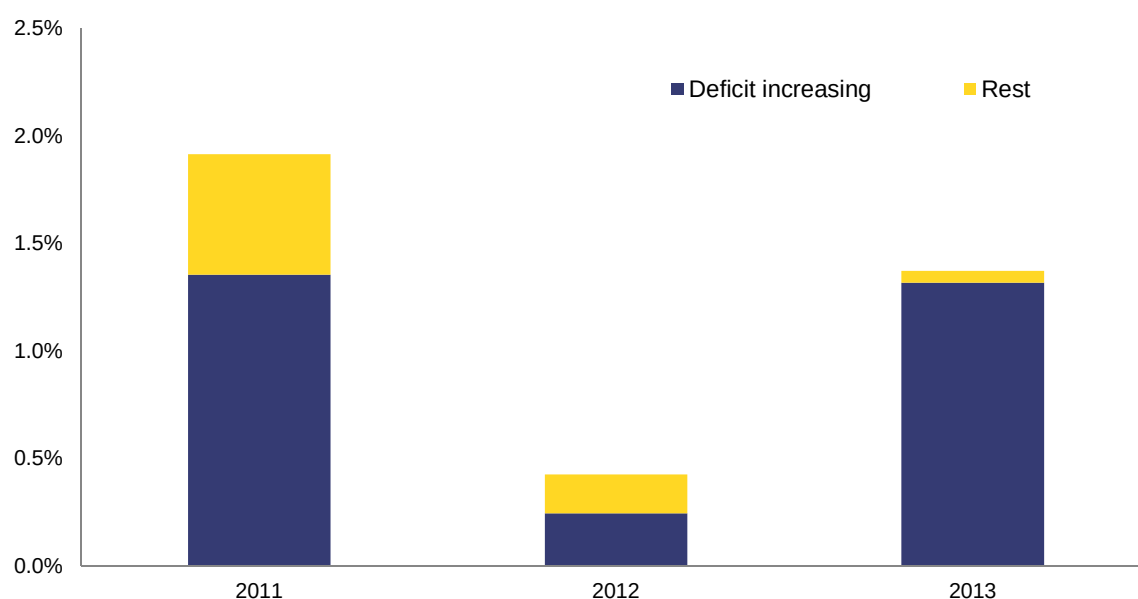
The state-owned insurance companies reviewed demonstrate reasonable profits and coverage ratios of premium income over claims. Nevertheless, profits may slow down going forward, with claims relating to the 2012 floods reducing profits. According to the AUKN report, the Slovenian insurance sector in general is marked by a reduction in demand for some insurance products, particularly due to lower economic activity in the construction industry and transportation. The report also states that financial investments represent a greater proportion of the total assets of Slovenian insurance companies without going into details on specific exposures. So far no significant direct exposure of the insurance sector to risks coming from the banking system was discovered (e.g. big CDSs and other credit insurance instruments exposures). However, insurance companies are exposed to risks given tightening conditions in capital markets and the industry's close link to both the banking sector and the rest of the SOEs.

Recapitalisations, called state guarantees and other capital transfers to loss making SOEs contributed 1.4 pps. to the budget deficit of 6.4% of GDP in 2011 (Table 2, Graph 33). This figure refers to deficit increasing capital injections as reported in the October 2012 EDP notification tables. In addition, the figure captures only direct recapitalisations and not the indirect recapitalisations (see Boxes 3 and 4); therefore it is underestimating the fiscal impact. Half of this amount (EUR 243m or 0.7 pp.) is attributable to the first recapitalisation of NLB, the largest banking group in Slovenia. The remainder was distributed amongst other loss-making SOEs in smaller capital injections, called state guarantees and other claims as described in Table 4 (disaggregated information is not available for the smaller transfers).

Some of the recapitalisations were carried out through the SOD holding, which is the only holding within the general government that has officially been recording accounting profits over this period, reporting EUR 115m of net profit for 2011; however, this profit was mostly due to non-recurring items amounting to EUR 180mn on revenue level.⁵¹ In addition, SOD was recapitalised in 2011 by EUR 60m and KAD by EUR 90m. An additional EUR 20m of capital increase into SOD was done in 2013. KAD and SOD capital increases are not classified as public deficit increasing one-off measures as the two funds are consolidated with GGA.⁵²

Deficit increasing recapitalisation needs apparently were lower in 2012; however they may increase in 2013 (Table 2, Graph 33). For 2012, the government has reported one direct capital injection of EUR 63m for the second NLB recapitalisation. An additional EUR 37m of called state guarantees (less repayments) appears in the government accounts in the October 2012 EDP notification tables. Known potential recapitalisations in 2013 are related to banks. In addition, NLB issued a contingent convertible (CoCo) bond of c. EUR 320m which was subscribed by the government in 2012 and was triggered in February 2013. Conversion of NKBM's EUR 100m hybrid instrument subscribed by the government in the absence of immediate private interest was now also triggered in early 2013 according to the bank's management. Conversion of these instruments is likely to be deficit increasing (see also Box 2).⁵³

Graph 33: SOE recapitalisations and other capital transfers, 2011- YTD2013*, as % of GDP



Source: October 2012 EDP tables, Ministry of Finance, news releases. Commission services calculations.

* 2013 figure includes all transfers known as at mid-March including conversion of the NLB and NKBM hybrids.

Table 2: State aid and non-state aid SOE recapitalisations and other capital transfers, 2011-2013

Company name	Transfers (EUR mn)			Type of Transfer (2011/ 2012/ 2013)
	2011	2012	2013	
NLB	243	63	320	State Recap/ State Recap/ NLB CoCo
NKBM	104	65	100	Recap/ Sale of Subsidiary/ NKBM Hybrid Loan
Adria Airways	49	-	-	State Recap
Slovenian Railway holding	119	-	-	Recognition of Slovenian Railways claims to RS
KAD	90	-	-	State Recap (not deficit-increasing)
SOD	60	-	20	State Recap (not deficit-increasing)
Other	79	24	28	Called state guarantees
Total	693	152	468	
Total as a % of GDP	1.9%	0.4%	1.3%	
Total deficit increasing	490	87	448	
Total deficit increasing as a % of GDP	1.4%	0.2%	1.3%	

Source: October 2012 EDP notification tables, Ministry of Finance, news releases

Notes:

The 2011 NKBM recapitalisation involved significant participation of unaffiliated private investors, who acquired shares at precisely equal terms to state-controlled entities. This amount is therefore not fully reflected in the total.

CoCo bonds issued in 2012 for the NLB in the amount of EUR 320m Euros were triggered in February, 2013. Conversion of the NKBM hybrid instrument is announced for April and has been taken into account in the calculations.

Box 4: Indirect public recapitalisations of banks and impact of cross-ownership

NKBM, the second largest banking group in Slovenia, has so far received c. EUR 170m in recapitalisations by state-owned undertakings. In 2011, it raised EUR 104.3m by means of public offering. The state participated indirectly by transferring its pre-emptive rights to acquire new share in the bank to three 100% state owned SOEs. In their capacity of pre-emptive right holders, those three SOEs acquired new shares in NKBM proportionately to the state's participation at the time, i.e. just enough to avoid diluting the overall state ownership below the initial 51%. In 2012, one of those companies, Posta Slovenije, which now holds a 6.6% stake in NKBM as a result of the above transaction, attributed EUR 5m of expected losses to devaluation of NKBM shares.⁵⁴ This compounds the financial pressure for the main universal service provider in the postal sector. In 2012, as described in Box 3, NKBM succeeded in improving its capital basis by EUR 65m through the sale of its insurance subsidiary to an SOE.

Together with the 2013 hybrid loan of EUR 100m, this brings state involvement for the past three years to around EUR 218m.

Accumulation of losses indicates more recapitalisations of SOEs and banks will be required beyond 2013. In 2011, a total of EUR 415.4m of net losses were generated by a third of the SOEs reviewed. This is equivalent to 1.1% of GDP (Table 3, of which 0.4% of GDP was consolidated with the general government deficit). The amount increases to EUR 924.8m or 2.5% of GDP (no direct change in general government deficit)⁵⁵ including the three largest banking groups (NLB, NKBM and Abanka, as discussed in section 3.1). The bulk of these losses were generated in companies outside the general government. Continuing losses could be expected to deplete capital to an extent that would require additional recapitalisations. Further recapitalisations of SOEs and banks would likely be recorded as deficit increasing one-off capital transfers.⁵⁶

Table 3: Overview of key non-bank SOE figures, 2011

	Total Losses	Total Profits	Gross Debt	Employees
TOTAL	-415.4	545.2	10905.1	81079
as % of GDP (Total Empl)	1.1%	1.5%	30.1%	10.0%
TOTAL INSIDE GG*	-144.7	0.3	1948.9	8952
as % of GDP (Total Empl)	0.4%	0.0%	5.4%	1.1%
TOTAL OUTSIDE GG	-270.7	544.9	8956.1	72127
as % of GDP (Total Empl)	0.7%	1.5%	24.7%	8.8%
BY SECTOR				
ENER	-3.2	146.1	993.3	10639
TRAN	-16.4	31.9	3209.4	3633
CF	-16.7	7.8	44.3	2493
COMM	0.0	42.9	488.5	11294
PI	-234.4	254.0	4220.7	39845
INS	0.0	62.1	na	4223
COMPANIES WITH HIGH LEVERAGE **	-411.7	106.2	9228.8	44789
as % of GDP (Total Empl)	1.1%	0.3%	25.5%	5.5%

Notes:

In EUR millions (except if stated otherwise), Employees: absolute number and share in total employment.

Debt of insurance companies is not included in the summary due to differences in business models.

Total net losses (net profits) is the sum of losses (profits) of all loss (profit) making SOEs, both inside and outside AUKN.

* Total inside GG comprises 100% of entities classified within general government but figures are available only on a non-consolidated basis, so the impact on GG deficit and debt after consolidation will be less. Furthermore the entire Slovenian Railway holding is included even though only part of it is classified in the general government due to data unavailability.

SOEs covered by AUKN (a subset of the companies included in the total) by sector:

(i) ENER - Energy sector (37.1% of book value of total government portfolio)

(ii) TRAN - Traffic, Transport and Infrastructure sector (32.0% of book value of total government portfolio)

(iii) CF - Capital Funds, Companies of Special Significance (12.0% of book value of total government portfolio)

(iv) COMM - Post and Telecommunications sector (8.6% of book value of total government portfolio)

(v) FIG - Financial and Insurance Groups Sector (8.5% of book value of total government portfolio)

(vi) PI - Portfolio Investments (1.4% of book value of total government portfolio)

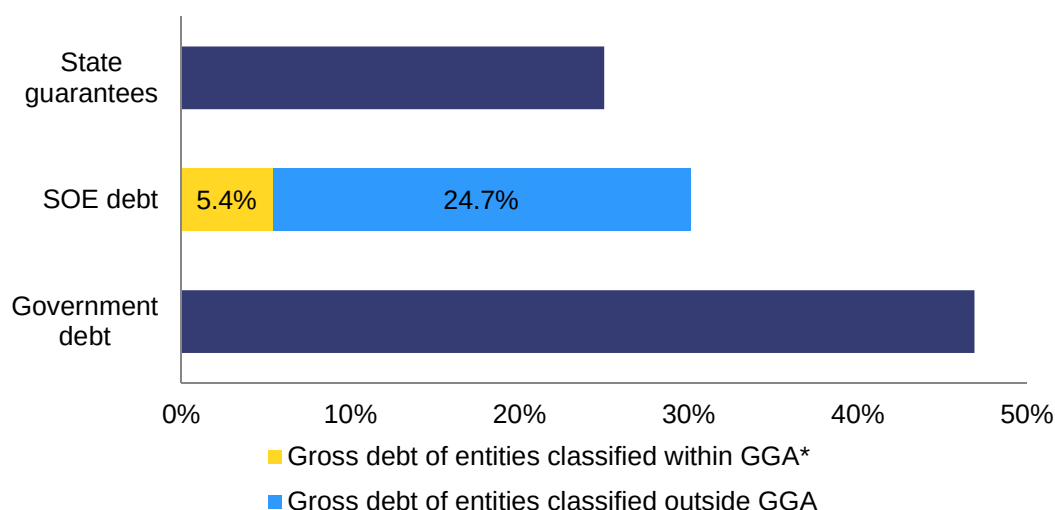
** Companies with leverage above 4 times EBITDA, i.e. reporting high levels of debt when compared against their ability to produce cash flows. Some of them also have net losses or even a negative operating profit (EBITDA).

Source: 2011 AUKN report, 2011 Annual company reports, Commission services calculations. See also Georvieva and Marco Riquelme (2013) for more details.

Total debt of non-bank SOEs is at least 30% of GDP, with a majority of this debt (26% of GDP) being concentrated in highly levered companies. SOEs consolidated with General Government Accounts (GGA) have debt equivalent to 5.4 of GDP (Table 3) compared with the total government debt of 46.9% of GDP in 2011.⁵⁷ Debt of SOEs outside GGA is 24.7% of GDP, with highway operator DARS being the largest contributor with 8.1% of GDP. DARS poses a relatively high risk to the state budget as its high level of debt, both in absolute and in relative terms, is 100% state guaranteed (Table 4). The government is exposed to other companies on a smaller scale as it owns less than a 50% stake.

Contingent liabilities in the form of state guarantees are equivalent to 25% of GDP, and SOEs are the main beneficiaries. This number covers various types of state guarantees, e.g. for financing international trade, construction and improvement of infrastructures, corporate restructuring etc. It excludes state guarantees for interest payments and state guarantees outside the central government. In addition to existing contingent liabilities, the envisaged BAMC would increase state guarantees by up to a further 11% of GDP (EUR 4bn). The main risk in terms of contingent liabilities lies with the loss-making Railway holding (and, as mentioned above, with DARS).

Graph 34: Government debt, non-bank SOE debt and contingent liabilities, 2011, as % of GDP



*GGA: General Government Accounts. Debt is reported on a non-consolidated basis.

Source: 2011 AUKN report, 2011 Annual company reports, European Commission services calculations

Table 4: Main SOE beneficiaries of state guarantees, debt principal, 30 June 2012

Debtor	Balance (EUR m)	As a % of GDP
Highway Company DARS	2898	8.1%
SID Bank	1282	3.6%
Slovenian Restitution Fund SOD	470	1.3%
Slovenian Railways Company SŽ	238	0.7%
Sava Hydro Power Plant Financing Company INFRA	38	0.1%

Source: Ministry of Finance calculations, November 2012

The government has decided on a new structure to manage its capital stakes. The Slovenia Sovereign Holding (SSH) Act came into force in December 2012. The aim of the SSH is to centralise the management of all investments owned by the Republic of Slovenia and the state funds. It requires the development of a classification of investments, target stakes in capital investments and methods of sale. The classification was adopted by the outgoing government and has not been approved by parliament, where the process is currently suspended. It remains to be seen how the SSH can achieve greater success than its predecessor, the Capital Assets Management Agency (AUKN), in terms of privatisations and efficient portfolio management. The 13 March coalition agreement foresees revisions to the structure and operations of the SSH.

4. POLICY CHALLENGES

Based on the analysis in sections 2 and 3, a number of broad challenges can be highlighted for Slovenia: (i) the credible repair of the banking system through a balanced set of measures and maintenance of financial stability through prudent supervision and improved governance structures; (ii) a sounder financing of the NIIP and growth through FDI facilitated

by an improvement of the business environment; (iii) cost-competitiveness developments supportive of adjustment and helping to avoid the re-emergence of external imbalances through continued public sector wage restraint, adaptation of the minimum wage setting and a set of labour market reforms; and (iv) the enhancement of adjustment capacity at the microeconomic level, particularly in relation to state ownership and labour market institutions. Economic policies associated with these challenges require a comprehensive reform agenda with mutually reinforcing positive impact on employment, economic activity, financial sector stability and reduction of imbalances. These measures should complement measures to correct the excessive deficit and ensure sustainable public finances in the long-term.

Challenges identified under the MIP in the 2012 IDR and relevant policy responses were reflected and integrated in the country-specific recommendations issued for Slovenia in July, 2012. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of Slovenia's National Reform Programme and Stability Programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the challenges identified in this IDR.

Banking system and financial stability

The government has accelerated its policy response to the banking sector's problems since May 2012, but efficient implementation will require a sound strategy and patient work on important technical details. As assessed in the in-depth section, current policies include the establishment of (i) a range of tools including an asset management company to carve problematic legacy assets out of banks' balance sheets, (ii) further state recapitalisations prompted by regulatory requirements and (iii) an upgrade to the legal framework for banking and bank supervision. As Slovenia moves into the implementation phase, strategic and technical questions remain. Efficient implementation will be challenging and technical expertise will be key.

To regain credibility and stabilise the financial sector, a new, independent and transparent assessment could usefully form the basis for a comprehensive strategy. The strategic imperatives are regaining credibility and market access, improving banks' governance and profitability, and right-sizing and strengthening banks' balance sheets, while minimising fiscal cost and risk. A new third-party asset quality review and a new thorough stress test are needed to quantify the challenges and ensure that the strategy, the overall fiscal envelope and the selection of tools are appropriate. These assessments would ideally be conducted by internationally recognised consultants under the guidance of a steering committee comprising the relevant international financial institutions and the Slovenian authorities. The asset quality review and stress test should cover the entire banking system (with the systemically relevant banks constituting an absolute minimum) and would inform a system-wide viability assessment. Publishing the approaches used, with underlying assumptions and main findings, would help to maximise credibility. Based on these findings, a strategy could usefully articulate how the fiscal resources can be mobilised most efficiently in order to constitute a clear and quantified roadmap. The fresh assessment can also provide information on legacy portfolios that could help in selecting the most efficient legal tools, especially if a mixed approach is required to cater for the diverse nature of legacy portfolios.

Strengthened balance sheets alone are not sufficient to safeguard the soundness of the banks concerned; privatisation would help improve corporate governance of these banks and could potentially also provide fresh capital.⁵⁸ Privatisation would help to address manifest corporate governance and credibility deficiencies and would reduce implicit fiscal liabilities and sovereign-banking contagion in the future. The former coalition agreement on retaining a blocking minority in banks and insurance companies was a major obstacle in this respect, while the 13 March 2013 coalition agreement is silent on bank privatisation. As an interim measure while the bank equity market remains depressed, it is of the utmost importance that governance of state-owned banks is improved substantially and that a framework to ensure that banks operate at arm's length is put in place.

Continued strengthening of the supervisory framework and, where necessary, promptly using the new powers for supervisory action are vital. A stronger, more active supervisor can guide banks through the challenging period ahead, involving dealing with legacy assets, deleveraging, shoring up capital positions, improving management and internal processes and developing sustainable business models. Strict provisioning requirements are essential. A supervisor with a strong reputation, underpinned by strong powers will also lend credibility vis-à-vis investors. Finally, it will safeguard against a repeat of asset price bubbles and reckless leveraging-up of firms and banks.

Improving the business environment

Policy progress on key business environment issues remains slow. In the area of regulated professions different sectors will be reviewed in the course of 2013 and 2014. The need for improved insolvency and receivership legislation has been recognised and amendments are now under discussion. State-involvement in the economy remains high and deters FDI, as shown in section 3.2 (see also adjustment capacity below).

The fast implementation of an ambitious plan to reduce state involvement in the economy and to improved corporate governance could stimulate private and foreign investment. Tackling the multiple challenges identified in the business environment in the context of the European semester, such as the rigidities around regulated professions, the problem of payment indiscipline, the inefficiency of civil justice, including bankruptcy procedures and contract enforcement, and the complexity of spatial planning procedures, would also be key components for a strategy to improve the investment context.

Cost competitiveness

Policy action to improve cost-competitiveness has been limited so far. As described in section 2.3, the 2010 hike in the minimum wage has compressed the bottom of the wage distribution. As a result there is the risk that upward wage pressures in sectoral collective agreements will increase in the future to re-establish wage differentials. If maintained, regular automatic adjustment of the minimum wage each year is expected to magnify these tensions. To the extent that public sector wage policies indirectly affect cost competitiveness, the currently negotiated wage cut is likely to be beneficial, at least in the short term.

A range of measures relating to the labour market can help reverse cost competitiveness losses. Wage growth consistent with recovery in cost competitiveness can be sought in conjunction with social partners. The government also has more immediate levers to influence wage developments, including public sector wages and minimum wages. Adaptation of minimum wage setting seems particularly needed in light of the analysis in section 2.3.

Adjustment capacity

Enhancing Slovenia's economic adjustment capacity is an urgent priority in order to minimise the cost of the crisis and set the foundations for future growth. Reallocation of labour and capital from firms that over-expanded in the boom phase is needed. As described in the 2012 IDR, the extent of resource misallocation in the years preceding the crisis stems from both over-investment in certain sectors and unwise lending and investment choices by banks and firms. The adjustment process will be significantly less costly and disruptive in terms of bankruptcies and unemployment if frictions can be removed. There is a particular risk of labour market rigidities interacting with deleveraging to cause firm failures and hence abrupt employment losses in the private sector.⁵⁹ In this IDR, the analysis of the state-owned enterprise sectors provides evidence of the many shortcomings of Slovenia's extensive state-ownership nexus. Most importantly, this nexus compromises the allocative efficiency of capital and labour markets and generates repeated recapitalisation needs. Funds of better performing state-owned companies appear to have been used in several cases to exclude potential foreign investors.

Slovenia has created a new holding structure (SSH) for managing the state's capital stakes, replacing the former agency (AUKN). A restricted list of companies for privatisation was adopted by the former government and is pending approval by parliament. The success of the privatisation process and the intended improvements to the corporate governance of enterprises remaining in state ownership will largely depend on political determination and the professionalism of the implementation process.

A significant withdrawal of the state from Slovenia's corporate sector, combined with arms-length governance of enterprises that remain in state ownership, could improve the adjustment capacity of the real economy and limit the fiscal burden of SOEs. A successful privatisation drive, which in the current economic environment may take several years to complete, ideally going beyond the currently envisaged list of enterprises, could yield substantial improvements in the credibility of the banking sector, corporate governance, fiscal costs, adjustment capacity and FDI.⁶⁰ To enable the envisaged privatisation it probably will prove necessary to reduce public ownership at least below the "blocking minority" threshold of 25%+1 share. Success will also depend on the efficiency of the regulatory framework and the promotion of competition in the sectors concerned.

The recent labour market reform is an important first step towards reducing frictions in the labour market. Labour market functioning will only be improved significantly if reforms are sufficiently ambitious and address labour market segmentation without introducing new elements of rigidity. The recent reform does not change the regulation of students' occasional work (i.e. the status of “student work”), which therefore remains to be reformed.

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