**COUNCIL OF THE EUROPEAN UNION**

**Brussels, 5 June 2012**

**10851/12**

**ECOFIN 504**
**UEM 153**
**SOC 486**

**COVER NOTE**

| | |
|---|---|
| from: | Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director |
| date of receipt: | 31 May 2012 |
| to: | Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union |
| No Cion doc.: | SWD(2012) 158 final |
| Subject: | Commission Staff Working Document - In-Depth Review for Slovenia in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances |

Delegations will find attached Commission document SWD(2012) 158 final.

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Encl.: SWD(2012) 158 final

EUROPEAN COMMISSION

Brussels, 30.5.2012
SWD(2012) 158 final

**COMMISSION STAFF WORKING DOCUMENT**

**In-Depth Review for SLOVENIA**

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

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## EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review takes a broad view of the Slovenian economy in order to identify actual or potential imbalances and the possible macroeconomic risks which they may entail. Following a boom period that was cut short by the 2009 global crisis, the Slovenian economy has struggled to recover as a robust performance of net exports has been insufficient to compensate for the protracted weakness of domestic demand. The main observations from this review are:

- **Slovenia's booming economy built up internal and external imbalances in the years before the global crisis and the internal rebalancing process is proving problematic.** Rapid growth, credit expansion and strong domestic demand have left Slovenia with a legacy of thinly capitalised banks reliant on foreign funding, over-indebted companies, a bloated construction sector, high real estate prices, deteriorated cost-competitiveness and a large negative net international investment position. This was caused by excessive and – in retrospect – unwise lending by banks during the years of plentiful and cheap wholesale financing. Luckily the financial health of households was largely unscathed and the boom was relatively short-lived, meaning the stock of internal and external debt has remained – in aggregate – relatively limited. De-leveraging is underway and the necessary adjustment process in Slovenia is expected to be lengthy. However, negative spill-over effects for other euro-area economies are expected to be small.

- **Continued deleveraging is necessary for the banking sector because it will not be able to replace its lost foreign funding for many years.** The share of loans from foreign banks in the sector's aggregate balance sheet reached over a third in 2008 and is now less than a fifth. Recapitalisations to cover loan losses and replacement financing such as government deposits, bond issuances (with and without government guarantees) and Eurosystem loans have not dispensed with the need for difficult choices. Instead, they have bought time in which banks can shrink their balance sheets to a size more commensurate with their retail deposit base and equity, neither of which can be expected to increase substantially in the current climate. Moreover, the sovereign is now operating in an environment of high interest rates and downgraded credit ratings which, if prolonged, could make deleveraging substantially more abrupt.

- **The difficulty of deleveraging and the corporate sector's reliance on bank finance limit the economy's adjustment capacity.** The slowness of the shift to deleveraging partly reflects the maintenance of relationships with existing borrowers. Very low recovery rates for creditors from recourse to insolvency procedures also prevent or dissuade banks from extricating themselves from lending to financially distressed businesses. This means the brunt of deleveraging is borne at the extensive margin, with banks extremely cautious when extending new loans. This could seriously hamper the reallocation of resources and business investment. Established companies can seek funding abroad, which may help expansion plans or new product lines. But such options are less available to smaller, newer, possibly more innovative companies, which rely heavily on domestic bank financing. Other corporate financing channels are largely closed-off in Slovenia, with equity funding poorly developed and direct financing from abroad rare due to the low share of foreign ownership.

- **Frictions in the labour market may also retard adjustment.** Labour market adjustment remained slow even after short-time working schemes expired in 2010. In construction, for instance, employment remains at over 70% its peak level despite the collapse in investment. Part of the slowness has come from the very strong labour market protection for permanent contracts. This means that adjustment has been concentrated on temporary jobs, as can be seen in the large inflows from temporary jobs into unemployment. However, employment is still declining. Without substantial economic growth Slovenia will not complete its labour market adjustment and will instead face new problems related to long-term unemployment.

- **Depressed output has helped to close the current account deficit, but competitiveness losses accumulated in 2008-2010 could contribute to the future reappearance of external imbalances.** The public sector wage deal in 2008 and the minimum wage uplift in 2010 were discrete factors raising wage growth above what was warranted given cyclical conditions. The REER (ULC) appreciated by 8.6% in 2008-2009, with relative ULC accounting for 6.1%. In 2010, when productivity rebounded, the effect on ULC was partially cancelled out by minimum wages. Given wage moderation in 2011, there has been no further deterioration in cost-competitiveness but the accumulated loss remains. However, as policy currently stands, there are strong in-built dynamics in both public and minimum wages that could reignite adverse trends in the coming years. Renewed economic growth would also put pressure on wages just above the level of the new minimum wage as employees seek to re-establish differentials that were compressed in 2010. Such developments could hasten the reappearance of wider current account deficits, inflation and renewed flows of debt-financing.

- **Solid economic growth and strong export performance would facilitate the correction of these internal imbalances and help prevent the re-emergence of external imbalances.** This, however, is difficult to achieve in the face of weak external demand, shrinking of the construction sector, private sector deleveraging and fiscal consolidation. It is also hampered by the current product structure and geographical orientation of Slovenia's exports. These obstacles will take a substantial amount of time to overcome given the weaknesses identified in the economy's adjustment capacity.

In this context, **the in-depth review concludes that Slovenia is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed.** In particular, macroeconomic developments related to corporate sector deleveraging and banking stability and unfavourable but less pressing development in external competitiveness deserve to be closely monitored, so as to reduce the important risks of adverse effects on the functioning of the economy.

The recapitalisation and sale of the biggest bank and the firm commitment to correcting the excessive deficit by the 2013 deadline are two important and relevant elements of the currently envisaged response. Prompt and thorough implementation in these areas can minimise the risk of the existing imbalances becoming excessive.

In this context, possible further areas for a relevant policy response could be found in corporate governance and prudential standards in the financial sector, in the business environment for FDI and in cost-competitiveness. Some specific areas for consideration include reducing the state's shareholdings, addressing the multiple challenges identified in the business environment in the context of the European semester, and refraining from public and minimum wage policies that could put pressure on wage costs.

## 1. INTRODUCTION

On 14 February 2012, the European Commission presented its first 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" 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 policy follow-up it will recommend to the Council.

For Slovenia, the AMR noted that two indicators in the scoreboard exceeded their thresholds in 2010 and suggested the need to assess the development and drivers of potential imbalances. The AMR explained that in the years before the crisis, Slovenia enjoyed strong growth and domestic demand conditions, coupled with some losses in price competitiveness and a gradual widening of the current account deficit. It identified signs that overheating occurred, particularly as regards private sector credit growth, construction value added and property prices. The Slovenian economy was hit hard by the global crisis and the AMR noted that this has brought some, perhaps temporary, adjustment in the external balance but this is still at an early stage.

Against this background, Section 2 examines the external and internal dimensions of imbalances including developments in competitiveness, private sector indebtedness and in asset markets. This is followed by a closer look at the implications of indebtedness of non-financial corporations for the banking sector in Section 3. Section 4 presents possible policy considerations.

## 2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

### 2.1. Macroeconomic scene setter

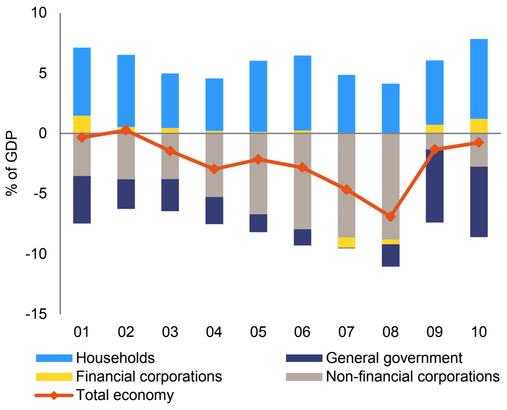
**Slovenia is currently in the second dip of a double-dip recession.** The 2009 recession was transmitted through the trade channel to a domestic economy on the verge of overheating. Real GDP plunged by 8%. The rebound in 2010 was comparatively weak as the lift from net exports was largely cancelled out by the drag from subdued domestic demand. The strengthening of this drag in 2011, with construction investment falling by around a quarter, stalled the recovery then pushed the economy back into recession in 2011-12. Unlike the first, this second dip came within an overall context of deleveraging and more subdued price and wage developments.

**The period from 2009 has been marked by weak demand, declining employment and rising financial distress.** Weak demand has brought a rapid deterioration of Slovenia's public finances. After initial resilience due to labour market support measures, employment contracted sharply and is forecast to remain on a downward path over the period covered by the Commission services' spring 2012 forecast. Many companies, especially those oriented to the domestic market, struggle to service debts and there have been notable bankruptcies, particularly in the construction sector. As a result, banks have continued to face substantial losses on their loan portfolios at a time when they face renewed stress on the funding side.

## 2.2. Sustainability of external positions

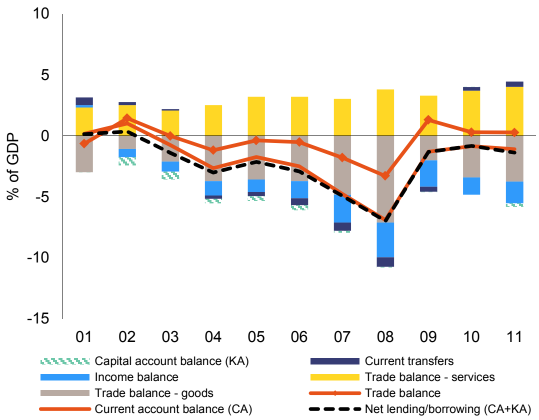
**From 2003, there was a trend of sustained and rising external imbalances, with the current account deficit peaking at 7% of GDP in 2008, which was driven by and in turn contributed to the emerging overheating of the economy.** Surging investment, principally by non-financial corporations, outstripped domestic savings. Indeed, in 2007 and 2008 when corporate investment reached its highest level, household saving fell sharply. As the sections below will expose, this investment surge was credit-fuelled, sometimes unproductive, and coincided with booming asset prices. These trends were mirrored in the goods trade deficit, which was widened by the booming and increasingly import-dependent export sector sucking in ever more investment goods and by the overall buoyancy of domestic demand. The income balance was also pushed into deficit by trends in factor remuneration, as interest mounted on foreign bank loans and as the number of foreign workers increased (largely in construction).

**Graph 1: Net lending/borrowing by sector (% of GDP)**




Source: Commission services

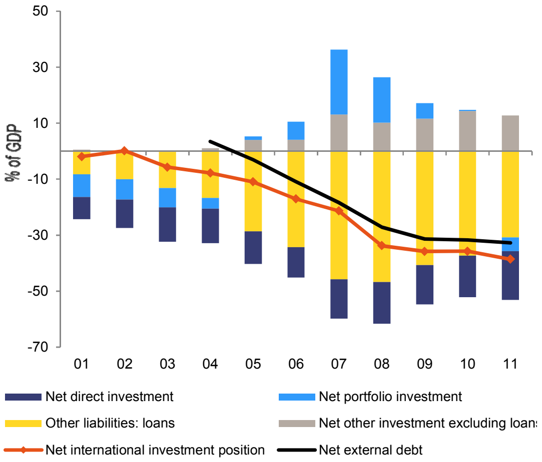
**Graph 2: Components of net lending/borrowing (% of GDP)**




Source: Commission services

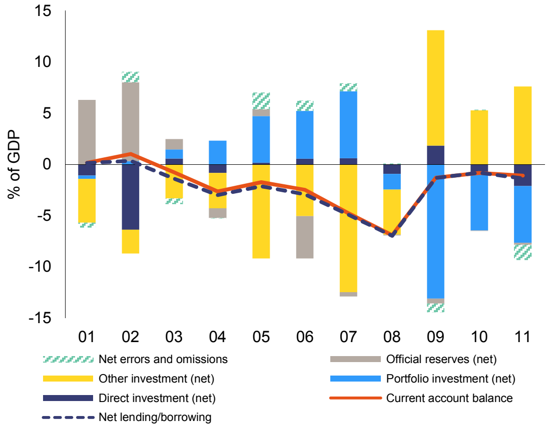
**The widening external deficit resulted in a steep deterioration in Slovenia's net international investment position** (NIIP), which went from balance in 2002 to a negative position of 35.7% of GDP in 2010. This was entirely financed through the banking channel. Domestic banks tapped international financial markets to make up the shortfall in domestic financing, pushing other liabilities in the form of loans from 9.3% of GDP in 2002 to 46.7% of GDP in 2008.

**Graph 3: Net external debt and composition of Net International Investment Position (% of GDP)**




Source: Commission services

**Graph 4: Financing of net lending/borrowing (% of GDP)**




Source: Commission services

**The global economic crisis interrupted these trends in 2009, preventing even greater imbalances from accumulating.** Although the maturity structure of banks' foreign liabilities was not especially short, the debt position was still vulnerable, not least because a lot of the investment it financed was predicated on rising asset prices and rates of economic growth above what is now considered sustainable. From a deficit of 7% of GDP in 2008, the current account returned nearer to balance in 2011[1]. The current level of the current account balance, once adjusted for the very weak stage in the cycle, is now broadly in line with Commission internal estimates of current account norms[2]. The rebalancing of the current account can be attributed primarily to weak domestic demand, but also to the impact on the income balance of lower profits, interest rates and dwindling numbers of foreign workers. The current account deficit is forecast to shrink further in 2012 and to widen slightly in 2013 as domestic demand begins to pick up. Despite this return to balance, however, adverse valuation changes, especially in 2008-09, contrived to keep the NIIP below minus 35% of GDP, where it is projected to remain in 2012-13. Currently anticipated external deficits would cause the NIIP to climb back above minus 35% of GDP within the next decade, abstracting from valuation and REER effects and the absorption of structural funds.

## 2.3. Competitiveness and export performance

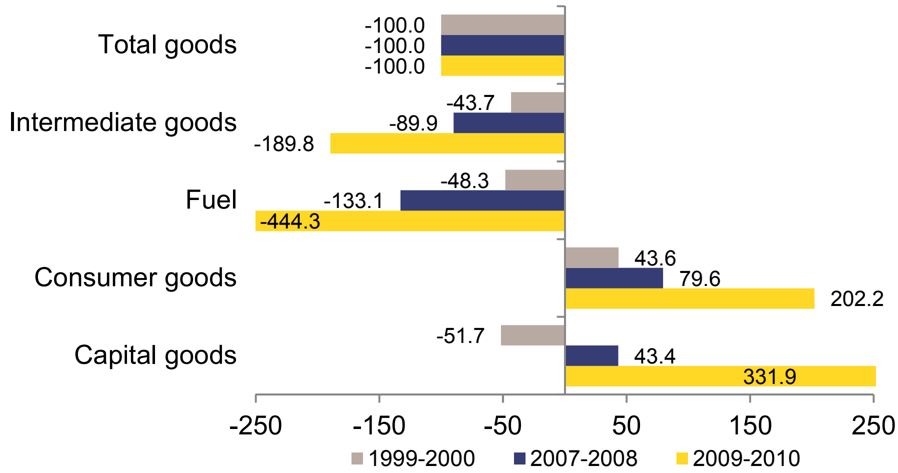
**Slovenia has historically enjoyed a strong services trade surplus – principally in road haulage and tourism – offset by goods trade deficits – principally in**

[1] - 1.1% of GDP, potentially subject to revisions.

[2] Based on the methodology in Matteo and Alessandro Turrini, 2010: "Comparing alternative methodologies for real exchange rate assessment", European Economy - Economic Papers 427, Directorate General Economic and Monetary Affairs, European Commission.

**intermediate goods and fuel.** The extent of the fuel deficit is exacerbated by Slovenia's position as a transit country and the size of the road haulage sector, which accounted for 2.6% of GVA in 2002 (2.5% in EU27) and rose to account for 3.1% in 2008 (2.4% in EU27). Large imports of intermediate and capital goods are a consequence of Slovenia's relatively large manufacturing sector which accounted for 24.2% of GVA in 2002 and still accounted for 21.3% in 2008 (versus EU27 shares of respectively 17.4% and 15.8%). The OECD has calculated that the import content of Slovenia's manufactured exports went from 40% in the mid-1990s to 51% in the mid-2000s[3]. The sector is focused on motor vehicles and related industries, including rubber and metal products, electrical and non-electrical machinery and equipment and pharmaceuticals. The sudden large positive contribution from capital goods in 2009-2010 shown in Graph 5 below is a reflection of the collapse in business investment.

**Graph 5: Trade in goods: contribution (%) to overall trade balance by broad economic categories (truncated scale)**

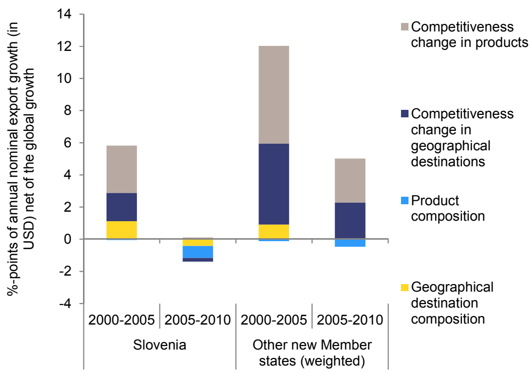



Source: Comtrade

**Slovenia's export market shares grew over the past decade but export performance lagged behind that of comparable countries in the years leading up to the crisis.** Slovenia's export market shares grew by an average 1.8% per year, as against 5.1% in Poland, 3.3% in Hungary and 9% in Slovakia. Some of this relative deficit can be explained by more benign factors. First, Slovenia was more integrated and its catching-up process more advanced than these other countries to start with. Second, while Slovenia does export a lot to Germany and France, it also borders and exports to countries that grew very slowly over the whole period (Italy) or in the more recent past (Croatia). Modest gains in export market shares are forecast over the period covered by the Commission services' spring 2012 forecast.

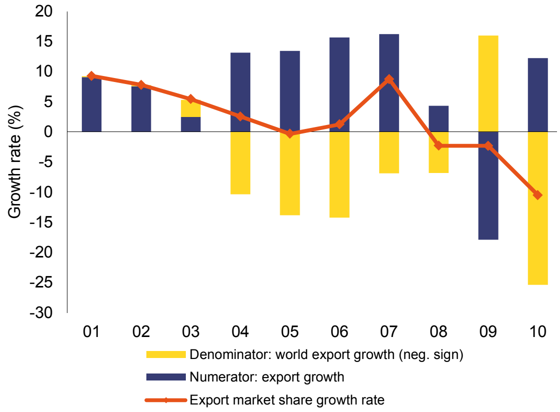
[3] http://stats.oecd.org/Index.aspx?DatasetCode=STAN_IO_M_X

**Graph 6:**
**Deviation from global export growth (shift-share analysis)**




Source: Comtrade

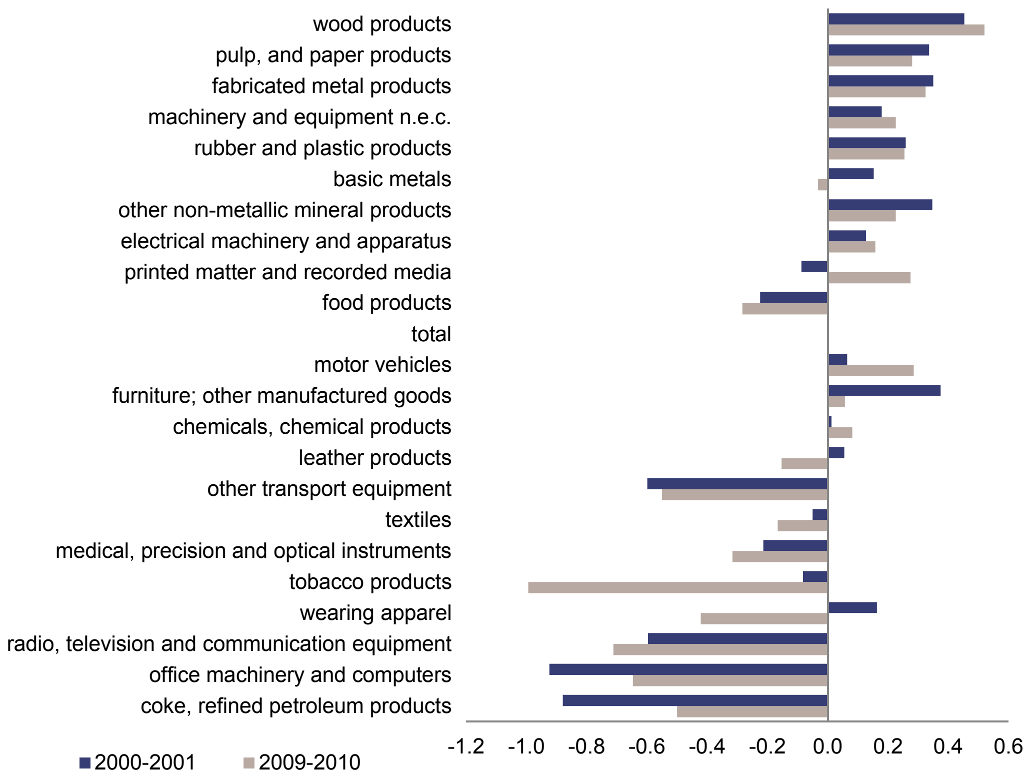
**Graph 7: Export market share growth (% y-o-y)**




Source: Commission services

**There are indications that competitiveness problems, including cost-competitiveness developments, may have hampered export performance.** As the deviations from global export growth shown above in Graph 6 indicate, Slovenia ceased to gain competitiveness in the second half of the last decade and the composition of exports even became a hindrance. This contrasts strongly with other Member States in Eastern Europe, which continued to gain competitiveness in both the product and geographic orientation dimensions over this period. The fact that Slovenia's product specialisation was a disadvantage in the second half of the decade might suggest insufficiently rapid upgrading of the export structure. Indeed, the symmetric revealed comparative advantage index shown below in Graph 8 highlights the extent to which Slovenia is still specialised in many basic industries. As the Member State with the highest income per capita of the EU8, Slovenia may well need to aim higher on the quality ladder.

**Graph 8: Trade in goods: Symmetric revealed comparative advantage index - Slovenia**



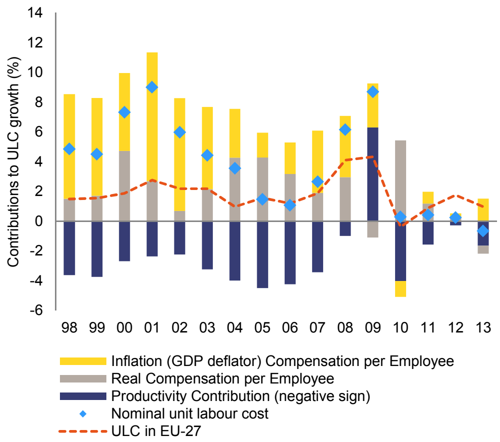

Source: Comtrade

**Cost-competitiveness came under pressure in the last decade as the buoyant labour market generated strong increases in nominal unit labour costs.** Prior to 2004, during the disinflation phase, devaluation of the Slovenian tolar could counter competitiveness losses. But this form of adjustment was no longer available after euro adoption in 2007, when inflation differentials and wage growth picked again with the surge in domestic demand. After several years of rapid wage growth in the private sector[4], 2008 also saw large public sector pay rises. A steep fall in productivity brought a further deterioration in statistical terms in 2009. The 22.9% discretionary increase in the minimum wage in March 2010 was a factor promoting countercyclical unit labour cost growth in spite of more benign productivity and inflation developments[5].

4 Which had a more pronounced effect on ULCs in the non-tradable sector.

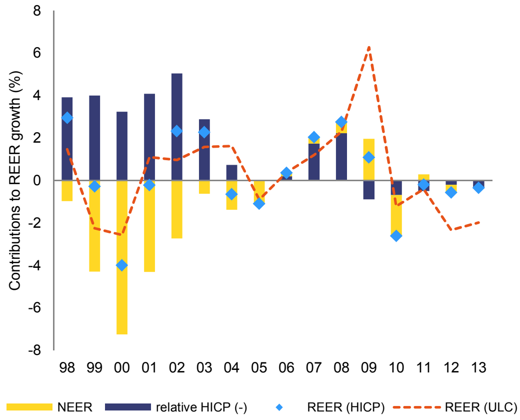
5 This brought the minimum wage to EUR 734.20 per month, among the highest in the EU as a percentage of average wages. This level was assessed to correspond to the poverty threshold. The number of workers at the minimum wage immediately jumped from 17,500 to 43,300 (5.2% of formally employed persons). Indexation in the subsequent two years has resulted in a further 4% nominal increase. Transitional arrangements were available for companies in financial difficulty.

**Graph 9: Decomposition of developments in ULCs**




Source: Commission services spring 2012 forecast

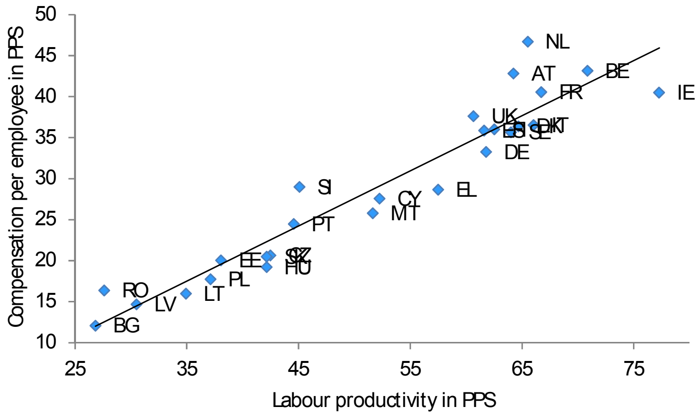
**Graph 10: Developments in REER (IC-36, HICP-based)**




Source: Commission services spring 2012 forecast

**Unit labour cost developments in 2011 have been more moderate due to a freeze on public sector wage growth and decelerating private sector wage growth.** Unit labour cost growth in line with the rest of the euro area has locked in relatively unfavourable labour cost levels, which could have an adverse impact on export performance and employment developments. Compensation per employee appears to be somewhat out of line with other Member States, considering the level of labour productivity. This disparity is especially obvious in the comparison with Member States with relatively lower labour productivity (those closer to the origin in Graph 11 below) and this is probably not down to differences in capital intensity and non-cost competitiveness. The disparity therefore represents a threat to the tradable sector and employment developments. To the extent that this situation is caused by a relatively high minimum wage that deters FDI and prevents creation of lower productivity jobs, it could also be said to limit the adjustment capacity of the economy. According to the Commission services' spring 2012 forecast, a small increase in unit labour costs is forecast for 2012, matched by a decrease in 2013, amounting to a small improvement in relative cost-competitiveness overall. However, as policy currently stands, there are strong in-built dynamics in both public and minimum wages that could reignite adverse trends in the coming years. Renewed economic growth would also put pressure on wages just above the level of the new minimum wage as employees seek to re-establish differentials that were compressed in 2010.

**Graph 11: Productivity and compensation per employee levels in Purchasing Power Standards (PPS) across Member States, 2010**




Source: Commission services (data and calculations)

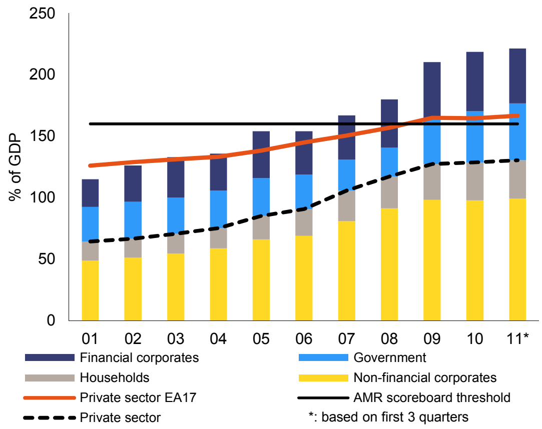
## 2.4. Private sector indebtedness

**The non-household private sector built up large debts and as a result Slovenia's banks and non-financial corporations face substantial difficulties with debt and deleveraging.** The period of widening external deficits was marked by a credit boom as Slovenian banks sucked in cheap but unstable foreign wholesale financing and lent freely to companies, taking increasing credit risk onto balance sheets which are very thinly capitalised by the standards of the region (the banking sector is the focus in Section 3). Annual private sector credit growth accelerated, peaking at 23.5% in 2007 and non-financial corporations took the lion's share (accelerating by over 40% in the same year). While high, private sector debt remains more contained than in some other countries because the credit cycle started relatively late and because Slovenian households abstained[6]. Nevertheless, this accumulated indebtedness is having a disproportionate impact on banks and the real sector because haphazard intermediation has resulted in a distribution of indebtedness that has proven poorly correlated with debt-service capacity (see Section 3). In aggregate terms, this suggests the economic capacity created by investment has been insufficient to justify the debt incurred in its financing[7].

6 A small boom in lending to households for housing purchases was also evident in 2009-10 but has since faded.

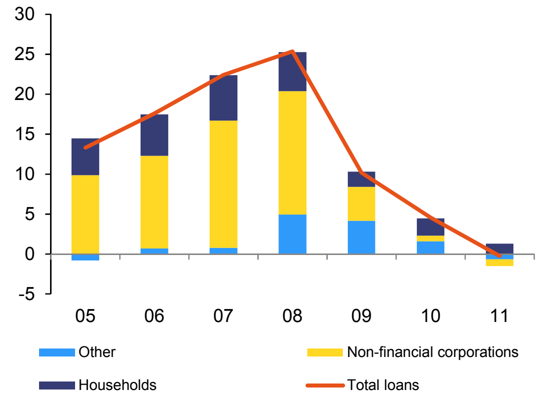
7 It also suggests that, in addition to net debt, the gross debt position may also provide a useful indication of vulnerabilities.

**Graph 12: Decomposition of debt (% of GDP)**




Source: Commission services

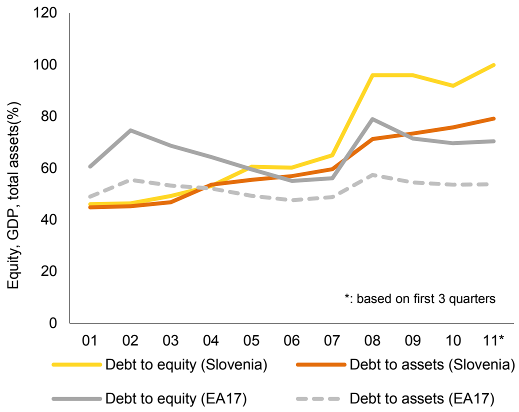
**Graph 13: Sectoral contributions to credit growth (%)**




Source: ECB

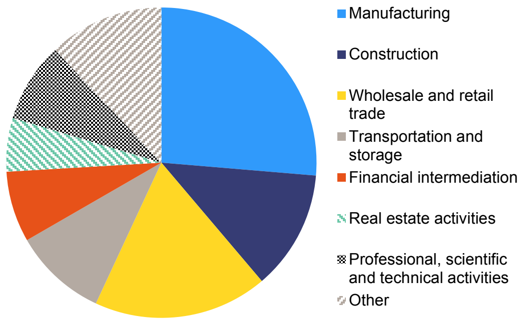
**Non-financial corporations accumulated excessive levels of debt in the years leading up to the crisis.** Excessively rapid credit growth steadily drove up the corporate debt-to-equity ratio as calculated by the Bank of Slovenia from around 0.8 in 2004 to over 1 in 2007, and this occurred despite the denominator effect from rapidly rising equity prices. In 2008, the ratio shot up to around 1.5 as companies took out loans amounting to a further 15% of GDP while the SBITOP stock market index plunged by around 65%. Graph 14 below, based on Eurostat consolidated debt data, shows that non-financial corporate sector leverage increased faster than in the euro area as a whole, with a pronounced upward shift in 2008 caused by declining equity prices. The trends in post-crisis credit quality described in Section 3 provide further after-the-fact proof that corporate indebtedness became excessive. In macroeconomic terms, these trends were intimately linked with the trends in current account financing described earlier. At the microeconomic level, they were partly driven by the expectation that economic growth and asset price inflation would remain at rates that have proven unsustainable. This also entailed insufficiently conservative valuations for equity and real estate collateral. This was particularly but not exclusively the case for lending to construction companies and holding companies, which now amount respectively to 8.4% and 5.6% of total lending to non-banking sectors.

**Graph 14: Leverage ratios of non-financial corporations, Slovenia vs. euro area**




Source: Commission services

**Graph 15: Sectoral distribution of lending to non-financial corporations (2011)**




Source: Commission services

**Non-financial corporations borrow overwhelmingly in the form of bank loans, in euros and on variable interest rates, and long-term loans outweigh short term loans by around two to one.** Thus, the key vulnerability – beyond simply the prevalence of debt in overall financing – relates to interest burdens. Declining interest rates in 2008-2009 largely offset the hit to private sector income streams, stabilising the ratio of net interest paid to income in aggregate, although not for the hardest hit sectors such as construction and real estate and financial and insurance activities. Future interest rate hikes, whether driven by monetary policy or by sovereign and banking funding stress, would place considerable stress on sectors that already need to clear a before-interest profit of as much as 10% just to meet interest payments.

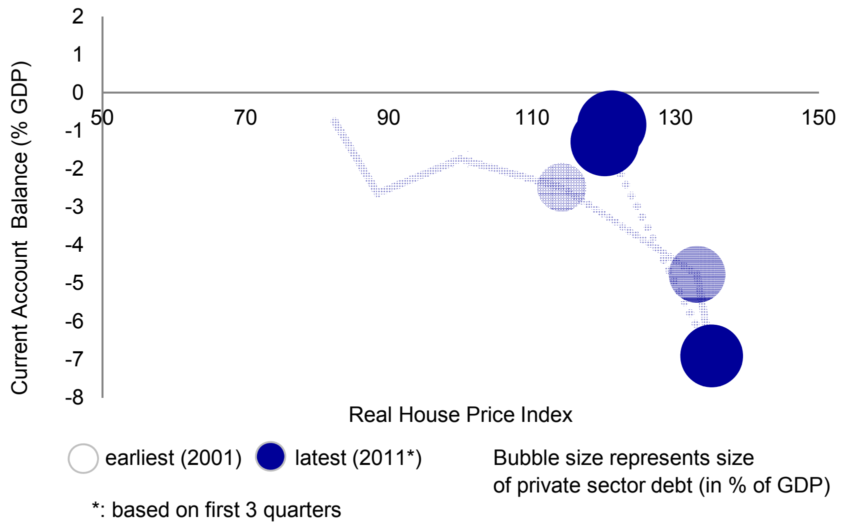
**Credit growth to non-financial corporations turned negative in 2009 and credit to this segment is now shrinking at a rate of around 5% per year.** In the absence of substantial injections of fresh capital in the real sector and a strong rebound in demand, this deleveraging seems set to continue for a long time. This could seriously hamper the reallocation of resources and business investment. Established companies can seek funding abroad, which may help expansion plans or new product lines. But such options are less available to smaller, newer, possibly more innovative companies, which rely heavily on domestic bank financing. Other corporate financing channels are largely closed-off in Slovenia, with equity funding poorly developed and direct financing from abroad rare due to the low share of foreign ownership.

**Ongoing corporate balance-sheet repair and the return towards external balance have coincided with depressed output and wider government deficits.** However, the capacity of the public sector to compensate for retrenchment in the other institutional sectors is limited. Required yields on Slovenian government bonds have already risen markedly. The general government deficit is forecast to decrease from its current high level, but further slippages in the roll-out of a credible fiscal consolidation strategy could lower sovereign ratings, partially impair banks' ECB-eligible collateral and further increase economy-wide interest rates. Such an intensification of these funding stresses could force more abrupt deleveraging throughout the economy and prompt a sharp recession. Spillover effects would probably be minor as the only country with concentrated exposure to Slovenia is Austria (amounting to 12.1% of capital and reserves on an ultimate risk basis).

### 2.5. Asset market developments

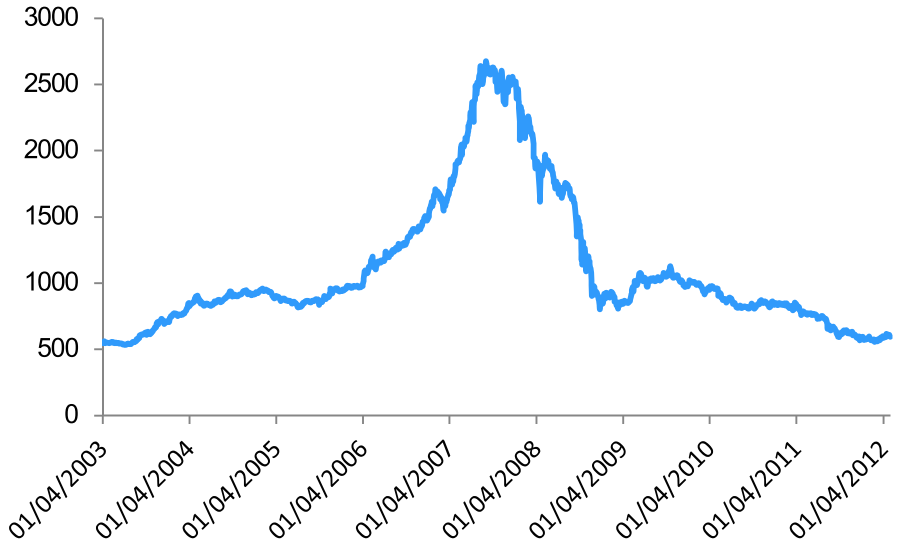
**As capital inflows mounted from 2003, asset prices started to rise steeply.** A feedback loop of lending and asset prices set in as a lot of lending found its way into real estate, construction and financial holding companies, including those that facilitated leveraged management buyouts. It should be stressed that households did not overstretch during this period: household debt levels remained low, loan-to-value ratios remained very conservative (peaking at 60.5% in 2007) and – with the exception of some Swiss franc denominated mortgages – there was an absence of riskier practices such as self-certification and equity withdrawal. The short data series (only from 2003) precludes more sophisticated analyses of divergence from house price fundamentals, but it is striking that prices of existing dwellings almost doubled in under five years, whereas they rose by only 32% in the euro area. Similarly abrupt developments were evident on the stock market.

**Graph 16: House prices, current account balances and household debt**




Source: Commission services

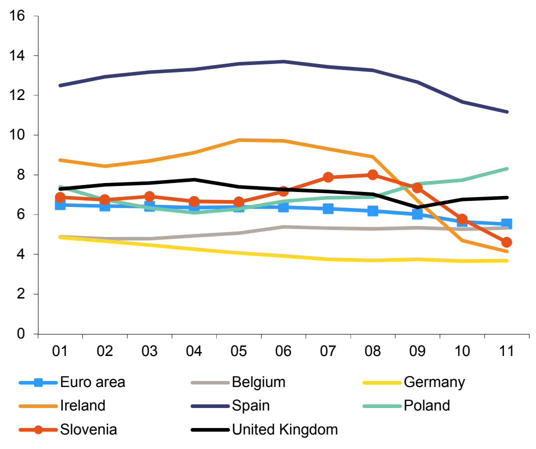
**Graph 17: Slovenian blue-chip stockmarket index (SBITOP)**




Source: Bloomberg

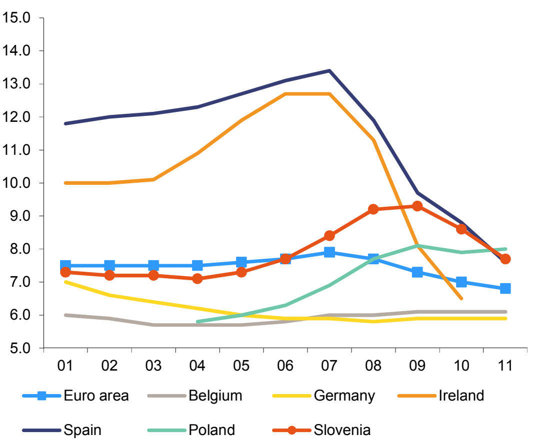
**Housing construction ticked upwards as a result of these trends, but it was public infrastructure investment, notably in highways, which caused the construction boom.** In the peak year, 2008, gross fixed capital formation in construction amounted to 18.1% of total GVA, out of which the residential segment represented only 5.1%. Even if the magnitude of the boom was more apparent in terms of investment than in terms of the size of the construction sector, nonetheless the timing of the supply side response was unfortunate, with GVA and employment picking up just as demand crashed across all segments due to the coincidence of the winding down of the highway-building programme and the global crisis.

**Graph 18: Share in total GVA of construction**




Source: Commission services

**Graph 19: Share in total employment of construction**




Source: Commission services

**Construction sector adjustment has started, although with some delay.** The GVA share peaked at 8.0% in 2008 and had already come down to 5.8% by 2010 (the euro-area average is 5.6%). However, adjustment in terms of employment has been slower and therefore still has further to run, with employment remaining at over 70% its peak. Investment levels, which amounted to 18.7% of GVA in 2008, have fallen rapidly and stood at 13.5% of GVA in 2010. The available short term indicators suggest the rapid decline in construction output may have slowed, which may mean the sector is approaching a more sustainable size. The Commission services' spring 2012 forecast foresees the share of construction investment in GVA will reach 9% in 2013.

**House price fundamentals remain a key uncertainty, but there are some indications of overvaluation.** The size of the 2003-2008 boom is by itself suggestive of a bubble, but uncertainty as to house price fundamentals complicates the quantification of the overvaluation.[8] Strong pre-crisis nominal GDP growth and convergence effects may have accounted for part of the boom. Buoyant incomes and households' low initial indebtedness also represented a latent financial capacity to bid up real estate prices, which may have been augmented by an unfortunately timed state-sponsored saving scheme. While households remain in sound financial health, the affordability of housing has declined dramatically. The ratio of house prices to per capita nominal GDP shot up between 2004 and 2010 (+44%) compared to the euro area (+14%). Based on Bank of Slovenia calculations for Ljubljana for the same period, the price-to-rent ratio increased by 27% to 1.5 for one-bedroom flats and went up by 37% to 1.2 for studio flats (with other housing categories falling between). The equivalent euro area increase was only 7% according to OECD data. Bank of Slovenia analysis of EU-SILC microdata[9] shows a rapid increase in the average age of holders of mortgage loans (in part also reflecting younger generations' current poor income prospects), and there has been a rapid lengthening of average mortgage maturities, with maturities over 20 years now accounting for 54% of the stock of mortgages, up from 39% in 2007.

**There has to-date been only limited adjustment in real estate valuations, with house prices currently only 10% below peak.** The anticipation of likely further price falls has fostered a widely observed 'wait and see' attitude and held back both supply and demand from the market. This was especially apparent in 2008 and 2009, when transactions volumes were more than halved and prices fell by around 14%. Subsequently, the market has revived to an extent with transactions and prices recovering a little, but bankruptcy proceedings, an illiquid market and a desire on the part of banks to avoid triggering a house price correction have kept a lot of property away from the market (transactions volumes in 2011 were still 31% below the 2007 level). Labour market weakness is likely to depress the housing market for the foreseeable future, making an eventual downward price correction more likely. However, the impact on household consumption and deleveraging is likely to be modest, given low loan-to-value ratios, low household indebtedness and the exceptionally low average frequency of household residence changes.

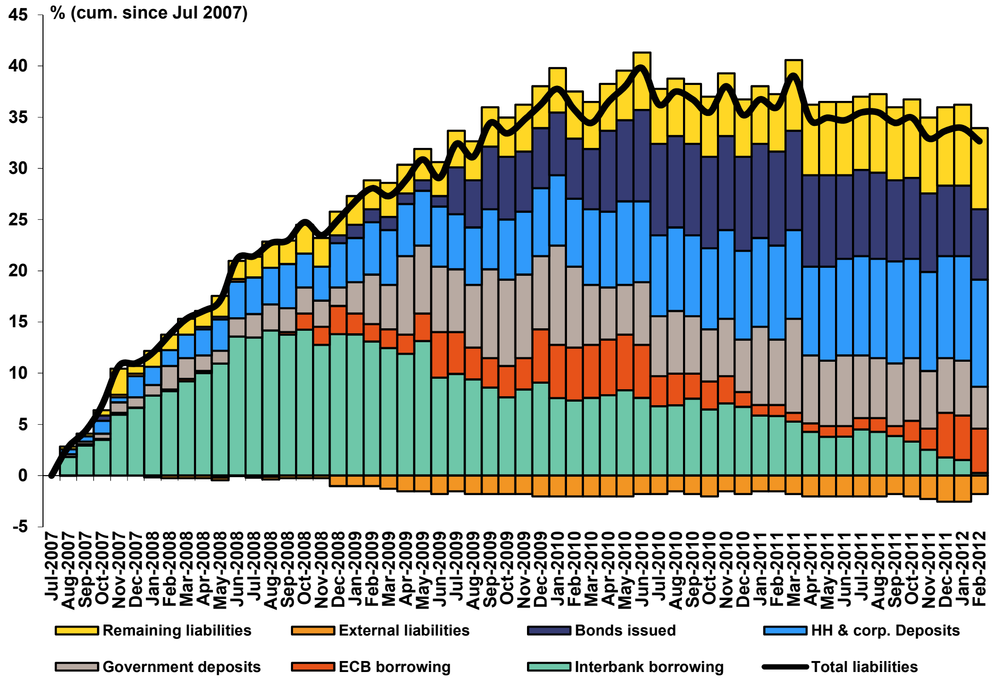
[8] Existing Bank of Slovenia estimates indicate a possible overvaluation of between 10% and 28% depending on the type of housing but these estimates are subject to major caveats.

[9] Bank of Slovenia May 2011 Financial Stability Review.

## 3. IN-DEPTH ANALYSIS: INDEBTEDNESS OF NON-FINANCIAL CORPORATIONS AND BANKING SECTOR VULNERABILITY

**The global financial crisis required Slovenian banks to shift rapidly away from foreign wholesale funding.** Banks issued bonds – both with and without government guarantees – and attracted more deposits. With substantial help from the government and from the ECB, banks have now repaid around a third of their foreign liabilities, bringing them down to the level of mid-2007. There is sufficient collateral to significantly expand borrowing from the ECB at least in the short term, but the other sources of replacement financing are unlikely to be as easy to mobilise in the coming period, as domestic deposit growth is unlikely to persist in the weak economic climate and as the government is fiscally constrained. Indeed, as banks under majority foreign ownership that previously relied on funding from their parent institutions intensify competition for retail deposits, funding strains may increasingly represent an income risk for the sector[10].

**Graph 20: Financing of the Slovenian banking sector**




Source: ECB

**The crisis and its aftermath have, with a lag, led to credit quality deterioration.** As the severity of corporate indebtedness has been revealed, so have repayment arrears to banks mounted. Many otherwise sound companies engaged in more productive activities have also suffered from weak demand and struggle to service their debts, resulting in a sustained accumulation of loan arrears. 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%. In the corporate segment, NPLs are now running at 18.5%. NPLs in small domestic banks increased to 12% of loans, while for

[10] Several of these banks have extremely high loan-to-deposit ratios and are covered by the Austrian bank supervisor's requirement to observe the limit of 110% loan-to-deposit ratio on new lending.

foreign banks they stand at 7.1%. The construction sector is the main driver of this trend, with NPLs now accounting for half the value of outstanding loans. However, other sectors are also affected, notably manufacturing, retail and finance. Households, which have remained financially sound, may begin to experience greater financial distress as labour market conditions continue to worsen in the near term.

**The banking system has struggled to come to terms with the large indebted construction companies and financial holdings that weak demand and falling asset prices have systematically bankrupted.** All three major construction companies have been affected (see box). Once banks seize real estate collateral, they are not offered to potential buyers at a market-clearing price. This is explicitly done to avoid triggering a market correction. Shares seized from holding companies have proven illiquid and the state has on occasion used its shareholdings in banks to block their sale. More generally, where indebted companies are no longer viable, ponderous bankruptcy procedures impede liquidation, delaying the reallocation of both the underlying real assets and the related lending capacity. Even where existing clients are potentially viable, restructuring of loans to potentially viable companies can be difficult. An initiative in 2011 to facilitate the restructuring loans and shareholdings of financially distressed firms with dealings with several banks failed to attract agreement between banks.

**The protection provided by recourse to insolvency proceedings is seen as unsatisfactory by banks.** The World Bank's ease of resolving insolvency indicator admittedly gives Slovenia's bankruptcy procedures a score close to the regional average, with relatively low costs. However, expected recovery rates are rather low. The legal framework has been described as debtor-friendly[11]. The amount of payment indiscipline reveals the extent to which banks forego the option of pushing for insolvency: pre-crisis, over a thousand entities were under court orders with arrears in excess of a year, yet only between 300 and 400 insolvency proceedings were initiated per year. Court orders roughly doubled with the crisis, yet the number of insolvency proceedings initiated has so far gone up by less than 50%.

**Box 1: Recent bankruptcies of Slovenia's largest construction firms**

Amid sharp contraction in the sector, two out of Slovenia's three largest construction companies (SCT Ljubljana and Vegrad Velenje) went bankrupt in 2010/11, while the third (Primorje Ajdovščina) was forced by banks into receivership.

SCT Ljubljana had been the symbol of Slovenian construction, with turnover peaking at EUR 534.2m in 2008. It was the main beneficiary of various public infrastructure projects, including the construction of highways where it earned between 50% and 75% of its turnover in the period 1995-2009. As a result of this focus, it had virtually no collateral. Vegrad and Primorje also depended on large public infrastructure projects.

Public investment fell sharply after the highway programme ended and this coincided with a sharp drop in private investment due to the onset of the economic crisis. The state also

11 For instance, the Bank of Slovenia explains in its 2010 review of the Stability of the Slovenian Banking System that "The long-term development of payment indiscipline has been facilitated by the Slovenian business environment, which is not restrictive enough with respect to debtors and presents too much of burden for creditors (an example of this is the complexity of protracted enforcement proceedings)".

postponed the reconstruction of railways due to fiscal consolidation. Initiatives by the construction companies to seek alternative revenues from operations in specific foreign markets (ex-Yugoslavia, Libya and ex-Soviet Union) failed.

The position of the banks which funded these firms' unsustainable expansion is further complicated by their ownership and financing structures as all three were taken over in highly-leveraged MBOs during the boom years. In other words, banks face losses both on operational lending and on their financing of the buy-outs.

**Given the difficulties of recovering outstanding moneys from financially distressed clients, banks have gradually seen deteriorating credit quality reflected in loan losses.** Write-downs as a percentage of total assets were 1.61% in 2010 and 2.34% in 2011, translating into return on assets of -0.2% and -1% respectively[12]. Considerable time lags are observed between the materialisation of repayment arrears and the booking of impairments. In addition to any optimistic bias, three factors can be distinguished that may explain these lags: (i) impairments are based on backward-looking criteria, (ii) those criteria are relatively lenient as regards the duration of arrears (over 180 days for so-called 'D' classified assets) and (iii) the impairments tend to be booked mainly in December each year with the audited accounts. Similarly, collateral valuations are largely maintained until such a time as the correction in real estate prices materialises. The combined effect of the rising trend in NPLs and these time lags has been a marked drop in the coverage of NPLs by impairments and the opening up of substantial scope for further provisioning. Together with the return to recession in 2011-12, these factors suggest further losses for the sector at least through 2012.

**Capital adequacy ratios were historically very low in Slovenia and recapitalisations have been required to stop mounting losses from pushing these lower, although overall capital ratios still comply with Basel II rules.** Despite the successful increases of the Slovenian banks' capital bases in 2011 compared to a year earlier, 11 banks would need additional capital of EUR 438 million (1.2% of GDP) to reach a Core Tier 1 ratio of 9%. The largest bank, state-owned NLB, with a 35% market share by assets, received a EUR 243m capital injection from the government in March 2011 but still needs a minimum of EUR 400m to meet the EBA target by the 30 June deadline according to the supervisor. The EBA recapitalisation exercise did not reveal additional capital requirements for the second largest bank, NKBM, with an 11% market share, but this bank has since posted losses amounting to around 17% of its capital (1.6% of its risk-weighted assets), implying a recapitalisation need there as well.

**The options for increasing capital are limited.** The government, a major direct and indirect shareholder in NLB and several other banks, is fiscally constrained. Negotiations are currently on-going with potential investors in NLB, but the largest private shareholder, Belgian KBC, itself has a restructuring plan to implement as it has also received state aid. The system as a whole has so-far been rather closed to foreign investors and progress in the negotiations will determine the speed with which the government can pursue its stated intention of selling its majority stake. Meanwhile, strong competition for deposits combined with depressed external and

[12]EUR 810m in 2010 and EUR 1,141m in 2011, translating into losses for the sector as a whole of EUR 98m and EUR 388m respectively.

internal demand is putting pressure on interest rate margins, stymying internal generation of profits and raising of capital. Meeting recapitalisation needs (of the two largest banks) therefore represents a major fiscal risk.

**Table 1: Banking sector key indicators**

| in % | Overall solvency ratio - CAR | | Tier 1 ratio | | Core Tier 1 | Return on assets (RoA) | | Non-performing Loans (NPLs) | | Coverage ratio (Loss provisions/NPLs) | | Loan/Deposit ratio*** | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | all banks | NLB Group | all banks | NLB Group | NLB Group | all banks | NLB Group | all banks* | NLB Group* | all banks** | NLB Group | all banks | NLB Group |
| 2007 | 11.2 | 10.8 | 7.8 | n.a. | | 1.4 | 1.1 | 2.6 | 2.3 | 123.1 | 152.0 | 144.5 | 143.0 |
| 2008 | 11.7 | 11.8 | 9.2 | 7.9 | | 0.7 | 0.2 | 3.3 | 3.8 | 78.4 | 111.6 | 162.8 | 123.0 |
| 2009 | 11.6 | 10.7 | 9.3 | 6.9 | 6.1 | 0.3 | -0.5 | 5.4 | 9.0 | 68.8 | 72.7 | 159.0 | 123.0 |
| 2010 | 11.3 | 10.2 | 9.0 | 6.0 | 5.2 | -0.2 | -1.1 | 7.4 | 14.5 | 65.7 | 62.0 | 156.0 | 125.7 |
| 2011 | 11.6**** | 11.0 | 9.6**** | 7.2 | 6.3 | -1.0 | -1.4 | 11.2 | 21.3 | 57.8 | 63.6 | 149.3 | 105.4 |

*NPL for all banks is defined as loans over 90 days over due.
** Own calculations
***For non-financial sector. For all banks, ECB database, June 2011.
**** Preliminary estimates
Source: Central Bank of Slovenia, ECB and NLB and Commission services calculations.

**Mounting loan losses and the difficulty of securing financing, not least fresh capital, have triggered a deleveraging process.** After two years in which credit growth slowed down but remained positive, banks are now reducing their exposure to non-financial corporates at a rate of around 5% per year. Deleveraging will continue in the near term as banks seek to reduce their exposure to over-indebted non-financial corporations and adapt their operations to reduced wholesale funding. Demand factors stemming from macroeconomic weakness and the poor financial health of the corporate sector will also depress lending. In time, this will limit the banking sector's income generation potential.

**The difficulty of deleveraging limits the economy's adjustment capacity.** The slowness of the bank response to the downturn partly reflects the maintenance of relationships with existing borrowers, for which continued lending serves as much for working capital as for investment purposes. This was apparent on an anecdotal level, most clearly in the construction sector, but it can also be deduced from the shift in lending *towards* those sectors in greatest difficulty, namely construction, real estate and financial services. In other words, the headline rate of deleveraging has in fact understated developments in less crisis-hit sectors. Banks' slowness to reduce exposure to segments with sharply declining credit quality stems in part from their perhaps realistic assessment that ever-greening of loans is often preferable to seizing collateral of doubtful value or triggering bankruptcy procedures. This means the brunt of deleveraging is borne at the extensive margin, with banks extremely cautious when extending new loans.

## 4. POLICY CHALLENGES

The preceding analysis has shown that Slovenia is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed. In particular, macroeconomic developments related to corporate sector deleveraging and banking stability and unfavourable but less pressing development in external competitiveness deserve to be closely monitored, so as to reduce the important risks of adverse effects on the functioning of the economy.

**The previous combination of widening trade deficits and inefficiently intermediated debt flows is not an appropriate development model for the future.** With external balance and sustainable investment financing as the overarching objectives, three mutually reinforcing policy agendas come to the fore:

**Tighter prudential standards and improved corporate governance could play a role in safeguarding against a repeat of asset price bubbles and reckless leveraging-up of firms and banks.** More stringent standards could be applied for bank capitalisation and other key ratios and greater conservatism could be applied to collateral valuations, reinforced by a redoubling of supervisory vigilance. Corporate governance could be improved in banks and firms through a reduction of state ownership and state intervention in management. This would also promote FDI. Professional management, insulated from political pressures and facing hard budget constraints, could develop more sustainable business plans and focus on commercial objectives. Optimal mobilisation of scarce deposits and capital and cleaning of balance sheets all necessitate a degree of coordination and consolidation the sector has so far failed to achieve.

**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 convenient location, Slovenia's inward FDI stock peaked at only 15.6% of GDP, compared to 95.5% in Hungary and 52.5% in Slovakia. Significantly increased FDI would be beneficial, even if it postpones the transition to a more sustainable NIIP. Well-applied FDI could provide much-needed equity to the real sector and bring fresh capital and improved risk management to the banks, allowing credit growth to resume in the future. FDI could also reinforce corporate governance and promote external balance by bringing higher technology content manufacturing, further integration within international supply chains and opening up access to growth or niche markets. Reduced state involvement in the economy and improved corporate governance are important preconditions for increased FDI. Tackling the multiple challenges identified in the business environment in the context of the European semester, such as the problem of payment indiscipline and bankruptcy, would also improve the investment context.

**Improving cost competitiveness, especially in terms of containing wage growth, could make a key difference in preventing the return of external imbalances.** Wage moderation can be sought in conjunction with social partners, but the most immediate levers to influence wage developments are public wages and minimum wages. Reduced protection for permanent contracts and a reduction in labour market segmentation would also favour employment growth over wage growth when labour demand recovers. Competitive wage levels would also make Slovenia a more attractive investment location.

**These three policy agendas are challenging and would require sustained commitment to implement.** Recent years have seen urgent structural reforms delayed and the context for pushing through reforms that challenge vested interests is likely to remain very difficult. This underscores the importance of effectively communicating with citizens and social partners about the need for and the objectives of reforms. However, it does not warrant delay, or trade-offs with the policy objectives of fiscal consolidation and pension reform. Indeed a credible and timely consolidation is necessary to ensure interest rates, credit ratings and sovereign financing stress do not push the economy on to a more destructive path of adjustment to past imbalances.