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Banka Slovenije/Central Bank of Slovenije

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This document is an update of the Policy Strategy Paper for Slovenia from December 2015, and emphasises certain important challenges relating to economic development and political decisions that must be made in the future. The more successful utilisation of EU funds and the creation of additional fiscal space within the bounds of European fiscal rules would facilitate the necessary support for monetary policy to ensure sustainable growth. Non-standard monetary policy measures to date have not had a significant impact on credit growth. However, the likely prolonged low interest rate environment could derail financial sector stability. The Bank of Slovenia is monitoring developments in the financial sector and adopting the appropriate measures. It is encouraging a more rapid reduction in non-performing loans and the restructuring of loans to large enterprises and SMEs, and is engaged in the development of tools for assessing the sustainability of banks’ business model and the drafting of guidelines to develop a risk management framework.

1. Introduction

This 2016 update of the Policy Strategy Paper for Slovenia reviews economic developments and policy implementation since the issuance of the previous edition on 10 December 2015, and highlights some of the important challenges that need to be addressed in the period ahead.

Last year’s paper noted that the state of the real economy and the financial sector had started to improve, but that the fundamentals for securing strong sustained growth, financial stability and long-term fiscal sustainability were not fully in place. The paper highlighted the importance of giving priority to further improving the situation in the economic environment, and thus the balance sheets of both enterprises and banks, increasing reliance on equity financing, improving the business environment and reducing the role of the state in the economy, enhancing supervision of the banking system and implementing fiscal consolidation and reforms. All of these aspects remain important a year later.

The state of the real economy and the financial sector in Slovenia has been encouraging again in 2016. Economic activity continues to grow, the banking sector is resilient to potential shocks, and the excessive deficit procedure has been completed. We should, however, emphasise that structural reforms are essential for sustaining favourable trends. Key structural policy priorities have been identified in the government’s National Reform
Successful implementation of these measures will require political resolve, social consensus, and economic policy coordination. It is important to ensure that the likely prolonged low interest rate environment does not derail financial sector stability and the gradual transition to a normal state. The banking sector is facing downward pressure on its current profits as the result of expectations that the positive effect of lower impairment and provisioning costs will not continue over the medium and long term, that banking regulations will further tighten in an effort to ensure a more robust financial system, that the trend of falling net interest margins will not reverse any time soon and that the volume of bank loans is not likely to begin rising in the short term. From this it follows that banks will have to adapt more actively to the external environment in which they operate to face all of the challenges before them. We can thus expect the further consolidation of the banking system in Slovenia, and the adjustment of banks’ operating costs and most likely the entire business models of certain banks. Banks will also have to take a more active approach to resolving those non-performing exposures that remain on their balance sheets. Without those adjustments, the currently favourable situation in terms of the banking system’s solvency could rapidly reverse.

2. Real sector challenges

A notable aspect of Slovenia’s economic recovery is that the contribution of domestic demand to GDP growth has exceeded that of net foreign demand since 2014. Private consumption has rebounded with the pickup in net job creation, rising (real) wages and the boost provided to disposable income by falling energy prices in the context of negligible inflation. Public investment contributed to the initial phase of economic recovery, but no longer in 2015. The contribution of public investment actually turned negative in 2016 owing to lower drawdowns of EU funds during the transition to the 2014–2020 financial perspective. However, this drop has been offset by the revival of private investment since the second half of 2015. Net foreign demand remains the key driver of Slovenia's growth. The current account surplus increased further in the first half of 2016, reflecting higher receipts from exports and tourism, and an improvement in the terms of trade.

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Outlooks regarding demand

The expected growth in private consumption is encouraging. The level of private consumption is still below the peak level achieved in 2011, meaning there is still sufficient room for growth. The expected increase in the volume of real estate transactions should stimulate further growth in household consumption of durable goods. One concern, however, is whether consumption growth will be affected by the declining tendency in consumption propensity (i.e. a rising saving ratio). That decline can be explained by the falling proportion of newly concluded contracts accounted for by permanent employment contracts, which is likely a reflection of the fact that the majority of new job creation in the economy requires flexible forms of work. Attention should therefore be given to optimising the relationship between flexibility and job security in the future, as well.

Stimulating private investment

The increase in private investment is a sign that private sector debt is declining, while profitability is rising. Most of the increase in investment has taken place at export-oriented enterprises, stimulated by strong export growth and rising profits. While profitability measured as return on assets has risen across the corporate sector during the past two years, it has reached historically high levels in the export sector.

More investment is needed to stimulate and sustain economic growth. The still positive saving-investment gap for the corporate sector is a signal that deleveraging is likely to continue in certain sectors of the economy and will act to limit the private sector’s investment and growth outlook. Investment recovery would be faster if the institutional, regulatory and administrative bottlenecks (so-called administrative barriers) that increase operating costs were eliminated more effectively.

The business environment in Slovenia has improved over the past two years, but certain deficiencies remain. Slovenia’s ranking in the World Bank’s Doing Business indicators has

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See also Annual Report 2015 [http://www.bsi.si/publikacije/Annual_ReportBS_15/index.html](http://www.bsi.si/publikacije/Annual_ReportBS_15/index.html)

The Chamber of Commerce and Industry of Slovenia also reports that the number of real estate transactions is rising. [https://eng.gzs.si/Portals/English/Vsebine/novice-priponke/sbl-january.pdf](https://eng.gzs.si/Portals/English/Vsebine/novice-priponke/sbl-january.pdf).
improved from 35th in 2015 to 29th in 2016 out of 189 countries, mainly on account of significant improvement in assessments of the resolution of insolvency and the enforcement of contracts. On the other hand, assessments regarding the simplicity of starting a business and dealing with construction permits have deteriorated, reflecting delays in the streamlining of procedures for spatial planning and building permits.³

The reform of the current structure and functioning of public administration would help improve the business environment and the effectiveness of policy implementation, which in turn would attract serious foreign investors with the ability to exploit Slovenia’s comparative advantages. The World Bank’s Worldwide Governance Indicators scores for Slovenia for governance effectiveness and regulatory quality have dropped significantly since 2010.⁴ In response to Slovenia’s worsening scores in several annual international competitiveness rankings, in April 2015 the government adopted the Public Administration Development Strategy 2015‒2020.⁵ The adoption of the strategy was a pre-condition for Slovenia to be able to draw from the European Union’s structural funds during the current financial perspective. Proper and timely implementation of this strategy is key to enhancing the business environment, and will require considerable cross-ministerial coordination.

Providing additional capital will not be enough for sustained long-term economic growth; boosting productivity through knowledge-based activities is also required. This dictates the mastery and widespread use of innovative technologies, and the enhancement of human capital accordingly. Slovenia will maintain its competitiveness and climb up the international value chain only if measures are adopted to invest adequately in research and development (R&D) and to create knowledge-based jobs. This could be accomplished through the use of European funds earmarked for the implementation of Innovation Strategies for Smart Specialisation and the involvement of universities in the economic environment.⁶

³ See http://www.doingbusiness.org/data/exploreeconomies/slovenia
⁴ See http://info.worldbank.org/governance/wgi/#reports
Ownership restructuring and corporate governance

Privatisation and the entry of private investors are also crucial for achieving higher productivity-driven growth as they typically bring about the required operational restructuring, the accelerated implementation of new technologies and more efficient managerial techniques. Political support is an important pre-requisite for successfully privatising state-owned assets. Inflows of foreign direct investment (FDI) increased significantly during 2014–2015, mainly as the result of privatisation processes and inflows into export-oriented enterprises. Nine of the 15 enterprises on the privatisation list drawn up in 2013 have been sold to date. The sale of three enterprises was unsuccessful due to the withdrawal of the potential investor from negotiations, a lack of appropriate bids or no interest from potential investors. The initiation of sales procedures was planned for 25 additional enterprises in 2016, while the tender process for the sale of state-owned shares is ongoing for 13 of these enterprises. In mid-2016 Slovenski državni holding (SDH) proposed modifications to the classification of state-owned enterprises into "strategic", "significant" and “portfolio”. That proposal is currently being discussed at the government level and will have to be approved by the National Assembly. This will impact continuing privatisation processes.

Greenfield FDI in Slovenia accounts for only a small proportion of equity capital inflows. The government prepared an FDI strategy in 2015 with the aim of promoting Slovenia as an R&D and logistics hub, and a green economy centre. The government has begun implementing measure to promote Slovenia as an attractive location for FDI. Successful implementation of this strategy will require adequate funding, sufficient human resources for dealing directly with enterprises and potential investors, the coordination of the activities of various stakeholders and the resolute implementation of structural reforms to improve the business environment.

Effective governance is crucial for enterprises that will remain state-owned. SDH is responsible for effective governance, and has in place formally defined core management tasks and objectives regarding effectiveness. The challenge, however, lies in that effectiveness itself, as many changes have been made to the members of SDH’s management and supervisory boards.

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in recent years. The success of state-owned enterprises will hinge critically on having stable supervisory and management boards, and on how decisively, independently and professionally SDH exercises its oversight responsibilities.

Financing small and medium-sized enterprises

A supportive financing framework for small and medium-sized enterprises (SMEs) will contribute significantly to enhancing the growth potential of this sector and the entire economy. According to the European Commission’s 2015 SBA Fact Sheet for Slovenia, the country lags behind most of the EU in terms of access to financing for SMEs, despite recent efforts and improvements. SMEs are overly dependent on bank lending and face less favourable financing conditions, on average, than large enterprises. Financing programmes are offered by the Slovene Enterprise Fund (SEF) and SID banka, drawing on resources made available by various European agencies. Available sources of financing have increased recently and the government has negotiated more favourable financing terms for SMEs, which should have a positive impact on the financing of projects and exports. The potential use of alternative financing sources must nevertheless be explored, including public-private partnerships and venture capital investments. Appropriate alternatives must be created for SMEs whose owners are wary of relinquishing some degree of control that is typically associated with equity financing. Institutional barriers that currently inhibit foreign venture capital funds from establishing a foothold in Slovenia must be eliminated.

The fact that policy makers are beginning to take the interests of SMEs into account in the early stages of the policy-making process is seen as positive. The Slovenian government’s “Single Document” stipulates the introduction of the so-called “SME test” from 2016, under which the impact of all new laws on businesses, especially SMEs, will be assessed. This programme should be implemented in full as soon as possible, and follow the principles of comprehensible, operational and useful written legislation.

3. Financial sector policies

Constraints to credit growth
The Slovenian economy is recovering, while net credit growth remains negative. Lending to the household sector is growing, while lending to the corporate sector continues to contract, despite stimulative monetary measures in recent years. There are significant factors, on both the supply and demand sides in Slovenia, that are slowing the pass-through of monetary policy measures to bank lending.

A significant cause for the negative growth in lending on the supply-side is the still-high level of non-performing loans (NPLs), despite the transfer of a significant number of NPLs of state-owned banks to the Bank Assets Management Company (BAMC) and the continuous reduction of the level of NPLs since their peak in 2013. Representing an additional limiting factor to credit growth are the commitments made to the European Commission in the context of the resolution and recovery of banks through state aid, including the commitment to reduce total assets, to which the largest systemic banks are bound. In light of bank recovery and resolution efforts, activities have also been carried out at the national and supranational level to strengthen banking supervision and improve risk management standards.

The effects of monetary policy measures on the demand side of credit growth have yet to be seen. Important factors weighing down demand for bank financing are deleveraging and operational restructuring by a certain segment of the corporate sector, greater room for internal financing created by rising profitability, reliance on domestic and foreign business-to-business lending, and borrowing via the issue of bonds and commercial paper. Survey responses indicate a decline in the number of enterprises reporting the availability of bank loans as a limiting factor in their business. This indicates an increase in the use of non-banking sources of funding. Bank lending is thus not strengthening, despite the favourable capital adequacy and liquidity of Slovenian banks. We can expect that trend to continue next year and over the next medium-term period in the absence of (investment) incentives for the corporate and household sectors.

Resolution of non-performing loans

The process of rehabilitating the portfolios of banks remains a priority. A speedy reduction in NPLs is crucial to improve the transmission of monetary policy to the real economy. The
The effective resolution of NPLs also facilitates debt restructuring at viable enterprises, while promoting the winding-down of non-viable enterprises.

The Bank of Slovenia, the Slovenian government and the Bank Association of Slovenia have adopted several measures that have contributed to the reduction in NPLs. The proportion of total classified claims more than 90 days in arrears has declined from its peak of 18.1% in November 2013 to 6.7% at the end of August 2016. That reduction is the result of the transfer of NPLs to the BAMC, the restructuring of NPLs, the liquidation of loan collateral, the sale of a portion of the credit portfolio and the write-off of loans. Close to €5.5 billion in NPLs was transferred off the banks’ balance sheets to the BAMC between 2013 and 2016. A sizeable proportion of NPLs, totalling almost €0.6 billion, remain on the banks’ balance sheets and comprise claims against non-residents, primarily from four of the former Yugoslav republics.

The master restructuring agreements (MRAs) between banks and large enterprises that the Bank of Slovenia assisted in drawing up have been relatively successful in reducing the level of NPLs. The Bank of Slovenia is monitoring the progress of the implementation of signed MRAs based on quarterly progress reports (half-yearly since autumn 2016) drawn up by the largest banks, and through half-yearly performance reviews of enterprises that account for the top 32 MRAs in terms of volume (close to €1.4 billion). The BAMC must also play an important role in corporate restructuring, as that is the reason it was established: to be engaged in the operational, financial and ownership restructuring of enterprises, while increasing the value of those enterprises and the claims that have been transferred to the BAMC.

The challenge for reducing the level of NPLs lies in the SME sector, where financial restructuring efforts are now intensifying. This task is more challenging due to the large number of enterprises involved, and their heterogeneity and small size. Guidelines on the restructuring of non-performing claims against SMEs were drawn up jointly by the Bank of Slovenia and the Bank Association of Slovenia in December 2015. On this basis, banks already have prepared their annual loan restructuring targets for the period 2017–2019. To facilitate the implementation of changes, the World Bank is providing technical assistance in the development of a tool kit and a restructuring manual for the management of NPLs. A workshop for banks is envisaged in January 2017.
Efforts for the more effective management of credit risk at banks and thus the limiting of new NPLs will be made easier when the upgraded Central Credit Register at the Bank of Slovenia becomes fully operational by the end of 2016. The scope and quality of debtor information contained in the Central Credit Register should enhance the capacity of banks to make informed decisions on extending loans and monitoring their clients. To that end, it is important for the banks to upgrade their IT infrastructure and data management capacity in a timely manner.

The Bank of Slovenia also adopted a preventive approach to resolving the issue of NPLs. To minimise the risk of the renewed accumulation of credit-risk losses, it issued guidelines in 2015 on how the banks should establish early warning systems (EWS) that incorporate indicators of future imbalances. The Bank of Slovenia is also participating in a high-level task force, set up by the European Central Bank in September 2015, aimed at making the resolution of NPLs speedier. The objective is to develop and implement a supervisory approach that will encourage the prompt recognition of credit losses and the speedy resolution thereof. The final version of the ECB’s guidance on the management of non-performing claims for banks and supervisors should be ready by the end of 2017. The aforementioned guidance of the ECB will apply directly to three systemically important Slovenian banks.

Strengthening the regulatory and supervisory framework

Regulation and supervision is being strengthened to make the banking system more stable and less crisis-prone in the future. The financial crisis demonstrated very clearly the importance of having adequate safeguards in place to prevent unhealthy risk-taking and unsustainable credit growth. Hence, the prudential rules of the Capital Requirements Directive (CRD) IV, which were transposed into Slovenian law in the new Banking Act (ZBan-2), call for the introduction of new requirements at banks in the coming years with regard to the quality and scope of capital (in the form of several layers of capital buffers), liquidity, leverage, and counterparty risk. The development of capital buffers and compliance with the minimum

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8 It its analysis of the balance of NPLs in the eight most exposed countries in the euro area, (Greece, Cyprus, Italy, Portugal, Spain, Ireland, Slovenia and Germany), the Single Supervisory Mechanism ranked Slovenia in the top half of most successful countries (behind Ireland and Spain) in terms of the drafting and implementation of supervisory guidance for the management of NPLs.
requirement for own funds and eligible liabilities (MREL) will present a challenge in an environment of low bank profitability.

**One of the measures to strengthen the stability of the financial system is the establishment of a national resolution fund.** That fund, which was encouraged by the Bank of Slovenia, began operating in March 2015. The fund is financed by banks and is aimed at protecting guaranteed depositors, in the event of the resolution and recovery of a specific bank, without an additional burden on public finances, even before the new European resolution mechanism took effect in January 2016. An important task will be harmonising the functioning of the national resolution fund and the European resolution fund.

Enhancing supervision requires commercial banks to focus on improving their methodologies for measuring and managing risks, the development of advanced models and the enhancement of overall banking supervision. The prudential methodology must be adapted to the specific characteristics of the enterprise it is meant to finance. Banks must be encouraged to develop and use advanced models for measuring risks, and to demand the appropriate granulation of data to facilitate a more precise overview of asset quality. Harmonising the implementation of activities relating to early intervention, resolution and recovery and the liquidation/bankruptcy of banks is crucial for timely measures, such as the sophistication of methodological tools for supervision and the resolution and recovery of banks, and the demarcation of early intervention indicator thresholds for the application of specific measures.

*Macropuridntial oversight*

**In line with the recommendations of the ESRB, the Bank of Slovenia has established an institutional framework for the macroprudential oversight of the financial system.** The basic aim of macroprudential oversight is to safeguard the stability of the financial system by identifying the emergence of systemic risks at an early stage and taking preventive measures to mitigate those risks.

The purpose of macroprudential policy and oversight is to **mitigate the effects of financial cycles and to increase the resilience of the financial system** to disruptions. The need for such instruments was demonstrated by the financial crisis.

In accordance with the requirement of ZBan-2, the Bank of Slovenia introduced two macroprudential instruments in 2015: the countercyclical capital buffer and a capital buffer for
systemically important banks (O-SII). However, since there is no sign of recovery in the financial cycle as yet, the current buffer rate is set at a non-binding level of 0% for both instruments. Two macroprudential instruments have been introduced in 2016, in the form of a recommendation, for residential real estate loans: a limit on the loan-to-value ratio and a limit on the debt service to income ratio. The recommended ratios for these two instruments also do not encroach on current lending activity and the lending policies of banks, as the situation on the Slovenian real estate market is stabilising and does not currently present any direct risk to financial stability.

In the future, the Bank of Slovenia will follow EU-wide initiatives that focus on the development of macroprudential instruments such as the leverage ratio, which seeks to prevent the build-up of excessive leverage, and the liquidity coverage ratio and the net stable funding ratio, which promote the short-term resilience of a bank’s liquidity risk profile.9

Business outlook for banks

The positive effect of measures adopted by the government and the Bank of Slovenia since the end of 2013 has helped to restore banking system stability. The average capital adequacy of the banking system is favourable, while the banks’ liquidity ratios remain high and stable. Following five years of losses generated by the banking system as a whole, a profit was generated in 2015. That trend continues in 2016. Profitability has increased mainly on account of higher net non-interest income and lower net loan impairments. Banks are experiencing significant downward pressure on their net interest income, primarily due to the continued contraction in lending activity and in part due to falling interest rates. However, a number of adjustment factors on the side of banks has limited the downward pressure on the cost-to-income ratio. The banks are shifting towards loans of longer maturities at fixed interest rates, as these carry a higher premium than short-term loans, taking into account the longer repricing period of asset interest rates. Not to be overlooked are the banking sector’s lower funding costs, which are the result of a decline in market interest rates and an increase in the proportion of sight deposits with interest rates of close to zero.

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9 By their nature, these macroprudential instruments differ from supervisory requirements for liquidity ratios at the micro level (i.e. at the level of individual banks), which are currently used in Slovenia.
Banks will face pressure on their profitability in the future owing to the expected continuation of a low interest rate environment. Opportunities to reduce deposit interest rates are limited, as these rates are already close to zero, and the possibility of a further increase in the proportion of sight deposits is diminishing. The banks’ cost-to-income ratio may thus decline, should market interest rates continue to fall and if the banks’ liability interest rates are unable to track the fall on the asset side. A greater source of concern, however, is the impending maturity of a large number of debt securities in the portfolios of banks with a relatively high yield. This is particularly important for banks that have received state aid. These securities currently account for 25% of banks’ assets and 20% of their interest income. Around 57% of securities will mature by July 2019, and it is highly probable that banks will replace them with instruments bearing a lower yield.

While falling net interest margins could be offset by an increase in bank loans, the prospects of a significant recovery in credit growth in the near-term seem low, taking into account the alternative sources of financing sought recently by the corporate sector and the commitments given to the European Commission when state aid was allocated to banks. The saving-investment gap in the corporate sector is still positive, while banks must compete with the providers of non-banking sources of financing. One major lesson of the economic crisis is that the funding model for the economic recovery should limit reliance on excessive debt financing and shift towards more equity financing, and that enterprises must only develop their core activity and purge non-core activities from their balance sheets.

The business models of banks will have to adapt to the low interest rate environment and higher costs on account of the new regulatory framework. The aforementioned positive effect on the profitability of banks will gradually diminish on account of the resolution of the banks’ remaining NPLs. Banks should optimise their business processes to reduce operating costs, and pay special attention to cost rationalisation by assessing their product portfolio and distribution channels. The consolidation of banks could lead to lower costs on account of economies of scale. It should be noted, however, that banks must avoid taking up excessive credit risks in their quest for profits in the context of an adverse external environment, and must limit the number of transactions that bear high credit risk.
EBA guidelines for the supervisory review and evaluation process (SREP) require the Bank of Slovenia to regularly analyse the business models of banks to assess business and strategic risks and the medium-term sustainability of a bank’s strategy. The European Commission is offering the Bank of Slovenia technical support in the development and implementation of a tool kit for assessing the sustainability of banks’ business models. With the assistance of the EBRD, the Bank of Slovenia is also drafting guidelines on the creation of an effective risk appetite framework and its inclusion in the methodology, procedures and processes of banks. These two initiatives will further strengthen the Bank of Slovenia’s institutional ability to perform its bank supervisory function.

_Banking sector consolidation_

Taking into account the size of the sector and the economy as whole, it is unlikely that the current structure of the banking sector in Slovenia is sustainable over the long term. We therefore _assess that the banking sector is ripe for further consolidation_. That consolidation is already in progress, with the orderly winding down of two banks and the completion of two bank mergers in 2016. The merger of another bank with the recently privatised NKBM banka is also in progress. Interest has been shown in the sale of individual banks, which creates the possibility for further mergers and/or links. The privatisation of the remaining two systemically important banks is foreseen within the next three years.

4. Fiscal policy

As a member of the European Union, Slovenia must fulfil its obligations under the Stability and Growth Pact (SGP). Fiscal developments are subject to close monitoring by the European Commission, and Slovenia must carry out substantial fiscal consolidation in line with commitments adopted within the scope of European rules and the Commission’s directives.

Slovenia has exited the excessive deficit procedure set out in the SGP, as the headline general government deficit fell below 3% of GDP in 2015. Following the elimination of its excessive deficit, Slovenia must now fulfil the requirements of the preventive arm of the SGP and make sufficient progress towards reducing its public debt from 83% of GDP at the end of 2015 to below the reference value of 60% of GDP. The SGP requires Slovenia to improve its structural
position annually by 0.6 percentage points of GDP in 2016 and 2017, and to make progress towards meeting the medium-term objective of a structurally balanced budget. The fulfilment of commitments from the SGP will be all the more challenging over the long term, as pressure will increase on pension and healthcare expenditure, while there are also risks associated with sizeable government guarantees.

The headline general government deficit is expected to fall to 2.2% of GDP in 2016, while the 2017 budget envisages a further decline to 1.3% of GDP in 2017 and to 0.8% of GDP in 2018. Key structural measures on the revenue side include a revenue-neutral tax burden distribution reform (a reduction in labour taxation and an increase in the corporate income tax rate), a reduction in administrative barriers and more effective tax collection. There are still no permanent measures on the revenue side. New savings will be achieved through lower interest costs, the extension of several temporary measures to limit the public sector wage bill, social transfers and pensions. One risk factor in that respect is the fact that wage policy for 2017 is still the subject of negotiations with public sector trade unions. Nevertheless, the government is striving to ensure that the new agreement and restrictive personnel policy will facilitate the management of public sector labour cost in line with the fiscal target. The proceeds from the ongoing privatisation process should be used for debt reduction.

The final headline general government deficit will depend on the transactions of the BAMC, which is a part of the general government but is legally independent and functions under market conditions. The underlying change in the structural position on this account cannot be estimated with precision at this time. As stated in the EC’s assessment of the 2016 stability programme for Slovenia, “there is significant uncertainty regarding the calculation of potential growth and the output gap in the specific case of Slovenia because of the specific situation of the labour market, the particularly large economic contraction in 2008–2013 and the structural reforms being implemented”.

A larger drawdown of EU funds from the 2014–2020 financial perspective is expected in 2017 (an increase from an estimated 1.5% of GDP in 2016 to 2.2% of GDP in 2017). The draft budget

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for 2017 envisions the resolution of all the delays in the drawdown of EU funds and issues owing to the slow drawdown of those funds. **Policy makers should aim for a more stable profile for the drawdown of EU funds and give priority to investments that support growth and technological development.**  

The implementation of structural measures to ensure the long-term sustainability of public finances is too slow. The Fiscal Rules Act was adopted by the National Assembly in July 2015. However, an independent Fiscal Council to oversee the implementation of the rules has yet to be appointed. Furthermore, too little has been done in terms of reforming the pension, healthcare and long-term care systems. The White Paper on pensions was released in April 2016 and is under public consultation. **Besides ensuring fiscal sustainability over the long term, the resolute and immediate implementation of structural measures would also help create the space for fiscal policy to support monetary policy efforts to stimulate demand and growth.** Fiscal policy can also support demand by changing the composition of the budget. Consideration should be given above all to reducing unproductive expenditure in the budget and increasing investment, which would improve total-factor productivity over the medium term.

**5. Conclusions**

Growth in economic activity in Slovenia remains stable. Both private consumption and private investment have increased, while net foreign demand has remained a key driver of the growth process. More investment is needed to stimulate and sustain economic growth. The pace of investment growth would increase if the institutional, regulatory and administrative barriers, or bottlenecks, that increase operating costs were effectively removed. Privatisation and the entry of private investors are also crucial for achieving higher productivity-driven growth.

The economy is recovering, while net credit growth remains negative. Growth in lending to the household sector is again positive, while lending to the corporate sector continues to contract despite monetary policy measures.

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12 The government should also ensure the requisite infrastructure to support the applicants of projects for that purpose.
The effects of monetary policy measures on credit growth have yet to be seen owing to both supply- and demand-side factors. Important supply-side reasons include the still-high level of NPLs, the European Commission’s requirements to limit the transactions and reduce the total assets of banks that have received state aid in the resolution and recovery process, and the measures that have been implemented to enhance banking supervision and improve risk management and governance standards. Also worthy of note are factors weighing down demand for bank financing, the continuing deleveraging and operational restructuring in a certain segment of the corporate sector, greater room for internal financing created by rising profitability, and the corporate sector’s reliance on non-banking sources of financing.

Monetary measures alone will not spur credit growth. Stimulating credit growth merely by lowering credit standards carries the risk of a renewed increase in the number of NPLs. Further improving the performance of the corporate sector and thus that of the banking sector is crucial. The Bank of Slovenia is actively engaged in the resolution of NPLs and encouraging the restructuring of loans to large enterprises and SMEs.

The banking system is once again generating a profit, and the stability of the system and its resilience to risks have been enhanced through recapitalisations and the partial resolution of NPLs. We are upgrading the regulatory and supervisory framework, and the macroprudential oversight framework to make the banking system more stable and less crisis-prone in the future. However, banks will likely face pressure on their profitability in the future owing to the likely persistence of low interest rates and the higher costs associated with the fulfilment of the requirements of the new regulatory framework. The business models of banks must be adapted to the new environment. Banks must also develop an effective risk appetite framework and include it in their business processes. Particularly those banks that have received state aid must improve their corporate governance, reduce the number of NPLs and continue preparations for privatisation. The latter must not stall, as any new state aid in the form of recapitalisation would require the greater inclusion of depositors in the resolution and recovery process. The Bank of Slovenia is actively developing tools for assessing the sustainability of banks’ business model and drafting guidelines for the development of a risk management framework.

Slovenia has exited the excessive deficit procedure in 2015. It should nevertheless undertake comprehensive fiscal consolidation in the short and medium terms in accordance with the
requirements of the preventive arm of the Stability and Growth Pact. That can only be achieved through permanent measures, including much-needed structural reforms to address the looming problem of public expenditure associated with the ageing population. The increased utilisation of EU funds and the creation of additional fiscal space within the bounds of European fiscal rules will facilitate the necessary support for monetary policy to ensure strong, sustainable growth.

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