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"RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS"
– SLOVENIA –

It is an honour to have this opportunity to present the recent economic and financial developments in Slovenian economy in front of you. But before I move to the recent, very positive developments, let me start with some past experiences that were not so favourable.

Background

In 2004 when Slovenia joined the EU, the economic growth was high, based on the competitive export sector, current account broadly balanced, public finances relatively sound, banking system healthy and inflation on a downward trend. Afterwards, the economic developments went astray and resulted in a short but strong overheating, which became more than evident in 2007, when Slovenia introduced euro currency. With common monetary policy not enough restrictive and domestic fiscal policy strongly pro-cyclical, the economy went into overdrive.

The crisis came in two waves. First, deep fall in global trade at end-2008 that hit Slovenia especially hard as a small open economy and resulted in large drop in industrial activity and in external trade. Second, construction bubble busted as many investment projects were put on halt due to a fall in confidence in the economy. In 2010 and 2011 there was a shy recovery but with unsolved fiscal and financial problems. In 2012 came the euro area sovereign debt crisis and Slovenia had to introduce severe austerity measures. Those included cuts in public sector wages and in social transfers and helped to keep the country's access to sovereign debt markets and to avoid the Troika Programme.

In 2013, it became evident that the banking system needed a decisive resolution. At the end of the year 2013 and in 2014, almost 4 billion EUR of state aid was injected into the banking system. Additionally, the soaring problem of NPLs that accumulated as a result of a long lasting crisis in the private sector and was heavily burdening the banks balance sheets, was tackled by establishing a Bad Asset Management Company. The impact of these operations on public finances was huge, and public debt, also for other reasons, increased to 80% of GDP in 2014, from 21% in 2008. Bank recapitalisations in 2013 alone added more than 10% of GDP to overall debt burden.

Economic recovery

Yet, this decision proved to be correct as – with contribution of ECB’s expansionary monetary policy – the costs of borrowing on debt markets fell and sovereign ratings started to improve. With strong export sector exploiting better conditions in the EU markets and decisive support from public investment financed by EU funds, GDP growth in 2014 exceeded 3%. At that time conditions on the labour market also started to improve, enabling recovery in private consumption. What was lacking was private sector investment.

It came in mid-2015 as corporate sector responded to growing domestic and foreign demand, increasing confidence, large financial surpluses and high capacity utilisation. New investment was mostly to machinery and equipment, adding much needed capacities to investment drained economy. Consumption recovery was supported also by energy inflicted deflation. All this was happening in the environment of continued contraction of lending activity in the domestic banking sector.

2016 was a year when the economy exhibited its strength of autonomous growth. A 2.5% expansion in output was recorded – one of the largest in the euro area – with a negative impact from the government investment. Nevertheless, growth in private sector investment continued as corporate sector stayed optimistic about future demand, while financing for investment was provided for mostly by large accumulated reserves of retained profits.

The latest growth in employment surpassed all expectations, in private and public sector alike. While growth in private sector wages remained subdued, there was a large increase in public sector wages. In such conditions, growth in private consumption accelerated. Through most of the year, purchasing power was still supported by deflation, but to a lesser extent than in 2015 as oil prices started recovering towards the end of the year, while there were first signs of increasing mark-ups in the economy, mostly in services. Deflation ended in the final quarter of 2016. Public finance situation was improving and Slovenia exited the "Excessive deficit procedure" in 2016 (after reporting the nominal deficit below 3% of GDP in 2015).

Despite increasing domestic demand, the current account surplus reached its new peak in 2016 at close to 7% of GDP, one of the highest in the euro area. Besides positive terms of trade, supported by low global oil and commodity prices, export sector kept expanding both in manufacturing and various types of services as the economy kept internationalising. A share of exports in GDP reached 80% in 2016.

Stable banking system despite impaired functioning of bank-landing channel

While the economy was expanding, the bank lending channel still didn’t work properly despite very aggressive monetary policy. Credit to the corporate sector continued falling due to reduced demand for loans from the corporate sector, but also due to European Commission's restrictions put upon them as receivers of state aid. Enterprises are primarily financing themselves by means of internal resources and financing from abroad. Lower demand for loans from domestic firms is also attributable to changes in the structure of the economy, with lesser importance of the construction sector. Changes in ownership due to privatisation also reduced their dependence on domestic banking system. Banks also changed their business strategies as they turned more heavily to households, increasing consumer and housing loans. Last data show rather unusual situation, namely the amount of household loans exceeded the amount of loans to corporate sector.

The improvement in the quality of the credit portfolio has been having a beneficial impact on the banks' performance. Last year's increase in profit was the result of lower impairment and provisioning costs. These are strongly dependent on the successful resolution of the bank’s non-performing portfolio: successful corporate restructuring, and the write-off or sale of non-performing claims. The banks’ net interest expenses have also continued to decline, but the sharply reduced level of interest rates and high proportion of sight deposits mean that the banks don't have much room left for additional cuts in interest expenses. Therefore, the key to managing income risk at the banks will be a gradual increase in lending activity, while ensuring credit risk is properly managed.

Outlook for Slovenia's economy

Looking at current global and domestic developments, GDP growth in Slovenia above 3% is viable. With competitive export sector, buoyant labour market, increasing purchasing power, and rising private investment, the prospects are good. In addition, public investment will start to increase due to renewed drawing from the EU cohesion funds. The economic growth will become predominantly driven by domestic factors with diminishing contribution from net exports and gradually shrinking surplus in the current account, as deleveraging processes come to an end. Nevertheless, zero or negative contribution from net exports should not be seen as a lack of competitiveness but as a sign of normalisation of the economy.

After the emergence from deflation in mid-2016, the headline inflation rose to 2.5% in February. While this appears as a substantial recovery in headline inflation, for now it is predominately driven by external factors, as it is the case for the euro area in general. Recovery in the domestic factors of inflation has been rather hesitant so far and has been limited to a rather narrow group of goods and services. Nevertheless, in light of the inflation developments in the first two months, our mid-term inflation expectations are higher than in autumn as annual average inflation around 2% may soon become a reality.

Challenges in the banking system

Growth in banks' lending is expected to gradually strengthen in the years ahead, particularly in the household segment. However, we do not expect to return to pre-crisis levels of bank lending to corporate sector any time soon, because of the reasons described before.

Favourable economic environment is expected to positively affect also growth in deposit by nonbanking sector. Furthermore, Slovenian households prefer traditional forms of saving. However, we expect that the growth rate of deposits from corporate sector will grow at the declining rate in the following years, as the precautionary motives for holding high level of liquid assets are declining, in the context of better access to banking loans and reduced uncertainty surrounding future financing. Stable growth in deposits is strengthening the stability of banks' funding structure, in which dependence on funding on the wholesale markets is declining.

The business models of banks will have to adapt to changes in environment. This is the main challenge for banks in the upcoming years. Although the bank balance sheet repair has been successful, SME NPLs remain elevated. Completing the resolution of this part of the portfolio should be one of the banks priorities. Also the further consolidation of Slovenian banking system, which is already underway could lead to lower costs on account of economies of scale.

To conclude, Slovenia has passed the critical phase, partly due to domestic policy decisions and partly due to improved conditions in the international environment. The outlook seems bright, but this should not restrain domestic economic policies to pursue long-term macroeconomic stability.