The Path to Stability and Growth: The Case of Slovenia

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Abstract

Slovenia's economic transformation is usually considered successful. It deviated from theoretical patterns: its general approach to reforms was rather conservative and was inclined to tolerate inflation. The decisive period was between 1991 and 1994 when the government implemented crucial reforms creating favorable conditions for inflation to decrease and, at the same time, turn the economy toward sustained growth. Indeed, GDP growth rates after 1993 were between 3% and 5% while inflation remained on a moderate level. Immediately before entering the EU and ERM II inflation was finally reduced.

Keywords: *economic transition, macroeconomic stabilization, sustained growth, Slovenia*

JEL Classification: E65, P20, P21, P24, P27

1. Introduction

By May 2004 the European Union (EU) had completed the transition for the 10 accession countries, at least from the formal point of view. They accepted the EU regulations which have consequently become a part of their economic system. Of course, full integration of those countries into the EU is a continuing process following the initial act of enlargement.

Most observers believe that Slovenia has made a rather successful transition from a quasi-command or quasi-market economy to a full fledged market economy. There are some obvious reasons for that: it is a small and thus manageable state which started from a comfortable position of a relatively high level of development, with the economy traditionally oriented towards Western Europe. But the Slovenian transition was characterized also by some significant deviations from the traditional patterns of transition found in other "new entry countries". In spite of these characteristics (or perhaps because of them?) economic growth

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was steady all the time, from the relatively early (in the beginning of 1993) exit from the transformational recession[1] on.

It has been little more than a decade since Slovenia gained independence and successfully exited its transformational recession. The decisive circumstances of that can now be viewed in the framework of reforms and steady growth all the way until the accession into the EU. In this paper we intend to present and explain the crucial conditions in which the macroeconomic stabilization with simultaneous growth was performed. Besides some work and analyses that have already been published on this matter[2] one of the sources for the ideas explained in this paper was also the author's personal experience in the government. A more comprehensive view is now enabled given the time difference. But of course, the final evaluation of the transition performance will be given by the successfulness of the integration into the EU.

2. Economic Development During the Transition

Slovenia, with EUR 13,677[3] GDP p.c., is on the same level as Greece and Portugal among the "old" EU members and is, together with Cyprus, a frontrunner among newly accessed members of the EU. The main macroeconomic indicators for Slovenia during its transition period are represented in Table 1.

Table 1
Selected Economic Indicator for Slovenia 1991 – 2005

Year	GDP Growth Real %	Inflation Rate % (end year)	Wages and Salaries Annual Change (real) %	Unemployment Rate % (survey based, ILO Standards)	Current Account % GDP	General Government Balance % GDP
1991	–8.9	240.6	–22.3	5.2	...	...
1992	–5.5	92.0	–1.4	8.3	6.3	0.2
1993	2.8	22.8	11.3	9.1	1.5	0.3
1994	5.3	19.5	6.0	9.0	4.2	–0.2
1995	4.1	9.0	4.7	7.4	–0.4	0.0
1996	3.6	9.0	4.4	7.3	0.2	0.3
1997	4.8	8.8	3.0	7.4	0.3	–1.1
1998	3.6	6.5	1.5	7.9	–0.6	–0.6
1999	5.6	8.0	3.0	7.6	–3.5	–1.4
2000	3.9	8.9	1.4	7.0	–2.8	–1.3
2001	2.7	7.0	3.1	6.4	0.2	–2.7
2002	3.5	7.2	2.1	6.3	1.5	–1.9
2003	2.7	4.6	1.9	6.7	0.1	–1.8
2004	4.2	3.2	–0.4	6.3	–2.1	–1.4
2005	3.9	2.3	2.3	6.7	–1.1	–1.1

Sources: Bank of Slovenia; Statistical Office of the Republic of Slovenia (various dates and publications).

[1] This term was used by Kornai (1993).

[2] Among the recent publications evaluating Slovenian development we should mention Mrak, Rojec and Silva-Jauregui (2004).

[3] This is the official data for 2005 provided by the Statistical Office of the Republic of Slovenia.

Slovenia's economic transition went through three distinct characteristic periods:

• 1990 – 1992: *Political and economic uncertainty, recession and high inflation.* Political circumstances in the region were extremely difficult for Slovenia. Most other parts of the former Yugoslavia were affected by war; a substantial part of Slovenia's traditional market was lost, and the newly-independent nation was struggling for international recognition. The encouraging elements were present in the surpluses of macroeconomic balances and in the fact that inflation started to decrease.

• 1993 – 1997: *From recession towards steady growth.* Both inflation and unemployment showed declining trends. The policy of stabilization and reforms initiated in 1992 – 1993 started to bring the results. By the end of this period the key reforms were carried out: ownership transformation of socially owned[4] enterprises and bank rehabilitation. Slovenia was also faced with a significant rise of wages and salaries, but the key macroeconomic balances were mostly kept in reasonable surpluses.

• 1998 – 2004: *Convergence.* Slovenia was approaching the EU and was faced with similar problems as most other candidates. However, the economy was already functioned as a full-fledged market economy; all former socially owned enterprises had been transformed into shareholders companies. The rates of growth were stabilized and reflected the European trends. But they were positive for the entire period, because Slovenia successfully neutralized the recession in the most important EU partners with the strengthening of markets in Eastern and Southeastern Europe. Surpluses in macroeconomic balances were not taken for granted any more and even the deficits appearing occasionally remained within acceptable limits. Inflation was moderate and seemed to be under control with a descending trend.

In 2004, from the formal point of view, the transition was concluded with the membership in the EU. Thus a new period of Slovenian economic development started.

Due to satisfactory economic performance in the first decade of independence and in the absence of greater social conflicts, the transition in Slovenia was often considered as a "success story".[5] Some encouraging signs appeared as early as in 1992, but at that time a prediction of a "success story" might have been accepted with a certain hesitation, although the macroeconomic surpluses, monetary

[4] The economic system of former Yugoslavia was much less of a planned type than in the other communist countries. The self-management system was for many years quite decentralized market oriented and open to foreign competition. We cannot speak about state ownership as the control over management belonged to the workers' councils acting more or less independent as a kind of supervisory boards. The companies were in so called social ownership with more or less autonomy.

[5] Even Mencinger (2001) agreed with that although he had often been exposed with criticism.

stabilization and a decrease of inflation gave some good prospects.[6] Later, in the mid-nineties, the expectations of a successful stabilization and turn into sustainable growth were confirmed (Kračun and Žižmond, 1997).

3. The Discussion on Gradualism

The majority of analysts evaluated Slovenia in the framework of a gradualist approach.[7] While there are many arguments speaking in favor of a gradualist approach, some macroeconomic shocks were unavoidable. Monetary reform was performed at once, as was import liberalization. One cannot speak about entirely a gradualist transition.

Had there been a choice there would have been many arguments in favor of gradualism in Slovenia. The political situation in the region and the level of market economy and development contributed to the opinion that unnecessary shocks could bring more harm than benefit to the overall economic situation. But of course there was no political consensus in the country about this matter. External experts (e.g, the Washington Consensus), on the other hand, have usually praised economic performance but criticized the too slow pace of the reforms, especially privatization.

The most significant "big bangs" that struck Slovenia were the political difficulties in the region. Economic transition of Slovenia was in the first period connected with the construction of a new independent state and with the endeavors for international recognition, while the immediate neighborhood was found in the dramatic circumstances of wars. Even though direct Slovenian involvement in Yugoslav wars was short and of minimal intensity, indirect effects strongly influenced its international political and economic situation. International recognition of Slovenia started more than half a year after factual independence while the membership in the World Bank and IMF was granted to Slovenia after a whole year, in mid 1992.

The dissolution of former Yugoslavia and the wars cut off a significant part of the markets and the redirection towards western markets was not easy, business with an unrecognized country with wars going on in the neighborhood was rather hazardous. Many companies did not survive, and consequently unemployment in

[6] The author presented the case of Slovenia in a speech delivered at the *Suedosteuropa-Gesellschaft* in Munich in October 1992 where he, due to encouraging macroeconomic results, envisaged a possibility of a "success story". This triggered a discussion among the participants who were mostly not unsupportive.

[7] See Mencinger in Chapter 5 of Mrak, Rojec and Silva-Jauregui (2004). On institutional changes see also Ovin (2001).

1991 and 1992 rose significantly (from almost full employment in the nineteen eighties to 5.2% in 1991 and 8.3% in 1992).

The characteristics of the Slovenian economy in the beginning of transition period were in many respects different from those in most other transitional countries. The level of marketization was much higher than anywhere else. The system of self management in former Yugoslavia and the reform attempts of 1980's enabled a high level of autonomy for Slovenian companies. There was nothing like central planning in the economy, most of the decisions were made autonomously within the companies, concerning of course the limitations caused by that semi-command economy.[8] Even before the transition started Slovenia was functioning with many elements of a market economy.

The proximity of the West European market was very important for the Slovenian economy. Slovenian companies met the international competition on a full scale and they acted in a completely autonomous manner. Slovenia was by far most export-oriented part of the former Yugoslav economy.[9] High involvement in the world market even before the transition started is an important characteristic that differentiates Slovenia from many other countries in transition.

The idea of a "big bang" transition, which had far more supporters than gradualism among most economists, stemmed from the assumptions which applied to other Eastern European countries more than to Slovenia. Here we were faced with less convenient political conditions on the one hand and more convenient economic conditions on the other. Eventually, too radical measures could bring to the economy harmful shocks, as the loss of a significant part of market was unavoidable because of wars. At the same time they could lessen the advantages that Slovenia already had due to a higher level of economic development and export orientation.

In spite of many arguments that could have been presented by the supporters of gradualism, the Slovenian economy was exposed to some shocks of choice as well. If one judges the transitional reforms by the well-known triad of macroeconomic stabilization – privatization with microeconomic restructuring – internationalization, in the Slovenian case some radical changes demanded rush adjustment as well. Only the privatization process took a rather slower pace: it took some time before a political consensus was reached and later the terms and procedures of its first phase, ownership transformation, were quite time consuming.

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[8] In order to stress the difference between the Yugoslav and other Eastern European systems we sometimes used the term semi command economy (Kračun, 1991).

[9] The best illustration of the Slovenian position within the former Yugoslavia is revealed in the data stating that Slovenia with 8% of population Slovenia contributed 16% of GDP and 33% of export to Western markets.

4. Monetary Stabilization

Slovenia's first stage of an independent monetary system was traumatic. In October 1991 it established its own monetary system. In four days, October 8 – 11, the existing currency, the Yugoslav dinar, was replaced with the new Slovenian tolar. This was certainly an unavoidable shock that occurred in conditions of high uncertainty and the absence of international reserves. The Yugoslav central bank was not cooperative in this effort, due to the political upheaval in the region. Indeed, immediately after the conversion the National Bank of Yugoslavia requested that foreign banks block the accounts of Slovenian banks abroad. Fortunately for Slovenia, however, foreign banks did not honor the request (RANT, 2004).

During this period Slovenia was neither a member of IMF nor even an internationally recognized country. All the international reserves remained under the control of the Yugoslav national bank. That is why the Bank of Slovenia had no other choice of instruments than control over the money supply with free floating rate of exchange. All other European countries in transition performed the monetary reform under the assistance of the IMF introducing a currency board and a fixed rate of exchange. Since Slovenia was a non-member of IMF, it could not count on its full assistance.

A couple of months after the monetary conversion the foreign currency reserves started to accumulate. Slovenian companies that kept their reserves abroad during the time of uncertainty gradually started with its repatriation. But at the same time Slovenia saw a significant rise of exports and a decline of imports simultaneously, which additionally strengthened foreign currency reserves. At the end of 1991 the foreign currency reserves of Slovenia reached the amount of 365.3 million USD and they grew to 1,167.6 million USD by the end of 1992 and to 1,569.6 million USD by the end of 1993 (Monthly Bulletin, 1994). With the loss of Yugoslav market at independence, Slovenian companies had to accept virtually any opportunity to export to Western markets regardless of the profits achieved; enterprises were like "exporters in distress". Export expansion towards the West gave the only hope for survival. Even a sharp decrease in wages was possible during this state of economic emergency.

On the other hand, the decreased import demand was also a result of separation from the Yugoslav market. As those sales fell sharply the need for imports in order to maintain production was much lower. But the remaining trade in the area of the former Yugoslavia transformed from domestic into foreign trade followed by payments in hard currencies.

Thus by the end of 1991 a recessional surplus was formed in Slovenia (it is evident from the Table 1 – in 1992 the current account surplus peaked at 6.3%

GDP while the GDP growth rate was still negative). As the foreign currency reserves grew and the monetary policy was restrictive, a balance on the currency market was soon established. In fact, internal convertibility of the Slovenian currency was enabled just few months after its introduction, even before Slovenia became an IMF member.

As a result of the balance on foreign exchange market the rate of exchange was rather stabilized. The surpluses even caused some appreciation tendencies. But inflation was still deeply rooted in the functioning of the economy. In spite of exchange rate stabilization in the beginning of 1992, disinflation was rather slow. Between October 1991 and March 1992 the retail prices grew for 95.3% and euro[10] grew for 81.3% vs. Slovenian tolar. But March 1992 to August 1992 the euro gained 7.5% in tolars only, while the retail prices were 22.6% higher in the same period (Monthly Bulletin, 1994).

In a way the exchange rate stabilization acted as a shock: it appeared unexpectedly fast and in conditions where inflation biased behavior was still a normal way of functioning. Many economists believed that the exchange rate anchor would have sooner or later stopped the inflation. But the exporting sector was caught in a snare. Most of the costs were following domestic inflation while the revenues were fixed by the rate of exchange. Inflation was not decreasing fast enough. Managed floating exchange rate regime was applied rather than exchange rate anchor policy.

5. Import Liberalization and Disinflation

Former Yugoslavia had many instruments restricting imports in order to protect the balance of payments, and were inherited in the regulation of the independent Slovenia. They were justified due to the uncertainty during the first couple of months after the independence. As a rule, protectionism always finds determined and influential defenders who are politically stronger than those advocating free trade. When internal convertibility eased switching the purchasing power to import and appreciation (in real terms) additionally decreased the prices of imported goods, the usefulness of trade liberalization was in the beginning not yet politically recognized.

During the first year of independence the Slovenian foreign trade regime[11] pursued a virtual continuation of Yugoslav's external trade policies, including protectionism. The maximum tariff rate according to GATT was augmented for

[10] It was the predecessor of euro, the European Currency Unit (ECU).

[11] For a trade policy review in Slovenia see Damijan and Majcen (2003).

about 60% with non-tariff duties and there was additional protection with quotas and widely used licenses. Slovenia tried to preserve a free trade regime with the countries of former Yugoslavia.

As early as in mid 1992 it became obvious that there was no chance to maintain a free trade regime among the countries of the former Yugoslavia.[12] The war in Bosnia-Herzegovina was on the way while Serbia-Montenegro was a target of economic sanctions by the international community. The only free trade agreements possible were with Croatia and Macedonia. In the beginning, symmetric agreements were signed. As Slovenia was far more economically developed than these partners, their viability was all the time questionable. Especially for Croatia, who was a very important trade partner, but as it was struck by the war it was not easy to maintain a relationship on equal basis. In autumn 1992, Croatia unilaterally cancelled the free trade agreement and introduced tariffs for imports from Slovenia.

This was the time when Slovenia had a surplus in the balance of payment, a stable rate of exchange and the inflation which was only slowly diminishing. It was clear to the economists that any improvement regarding inflation could be achieved only with import liberalization that would strengthen the competition on the domestic market.

When neighboring Croatia reestablished trade barriers for Slovenian goods, Slovenia abolished almost all non-tariff import barriers but the trade regime with Croatia was placed on the same level as with other countries. The general protection level was decreased, which significantly contributed to the decrease in inflation by the end of 1992.

While the monthly rates of inflation in the first half of 1992 were between 5.1% (April 1992) and 15.2% (January 1992), they sank to the rates between 1.1% (December 1992) and 3.4% (October 1992) in the second half (Monthly Bulletin, 1994). In 1993 the annual inflation rate was 22.8% with a continuing decreasing tendency (see Table 1).

Not everyone supported trade liberalization, despite the favorable macroeconomic consequences. Farmer's lobby expressed a deep discontent, even though agriculture remained highly protected. In spring 1993, protesters even blocked some roads and the Government had to retreat in some aspects of trade liberalization related to agriculture.

Import liberalization had an important influence lowering inflation, but not enough to save exporters completely. Prices in tradable sectors were stabilized almost completely while non-tradable sectors kept pushing inflation higher. The latter represented a substantial part of non-stabilized costs.

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[12] Trade in disintegrating countries was analyzed by Fidrmuc Jarko and Fidrmuc Jan (2003).

6. Wages and Recovery

From 1988 – 1992 wages[13] and salaries fell by 28.7% in real terms. This happened in the dramatic circumstances of failed reform attempts in the disintegrating former Yugoslavia, final decomposition and at the time of establishing a new independent nation. Slovenia started economic transition at the same time. In any case such a drop in personal incomes was a huge concussion.

With normalization of life in 1992, pressures from trade unions and the general public for wage increases escalated. The ownership status in the majority of enterprises was undefined before the ownership transformation, so there was a lack of institutions capable of credible action in the opposite direction to balance the forces. The first signs of economic success in the independent country increased the number of those trying to garnish it for their own fortune.

During this time export expansion could have been sustainable only if the wage costs had been kept under certain limits. The fact that the wages had not followed the inflation in 1991 and 1992 (their average drop in 1992 was 22.3% in real terms) helped in preserving the exporters' competitiveness. Even keeping wages in line with inflation could have been too burdening for exporters after the exchange rate had been stabilized. But in the second half of 1992 nominal wages started to surpass the inflation rate. For the Government this was definitely the time to act, also because many kinds of expenditures (e.g. pensions, salaries in the administration and in the public sector) were indexed to the wages.

After the elections which took place at the end of 1992, a new government was formed at the beginning of 1993. The growth of wages which significantly surpassed the inflation was among the problems that had to be addressed. Many economists[14] issued warnings about the hazardous wage growth in a small open economy that could jeopardize the encouraging results that had been reached thus far. In spite of prevailing liberal way of reasoning, the new government decided to act administratively to put wages under control. According to the constitution such an act had to be adopted by the Parliament.

However, the act proposing the limits on wage growth was not passed by the Parliament. On the contrary, the expectations of the forthcoming wage limitations triggered a jump of wages upwards. During 1993 wages and salaries grew by 11.3% in real terms. At first sight this seemed to be a serious failure which demonstrated the inability of the Government to control the excess developments of macroeconomic aggregates.

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[13] Wage formation during economic transformation in Slovenia was analyzed by Bojnec (2003, 2004).

[14] It seemed that the Government was influenced by the warnings issued by Bole (1992).

But fortunately, alongside the wage growth the first signs of recovery took place. After several years of consecutive decreases, GDP started to rise again in 1993 (annual growth rate –5.5% in 1992 but +2.8% in 1993 and +5.3% in 1994 – see Table 1). Since then Slovenia has never seen a negative rate of GDP. It seemed that the turn from transformational recession to economic recovery and steady growth began almost simultaneously.

It would be preposterous to say that the wage explosion caused the turn into recovery at the beginning of 1993 and that the main reason for the successful turn towards growth lied in the Government failure to control wages. However, to a certain extent wages could have been one of the triggers of economic recovery. After a considerable loss of markets that was caused by the Balkan wars, and despite the fact that the Western markets could absorb only a limited part of Slovenia production, enhanced domestic demand appeared suddenly. Many producers sensed the opportunity to increase their capacity utilization. Slovenia experienced the first signs of recovery as early as at the beginning of 1993 when the rest of Europe still suffered from recession.

When the European recovery started in the second half of 1993, Slovenia was ready to take advantage of the challenges and opportunities. The revival, firstly based on domestic demand, found its continuance with export increases. Thus, the positive economic developments became firmly rooted in place.

The economic recovery of that time was of course the result of a much wider web of circumstances. The role of wages attracts interest especially because of the warnings issued by many economists about the wages that surpassed the labor productivity as a rule not only in Slovenia but also in the whole region of Central and Eastern Europe (e.g. Bojnec, 2003 and 2004). There were also other favorable conditions present (most of the questions regarding privatizations had been clarified, the relations with the main international economic partners had been settled) because of which the uncertainty of the first two years of independence was lowered significantly. Favorable effects came from domestic as well as from international occurrences.

In the context of conditions for economic recovery, perhaps most important was the Ownership Transformation Act that was adopted by the Parliament in November 1992. The adoption followed rather long and controversial discussions seeking a political consensus among many options. Afterwards the way of privatization in Slovenia became transparent. The concept of ownership transformation offered favorable possibilities for internal workers and management buy-outs. The general population was satisfied with citizen certificates. This was a start to microeconomic restructuring of formerly socially owned enterprises.

At the same time, bank rehabilitation[15] was important for lowering uncertainty and increasing credibility. During the dissolution of former Yugoslavia and in the first stages of transition in Slovenia banks suffered heavy losses. Bank rehabilitation process started in November 1992 with the Bank Rehabilitation Act. At the beginning of 1993 the bad assets of the three state banks were swapped for government bonds through the state Bank Rehabilitation Agency. Slovenia issued approximately 1.9 billion DM in bonds, less than 10% of GDP at that time. From that time on business was much less risky. By 1997 the bank rehabilitation process was successfully completed.

Because of these acts (the Ownership Transformation Act and the Bank Rehabilitation Act), by 1993 companies could act in a much more stable and predictable macroeconomic environment than before. A decrease in inflation and currency convertibility eased business operations. For a variety of reasons, it was also important that the balance of payment remained positive. By this time there was no longer significant uncertainty for Slovenia in international relations. It was widely recognized with established diplomatic relations with all the important countries and a member of relevant international organizations. Thus economy was supported with the necessary international infrastructure.

In spring 1993 Slovenia concluded, the cooperation agreement with the (then) European Community. It confirmed the Slovenian orientation towards EU membership and settled the mutual trade relations. Asymmetric trade liberalization finally eliminated all the barriers that impeded Slovenian exports to the European Community.

7. Tolerance to Inflation

Since 1993 all of the macroeconomic indicators except inflation have been favorable. Inflation was moderate (as defined by Dornbusch and Fisher, 1993). However, the decrease of inflation after it reached a moderate level demands high social costs, while the results can be modest or even questionable.

The comparison of inflation between Slovenia and other transitional countries reveals an important difference. In other transitional countries inflation appeared suddenly at the end of 1980's with the beginning of the liberalization process. It was considered a new phenomenon in a centrally planned economy as inflation was not a way of life for these generations and tolerance to inflation was not developed.

Slovenia inherited its inflation from the former Yugoslavia where it represented the way of life for some decades. Generations living there in the 2nd half of the 20th century did not have any other experience of economic life but with inflation. With the separation from the former Yugoslavia and the establishment

[15] Bank rehabilitation process was thoroughly explained by Štiblar and Voljč (2004).

of an independent monetary system, Slovenia had the chance to build up an economy without inflation for the first time after many decades. At the beginning the monetary reform was followed by an exchange rate stabilization process with positive macroeconomic balances, which in turn enabled the turn into disinflation. In spite of disinflation tendencies at the beginning during the second half of the 1990's the inflation persisted at close under 10% annually.

The main reason for this continued inflation could not be found in any of the macroeconomic balances. The current account was in surplus during the most of the years of the last decade (see Table 1). The general government's deficit usually amounted to 1% to 2% of GDP. But there was strong inflation inertia. In the decades of living with inflation the population and companies developed many mechanisms to survive in the time of inflation.[16] Some of them were even formalized. Many aggregates were indexed – wages and salaries, interests, prices in the controlled sectors. As a consequence, life with inflation was much easier, but every move triggered a chain of secondary price corrections which made inflation persistent.[17]

Currency stability was never questionable as the current account was mostly in a slight surplus (Table 1). On the other hand, non-tradable prices, wages and other indexations were pushing the costs to such extents that the Central bank had to enable some currency depreciation. Controlled floating and sterilization of surplusses allowed certain adjustment to inflation, although the conditions on the currency market were favorable to a fixed rate of exchange or even slight appreciation.[18] There was a tradeoff between moderate inflation and a loss of export competitiveness. Before 2001, moderate inflation was less evil: with a deliberate depreciation the external damage of inflation was partially neutralized. However, till mid 2001 inflation persevered at over 8%, which was too high for entering the EMU.

8. Fulfillment of the Remaining Maastricht Criteria

For Slovenia fulfilling of the fiscal part of the Maastricht Convergence Criteria[19] has never been in question: the general government deficit has never surpassed 3% of GDP (see Table 1) and public debt remained under 30% GDP which is considerably below the reference value at 60% GDP. With disinflation after 2002 Slovenia met the monetary criteria as well. The long-term interest rate

[16] Links between certain measures of economic policy and prices were calculated with a dynamic interdependence model in Kračun (2000). Later, the same model was used by Beko and Festić (2004) to present disinflation scenarios for Slovenia in 2004.

[17] We defined the Inflation Multiplier (Kračun, 1999).

[18] Exchange rate policy was analyzed by Bole (1997) and Bole (2004).

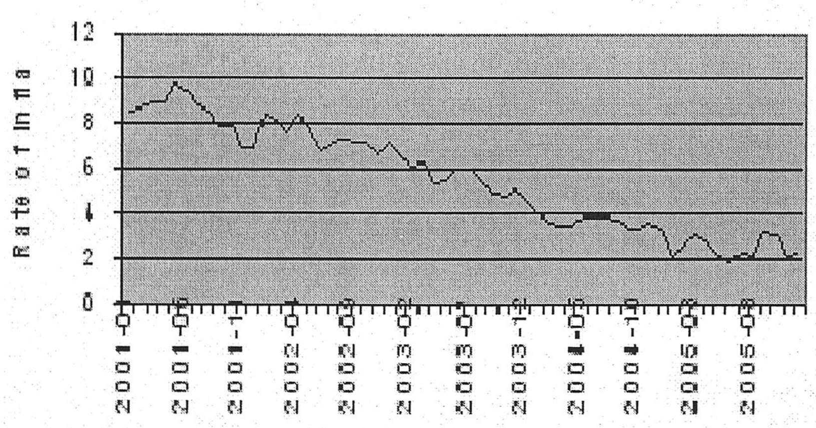
between September 2003 and August 2004 averaged at 5.2% while the reference value was set at 6.4%. The exchange rate of Slovenian tolar is fixed since the date of entry into ERM2. But the reference value for inflation[20] was under the actual inflation rate in Slovenia (ECB, 2004) till 2005.

The thesis of a "less evil" inflation as long as it remained in one digit rate when experiencing high rates of GDP growth, moderate unemployment and balanced macroeconomic accounts was defendable only until the final preparations for entering the EU and EMU. After 2000 all the measures and instruments that had eased life with inflation turned into burdens. To decrease inflation to dimensions acceptable for entering the EU and EMU Slovenia had to abolish all ways of indexing.

A decisive decrease came not earlier than immediately before entering the EU and the ERM 2 exchange rate system. Namely, as late as in 2001 a new monetary policy was adopted, with a primary objective of price stability, and it was supported by structural reform including de-indexation of wages and financial contracts. In July 2004 Slovenia entered ERM 2 with inflation having an explicitly decreasing trend.

Figure 1

Annual Rates of Inflation % from 2001-01 – 2005-12



Source: Monthly Bulletin (2006).

[19] Five criteria for the economies seeking to join European Monetary Union (EMU) – the Maastricht Convergence Criteria are: "Annual inflation should be no more than 1.5 percentage points above the average inflation rate of the three EU countries with the lowest inflation; long-term interest rates should be no more than 2 percent above the average of the three countries with the lowest inflation; budget deficits should be no higher than 3 percent of GDP; the national debt should be no more than 60 percent of GDP; and exchange rates should be within the normal bands of the ERM and should have undergone no realignments for at least 2 years." Cited from Mrak, Rojec and Silva-Jauregui (2004), p. 129.

[20] Calculated for the September 2003 to August 2004 period it was 2.4%.

As we see from Figure 1, the tendency of inflation between 8% and 10% remained after 2000. The decisive downward turn of the trend occurred in mid 2001. Until end 2005 the rate of inflation sank under 2.4% annually.

Beside de-indexation discussed above, and other domestic efforts (such as monetary policy with primary objective of price stability, supportive fiscal policy and progressive liberalization of financial markets) some exogenous occurrences also contributed to the inflation decrease. As the US dollar started to depreciate the cost push of substantial part of imported inputs was eased. In addition to the slowing depreciation of the Slovenian tolar against the euro, it also appreciated strongly against US dollar in 2002 – 2004 (see Table 2).

Table 2

Inflation and Exchange Rates 2001 – 2005

Year (end)	2001	2002	2003	2004	2005
Inflation %	7.0	7.2	4.6	3.2	2.3
Exchange rate EUR %	4.7	4.0	2.8	1.3	–0.1
Exchange rate USD %	10.4	–11.9	–14.3	–7.2	12.7

Sources: Bank of Slovenia; Statistical Office of the Republic of Slovenia (various dates and publications).

The cycle of inflation which has been deeply rooted in Slovenia for the last half of a century finally got its epilogue. It was more persistent than in other countries accessing EU not only because of the history, but also because of the fact that all other economic indices offered a rather favorable picture. There was no spectacular big bang action against inflation. It corresponded to a rather conservative approach that characterized the transitional reforms in general. But due to the entering the EU and EMU no more tolerance against inflation was possible. Finally, in 2005 Slovenia fulfilled the Maastricht convergence criteria for inflation as well.

9. Conclusions

Slovenia's economic transformation can be considered successful by most criteria. Its final stage will be full integration into the EU and EMU, so the final appraisal of its transformation will depend on the role that Slovenia is going to play in the EU. Further, the role that the enlarged EU will take over in the world economy is also important.

Of course every transition is different. There are two important areas where Slovenia's transition deviated from theoretical patterns that had been developed at the beginning of the East European transition process. On one hand, the general approach to reforms was rather conservative and had more elements of gradualism than shock therapy. On the other hand, Slovenia tolerated inflation to a higher extent than this was acceptable for other EU accession countries. But both deviations had their reasons, as discussed above. The final result should be a proof of their relevance.

The gradualist approach is usually legitimated with a high level of economic development and the presence on the international market before the start of transition. Political conditions in the region dictated caution as well: disintegration of the former Yugoslavia and the Balkan wars were among strong arguments for prudence and for avoiding unnecessary shocks. But there were many moves deviating significantly from the gradualist pattern, namely a monetary reform and the liberalization of imports. That is why Slovenia can be considered to have experienced a widespread gradualist approach, but not about a consequent gradualist pattern.

Tolerance to inflation could be understood in the gradualist framework as well, but there were more far-reaching reasons. Until the end of the 1990's Slovenia decided to pursue some other priorities than fighting inflation at any price. Economic growth, decreasing unemployment and the maintenance of export competitiveness were among those ranked highest. As the macroeconomic balances were acceptable, moderate inflation could have been under control without any risk of galloping. As late as a couple of years before entering the EU and ERM 2 disinflation had to be positioned as the first of targets. This approach was confirmed with a steady economic growth from the exit from transformational recession in 1993 till today.

A decisive period in which the foundations of later economic growth were set was during 1991 – 1994. During this period crucial reforms started and the turn from recession into growth succeeded with a simultaneous decrease of inflation to a moderate level. This passage cannot be aligned into any single pattern, and neither can these experiences be generalized without any limitations. But the sequence of monetary reform and stabilization followed by import liberalization created favorable conditions for decreased inflation and economic growth. At the end of the day, even the increase in wages and salaries contributed to the recovery in spite of the opposite efforts of the Government: thanks to the impulse of domestic demand the economy was prepared for the European recovery few months later.

The ultimate argument for the successful transition was growth which preceded the entering the EU. Rates of growth after 1993 were between 3% and 5%, even during the years of recession in the neighborhood countries. The lowest growth was 2.7% during the world-wide recession year 2003, but the collected data for 2004 and 2005 show considerable improvements. Thus Slovenia has entered the EU with the dynamics of a good base for further integration. In many ways Slovenia has shown that each country's story is unique, and that there is not just one way to successfully transform an economy.

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