



# SLOVENIA AND THE EU: SUCCESSES AND CHALLENGES



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SLOVENIA

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**E**normous political, economic and institutional changes started in Slovenia in the 1980s, way before Slovenia formally entered the EU in May 2004. I was asked to assist in transitioning from the Yugoslav economic system of self-management to a market economy. Professionally and academically, these were exceptionally exciting times but came with enormous responsibility and exhausting work.

It started with a military conflict that followed the declaration of Slovenia's independence. A new country could only start functioning with proper institutions and capacity building and with worldwide recognition. The positive spirit, the perception of a bright future, and the joy of achieving the dream of our own independent country, were extremely motivating, and professionally strong leaders contributed to the success of this formidable task.

The main driving force for reforms was the goal of joining the clubs of developed countries: the EU, the EMU, the OECD, the Schengen zone... In Slovenia, public support for the country's integration into these institutions was amongst the highest among all the candidate countries.



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The fear of failing to complete formal integration in the first wave forced leaders to put the most skilled and experienced individuals to top positions. They not only led very prudent and growth-enhancing economic policies (monetary as well as fiscal) but also negotiated good terms in integration agreements (i.e. EU Association Agreement).

The transition and integration tasks were extremely demanding as there were no established good practices and the structure of the economy was very specific. Opinions on the best course of action differed greatly. The views expressed sometimes came from opposing angles, often reflecting vested interests. The most heated disagreements were on how to privatize and on whether to adopt a fixed or flexible exchange rate policy. I was heavily involved in these discussions, not only academically but also as coordinator of many consultancy projects for the government and as a member of strategic councils. I was also appointed to a number of executive positions, such as chairman of Slovenian SEC and as Minister of Finance.

### **First 15 years of transition (from 1989 to 2004)**

In the early 1990's there was a wide discussion on the sequencing priorities of the transition countries – first, structural changes and then macroeconomic stability or vice versa, a gradualist or

a 'big-bang' approach. Transition countries also set the goal of joining the EU and the EMU. To achieve this successfully, nominal and real convergence was necessary, which required additional complex (and difficult) economic decisions, including structural changes to mitigate new exogenous shocks, and additional economic policy constraints.

In Slovenia, gradualism was the main characteristic of this period. In the first phase, until 1995, the priority was macroeconomic stabilisation; structural adjustments prevailed in the second phase until 2000; and in the third 'landing phase' entering the EU and ERM2 in 2004.

By 1999, Slovenia achieved a considerable level of macroeconomic stability with stable economic growth and low unemployment. However, market structure distortions and a slowly deteriorating fiscal stance were major macroeconomic concerns. Additionally, EU accession commitments and the fixed horizon of convergence triggered changes in the macroeconomic environment. Capital controls had to be removed, VAT and excise duties introduced, and economic policy constraints increased. Policy goals were changed, targeting short-term, nominal Maastricht criteria. To prevent the potentially high macroeconomic costs of reduced real convergence, additional structural and macroeconomic policy changes were necessary in the landing phase.



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In this phase, I served my first term as Finance Minister. We used two strategic principles of economic policy: not allowing equilibrium in one main macroeconomic segment to be achieved by disequilibrium in other segments, and high coordination of monetary and fiscal policy.

Monetary policy focused on controlling domestic demand to curb prices of non-tradables. A flexible exchange rate policy allowed interest rate differences between the Slovenian currency, the Tolar, and foreign exchange-denominated financial claims, to be kept equal to the Tolar risk premium.

Fiscal policy was active in achieving fiscal convergence criteria and, in coordination with monetary policy, in supporting convergence of nominal long-term interest rates and inflation. Measures like de-indexation, lowering of inflation expectations, mitigating supply side price shocks, government debt restructuring, stricter control and restructuring of government spending, were implemented. The interplay of both policies enabled us to meet the Maastricht criteria with relatively high economic growth, low unemployment and external equilibrium.

A positive climate in society with demanding accession commitments on one side, and sound economic policy with deep structural changes on the other, lead to a fast nominal and

real conversion process. From 1995 to 2004, GDP per capita in PPP as a percentage of the EU28 average increased from 75% to 85% while maintaining the highest GDP per capita in PPP terms among transition countries.

### **Second 15 years (from 2004 to 2019)**

Unfortunately, this next period recorded a standstill leading to the same 85% in 2017 as in 2004. Joining EMU greatly reduced the flexibility of economic policy and the European Union's ill-designed methodology for estimating the structural fiscal stance caused erroneous economic policies with enormous loss of GDP during the crisis.

Abandoning the stability paradigm when the economy was overheated after elections in 2004, lead to a pro-cyclical economic policy with anti-pension reforms, an increase in public sector wages (+17%), an intensive highway program, tax cuts (equivalent to 2.5% GDP), and a switch from domestic to foreign public debt, etc. The European Commission's overly low estimate of the structural fiscal deficit did not give the badly needed warning and we entered the crisis in 2008 unprepared with a 164% increase in gross foreign debt since 2004, a huge structural fiscal deficit, and a substantial loss of competitiveness.



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The new government in 2009 was unable to unblock the political standstill, which followed the shock of the economic crises raging at the time. Important measures (i.e. recapitalization of banks) were prevented due to political disagreements within the government and between key institutions (i.e. Bank of Slovenia and Ministry of Finance). Although necessary pension and labour market reforms were adopted, they were subsequently blocked by the (miss)use of referenda.

Due to an extremely tense political situation, the next two governments were short-lived. The 2012 government set a pro-cyclical economic policy of austerity with reduced public sector wages and employment and frozen pensions. Bold public announcements of austerity measures and even the need for 'Troika' assistance caused the biggest ever reduction in consumer, business and investor confidence with expected consequences. However, the pension and the labour market structural reforms were adopted, and the State Sovereign Holding (SSH) and the Bad Bank were established as recommended by the Commission.

The 2013/2014 government was heavily guided by the recommendations of the Commission within the excessive deficit and macroeconomic imbalance procedures and by poor access to financial markets. It successfully implemented structural reforms to rebuild the trust of financial markets and competitiveness, i.e.

changes in the constitution, bank recapitalisation, making SSH and Bad Bank operational, and major corporate restructurings. As austerity measures were not fully implemented and EU funds were successfully drawn, highly needed domestic demand was not repressed anymore. All this enabled the switch from negative to positive economic growth.

In the next government (2014-2018) I served again as finance minister in the first half of the term, which was an overwhelming intellectual challenge. After a thorough economic analysis we opted for counter-cyclical economic policy of reaching stability with growth. The concept was extensively debated with the European Commission and differences of opinions helped us to avoid important mistakes. The structure of the orientation was:

### 1. Fiscal stimulus:

- Drawing all remaining EU funds (net 2.9% GDP) of the previous financial perspective
- Positive public expenditure growth, but lower than revenue growth
- Mid-term fiscal objective not in 2017 but in 2020
- 2015 – goal only less than 3% headline deficit, not structural effort
- 2016, 2017 – EU reduced requested fiscal effort for Slovenia due to misguiding structural estimates



2. Domestic private demand: restoring business and consumer confidence with: political stability, non-aggressive decision making, social agreement, public sector wage agreements, continuous improvements of business environment, etc.
3. Improving public investment: projects with higher GDP multiplier, improved control
4. Structural changes: fiscal sustainability, restoring private sector financing, improvements in the business environment, reducing administrative burden, improving competitiveness.

The economic results were outstanding. However, due to a long period of hardship during the crisis, public attitude towards politics was very negative and reaching unpopular but necessary policy decisions was very hard work.

### **The next 15 years**

The crisis revealed that the EMU is not well designed for downturns. For geographically peripheral euro area countries, after 2005, the costs of inappropriate signals from the key European fiscal framework indicators were enormous. Detecting the wrong estimates of potential output for Slovenia in 2016

helped to avoid new, painful consequences. Especially in small peripheral countries, national macroeconomic stability needs a new logic as well as the European stabilisation framework. Lessons learned are reflected in the controversial debate on deepening the EMU. In my opinion, irresponsible behaviour of 'the periphery', the usual starting point of these discussions, is not the main reason for the EMU's weaknesses.

The following table clearly shows that when all economic policy instruments were available, mostly before entering the EU and ERM2 in June 2004, Slovenia's economic policy was much more prudent than that of the core or the euro area as a whole.

There are two reasons. First, the ECB's monetary policy serves the needs of the Core and is ill suited for the Periphery. Second, fiscal rules immobilise fiscal policy, especially during crises, they are highly pro-cyclical and thus detrimental, especially for the Periphery, where the contagion starts. The Periphery, with its specific economic structures, is much more prone to asymmetric shocks and also serves as a shock absorber for the Core (i.e. Vienna agreement, real estate investments in Spain...). Such differences cannot be overcome by structural reforms. Slovenia will never replicate Germany's economic structure for numerous reasons e.g. size, infrastructure, geography, specialisation, labour force.



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2004

	General gov. balance % of GDP	General gov. debt % of GDP	GDP growth in %	GDP PPP pc EU28 = 100
Euro area 19	-3,0	68,4	2,3	110
Germany	-3,7	64,8	1,2	119
France	-3,5	65,7	2,8	109
<b>Slovenia</b>	<b>-2,0</b>	<b>26,8</b>	<b>4,4</b>	<b>85</b>

2017

	General gov. balance % of GDP	General gov. debt % of GDP	GDP growth in %	GDP PPP pc EU28 = 100
Euro area 19	-0,9	86,8	2,4	106
Germany	1,0	63,9	2,2	128
France	-2,7	98,5	2,2	104
<b>Slovenia</b>	<b>0,1</b>	<b>73,6</b>	<b>5,0</b>	<b>85</b>

Source: Eurostat

automatic response and not a slow process of conditionality that sometimes results in the forced privatisation of state assets at low prices bought by the Core.

## Instead of a conclusion

I am very proud that Slovenia was in the first group of transition economies to join the EU. The country benefited enormously in the first 15 years of its transition, during its accession phase. Despite some disappointments in the second 15 years, the pride is still there. Nevertheless, there are still many intellectual challenges left for the EU to overcome before it can realise its full potential to promote economic prosperity in a peaceful, sustainable and harmonious European society.

Thus, the actual problem is that the Periphery lacks essential economic policy instruments to respond pre-emptively or at least immediately to neutralise shocks. The system should primarily be decentralised. The centralised part should enact a fast, rather