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Combating the Financial Crisis: Will Slovenia Make It?

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By selling the shares in Mercator company on 14 June, which was the biggest privatisation in Slovenia since the beginning of the financial crisis, this country has begun the main phase of the implementation of a structural reform programme. It includes a number of measures, to be executed from July, and aimed at restoring the stability of the banking sector and the country's economy. However, privatisation of the banks and consistent reduction of budget expenditures will be essential. Any failures in either regard may result in Slovenia becoming yet another eurozone country dependent on a bailout from the European Stability Mechanism.

Austerity Plan. The problems with the banking system in Slovenia have been enumerated in many reports, and the recent economic survey published in April by the Organisation for Economic Cooperation and Development only proved that this country is in need of further, immediate structural reform in order to escape a severe banking crisis. The report indicated that the main reasons for the breakdown in the banking sector included excessive risk-taking, weak corporate governance of state-owned banks (the so called "bad loans" of Nova Ljubljanska Banka, Nova KBM and Abanka Vipa reached €7 billion), and insufficiently effective supervision tools. At the same time, the OECD recommended that the Slovenian government recapitalise and privatise these banks and improve the insolvency procedures, which would be ways to overcome debt in the banking sector.

In response, the Slovenian government announced in May a reform package which presumed the privatisation of 15 significant state companies, including Slovenia's second biggest bank Nova KBM, Telecom Slovenia and Adria Airways. The government pledged not to retain controlling interests in any of these, and to undertake further privatisation if required. The sale, of all government-held shares in Mercator, the largest Slovenian supermarket chain, helped earn almost half a billion euro (a year ago the shares were worth twice as much). In addition, the government's intention is to create a "bad bank" which would take over "bad credits" from three state-owned banks. This is to be followed by a rise in the basic value added tax rate, from 20% to 22%, and in the lowest VAT rate, from 8.5% to 9.5%, as of 1 July, which would bring €1 billion to state budget. Another half billion euro is to be saved through cuts—among other things—in the salaries of public servants. According to the government, the savings measures will allow Slovenia to decrease the budget deficit form 7.8% as forecasted for this year to some 3.3% in 2014, but may contribute to the deepening of the recession.

Slovenia's Financial Crisis. Extraordinary austerity measures are needed for Slovenia because it was hit heavily by the effects of the global financial crisis, which revealed the failings in this country's economic policy, especially in supervision of the banking sector. Slovenia was the first EU newcomer to change its national currency for the euro, which took place in 2007. This enabled Slovenia to perform even smoother trade exchange with its main foreign partners: Austria, Germany, France and Italy, which were receiving more than half of Slovenian exports. The favourable situation on the European markets, a small and export-oriented economy, and loans from domestic banks for enterprise development, helped Slovenia's economy to grow faster than any other in Europe. Within five years of joining the EU, Slovenia's GDP per capita had rocketed from €17,300 to €23,000, and unemployment had dropped from 6.7% to 4%.

The situation started to change rapidly during the global economic crisis. At the beginning of 2009 Slovenia experienced a sharp GDP slump of –7.9%, and within one year unemployment had risen to over 10%. Declining external demand for Slovenian products in the European markets, lower domestic consumption and ineffective implementation of economic reforms consolidated the recession. It became clear that the economic boom was in great measure built on the banking sector financing Slovenia's vast domestic activity with a very ineffective system of loans, which were challenging to pay back in the situation of the breakdown on European markets.

Political Repercussions. Unfavourable macroeconomic indicators, including a rise in unemployment to 12%, led to the fall of Borut Pahor's social-democratic government and to Slovenia's first early election in December 2011. Its results brought Janez Janša—the prime minister from the country's golden era of 2004-2008—back to power.

Despite the new government's announcement of reforms and austerity measures, the European Commission revealed in 2012 that the general government public debt exceeded 50% of GDP (up from 22% in 2008). This clearly indicated that no structural reforms had been implemented successfully in Slovenia. Apart from the economic situation, corruption scandals involving Prime Minister Janša contributed to yet another government collapse, at the beginning of 2013. The new prime minister, Alenka Bratušek, has aimed to conduct reforms in line with external recommendations, in order to help Slovenia escape the need to use the European Stability Mechanism—which would require much more severe reforms.

Conclusions. Restoration of Slovenia's economic stability will be reliant on the efficient restructuring of the banking sector and on the course of privatisation of other enterprises with state-held shares, as well as on the implementation of unpopular structural reforms. The government has not yet announced a potential buyer for Nova KBM. If the processes go as slowly as in the case of the reform package prepared by previous government, the public deficit might grow even more. This could mean the failure of the savings programme and the need for negotiations with the Eurogroup, regarding a financial assistance package. In such a scenario, the collapse of yet another government cannot be excluded.

On the other hand, although it is not likely that Slovenia will recover from the recession before 2014, the commitment to the recommendations of both the OECD and the EC may enable this country to prevent further fiscal problems. Smooth privatisation, and recapitalisation by foreign direct investment, would help increase the stability of the banking sector. Nevertheless, the consequent implementation of cuts in government spending will also be vitally important. And, since the EU Member States' economies are interdependent, the general situation in the eurozone, especially the growth rate of Slovenia's trading partners, are other factors that will influence this country's recovery.

If Slovenia does need international financial assistance, it would mean that the crisis zone has moved northward, from the southern peripheries of the EU (Cyprus, Greece, Italy, Spain and Portugal). This could not only contribute to bringing the recently-emerging prospects of a divided Europe between the economically stable north and the uncertain south closer to reality, but could also have regional repercussions, with all of the Balkan countries being perceived as belonging to the latter group. Consequently, on one hand, it may result in increased reluctance from the EU-17 when Bulgaria and Romania intend to join the eurozone. On the other hand, the Western Balkan countries may be treated in a stricter manner regarding fulfilment of the economic criteria to become EU Member State. In this respect, Croatia's performance after joining the Union in July 2013 will be crucial for the image of the Balkan states' economic transformation.

Due to the small size of the economy of Slovenia (a nation of about 2 million inhabitants), the potential exacerbation of the crisis in its banking sector will have no direct impact on Poland and other Central European countries. For the same reason, the EU will be able to make use of existing instruments if financial assistance is needed. Despite this, any difficulties in the eurozone are not favourable for Poland. This is not only because the Polish economy and domestic growth is greatly reliant on eurozone economies, but also because any further problems in the EU-17 may contribute negatively to the internal debate in Poland on the launching of preparations for entry to the common currency area within the coming years.

The case of Slovenia proved that a stable structure of the economy—including effective and politically independent supervision of the banking sector—are prerequisites for sustainable economic growth. In this context, it is important the state financial supervision institution has respect. In Poland, the system for securing deposits, run by the Bank Guarantee Fund, is considered to be more stable than similar solutions in many other countries of the eurozone, and these standards should be maintained. Due to the heavy reliance of the Polish banking sector on large banking groups from the eurozone, it is desirable to track the processes leading to the unification of supervision of eurozone banks, within the framework of the so-called Banking Union.