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6 Political Independence and Economic Reform in Slovenia

Boris Pleskovic and Jeffrey D. Sachs

With the dissolution of Yugoslavia and the Soviet Union, twenty new independent states have emerged where there were previously two. In each of these new states, there is an urgent agenda, including the creation of state institutions (fiscal authority, tax authority, central bank, border control, etc.), macroeconomic stabilization, and economic transformation from a socialist economy to a market economy. These momentous changes are generally being carried out under conditions of extreme political uncertainty, typically with legislative bodies that are only partially elected, or that were elected under the old regime, and with constitutions that are holdovers from the Communist period.

Of all the new countries, the one that has gone the furthest in economic reform is Slovenia. Slovene independence from Yugoslavia was achieved in steps during the period December 1990–October 1991 (see table 6.1). By the end of this process, on 8 October 1991, Slovenia introduced its own currency, the Slovene tolar, thereby becoming the first of the new states to achieve monetary independence.[1] As we shall stress, monetary independence has been highly effective in sparing Slovenia from the resurgence of hyperinflation in the rest of the former Yugoslavia in 1992.

Even with relative successes in the areas of macroeconomic stabilization and trade liberalization, Slovenia has proceeded far too slowly in the area of privatization. The delay in implementing privatization was not accidental but rather the result of intense political infighting of a sort that is being played out

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1. The first state of the former Soviet Union to achieve monetary independence, Estonia, benefited by a careful examination of Slovenia's experience (Hanson and Sachs 1992).

Table 6.1 Timetable to Independence

26 December 1990	Referendum on independence passes with 90% approval. Slovene government appeals for loose confederation of Yugoslav republics, to be negotiated during the next 6 months
25 June 1991	Declaration of full independence and sovereignty, 6 months after referendum. Outbreak of war on 27 June 1991
7 July 1991	Brioni Accord, sponsored by the EC, calling for 3-month delay in implementation of full sovereignty, to pursue further negotiations
8 October 1991	Full independence and monetary reform, 3 months after Brioni Accord
15 January 1992	Recognition by the EC

throughout Eastern Europe and the former Soviet Union. On the one side are the non-Communist parties of the center and right that argue for a widespread distribution of shares to the general public; on the other side are lobbying groups of state managers and the new left-of-center parties that have succeeded the previously ruling Communist party who together are fighting for a transfer of ownership to the managers themselves. Similar political infighting has delayed several structural adjustment measures in Slovenia, including a much needed banking reform.

In this paper, we seek to explore Slovenia's progress in the triple tasks of state building, stabilization, and transition to a market economy. We begin with the political history of Slovene independence and then turn to the sequence of economic policy measures that accompanied the process of political independence, with special emphasis on monetary reform, macroeconomic stabilization, and the debate over privatization. We also examine the early evidence on Slovenia's trade prospects, related both to the breakdown of trade within Yugoslavia and to the shift of trade toward Western Europe. We conclude by outlining the priorities for the future, which include privatization and financial restructuring of commercial banks and enterprises.

6.1 Overview of Slovenia

Before 1991, Slovenia was most recently an independent country in the seventh century, when it was known as Carinthia. It was subsequently incorporated into the Frankish empire and later into the Hapsburg empire. In 1918, Slovenia joined Croatia and Serbia to establish Yugoslavia. When Yugoslavia became a Communist state under Marshall Tito's leadership following World War II, Slovenia became one of the six republics of the new socialist state. It became independent in 1991.

Yugoslavia, it is well known, chose a distinctive path of socialist development after Tito's break with Stalin in 1948. Industry was socialized, as in the rest of Eastern Europe and the Soviet Union, but was not subjected to central planning after 1965. Market forces were given more scope, and enterprises were left with significantly more autonomy than in the Stalinist states. Ownership was deemed to be "social" rather than "state," on the ostensible grounds that enterprises were managed by workers' councils rather than through centralized branch ministries. Yugoslavia also maintained a trade pattern that was distinctive among the socialist economies, in that the direction of trade remained heavily toward Western Europe rather than toward the other socialist states. Yugoslavia was never a member of the Council for Mutual Economic Assistance (CMEA) trading arrangements.

We will have occasion to discuss the ownership patterns in Slovenia later in the paper, but at this point it is worthwhile to clarify the distinctive features of the Yugoslav socialist model. While a vast economics literature emerged to describe Yugoslavia's "market socialism" and "workers' management system," the economic realities in the Yugoslav socialist economy were quite different from the idealizations in the academic literature. More important than the ownership and control structure itself was the fact that Yugoslav industrial enterprises were far more market oriented than their counterparts in Eastern Europe. These enterprises traded with Western customers, had considerable flexibility as to choice of inputs and outputs, and had some flexibility related to prices. In general, there was not a chronic shortage economy in the industrial sector or in the consumer markets, so that inputs were available on a fairly reliable basis. As a result of these factors, many Slovene companies were able to compete in name-brand markets, where quality and reputation are paramount, something unheard of among East European enterprises.[2] A good illustration is the Slovene ski manufacturer Elan, which successfully entered the Western ski market.

6.1.1 Economic Structure

Slovenia is the richest East European country. Its income per capita was over U.S.$6,100 in 1990, compared to an overall Yugoslav average of U.S.$3,060 and an average in the non-Slovene part of Yugoslavia of U.S.$2,800. While its income per capita is comparable to Greece and Portugal, and despite its relative openness, the industrial and employment structure of the Slovene economy has important similarities to other East European countries. As in other socialist economies, open unemployment was practically nonexistent in Slovenia until recently (Abraham and Vodopivec 1991).[3] Also, the Slovene economy, like others of Eastern Europe, is heavily concentrated in industry, compared with OECD countries, which have much larger service sectors (see table 6.2). In terms of employment and output, Slovenia is different from the rest of Yugoslavia, possessing a very small agricultural and a large industrial sector.

2. Some argue that the geographic location of Slovenia made its economy and its people even more exposed than those of the other Yugoslav republics to market forces.

3. There was, however, open unemployment in other parts of Yugoslavia, and the overall unemployment rate of Yugoslavia had reached 12.8 percent in 1990.

Table 6.2 Structure of GDP, 1988

	Agriculture	Industry	Services
Value added:			
Slovenia	4.5	51.5	44.0
OECD	2.8	33.0	64.1
Employment:			
Slovenia (1989)	9.9	50.9	39.2
OECD	9.4	30.0	60.6

Source: For the OECD, *The Economist Book of Vital World Statistics* (New York: Random House, 1990), 36. For Slovenia, *Development Issues of the Statistical System: Gross Domestic Product of Slovenia in 1987–1988,* no. 3 (Ljubljana: Statistical Office of the Republic of Slovenia, December 1991).

Other similarities between Slovenia and other East European countries include a very small privately owned sector, full employment with substantial excess demand for labor, and a relatively well-educated labor force. Slovenia also resembled other East European countries in the existence of a soft budget constraint for its enterprises, low labor mobility, and political intervention in enterprises in terms of investment and employment.

The Slovene economy is relatively open. Representing just 8 percent of the total Yugoslav population in 1990, Slovenia accounted for 20 percent of the gross domestic product (GDP) in the former Yugoslavia and 29 percent of total Yugoslav exports. In recent years, the volume of external trade (excluding the former Yugoslavia) amounted to U.S.$10 billion, equivalent to about 95 percent of the Slovene GDP, with exports exceeding imports by about 5 percent of GDP. In 1991, about 80 percent of merchandise trade was conducted with developed countries, 14 percent with East European countries, and about 6 percent with the developing countries. Major trading partners have been Germany (25 percent) and Italy (16 percent). As mentioned above, the former Yugoslavia was not a member country of the CMEA. Most of its trade with the former Soviet bloc was conducted in convertible currencies. In recent years, about 25 percent of the total sales by Slovene enterprises were exported to the markets of the former Yugoslavia. In 1992, trade with the rest of Yugoslavia has declined sharply, as we shall note below, and has shifted away from Serbia and toward Croatia because of the UN blockade of Serbia.

6.1.2 Political Developments

The first free elections in Slovenia were held in April 1990. The center-right coalition of six parties, called DEMOS, won the elections with a 52.9 percent majority. The opposition was represented by four parties on the left, combining political forces emerging from the now-divided Communist party. Legislative power is shared by three chambers in the Parliament. Every law has to be agreed on by each of the three chambers. The first two chambers were elected directly by the entire electorate. The third chamber, represented mainly by managers of social enterprises, was elected by the employees of enterprises only. Although a new constitution was adopted in December 1991, abolishing the third chamber, Slovenia will maintain its old institutions until the next elections, scheduled for the end of 1992.[4]

Despite a weak majority, DEMOS was able to avoid political instability at the beginning of its rule. Since most parties held the common goal of obtaining independence for Slovenia, there was more or less a nonpartisan spirit in the Parliament during the war and struggle for independence.

Following the recognition of Slovenia and the achievement of the main goal that had unified the parties, intense political infighting began. Political parties and interest groups had by then become better organized, and the economic reforms became increasingly politicized. The democratic parties argued for quick and transparent privatization of social enterprises and banks, including denationalization. On the other side, the opposition defended a gradualist reform process in order to prolong the life of the old system, under which it continues to hold major positions.

When it became clear that the two sides could not reach an agreement, the opposition started to block major legislation, including privatization, through the third chamber, where it had a majority. This resulted in a paralysis of the Parliament, which lasted for months. In April 1992, the government lost a motion of nonconfidence, and a new coalition of center and left parties formed a new government.

The experience of Slovenia seems to confirm recent cross-country research, which has shown that multiparty governments are especially prone to parliamentary paralysis (Sachs 1992). Some expected that the more developed and open Slovenia would pursue market reforms, including privatization, vigorously and serve as an example for the rest of Eastern Europe. These expectations were met to some extent since substantial progress was made in several areas of economic reform. An enormous task was accomplished, especially with respect to state building, monetary reform, and macroeconomic stabilization. On the other hand, Slovenia's relative prosperity may have reduced the sense of urgency regarding the major structural changes, including privatization and financial restructuring.

6.2 Economic Conditions before Independence

6.2.1 Yugoslav Hyperinflation

The Yugoslav economy was characterized by stagnation and unstable and rising inflation during the 1980s. Average output growth was 0.6 percent in the period 1981–89, as compared to 6.4 percent during 1974–80 (Estrin and Takla

4. After we wrote the paper, elections took place in December 1992.

1991). Open unemployment averaged 14 percent during the period 1981–89. Inflation started to accelerate in 1983, reaching about 70 percent in 1985, 90 percent in 1986, and 2,800 percent in 1989. The economy reached hyperinflationary rates of 50–60 percent per month at the end of 1989. At that time, Slovenia was still part of Yugoslavia and, as part of the dinar area, was subject to the same hyperinflation.

The hyperinflation was caused by chronic fiscal imbalances that resulted in a heavy debt structure, both of enterprises and foreign debt. The most interesting aspect of the Yugoslav hyperinflation, however, was that a significant component of the money in the economy was indexed money. This was a reflection of an acute case of currency substitution in the form of deutsche mark–denominated deposits within the banking system. Guest workers in Germany were encouraged to repatriate savings through the availability of deutsche mark–denominated accounts. These accounts were so popular, in view of the high and unpredictable inflation rate, that more than 80 percent of household monetary savings were in foreign-currency-denominated deposits by November 1989 (Banka Slovenije 1991). In addition, there was significant formal and informal indexation of wages and salaries.

This meant that there was little room for credit expansion without fueling inflation, as the ability to collect an inflation tax was almost nil. In addition, under the guidance of the International Monetary Fund (IMF), the key interest of which was maintaining Yugoslavia current on its external debt servicing, the Yugoslav authorities in 1988 and 1989 pursued an undervalued real exchange rate policy, in which the nominal exchange rate was steadily devalued in order to try to meet an undervalued real exchange rate target. Since each ratchet of the exchange rate was almost immediately matched by a rise in domestic prices and wages as well as in the dinar value of the domestic money supply, the devaluations were able to achieve the real exchange rate target only at the cost of rapidly accelerating inflation.[5]

An underlying cause of rising inflation throughout the 1980s was the inability of the federal authorities to exert any monetary control and to enforce financial discipline on enterprises. Enterprise losses increased from a measured 3 percent to 15 percent of GDP in the second half of the 1980s, although these data do not take sufficient care in distinguishing nominal from real interest costs of enterprises in measuring their true losses. These losses were accommodated by the banking system, within a system of soft budget constraints. And, despite its relative flexibility, the Yugoslav economy still suffered from political intervention at the enterprise level, with significant restrictions on free trade and partial control of prices. In 1987, only around 40 percent of prices were freely determined, and 48 percent of imports were subject to licenses.

5. This outcome of a real exchange rate rule for exchange rate policy has been observed extensively in Latin American countries, most notably in Brazil, the pioneer of the so-called crawling peg.

With a background of stagnation, poor financial discipline of enterprises, banks, and governments at all levels, and a drift toward hyperinflation, a systematic reform process began in the late 1980s, with a comprehensive stabilization package being introduced at the start of 1990. The government gradually liberalized most prices and imports between 1988 and 1989. As a result of this policy, the federal price office was abolished, and 87 percent of imports were liberalized by the end of 1989. At the same time, the government started enterprise and banking reforms.

6.2.2 The Markovic Program

In January 1990, the federal government under the leadership of Prime Minister Ante Markovic implemented an anti-inflation stabilization program. The program included current account convertibility of the dinar, an initial 20 percent step devaluation of the dinar at the start of the program, and tight fiscal and monetary policy. The policy of a crawling peg was abandoned, and a fixed exchange rate of seven dinars per deutsche mark was established to provide a nominal anchor to the system; it was held at that level throughout 1990. The government also froze nominal wages for six months at the start of the stabilization program. The program quickly brought down inflation to nearly 0 percent in April 1990.

Incomes and demand policies started to relax again in the summer of 1990 since the federal government was unable to implement the complementary structural reforms required of the program (including the bankruptcy of major loss-making enterprises) and thereby to maintain overall financial and wage discipline. The monthly rate of inflation increased to 2 percent in July and 8 percent in October, before falling to 3 percent in November and December 1990. Money in circulation rose by 138 percent in the ten months to the end of October, compared with an increase of retail prices of 110 percent, revealing a relaxed monetary policy (Estrin and Takla 1991). The breakdown of financial control and incomes policy was caused in part by the start of the centrifugal political process in the republics, which eventually led to the disintegration of Yugoslavia.

In the middle of 1990, a series of free elections started in the different republics, for the first time in forty-five years. Intent on garnering public support, political leaders in the republics began to chafe at the monetary and incomes restrictions of the Markovic Plan and began to seek ways to circumvent them. About the same time, Prime Minister Markovic began to run for office in a federal election foreseen at the end of the year. He formed a party and raised the wages of public-sector workers substantially as part of the election campaign. These events undermined the stabilization program and raised inflationary expectation in the public. Retail prices in Yugoslavia increased by 122 percent from December 1989 to December 1990.

The current account of the balance of payments deteriorated over the year. In the summer of 1990, exports fell sharply. To improve exports, the federal government devalued the currency, from seven to nine dinars per deutsche mark, on 28 December 1990. However, the prospect of stabilizing the economy further deteriorated after the central bank branch located in Serbia issued U.S.$1.3 billion of currency, in late December 1990 and early January 1991, that had not been authorized by the main office of the central bank.

At the beginning of 1991, the Yugoslav economy had a budget deficit of U.S.$2.6 billion, a 10.9 percent decline in industrial output, resulting in a 20 percent decline in GDP (for 1991 overall), and an unemployment rate of 18 percent (Chamber of Commerce 1991). The increasingly independent republics refused to pay taxes to the federal government, owing to political differences concerning the restructuring of the federation, and the National Bank of Yugoslavia relaxed monetary policy. A new inflationary cycle began; monthly price increases accelerated to double-digit levels in mid-1991, effectively marking the end of the economic reform program launched in 1990.

Although the stabilization program was successful in its first phase, it began to fail when monetary policy and financial policies were allowed to return to their previous laxness in the second half of 1990. What Yugoslavia's experience shows is that an effective stabilization program requires a determined and strong government to enforce a strict monetary and fiscal policy and financial discipline on enterprises and local government.

6.3 Slovene Independence

Under pressure from the Slovene public, as a result of growing political differences with the rest of Yugoslavia on the future direction of the federal state as well as the rapidly deteriorating economic situation, the Slovene Parliament voted to hold a referendum on independence on 26 December 1990 (see table 6.1 above). The referendum produced a 90 percent majority in favor of independence. After the referendum, Slovenia proposed a six-month period of negotiations with the other Yugoslav republics to form a loose confederation in the country. Six months later, and after no progress in the negotiations, on 25 June 1991 the Parliament of Slovenia declared full sovereignty. On 27 June, the Yugoslav armed forces attacked the country. Ten days later, the European Community (EC) helped bring about a cease-fire. An agreement, called the Brioni Accord, was reached in which Slovenia agreed to a three-month delay in implementation of full sovereignty in order to give time for further negotiations between Slovenia and the rest of Yugoslavia.

Three months after the Brioni Accord, and with no progress in the negotiations, the Parliament reactivated the implementation of independence laws. The drive toward independence was also spurred by the psychological effect of the attempted bombing of the Yugoslav prime minister by the Yugoslav air force during a visit by Markovic to Croatia and a rumor that the central bank in Belgrade intended to flood Slovenia with dinars. These events led to the early introduction of the national currency. The parliament called for the introduction of the Slovene tolar on 7 October 1991, and the government and monetary authorities undertook monetary reform the next day. On 15 January 1992, Slovenia was recognized by the European Community. Recognition by several other countries followed immediately and by the United Nations six months later.

6.3.1 Economic Steps toward Independence

In the spring of 1991, the government of Slovenia designed a macroeconomic program for the economic independence and restructuring of Slovenia (Assembly of the Republic of Slovenia 1991). The program, which was subsequently passed by the Parliament, had five elements: (i) monetary independence, (ii) macroeconomic stabilization, (iii) financial restructuring of loss-making enterprises, (iv) restructuring of commercial banks, and (v) privatization. There was also a wide range of legislation undertaken to establish the basic economic institutions of a sovereign state.

The macroeconomic program was designed as a comprehensive package of interrelated market reforms to be launched simultaneously with independence (Lipton and Sachs 1991). While the preparation started in all areas of the package at the same time, not all steps of the program were implemented in the order originally intended because of several unexpected turns of events. The declaration of independence did not lead to immediate sovereignty. War broke out, disrupting the work of the government and forcing the government to design and implement an emergency economic program instead of preparing long-term economic reforms. At the same time, under the Brioni Accord, the government agreed to three months of further negotiations, which again upstaged consideration of long-term reforms. When Slovene sovereignty was achieved, state-building activities, particularly issues of national defense, received most of the attention.

Among economic reforms, only the most urgent ones, monetary reform and macroeconomic stabilization, received wide political support. Under the circumstances, privatization and financial restructuring of enterprises and banks were not perceived as immediate priorities by the Parliament and the major political actors. Of the three closely related structural reform issues, privatization was considered as the most important. When privatization became a political issue, the other two reforms were put on a waiting list. Preparatory work continued on all three reforms, and the expectation was that, when privatization passed the Parliament, the others would follow immediately. As in the rest of Eastern Europe, however, privatization has proved harder than expected. Unfortunately, the delay of privatization slowed down the needed restructuring of banks and enterprises. In spite of this delay, enormous progress was achieved in most other areas of the economic program, especially monetary and fiscal reforms and institutional development, as discussed in the following sections.

6.3.2 Monetary Reform

In March 1991, the political leadership decided to make all the necessary preparations for the introduction of a new currency.[6] The new national currency, which was to be stable and convertible from the outset, was meant to isolate Slovenia from the inflationary chaos in the rest of Yugoslavia. The basic idea was straightforward. All bank accounts, domestic wages, prices, and other contractual relations were to be converted automatically from dinars to the new currency, the tolar. Currency in circulation was to be physically converted during a short period of time. The new currency was to be the sole legal tender after conversion and was to trade freely with international currencies on a convertible basis and also float freely vis-à-vis the Yugoslav dinar (Pleskovic and Sachs 1992).

To this end, actions were carried out on three fronts. First, steps were taken to create a central bank that was capable of carrying out credible and disciplined monetary and exchange rate policies. These steps included the drafting of a central bank law that assured its independence, the development of a policy design and control unit in the new central bank, and, perhaps more important, fiscal reforms to minimize the pressures for monetization of budget deficits. These steps resulted in the central bank law and the macroeconomic program adopted by the Council of Ministries in September 1991.

Second, to make the new currency convertible, legislation was adopted that established a unified market for foreign exchange, without the previous sharp socialist distinctions between households and firms. With a unified foreign exchange market, the central bank could intervene to carry out its exchange rate policy using a market-based approach.[7]

Third, the logistics of the conversion process required sufficient preparation to ensure a swift implementation that would minimize economic disruption and any chances of aggressive action by the federal government or by other republics. In the event, the conversion process was carried out in three days without halting the entire economy. However, the central bank board continued

6. Provisional notes were printed by the end of 1990 for emergency purposes, but there was no specific economic program for the monetary reform at the time. These notes were intended to be used in case the central bank in Belgrade stopped supplying Slovenia with dinar notes.

7. During the spring and summer of 1991, the National Bank of Yugoslavia maintained a substantially overvalued exchange rate that was harming the export-oriented republics of the north. As part of a strategy to minimize the effect in Slovenia of Belgrade's return to currency inconvertibility and overvaluation of the dinar in 1991, two foreign exchange markets were allowed in the Slovene territory prior to the introduction of a national currency. The first of these markets was a scheme (known as the EDP) that essentially allowed enterprises to operate at the free market rate of the dinar rather than the overvalued official rate. The second of these markets was meant to bring the black market into the financial system, allowing all individuals to trade foreign exchange within the system. The main trader in this market was the Ministry of Finance, which used the opportunity to build up some reserves for the government at the expense of running a fiscal surplus. The development of this market, just after the war, was instrumental in minimizing the effect of the uncertain political environment on tourism and border trade.

to convert dinars into tolars in special cases for several weeks after the initial deadline.

Several issues arose throughout the implementation of the process just described. Other monetary options were considered and discussed widely prior to the introduction of the new currency. These included the use of a currency board (in which the tolar to deutsche mark conversion rate would be irrevocably fixed and the currency would be fully backed by foreign exchange reserves) and the introduction of a parallel currency to circulate alongside the Yugoslav dinar, in which case both currencies would remain legal tender, at least for a while. The currency board was ruled out because Slovenia did not have foreign exchange reserves and external financial support could not be secured to allow the arrangement to succeed. The parallel currency alternative was dismissed from the beginning because it would only aggravate the existing currency substitution without isolating Slovenia from the ravages of Yugoslav hyperinflation (Pleskovic and Sachs 1993). The political leadership, under Prime Minister Lojze Peterle, stood firmly behind the concept of having a single national currency, designed to be stable and convertible from the start.

In addition, and as has already been mentioned, the introduction and management of the new currency was a fairly detailed process, and not all steps turned out as originally conceived (Jaramillo-Vallejo and Pleskovic 1991). The implementation started on 7 October 1991, when the Slovene monetary unit, the tolar, was declared by the Parliament as the sole legal tender in Slovenia, thus allowing the monetary reform to take place. The commercial banks, the Social Accounting Service, and the post offices were closed for most transactions during the three days starting 8 October 1991. The conversion of dinar banknotes into tolar banknotes was mostly accomplished in the first day and a half since Slovenia has a population of only 2 million and the amount of dinar cash in circulation was limited after several years of hyperinflation.

As planned, all bank accounts and all contracts were converted at a one-to-one ratio with the existing dinars. Dinar cash notes were converted into tolar notes, up to a limit of 20,000 dinars per person without restrictions. Dinars collected by the Bank of Slovenia (the central bank, hereafter BOS) during the conversion were deposited and frozen at the central bank, waiting for later negotiations with the rest of Yugoslavia.

The major motivation for the monetary reform was to protect the Slovene economy from hyperinflation, a fate expected for the Yugoslav dinar. As it turned out, these expectations were correct. Yugoslav inflation has grown very rapidly since October 1991, reaching 102 percent per month in July 1992. In contrast, in Slovenia, monthly inflation peaked at 21.5 percent in the month of conversion (resulting mainly from the depreciation of the tolar in the conversion process). Since then, the monthly inflation rate gradually fell to 5.1 percent in April 1992, to 2.0 percent in July 1992, and to 1.4 percent in August 1992. This deceleration in inflation took place without the use of price controls, although there was a temporary wages policy through February 1992. The monthly inflation rates of Slovenia and Yugoslavia are shown in table 6.3.

The differences in inflation also show up when comparing the free market exchange rate of the Slovene tolar and the black market rate of the Yugoslav dinar. As of 8 October 1991, the exchange rates were the same, as the tolar was substituted for the dinar on a one-to-one basis. Thereafter, the dinar has continued to depreciate rapidly vis-à-vis international currencies as well as against the tolar. By April 1992, the tolar purchased eight dinars (at the black market rate of the dinar). Exchange rate developments are shown in table 6.4. As described below, the tolar foreign exchange market was actually segmented, with the result that there were three relevant rates (by June 1992, the rates had largely converged). The free market rate is shown in table 6.4.

Slovenia started its monetary conversion without any foreign exchange reserves at the central bank. Foreign exchange reserves in commercial banks equaled $204 million at the end of September 1991. The improvement in the trade balance, due to the rapid recovery of exports and the compression of imports, together with a large amount of inflow of private capital, resulted in the banking system's having U.S.$1.0 billion in net foreign assets by August 1992. Private capital inflows were spurred by the new housing privatization program and by the introduction of capital account convertibility in the household market. At the same time, the BOS built up foreign exchange reserves from zero in October 1991 to about U.S.$660 million in August 1992. The positive trade balance reflected tight demand management, supported by an initial real devaluation of the tolar at the time of the monetary conversion, as well as the convertibility of the currency, which ended the antiexport bias of the overvalued dinar.

6.3.3 The Tolar Foreign Exchange Market

Immediately after the introduction of the new currency, the BOS organized the foreign exchange system in two separate markets. The government and enterprises were allowed to participate on the main market, while households had to carry out all their transactions on the parallel market. There were multiple exchange rates established for the main market: the official rate, the interenterprise rate, and the interbank rate. There were additional restrictions imposed on enterprises, as described below.

The initial foreign exchange policy was severely criticized by many observers, ourselves included. First, the critics pointed out that interbank meetings could not represent an appropriate vehicle for foreign exchange determination because of the monopolistic structure of commercial banking in Slovenia. Second, they emphasized that, in order to create an effective foreign exchange market, it is necessary to include all the players, including enterprises, banks, and households, and to remove restrictions on enterprises (Jaramillo-Vallejo 1991).

Reacting to political pressure, the BOS gradually relaxed some of the re-

Table 6.3 **Monthly Inflation Rates of Slovenia and Yugoslavia**

	Slovenia	Yugoslavia
1991:		
October	21.5	18.8
November	18.7	16.6
December	15.4	18.2
1992:		
January	15.2	26.1
February	11.0	42.2
March	11.5	43.2
April	5.1	72.2
May	6.5	80.8
June	5.9	102.2
July	2.0	62.0
August	1.4	42.4

Source: For Slovenia, Bank of Slovenia (1992); for Yugoslavia, communications from the Republican Statistical Office of Serbia; and various 1991 and 1992 issues of *Ekonomska Politika* (Belgrade).

Table 6.4 **Exchange Rate Developments in Slovenia and Yugoslavia**

	Tolar (free market)/DM	Dinar (black market)/DM	Dinar (black market)/ Tolar (free market)
1991:			
October	38.50	38.50	1.00
November	42.28	48.00	1.12
December	42.16	55.00	1.30
1992:			
January	45.75	85.00	1.86
February	52.31	125.00	2.40
March	52.70	220.00	4.17
April	56.15	450.00	8.01
May	53.02	580.00	10.93
June	51.17	1,300.00[a]	25.40
July	53.35	300.00[b]	5.60

Source: for Slovenia, Bank of Slovenia (1992); for Yugoslavia, various 1991 and 1992 issues of *Ekonomska Politika* (Belgrade).

[a]Effect of the UN blockade against Serbia and Montenegro.

[b]Denomination by 10.

strictions and changed its foreign exchange policy. It decided to implement a second-best policy, creating three foreign exchange markets that operate simultaneously: the interenterprise market, the official market, and the household market. The official market deals with the need for servicing foreign debt and making payments of essential imports through the budget and receiving payments of custom duties and taxes. The official exchange rate is used only in the official market. The interenterprise market deals with the need for current account transactions, while the household market serves individuals.

Exporters were initially required to surrender 30 percent of export proceeds for official purchases at the official exchange rate because of the BOS concern with the reserve buildup. In December 1991, when BOS felt more comfortable with its level of reserves, this requirement was repealed. In the interenterprise market, enterprises were allowed to sell and purchase foreign exchange among themselves or with commercial bank intermediation, at market-determined rates. Until mid-April 1992, enterprises were given only forty-eight hours to sell their foreign exchange earnings. After forty-eight hours, the individual enterprise had to sell its foreign exchange to the BOS at the official rate. To reduce the negative effect of this policy, the BOS started issuing foreign exchange–denominated CDs to exporters in January 1992. These CDs carry market interest rates and can be traded on the stock exchange.

The household market operates through a network of officially licensed foreign exchange offices. Until March 1992, the official exchange rate was between 10 and 49 percent lower than those in the other two markets. Since then, the differences among the rates have rapidly declined, and, by June 1992, all three rates had practically converged. In June 1993, the official exchange rate was 51.08, compared to the free market (interbank) rate of 51.17 (Bank of Slovenia 1992).

6.3.4 Fiscal Policy Reform

In order to achieve full economic independence from Yugoslavia through an independent and stable currency, Slovenia needed fiscal independence. In addition, the stabilization program required tight fiscal policies to control budget deficits. Slovenia has been quite successful in both modernizing the tax system and controlling budget deficits. However, much remains to be done, especially in reorienting public spending to better serve the needs of the restructured economy.

In the past two years, the government has undertaken significant reforms in taxation and fiscal consolidation. Under the self-management system, Slovenia had a very decentralized public sector. Public-sector agencies had independent authority to administer expenditures and set taxes. Most public services, such as health care and education, were financed through earmarking at various community levels. The republican government budget was responsible only for government administration and subsidies to the economy, accounting for less than 20 percent of total public-sector expenditures.

Tax reform started in 1990 and was implemented on 1 January 1991. The reform replaced old taxes and contributions with standard taxes on personal income and corporate profit and a simplified sales tax. Taxation on enterprise income was significantly reduced, while sales taxes were increased in 1992 to compensate for the loss of revenue. The reform also consolidated all the previous off-budget funds, with the exception of the pension and health fund, into the central government budget. So far the reform has been successful and is being continued, with preparatory work for introducing a value-added tax.

Under the Yugoslav system, Slovenia was not allowed to borrow in order to finance budget deficits. Thus, the government would adjust expenditures to match the revenues. For this reason, there was no need to make a drastic fiscal adjustment in 1991 since the republican budget had been traditionally balanced (Jaramillo-Vallejo 1991). This also means that the stabilization program in Slovenia did not require "shock" therapy, from the point of view of reducing a large fiscal deficit.

The overall public sector formally registered a surplus in 1991 amounting to 2.1 percent of GDP. In 1991, total expenditure of the public sector was reduced to 41 percent, compared to 49 percent of GDP in 1990. The reduction was possible because of lower transfers to the federal government. However, owing to arrears incurred by public utilities, the health care system, and local governments, the actual fiscal stance might have been more lax than reported.

An important accomplishment of the monetary reform in Slovenia was that the links between fiscal policy and money creation were severed by the government. Although the government might have accrued arrears in the budget, it has not financed its expenditures with loans from the BOS. This is an important change, compared with the previous policy of the federal government. Nevertheless, the Slovene government will need to continue to make efforts to balance the actual budget expenditures and improve financial discipline in the future.

In the 1992 budget, real increases are planned for administration, defense, agricultural subsidies, and investment programs in the infrastructure sector. Total public expenditures are projected to increase to 46 percent of GDP. A deficit of about 1.2 percent of GNP is projected. The deficit is expected to be financed mainly by borrowing from the domestic capital market.

The main weakness of the 1992 budget is that it puts too much emphasis on state security, for example, defense and police, while neglecting the need to restructure the economy. No financial resources are provided in the budget for bank and enterprise restructuring. The budget ignores increasing losses and indebtedness of enterprises and banks and the need for a comprehensive reform in these two sectors. A serious reform effort and future privatization will most likely result in increased unemployment, thus requiring additional resources for a social safety net. The 1992 and future budgets will need to take these issues into account in order to speed up the transition toward a market economy.

6.3.5 Institutional Reform

Compared to the East European countries, and similar to the new states that emerged out of the Soviet Union, Slovenia has faced enormous institutional challenges in the past two years (Lipton and Sachs 1992; Pleskovic 1993). One of the key aspects of independence is the need to create the legal and administrative basis of a sovereign state. It is an enormous institutional, legal, and administrative task to draft the laws. The new state must also quickly make a central bank, Ministry of Finance, and other institutions, largely taking existing institutions and turning them into self-sustaining actors. As a part of this process, the Slovene government drafted seventy-six laws, most of which are economic laws representing the legal cornerstone of independence.[8] The list of laws is shown in appendix table 6A.1.

A great deal of the macroeconomic events of the first year consisted of establishing the legal, administrative, and political base for state independence. Thus, Slovenia was faced with the task not only of reorienting its institutions to fit the needs of a market economy but also of building completely new institutions, sometimes from scratch, ranging from border controls and customs to the central bank.

In terms of economic institutions, the first priority of Slovenia was to establish its independent central bank and the necessary banking legislation. The task of creating a new central bank was facilitated to some extent because, in the former Yugoslavia, each republic had its own branch of the National Bank of Yugoslavia (NBY). The republican national banks, as they were called, together with the NBY, implemented monetary policy. While the Bank of Slovenia (formerly the National Bank of Slovenia) still needs upgrading and technical assistance to function as an independent modern central bank, substantial progress has been made in a short period of time.

To facilitate the privatization process, Slovenia established in March 1990 the Privatization Agency and the Development Fund. Both institutions were created as state-owned enterprises. The Privatization Agency's function is to monitor the privatization process, while the responsibilities of the Development Fund are limited to management and disposal of shares obtained from privatization. The role of the two agencies has been so far limited to the sale of a few enterprises to foreign owners, the evaluation of enterprises, and the preparation of legislation. As of the summer of 1992, no institutional arrangement has been made for restructuring chronic loss-making enterprises. However, there is growing pressure to deal with financial restructuring of poorly performing enterprises because of increasing losses.

Slovenia established the Bank Restructuring Agency in September 1991. An Enterprise Restructuring Agency is under consideration. The primary role of these two agencies will be to deal simultaneously with increasing debt, competition issues, and the poor financial performance of the banking sector and loss-making enterprises.

The government recognized the need to consolidate the existing twenty-three ministries into fourteen and has submitted the relevant legislation to the

8. There were other laws, e.g., for defense, police, and administration, that were important for achieving independence. Those are not included among the seventy-six laws, which focused primarily on economic legislation.

Parliament. The proposed legislation will, for example, abolish the Ministries of Planning and Industry. On the other hand, the role of the Ministry of Finance will be strengthened as part of the reorganization, which includes the establishment of a Treasury.

Slovenia has recognized that one of the most pressing needs is to design a legal framework for market activities. To that end, in the spring of 1991, the government conceived and started to draft sixty-one laws. The majority of these laws are related to economic reform. The list of the laws was submitted to the Parliament as part of the macroeconomic program in the fall of 1991 (see app. table 6A.1). The laws range from new auditing and accounting legislation to an antimonopoly law. The laws are at various stages of preparation, as seen in the table. Some of them (e.g., housing privatization, denationalization, pension, and health insurance laws) have already passed in the Parliament, while others (e.g., company, enterprise privatization, and bankruptcy laws) were submitted to the Parliament but have not yet been acted on.

6.4 Reform Agenda and Structural Adjustment

6.4.1 Current Economic Situation

Slovenia has been successful in carrying out the goals of political independence while at the same time achieving stabilization and carrying out fundamental economic reforms. Given difficult circumstances, including a civil war and a major loss of Yugoslav markets, Slovenia has performed relatively well during the last two years of transition from a socialist to a free market economy.

As in other East European countries, economic stabilization in Slovenia has been associated with a sharp initial decrease in output. Real GDP decreased by 2.7 percent in 1989, 3.4 percent in 1990, and 9.3 percent in 1991. Unemployment increased from 2.9 percent in 1989, to 4.7 percent in 1990, and 8.1 percent in 1991. On the demand side, the decline in output was caused by the reduction in exports to former CMEA countries, and especially to former Yugoslav markets, as well as by a drop in domestic consumption. While the decline in output was deep, it was less severe than in most other countries in Eastern Europe. Part of the reason for this is that Slovenia was more open and market oriented before the reform started and has therefore been able to shift production to Western markets more readily.

In the spring of 1992, there was an indication of economic recovery, particularly in the construction, transport, and tourism sectors. The decline in industrial output continues in 1992, but at a slower rate than in the last quarter of 1991. The unemployment rate has increased only marginally since the end of 1991, but it remains at 11 percent, the highest level in history (table 6.5). Merchandise exports increased in the first half of 1992 to U.S.$1,960 million from U.S.$1,890 million in the first half of 1991. Imports declined by

Table 6.5 Current Economic Indicators for Slovenia

	Industry, Monthly Growth Rate (deseasonalized)	Exports of Goods and Services[a]	Unemployment Rate (%)
1992:			
January	−1.69	275.6	10.5
February	−1.44	412.5	10.7
March	−1.46	503.7	10.7
April	−1.33	459.6	10.8
May	−1.50	406.3	10.8
June	−1.12	510.6	11.0

Source: Bank of Slovenia (1992).
[a]Millions of U.S. dollars.

U.S.$450 million during the same period. As a result of the decline in output, exports as a percentage of GDP increased from 39.5 percent in 1989 to 53.2 percent in 1991 (Ministry of Planning 1992).

The economy is expected to experience a recovery over the next few years. There are two fundamental problems that need to be addressed in the near future in order to speed up the recovery. First, trade will have to continue to be reoriented toward new Western and Eastern markets to compensate for the loss of former Yugoslav and CMEA markets, and, in many cases, enterprises will have to restructure internally in order to reorient to the new markets. As we have noted, the shift to Western markets is already occurring. Second, both the enterprise and the banking sectors are burdened with structural and financial problems, which impede a quick economic recovery. An appropriate solution to these problems will require faster progress in passing and implementing legislation on privatization and restructuring of enterprises and banks.

6.4.2 Trade Reorientation

From the macroeconomic point of view, the notable aspect of independence, besides monetary reform, was the internal shock caused by the civil war. The war cut Slovenia off physically from the markets in the rest of the country. These markets accounted for about 25 percent of total sales of Slovene enterprises in recent years. The civil war and economic problems in the former Yugoslavia nearly destroyed these markets and the financial system. In 1991, these problems caused a 38 percent reduction in exports to the other Yugoslav republics.

Slovenia did not suffer a major CMEA shock since, in the recent past, less than 20 percent of total trade was with Eastern Europe and the former Soviet Union. However, owing to the decline in economic activity in Eastern Europe, trade with these countries declined by over 20 percent and with the former Soviet Union more than 40 percent in 1991.

The adjustment of Slovenia's trade has been quite remarkable, despite the war and loss of markets in the former Yugoslavia and Eastern Europe. This was possible because of Slovenia's Western orientation in trade. In 1989, 68 percent of Slovenia's external trade (not counting the Yugoslav market) was with developed industrial countries, and 8 percent was with developing countries. In 1991, trade with the West increased to 80 percent of the total. Merchandise exports (machinery and transport equipment and various consumer products) to the West increased by U.S.$68 million to U.S.$3,074 million in 1991. The companies with the fastest supply response have been in transport equipment and electrical machinery, which are the largest exporters to the Western markets.

Despite the unfavorable circumstances in Eastern Europe and the Soviet Union, total Slovene exports of goods to non-Yugoslav markets in current prices declined by only 6.3 percent in 1991. This decline was on the East European and Soviet markets. Exports of nonfactor services declined by 38 percent, owing to tourism and cross-country transportation, the two sectors most affected by the civil war. The current account of the balance of payments had a surplus of U.S.$225 million in 1991 and U.S.$330 million in the first quarter of 1992. Decreased imports and increased exports to the West resulted in a trade (goods and nonfactor service) surplus of U.S.$351 million in 1991 and U.S.$366 million in the first quarter of 1992.

In the medium term, Slovenia will have to integrate itself more closely with Western Europe. The primary short-term goal of Slovenia should also be to continue reorienting its trade from the former Yugoslav and CMEA markets to new Western and Eastern markets. To achieve this goal, Slovenia will need to continue pursuing the goal of having a convertible and stable currency that does not become an obstacle for competitiveness. To this end, Slovenia should move to a unified foreign exchange market, where the exchange rate is determined mainly by market forces (Jaramillo-Vallejo 1991). Recent convergence in the parallel and official exchange rates for the Slovene tolar opens the way for an early merging of the current three foreign exchange markets.

While it will be difficult to recover trade markets with the former Yugoslavia, an effort should be made to simplify transactions with those markets. Under the current arrangements between Slovenia and Croatia, exporters from one republic are allowed to set up a nonresident account in the other and use the balance in that account to pay for their own imports. The bilateral nature of this arrangement has made it ineffective, highlighting the need for the establishment of a free market for exchange between the tolar and other currencies in the former Yugoslavia.

Slovenia inherited the Yugoslav system of foreign trade. With the recent removal of quantitative restrictions in most sectors (except agriculture and textiles), the trade regime has become relatively liberal. Tariffs are imposed on most imported items, with rates ranging between 0 and 25 percent. In addition, a special import duty, imposed on all imports, was recently lowered from 13 to 6.5 percent. The new customs law intends to abolish the special import duty. It is proposed that import duty rates should be between 5 and 25 percent (Chamber of Commerce 1991).

6.4.3 Privatization Strategy

A political decision to privatize commercial enterprises was part of the election campaign of the winning DEMOS coalition in 1990. The privatization strategy has been focused on the start-up of new private firms and the privatization of the existing social sector enterprises. Although several laws were drafted and submitted to the Parliament, only limited success has been achieved so far.

Slovenia inherited the "social" ownership pattern of enterprises from Yugoslavia. While, in the past, enterprises in Yugoslavia were "self-managed," the system was drastically changed with the 1988 Enterprise Law and the 1989 Law on Social Capital (Milanovic 1991). These two laws limited the self-management rights of workers and allowed firms to be transformed into joint-stock companies. The laws permitted internal and spontaneous privatization and have been restricted in Slovenia because of abuses. At present, enterprises in Slovenia are neither state owned nor self-managed: property rights are undetermined. Managers, workers, and the state all have some de jure decision-making powers. However, in practice, most of these enterprises are controlled by managers, who have, de facto, almost absolute decision-making power over them.

While existing small enterprises are being privatized rapidly in Poland, Czechoslovakia, and Hungary (Gelb and Gray 1991), this type of privatization was delayed in Slovenia. Some parliamentary parties were concerned that separate privatization of small enterprises would delay the privatization of large enterprises. In addition, most retail trade and services are part of large monopolies, which are difficult to break up without a comprehensive privatization law.

New private enterprises expanded rapidly during the last two years. However, official statistics on this phenomenon are scarce, as the official data still focus on the public sector. There were 4,000 registered commercial companies in 1989, about 8,000 in 1990, and 12,000 in 1991 (Ministry of Planning 1991). Of these, about 2,600 are social enterprises. While employment in the public sector declined by 8.2 percent, private-sector employment increased by 4.0 percent and self-employment by 8.1 percent in 1991. In the same year, 16 percent of the labor force, including agriculture, was registered in private business.

The Slovene economy is still dominated by socially owned enterprises. They account for over 80 percent of value added and for 84 percent of total employment and produce nearly all statistically recorded nonagricultural output. There are about 2,600 social enterprises to be privatized, representing about 58 percent of the value of social capital (the remaining 42 percent of social capital is in infrastructure, public utilities, and the like, which generally will not be privatized in the near future). Of these, about 150 are large enterprises with over 500 employees, 750 are medium sized with employment between 125 and 500, and the rest are small.

The first debate on privatization in Slovenia focused on the issue of whether "socially" owned enterprises should be first renationalized and then privatized or whether the intermediate stage should be skipped. The issue was resolved in favor of direct privatization. Since the elections, three drafts of the privatization law have been submitted to the Parliament.

In December 1990, the government submitted to the Parliament the first draft privatization law. This law was based on the evaluation of enterprises by registered professionals. According to the draft law, enterprise managers[9] would have been allowed to gain 100 percent control over the enterprise by purchasing 10 percent of the shares at a discount, provided that they buy additional shares over the next years. The other 90 percent of the shares would have been nonvoting "preferred shares" held by the government. The managers would have had the right to purchase these shares over time. The preferred shares would have paid a dividend yield of only 2 percent. Essentially, the managers would have had ownership rights to the enterprises using the very small amount of their own money as a down payment and would have been allowed to buy the rest of the shares by reinvesting enterprise profits over five to ten years. The general public would have received only a 2 percent return on equity in the interim and no share ownership in the end.

The draft law was widely discussed, strongly supported by the existing managers, and severely criticized within the democratic coalition (DEMOS). Several weaknesses were pointed out. First, many believed that accurate evaluation is virtually impossible given the absence of capital markets. Second, the proposed law was considered to be open to speculation and unfair, benefiting a small group of existing managers. Third, taking into account the low level of domestic financial savings, the proposal was considered especially inappropriate for large, capital intensive, and expensive enterprises. For these reasons, the proposed law lost the support of the ruling coalition.

The government, under the direction of new economic ministers, designed a second draft law on privatization. This draft was based on worker-management buyouts for small- and medium-sized firms and mutual funds and other institutional investors for large enterprises with over 500 employees. For large enterprises, 35 percent of shares would be distributed to adult citizens for free, 20 percent to pension funds, and 15 percent to a special "compensation fund," the shares of which would have been distributed to individuals meriting compensation as a result of the confiscation of private property in the course of Yugoslav

9. The draft law stated that managers and workers would buy the shares. However, with an average salary of approximately U.S.$200.00 per month, workers would hardly be in a position to buy them.

nationalizations of the late 1940s and early 1950s. Ten percent of shares would be distributed to workers free of charge, and 20 percent would be bought by workers and managers at book value.

In the fall of 1991, the second draft law passed the two democratic chambers of the Slovene Parliament, but then it was blocked in the third chamber. The third chamber (the chamber of "associate labor") represents socialist managers under the old Communist constitution. The managers filibustered for months, despite the clear majority political support for the broadly based mass privatization approach.

To avoid the blockade, the government, together with representatives of the major parliamentary parties, designed a third compromise draft privatization law. In this draft, the role of mutual funds was slightly scaled back, and the possibility of manager buyouts was enhanced, but under clear, transparent, and fair procedures. According to this proposal, 20 percent of shares would be distributed to workers and managers in their enterprises for free. Forty percent of the shares would be reserved for institutional investors. Of these, 20 percent would be distributed free to all citizens via five to ten mutual funds, 10 percent to the pension fund, and 10 percent to the compensation fund. The workers and managers would be allowed to choose between receiving free shares in their enterprises or in mutual funds. The remaining 40 percent of the shares would be sold to workers and managers or outside investors.

The compromise draft privatization law gained the support of a majority of the parliamentary parties. After intense debates in the Parliament, the concept of free distribution of shares received substantial support from the general public. A recent survey shows that 55–65 percent of the population support free distribution of shares (Tos 1992). The opposition to this concept from the third chamber of the Parliament weakened, after several of the managers-deputies started their own private enterprises. The compromise privatization law was passed by the Parliament in November 1992.

6.4.4 Financial Restructuring

Financial restructuring of commercial banks and enterprises was considered a high priority of the macroeconomic program of the government. The main goals of the program were to restore competition in both the banking and the enterprise sectors, to rehabilitate troubled banks and enterprises, and to change the ownership structure.

Slovenia inherited from the former Yugoslavia a banking sector that suffers from serious deficiencies, which impede the development of an efficient financial system. First, the banking system is heavily dominated by one bank, Ljubljanska Banka, which with thirteen associated regional banks controls over 90 percent of the banking business in Slovenia. Second, this bank and others in Slovenia are owned by social enterprises, which in turn are also major debtors and have their representatives sitting on the bank boards. Third, there is a large share of nonperforming loans in the banks' portfolios (30–40 percent) and an inadequate capital structure. Fourth, there is low confidence in the banking system, stemming from limitations on the withdrawals of households' foreign currency deposits (DM 1.8 billion) as a result of insufficient foreign exchange reserves to back the deposits.[10] Fifth, many banks are currently charging very high real interest rates for corporate loans, ranging between 20 and 30 percent per annum, apparently as the result of the existing monopolistic structure of the banking system and the poor quality of its portfolio. Sixth, traditionally, there have been very close ties between the central bank and the commercial banking system, causing problems with the effectiveness of monetary policies and banking supervision.

These issues have been widely discussed by the government and the Parliament. Eight months after the 1990 election, the situation initially worsened, when the two largest Slovene commercial banks were merged into a monopoly. Substantial progress has been made since then in improving the banking structure. Modern laws governing the central bank and commercial banking, prudential regulations, and the rehabilitation of banks have changed the banking system. Banks have been audited for the second time, and the Bank Restructuring Agency was established in the fall of 1991.

In the spring of 1992, the government prepared a partial bank restructuring program dealing separately with the problem of frozen foreign exchange deposits. The program consisted of a law to issue public bonds to cover DM 1.8 billion of frozen foreign exchange deposits of households. Because the law did not address bank restructuring and privatization, it was rejected by the Parliament.

Since then, the agency has prepared a bank restructuring program, which is currently under consideration and which draws on the independence program of the spring of 1991. Major objectives of the program are to restore the balance sheet of the banks to a healthy position, improve competition, change the ownership structure through privatization, and improve the structure and regulation of the banking system. An important aspect of the problem, still not properly addressed, is related to the financial restructuring of heavily indebted enterprises.

Although significant progress was made in revising the legal framework for enterprise activities, Slovenia has not advanced far with enterprise restructuring. Some firms have taken the initiative themselves, mainly through joint ven-

10. During the 1970s and 1980s, households were allowed to deposit foreign currency into foreign-denominated bank accounts (mostly deutsche mark denominated). This was used widely, for example, by families of Yugoslav guest workers in Germany as well as by the local domestic population. Deposits in each of the republics were credited to households, while the foreign exchange was routinely and mandatorily transferred to the National Bank of Yugoslavia in Belgrade. The central bank did not maintain these reserves in order to back the deposits in the banking system. Rather, the reserves were spent in debt servicing or in foreign exchange market intervention. Thus, the Slovene banks (mainly the Ljubljanska Banka) have foreign-denominated liabilities but insufficient foreign exchange assets, and Slovenia as a whole lacks the official reserves to provide to the commercial banks in the event of a major withdrawal of deposits. Starting in 1991, severe restrictions were placed on the withdrawal of these funds.

tures with foreign partners. Owing to the lack of privatization and bank restructuring, a vast majority of social enterprises have not made the adjustments that are needed to deal with the shift of markets and increased competition. This has resulted in the increase of enterprise losses, defaults on debts to the banking sector, and a rise in interenterprise arrears. In this pattern, Slovenia matches the experience of almost all other socialist economies in the transition to a market economy.

The financial position of Slovene enterprises has worsened since 1987. In 1991, the reported losses reached 31.4 billion tolars, or about 8.7 percent of GDP. About 100 large industrial enterprises account for two-thirds of total enterprise losses. The rest of the losses are concentrated in the public utility and infrastructure sectors. The lack of financial discipline, excessive employment, and past wasteful investments have been the main causes of the poor performance of Slovene enterprises. Past price controls also caused losses in some sectors. The losses are currently financed more or less automatically by interenterprise credits and arrears, bank loans, and, in a few cases, government subsidies, including tax exemptions.

As in other East European economies, bankruptcy has rarely been resorted to in Slovenia, mainly because the existing legislation is difficult to apply, banks are owned by social enterprises, the collateral system is underdeveloped, and there is a lack of professional experience with the process. In 1990, about 119 bankruptcy cases were initiated. In 1991, 571 enterprises qualified as bankrupt under the current legislation, but only 200 cases were initiated, as the current bankruptcy law has effectively been suspended with respect to social enterprises owing to the unusual circumstances of 1991 (the declaration of independence, the Yugoslav invasion). A new bankruptcy law is being considered by the Parliament, one along the lines of the American "Chapter 11."

One of the main factors influencing the adjustment process of enterprises is the weakness of the ownership structure in social enterprises and banks. Social enterprises in Slovenia are major owners of the banks. They have restricted the autonomy of the banks for credit allocation, thus limiting the bank's capacity to exert adequate financial discipline and worsening their portfolio of bad debts. In addition, the absence of ownership or clear control rights in the enterprises gave an incentive to managers and workers to decapitalize enterprises and increase the enterprises' debts. As a result, many viable enterprises are unable to service their rapidly accumulating debts, and many banks are close to insolvency. Therefore, a full recovery of the enterprise sector is conditional on faster progress on restructuring and privatization of banks and social enterprises simultaneously.

These facts were recognized by the government macroeconomic program in 1991. The program of financial restructuring of commercial enterprises and banks included, as the key element, generalized debt equity swaps between banks and heavily indebted enterprises, which could reduce the cash flow devoted to debt service payments. In addition, the program suggested that moneylosing enterprises should be divided into three categories: (i) manufacturing enterprises to be financially restructured; (ii) manufacturing firms to be closed down; and (iii) public utilities, infrastructure, and state enterprises to be regulated. For the first category (i.e., heavily indebted enterprises), it was suggested that the debts of the enterprises needed to be reduced prior to or as part of privatization. For the second category, the restructuring was to include a clear timetable for closure and explicit subsidies to reduce employment gradually when outright closure was not feasible because of social or economic implications. For the third category (i.e., state enterprises), it was suggested that the government should establish a system for governance, regulation, and restructuring of these enterprises into commercial public services.

For the banking sector, the program of financial restructuring included breaking up the monopoly, a change in ownership structure and privatization, implementing prudential regulation, and establishing new institutions (e.g., deposit insurance, an export bank) and new banking legislation, including antimonopoly, accounting, and auditing legislation.

6.5 Conclusion

Of all the new countries, Slovenia has gone furthest in economic reform during the last two years. During this time, Slovenia achieved political independence, stabilized its economy, introduced its own currency, and carried out fundamental economic reforms. Slovenia has made significant progress in its transition from a socialist to a market economy, despite difficult circumstances, including civil war and a loss of major markets.

Slovenia was more developed than other countries of Eastern Europe before the transition. Its economy was more open, prices and imports were relatively free, and the budget was more or less balanced. Nevertheless, it suffered from high inflation and a lack of monetary and fiscal discipline, especially at the federal level. By accomplishing successful monetary and fiscal reforms and macroeconomic stabilization with sharply reduced inflation, Slovenia has proved that it can manage its macroeconomic affairs better than the former Yugoslavia.

Slovenia is much richer and more open to the West than any other East European country. It is well ahead in terms of income per capita. But the gap is narrowing with respect to structural reforms and progress toward a market economy. Some countries of Eastern Europe, like Poland and Czechoslovakia have been quite successful in stabilizing and liberalizing their economies in a relatively short time. Poland, Czechoslovakia, and Hungary have made better progress in terms of privatization, especially of small- and medium-sized enterprises, and the rapid growth of the new private sector.

After accomplishing a successful stabilization and monetary and institutional reforms, the weaknesses of the socialist legacy of "social" ownership are becoming more clear in Slovenia. These weaknesses are reflected in an inefficient banking system and increasing losses and debts of social enterprises and banks. To overcome these problems, Slovenia has to turn its attention to the medium- and long-term problems of privatization and the restructuring of enterprises and banks. These problems deserve priority if Slovenia wants to retain a competitive edge in exports and become more efficient in its domestic markets. Restructuring of the economy will require reorientation of resources from heavy toward light industry, housing construction, and services. The social sector has to be substantially reduced and made more efficient through privatization and restructuring to reduce its heavy burden on the budget. Without privatization, enterprises will be left without incentives and the tools to restructure. While Slovenia needs to continue the stabilization policies and continue building free market institutions and legislation, privatization and restructuring are the most important issues left on the reform agenda.

Slovenia has an excellent opportunity to develop a full-fledged market economy and become integrated with Europe if it speeds up the reform process. It has all the conditions necessary to reach this goal in a relatively short time. The challenge ahead is to reach a consensus and implement the rest of the reforms needed for a well-functioning free market economy.

Appendix

Table 6A.1 A List of 76 Laws—the Legal Cornerstone of Independence

Ratified laws

1. Law on the Bank of Slovenia
2. Law on Banks and Savings Banks
3. Law on Pre-Rehabilitation, Rehabilitation, Bankruptcy, and Liquidation of Banks and Savings Banks
4. Law on Foreign Currency Transactions
5. Law on Credit Transactions with Foreign Countries
6. Law on Pricing
7. Law on the Agency Guaranteeing Bank Deposits and Savings
8. Law on Denationalization
9. Law on the Agency for Privatization
10. Law on the Development Fund
11. Law on Cooperatives
12. Law on Registration of Businesses
13. Law on Bank Restructuring Agency
14. Law on Customs Service
15. Law on External Affairs

Proposed laws[a]

16. Law on the Ownership Transformation of Enterprises
17. Law on Economic Public Services
18. Law on Mutual Funds and Investment Companies
19. Law on the Compensation Fund
20. Law on Capital and Personal Enterprises
21. Law on Involuntary Settlement and Bankruptcy

Table 6A.1 (continued)

22. Law on Co-Management of Employees
23. Law on the Representation of Labor Unions
24. Law on the Protection of Competition
25. Law on Commerce
26. Law on the Protection of Consumers
27. Law on the Protection of Industrial Property
28. Law on Small-Scale Business
29. Law on Commercial Tax
30. Law on Customs
31. Law on Customs and Tariffs
32. Law on Free Trade Zones
33. Law on Accounting
34. Law on Financial Auditing
35. Law on Financial Transactions
36. Law on the Stock Exchange
37. Law on Securities
38. Law on Public Debt
39. Law on Institutions for the Stimulation of Exports
40. Law on Foreign Investment
41. Law on Public Servants
42. Law on Real Estate and on Real Estate Rights of Foreigners
43. Law on Railways
44. Law on Longshore Activities
45. Law on Airports
46. Law on Postal and Telecommunication Services
47. Law on Telecommunications
48. Law on Postal Services
49. Law on Roads
50. Law on Road Transportation
51. Law on Energy
52. Law on Rational Use of Energy
53. Law on Goods Reserves
54. Law on Innovation
55. Law on Employment of Foreigners
56. Law on Insurance
57. Law on Special Taxes for Import of Agricultural Products
58. Law on the Stimulation of Tourism
59. Law on Standardization and Technical Regulations
60. Law on Meteorology
61. Law on Public Notaries

Other ratified laws

62. Law on financing public expenditure
63. Law on income tax
64. Law on taxes on the profit of legal entities
65. Laws on income taxes
66. Law on amendments to the law on working relations
67. Law on taxes on citizens
68. Law on employment and unemployment insurance
69. Law on amendments of pension and disability insurance
70. Law on prices

(continued)

Table 6A.1 (continued)

71. Law on foreign credit transactions
72. Law on the monetary unit of the Republic of Slovenia
73. Laws on the use of the monetary unit in Slovenia
74. Law on housing
75. Law on research activities
76. Law on the partial reimbursement of damages caused by military aggression on the Republic of Slovenia in 1991

Note: The first 61 laws were submitted to the Parliament as part of the macroeconomic program for the independence of Slovenia. The rest of the list represents other laws ratified during the last two years.

[a]Some of the proposed laws may have been ratified.

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Discussion Summary

Saul Estrin made three points. First, he noted that, in comparison to the rest of Eastern Europe, Slovenia began the reform process with relatively favorable initial conditions. He emphasized Slovenia's long-standing experience with markets, high income per capita, extensive past success in exporting to the West, and limited exposure to the CMEA shock. However, he did note that Slovenia was hard hit by the breakdown of trade among the newly independent Yugoslav republics. Second, Estrin discussed the particular problems that Slovenia faces because of its legacy of worker-managed firms. Estrin suggested that workers and managers have a strong vested interest in the privatization process since these groups have heretofore controlled the firms in which they work. Moreover, because these control rights are vaguely defined, the privatization process may generate substantial conflict among the principal actors. Third, Estrin noted that the new states in what was once the Soviet Union and Yugoslavia face special challenges created by the transition to statehood. He observed that these hurdles would be relatively less problematic in Slovenia because its population is ethnically homogeneous and government legitimacy is not substantially questioned.

Simon Johnson asked the authors to evaluate the development of the private sector. *Boris Pleskovic* responded that the private sector has grown very rapidly but that its progress has been impeded because the legislature has not passed the Law on Small-Scale Business.

Jacek Rostowski asked why Slovene inflation continued at a rate of over 10 percent per month one quarter after the macroeconomic stabilization program was initiated. *Jeffrey Sachs* observed that the continuing high rate of inflation could be blamed on an expansionary monetary policy that violated the planned program of tight credit. Rostowski also asked to whom the enterprise managers are responsible since the workers' councils have been disempowered. Pleskovic answered that the managers are often not responsible to anyone. He said that the primary way to exert control over them is to cut off their access to subsidies.

Jan Svejnar asked for an elaboration on the political situation in Slovenia. Sachs responded that the Slovene political system is very complicated and currently prone to deadlock: Slovenia has three parliamentary chambers, ten political parties represented in Parliament, and a president and prime minister from different political factions. Sachs noted that the large number of elected political parties is a consequence of Slovenia's system of proportional representation with a minimum threshold.

Sachs concluded the session with a response to Estrin's comments. Sachs noted that the system of worker management was largely symbolic; managers were effectively in charge even before the current reform process. Sachs said that the current political phase is not just a clean discussion about the efficacy of different models of privatization but rather a struggle over who is going to end up owning/controlling Slovenia's assets at the end of the day.

Sachs also wanted to add to Estrin's list of the peculiar features of the Slovene initial conditions. Sachs noted that the Slovene banking system is particularly problematic because the banks are owned by the same enterprises to which the banks made many of their loans. On top of this problem, the banks have hitherto been largely unregulated.