

GROWTH REMAINS ON TRACK

Basic economic data on Slovenia

Population: 2M inhabitants (0.6% of the euro area)
 Nominal GDP: EUR 29.7bn (2006; 0.3% of the euro area)
 GDP per capita SPP: 81.9 (2005; EU25 = 100; EA = 106.3)

Agriculture 3% of GVA	Construction 8% of GVA	Industry 27% of GVA
Market services 39% of GVA		Non-market services 23% of GVA

Slovenia has been enjoying a period of strong growth since 2004. Domestic demand is the main driver. At the same time, exports – which constitute the prime outlet for industry – are rising rapidly. Although exports are likely to start slowing next year, the “exports and growth in credit => investment => employment => wage increases => consumption” dynamics ought to remain intact in 2007 and 2008, Growth should consequently prove highly resilient: +5.5% in 2007 and +4.2% in 2008.

The two key risk factors weighing on this scenario are) a sharp surge in inflationary pressure, sparked by a tightening labour market, and a contraction in exports.

A remarkable economic success story

At the time of the de-unification of Yugoslavia, Slovenia was the richest entity of the former Federal Republic. Its industrial facilities and productive structure were the closest to Western standards. In addition, Slovenian territory emerged unscathed from the war that ensued. As a result, Slovenia was by far the best placed to adapt to the market economy and to integrate successfully into the European Union. This was a challenge that the country subsequently met. Slovenia became the 13th Member State of the euro zone in January 2007.

Economic activity has been robust since 1995. Following a soft patch in 2001-2003, when growth rates hit a trough of +2.5% (in 2003), Slovenia's economy rebounded steadily and the pace of growth accelerated to +5.5% in 2006. Since 2004, the prime momentum has been provided by domestic demand, notably household consumption (+4.2% in 2005 and +3.6% in 2006). More recently, investment has staged a spectacular recovery, after languishing in the doldrums for a certain period of time: +11.6% in 2006 versus +1.8% in 2005. The contribution from foreign trade has been negative since 2003, as imports (+11.4% in 2006) have been fuelled by the strength of domestic demand. That said, exports have been doing much to underpin economic activity: annual growth rates have been in excess of 10% since 2004 (+11% in 2006).

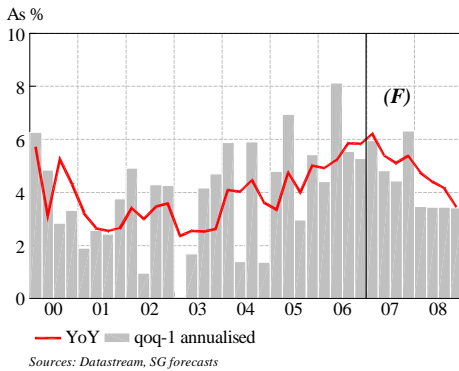
Growth rates of this level have been achieved without major macroeconomic imbalances. Firstly, inflation has been reined back steadily: annual average rate of 2.3% in 2005 versus 9% in 1996. In 2006, inflation remained well contained at 2.8% (compared with 2.2% in the euro area), despite the upward pressure exerted by oil prices. It would appear that the adoption of the euro caused a short-lived explosion in prices. The yoy inflation rate surged from 1.5% in October 2006 to 2.8% in December 2006 and 2.7% in January 2007. In February and March this year, the phenomenon dissipated and the inflation rate retreated to 2.1% and 2.3% respectively.

The current account balance has held stable at between -2% and -3% of GDP (-2% and -2.5% of GDP respectively in 2005 and 2006), except during the soft patch in 2001-2003, when it turned slightly positive because imports slackened in line with domestic demand. The trade balance is heavily in deficit: -3.7% of GDP in 2005 and -3.8% in 2006.

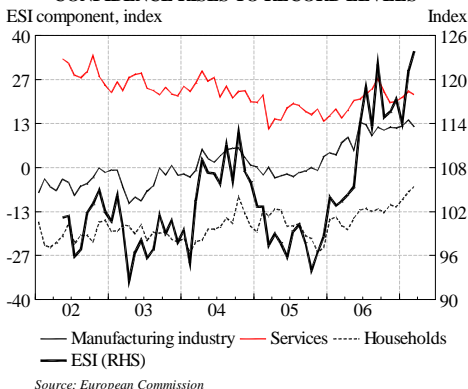
Fiscal policy is extremely sound. After an expansionary phase between 2000 and 2003 - the fiscal deficit peaked at 3.9% of GDP in 2001 - the government took advantage of the strong growth period underway since 2004 to bring the deficit down to 1.5% of GDP in 2005 and to 1.4% of GDP in 2006. Against this backdrop, public debt, which rose during the expansionary phase (peak level of 29.1% of GDP in 2002), has subsequently been on a downward trend, undershooting 28% of GDP.

Industrial activity will continue to be underpinned by exports

Since 2001, manufacturing industry output has been picking up steadily: +7.6% in volume terms in 2006, versus +4.4%: in 2005. Intermediate goods (+10% in 2006) and investment goods (+8%) represent the key growth drivers of production. Production of consumer goods is admittedly dynamic, but growth rates are still considerably lower (5.2% in 2006). Exports constitute the main outlet for industrial production. However, in 2006, the close correlation between these two variables loosened, due to the impact of a massive increase in investment (+14.8% and +13.7% respectively on the year in Q3 and Q4 2006). According to an ESI survey, industrial confidence has been holding up at record levels since June 2006:

GROWTH WILL REMAIN ROBUST,
BUT CONSOLIDATE IN 2008SHARP FALL IN UNEMPLOYMENT UNDERWAY,
INFLATION IS STILL WELL CONTAINED

CONFIDENCE RISES TO RECORD LEVELS



i.e. +12.2 points in March, which is 14 points above the long-term average. More specifically, the index is being shored up by production prospects and, to an even greater degree, by order book levels, notably exports as this index component scaled record heights in March. Based on survey findings, exports, which have been growing rapidly since 2004 (in the region of +11% yoy and +10.7% in the fourth quarter of 2006), should remain buoyant over the short term. More generally, the key factors of Slovenia's success will remain broadly the same in 2007 and 2008 and export growth rates will hold up at high levels.

Firstly, Slovenian exports are heavily geared to European countries. In 2005, Europe accounted for 88% of Slovenia's export sales (57.2% in the case of its top five trading partners - Germany: 19.8%; Italy: 13%; Croatia: 8.9%; Austria: 8.6%; and France: 6.9%). The imports of these countries, Croatia, Germany and Austria in particular, ought to remain resilient, despite the fact that the pace of economic growth in the euro area is set to decline gradually.

Secondly, Slovenia's manufacturing industry is focused primarily on low/medium technology products and on the production of intermediate goods (50% of exports). As a result of its production industry profile, Slovenia is able to maximise complementarity with the EU-15. Slovenia offers the attractions of geographical proximity, hourly wage costs that are nearly half those in the EU-15 (€13 an hour in Slovenia in 2005, compared with €25 an hour in the EU-15), and specialisation in different technologies. All these factors should enable Slovenia to partially offset reduced buoyancy in its export markets by gains in market share.

Thirdly, the geographical breakdown of its exports (Croatia excluded) will make it possible for Slovenia to limit currency risk as its key trading partners are located in the euro area. This means that appreciation in the euro is unlikely to act as a significant downward pull on Slovenian exports.

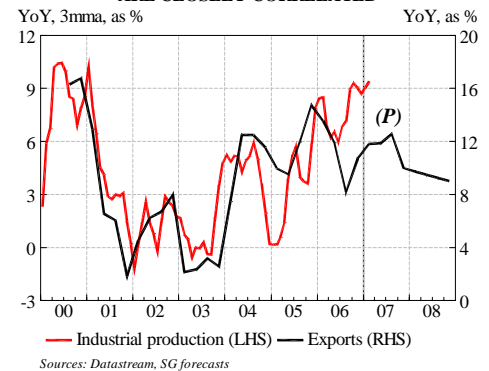
Lastly, Slovenian exports should rise by 11.5% in 2007 and by 9.4% in 2008. The main reason for the softer trend predicted in 2008 is the prospective decline in demand from EMU countries. Imports will remain closely correlated to exports, though growth rates will be slightly higher. The contribution of foreign trade to GDP growth will consequently remain negative: -0.7 points in 2007 and -0.6 points in 2008.

The business climate will remain favourable for households

According to the latest ESI survey, household confidence has reached record levels of -6 points, which is 12 points above the long-term average. This is largely attributable to the fact that the business climate is particularly favourable for households. Disposable income has received a boost from an improvement in the job market and sustained growth in wages. On the one hand, the unemployment rate (Eurostat methodology) fell sharply during 2006: 4.7% of the working-age population in February 2007, versus 6.6% in January 2006. Employment rose timidly at the beginning of 2006, but has been recovering vigorously since the third quarter of last year (+3.4% in February 2007). On the other, wages are rising rapidly: the wage-related labour costs jumped by 10.7% yoy in the fourth quarter of 2006, as a result of extremely strong increases in the services and construction sectors. Moreover, inflation has remained under control (cf. p. 34). Lastly, growth in spending power has been substantial, as attested by the 3.6% increase in household consumption in 2006.

Employment should continue to accelerate sharply in 2007 and 2008. This factor can be expected to exert upward pressure on wages. Despite the fact that there are still reserves of labour - the activity rate (59.3%) is low - scarcity of manpower will prompt wage increases. The latter are likely to stabilise at between 7% and 8% over the period 2007-2008. This will have an impact on inflation, via second-round effects. These will probably be limited in 2007, as inflation is set to ease back to 2.4% versus 2.8% in 2006, largely due to the base effect linked to the escalation in oil prices in the second and third quarters of 2006. Inflation is therefore likely to retreat to approximately 1.3% yoy in the second and third quarters of this year and then accelerate to some 2.3% in the last quarter. In contrast, 2008 promises to be a more difficult year: inflation is estimated at 2.9%, which is substantially in excess of the euro area (+1.7%).

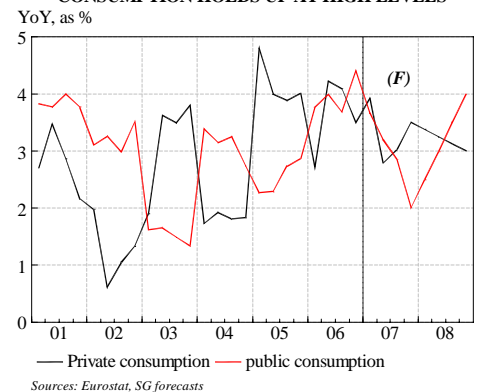
INDUSTRIAL PRODUCTION AND EXPORTS ARE CLOSELY CORRELATED



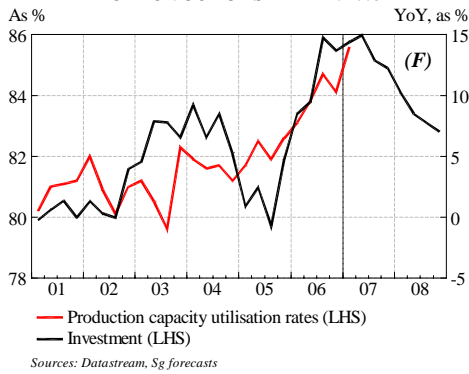
WAGE INCREASES ACCELERATE SHARPLY AT THE END OF 2006



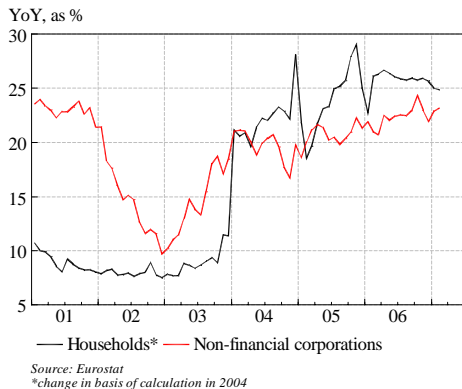
CONSUMPTION HOLDS UP AT HIGH LEVELS



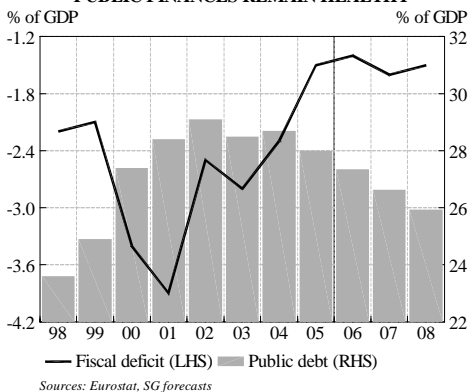
INVESTMENT IS SET TO REBOUND VIGOROUSLY IN 2007 BUT RUN OUT OF STEAM IN 2008



GROWTH IN CREDIT SHOULD PROVE ROBUST



PUBLIC FINANCES REMAIN HEALTHY



Gains in household spending power will nonetheless remain considerable. This means that household consumption will remain robust this year and next: +3.3% and +3.2% respectively.

Investment fuelled largely by construction

Productive investment will remain highly dynamic. Production capacity utilisation rates are standing at historically high levels: 85.6% in the first quarter of 2006. Exports will continue to drive industrial production. This will pave the way for higher production capacity rates and thereby underpin investment. At the same time, the sharp increase in lending to non-financial companies – in excess of 20% yoy in February – is likely to continue.

On top of investment in capital goods, residential investment should prove buoyant. The construction component of the ESI survey has reached an all-time high. Demand for housing is strong, fed by home loans (+42.5% yoy in February 2007). This trend should remain broadly intact in 2007 and 2008, as the decline in credit promises to be extremely gradual. On this basis, the risk of a property market slowdown can, in all probability, be ruled out in the near future.

The strong growth in investment recorded in 2006 (+11.6%) looks set to gather pace in 2007 (+13.6%) and then tail off in 2008 (growth rates will, nonetheless, remain at a healthy 8.3%).

All things considered, GDP growth ought to hold up at robust levels in 2007 (+5.5%), but slacken in 2008 (+4.2%) when domestic demand will suffer from lower investment.

Public finances geared to fostering knowledge-driven expansion

Slovenia continues to lag far behind the euro area, even though it has overtaken Portugal in terms of per capita GDP (PPP). The country is in the middle of a catching-up process, which raises the question of the relevance of euro area monetary policy for the Slovenian economy.

Euro area monetary tightening is expected to come to an end next June. However, in the case of Slovenia, a refi rate of 4% will still be accommodating, given the expected trend in monetary variables and prospective GDP growth rates. The economy thus risks overheating as a result of pressure on the job market (low unemployment rate) and on the goods market (high production capacity utilisation rates).

The adoption of an appropriate policy-mix by the Slovenian government will consequently be of fundamental importance. A restrictive fiscal stance – taking the country into surplus in 2008 – combined with slight accommodation in monetary policy, would a priori appear to be the most suitable solution for the economic situation in Slovenia. However, it would seem that the government thinks otherwise. The latter plans to maintain an expansionary fiscal policy in 2007 and 2008, which suggests that the fiscal deficit will remain at between 1.5% and 1.6% of GDP, according to the stability and convergence programme unveiled last December. That said, excluding public sector investment in transport infrastructure - which is expected to double between 2006 and 2008 due to European funds - the government's programme gives priority to higher education (14.5% increase in spending between 2005 and 2008), R&D (+42%) and to measures aimed at enhancing competitiveness and entrepreneurship (+235%). Investment of this nature should enable Slovenia to maintain healthy gains in productivity, which ought to limit the risk of galloping inflation.

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WORTH WATCHING

Wage increases. The risk of a second-round effect via the price-wage spiral is, by no means, negligible. The job market is currently under severe pressure. There is consequently a risk that the catching-up process will be transformed into overheating. The government will have to take action to promote the employment of women and older-generation workers in order to parry a potential shortage of manpower.

As %	2004	2005	2006	2007 (f)	2008 (f)
GDP volume	4.0	4.3	5.5	5.5	4.2
Consumer prices	3.2	2.3	2.8	2.4	2.9
Unemployment rate	6.3	6.5	5.6	4.7	4.7
Current account (% of GDP)	-2.7	-2.0	-2.5	-2.9	-2.5
Fiscal deficit (% of GDP)	-2.3	-1.5	-1.4	-1.6	-1.5

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