

Assessment and recommendations

The major policy challenges are sustaining high economic growth and social cohesion...

Slovakia is enjoying sustained high economic growth. Unemployment has fallen considerably, although long-term unemployment remains stubbornly high. The incoming government has made achieving a more equal distribution of income a priority insofar as this can be done without damaging long-term growth prospects. Ensuring that the benefits of high economic growth are more widely distributed is vital for making such growth sustainable. This objective calls for policies that give more priority to poverty alleviation, strengthen employment and remove barriers to competition in product markets. In the long term, improving education outcomes, including by reducing the impact of socio-economic background on outcomes, will be central to sustaining high economic growth and social cohesion.

... and maintaining macroeconomic stability once inside the euro area

The new government, like its predecessor, is committed to euro area entry in January 2009, with Slovakia being on track to satisfy the entry criteria. This raises the challenge of ensuring that policies support economic performance once in the currency union. A problem that could arise in the first years of euro area membership is that adjustment to the decline in real interest rates associated with the elimination of currency risk and adaptation to a rise in steady-state inflation associated with Balassa-Samuelson effects (estimated to be 1-1½% per year in the long run) in a currency union could contribute to a post-entry boom-bust cycle, calling for a counter-cyclical fiscal policy. In the longer term, adjustment to idiosyncratic shocks will have to occur entirely through changes in domestic wages and prices owing to the absence of a floating national currency. Maintaining macroeconomic stability in these circumstances calls for preserving flexibility in labour and product markets.

The economy is dynamic and short-term unemployment is falling rapidly

Broad based economic growth strengthened markedly in 2006 and the output gap is estimated by the authorities to have turned positive in early 2006. They estimate a potential growth rate of about 7½ per cent in 2006-07, boosted by the coming on stream of two new car plants, falling to 5¼ per cent by 2009. Employment growth accelerated to 2.3%

in 2006 and, with many Slovaks working abroad, national employment grew even more rapidly (3.9%), driving the unemployment rate down sharply, to 13% in late 2006. However, long-term unemployment remains stuck at around 10% of the labour force. Despite the sharp decline in short-term unemployment, real wage rate growth over 2005-2006 was on average around the labour productivity growth rate (close to 5% per person employed). With economic growth projected to remain around 8% in 2007 and to fall back to trend in 2008, the economy is likely to rise further above potential output.

Slovakia is on track to satisfy the criteria for entry to the euro area in January 2009

Slovakia is well placed to meet the conditions for euro adoption in 2009. HICP inflation fell to 2¼ per cent (year-on-year) in early 2007, supported by falling international energy prices, regulators taking a tougher line on margins (notably for electricity and gas), and exchange rate appreciation. Inflation is likely to fall somewhat through 2007-2008, which would correspond to an average annual inflation rate over April 2007-March 2008 below the Maastricht reference rate, which is estimated by the authorities to be 2.9%.

The government adopted a budget for 2007 based on very cautious assumptions that provides for a 0.8 percentage point of GDP reduction in the general government deficit to 2.9%, satisfying the 3 per cent of GDP Maastricht deficit reference value; the debt criterion is easily respected as government debt was 33% of GDP in 2006. Further budget consolidation is programmed through the remainder of the decade aimed at cutting the structural deficit to 0.9% of GDP in 2010, in compliance with the medium-term objectives for the sustainability of public finances agreed for Slovakia in the revised Stability and Growth Pact (SGP). Commendably, budget consolidation is being achieved primarily through expenditure restraint, which increases the likelihood that consolidation will prove durable. Although no problems have come to light so far, the considerable decentralisation of government responsibilities since 2004 raises the risk of general government consolidation commitments being undermined by poorly co-ordinated debt accumulation of lower levels of government. To guard against this risk, *the government should consider introducing a mechanism that allows fiscal policy to be better coordinated across levels of government.*

Concerning the other two Maastricht criteria, the long-term interest rate criterion is likely to be met. Long-term interest rates are already comfortably below the reference value (indeed, 10-year government bond rates are only 40 basis points higher than German rates). As regards the exchange rate criterion, the Slovak koruna has participated in ERM2 since November 2005. The exchange rate has remained within the 15% fluctuation bands around the central ERM2 rate, albeit much closer to the upper band than the lower band. In view of significant inflows of foreign direct investment followed by the progressive acceleration of economic growth and substantial appreciation of the estimated equilibrium real exchange rate, it was mutually agreed in March 2007 to revalue the ERM2 central rate for the Slovak koruna against the euro by 8.5% to SKK 35.4424. This step was well founded and timely. It will support the authorities in maintaining macroeconomic stability.

Fiscal policy may need to be restrictive to counter post-entry overheating

An immediate issue that the authorities may face following entry to the euro area is a temporary boom. Such a boom could be caused by the decline in real interest rates associated with entry to the euro area, as discussed above. Through multiplier and accelerator effects, adjustment to lower rates would be likely to entail some overheating. In addition to increasing the current account deficit, this would tend to increase domestic inflation (especially for assets such as housing), further reducing real interest rates temporarily and hence reinforcing the boom. The ensuing loss of competitiveness would at some time slow the economy to below the trend rate, eventually enabling competitiveness to be restored and the economy to return to trend, though such an adjustment period could prove painful. It would be desirable to take whatever actions are possible to forestall such a boom-bust cycle. Fortunately, the planned fiscal consolidation through to 2010 means that fiscal policy settings will lean against growth in aggregate demand in the lead up to euro area membership. *It would be prudent to allow automatic stabilisers to work fully. In the event that the economy nevertheless appears to be overheating, an even stronger counter-cyclical fiscal policy stance would be required.*

Convergence in living standards has been slowed by a decline in the employment rate and uneven productivity performance

Sustained high economic growth in recent years is gradually narrowing the gap in living standards between Slovakia and advanced European countries, but there is still a long way to go. GDP per capita (in PPP terms) rose from 44% of the EU15 average in 1998 to 51% in 2005, mainly achieved through rising labour productivity. However, productivity growth was lower in some of the sectors in which it is more difficult to establish competitive market conditions, notably in the utilities and the distribution sectors, although the recent expansion of large retail outlets suggests that productivity growth should improve. Furthermore, labour utilisation detracted from catching up to EU15 living standards, reflecting a growing gap between the employment rate in Slovakia and the EU15 countries. There clearly is considerable scope to support convergence in living standards by increasing the employment rate, especially if the benchmark is taken to be the best performing OECD countries (11 have employment rates over 70% compared with 58% in Slovakia).

Despite a pick-up in job creation, unemployment for some groups remains high while obstacles to participation persist

Strong economic growth has begun to feed through to the labour market, and high demand for skilled workers has led to widening wage differentials. However, job prospects for the most vulnerable groups remain poor. The long-term unemployment rate is the highest in the OECD, and is especially high for youth. To some extent, long-term unemployment can be expected to decline as the impact of strong growth and past reforms of welfare and employment protection legislation work through. However, low regional worker mobility

contributes to keeping the duration of unemployment high. At the same time, the overall employment rate is low, with particularly weak labour market participation among older workers and young women. Policies addressing these issues are needed and would also positively impact on poverty.

Labour market policies addressing income inequality need to support employment growth

The government has decided on a number of measures aimed at distributing more of the fruits of high economic growth to low-income earners. It has: increased the minimum wage over and above average wage growth and the government manifesto envisages further such increases; reintroduced legal extension of nation-wide sectoral wage agreements but with the possibility for individual employers to request exoneration from the government on grounds of differences in socio-economic conditions; and proposed changes to the labour code that somewhat tighten employment protection legislation (EPL). *Significant further increases in the minimum wage relative to average wages should be avoided as they would harm employment prospects of the low-skilled and consequently fail to reduce income inequality. Similarly, the authorities should make liberal use of their powers to accept requests for exoneration from legal extension so as to limit the loss of responsiveness of wages to local conditions, which would aggravate unemployment in eastern regions.* By contrast, some of the planned changes in EPL would not harm employment and would promote equity. Indeed, abolishing exemptions from normal EPL provisions for part-time workers would improve their career prospects. *All such exemptions should be abolished.* At the same time, *tightening general EPL provisions, which would significantly increase employment costs, should be avoided.*

High social security contributions still weigh on employment of workers with relatively low earnings potential. As in other countries, disincentives to work inherent in the tax-benefit system are more pronounced in households with children than in other households. *An in-work benefit, which would both support the expansion of employment and reduce poverty, should be considered. Such a benefit should rise with the number of children, should be conditional on a minimum threshold for hours worked and should be phased out above a poverty threshold for household income.*

The pension system generates poverty traps for low skilled workers

There is a substantial risk that many workers with modest earnings potential accumulate pension entitlements in the reformed pension system which will fall short of social assistance entitlements. Pensions will be strictly proportional to contributions in the reformed pension system in most cases and social assistance will continue to be withdrawn rapidly as pension income rises, generating poverty traps and disincentives to work in the legal economy. In the mandatory funded second pillar pension system, risk and return characteristics may in future be impaired by the requirement to invest 30% of asset portfolios in domestic assets, increasing the proportion of pensioners with pension entitlements that fall below social assistance. While this requirement does not at present appear to be binding, it may restrict financial investment choices once the second pillar

system matures. To reduce the risk of poverty traps in the pension system a number of measures should be taken:

- *The existing redistribution mechanism in the reformed pension system could be reviewed for possible extension. In this regard, mandatory pensions, which are currently not subject to taxation (i.e., exempt-exempt-exempt (EEE) arrangements) could be subject to personal income tax (either EET or TEE) and resulting revenues be used to raise 1st pillar pensions, leaving the average net pension unchanged.*
- *The rate at which social assistance payments to pensioners are withdrawn as pension income rises should be lowered with budget costs financed by cutting the tax advantages for voluntary third-pillar pension saving schemes.*
- *The requirement that 30% of financial investments in the second-pillar pension scheme be directed to domestic assets should be lifted.*

Activation of the long-term unemployed needs to improve further

Active labour market policies (ALMPs) are heavily geared towards large-scale job creation programmes. Such programmes have proven ineffective in lowering long-term unemployment. Resources for placement services are not yet allocated in a fully effective manner. Improving ALMPs would also have benefits in terms of making wages more responsive to labour market disequilibria. Training measures for the unemployed should be expanded, especially for the young unemployed, while subsidized job creation should be more narrowly targeted. The capacity of PES to provide effective job-search assistance and monitoring needs to be strengthened.

Regional disparities in labour market performance need to be reduced

The virtual absence of a private-rental-housing market, despite some recent improvement, is a barrier to regional labour mobility, contributing to persistently low employment rates in eastern regions, high structural unemployment and a slow transition of youth from education into jobs. Government policies are focussed on construction of subsidised public sector rental housing, for which waiting lists are long, discouraging mobility, and on providing subsidies for households purchasing their own homes. *Priority should be given to removing hurdles to the development of the private rental market, reviewing regulation and improving law enforcement. Public sector housing construction should be targeted to regions where housing demand is the strongest, with public-sector rents for middle and high income households set in line with market rental rates. When the conditions for private rental market development are in place, subsidies for public sector housing construction should be replaced by a cash housing benefit.*

Obstacles to labour market participation of older workers and young women need to be eliminated

Participation rates of older workers are still low, despite recent increases, and participation of young women has been falling markedly. The dramatic impact of demographic ageing

on labour supply growth expected from 2030 onwards further raises the need to take steps to improve labour utilisation.

- The statutory retirement age is 62 years for men and will reach this age for women by 2014. This age is relatively low, reflecting lower life expectancy that in other OECD countries; although life expectancy is likely to rise in line with improving living standards. *The statutory retirement age should be indexed to gains in life expectancy once the increase in the retirement age for women has been phased in.*
- Pension adjustments for retirement before or after the statutory retirement age (6 per cent per year) are still lower than implied by actuarial neutrality (around 8 per cent per year) *Pension discounts for retirement before the statutory retirement age and supplements for retirement after the statutory retirement age should be raised to actuarially neutral rates.*
- Experience across OECD countries shows that while parental leave helps parents reconcile family and work life, excessively long such leave harms mothers' career prospects. *The duration of parental leave should be shortened from the current three years with the benefit for the remaining period up to three years being paid in the form of subsidies for childcare.*
- A high tax wedge on second earners, relative to the main earner, in two earner households discourages female labour supply, which is more sensitive to variations in the net wage than men's. *This tax wedge should be eliminated.*

Education has a vital role to play in achieving economic and social sustainability

Improving education outcomes is a vital part of Slovakia's strategy to catch-up with living standards in the advanced European countries. Better outcomes raise productivity and employment prospects and, if distributed more evenly, reduce income inequality and poverty. While some education outcomes are favourable, such as the low secondary-school dropout rate, others have room for improvement:

- Education achievement is below the OECD average according to the 2003 OECD PISA study and is strongly influenced by socio-economic background. Roma children, who are mainly from lower socio-economic backgrounds and represent a significant and growing share of children, have particularly poor achievement;
- Labour-market outcomes for graduates of secondary vocational programmes not leading to tertiary education are poor (unemployment rates for such persons are much higher than for other persons with upper secondary attainment), suggesting that these programmes are not equipping graduates with skills to cope with adverse structural shocks; and
- Tertiary attainment is low (12% of the population aged 25-64), albeit rising (14% of 25-34 year olds, compared with an OECD average of 31%).

Education reforms are needed to improve student achievement and reduce the impact of socio-economic background

International evidence shows that early childhood education has a significant effect on learning in subsequent stages of education, especially for children from lower socio-economic backgrounds. Accordingly, the authorities plan to increase participation in kindergarten by making it free of charge for five-year olds from 2008 onwards. A practical difficulty with increasing participation is that kindergartens are not available throughout the country, especially in poor districts with large Roma populations. *The government should ensure that municipalities not offering an adequate supply of kindergartens are financially able to do so and in fact do so. Moreover, efforts should be made to increase participation of children from lower socio-economic backgrounds from four years of age.* This would be particularly helpful for Roma children as many do not attend kindergarten but stand to gain much from doing so, notably through greater competence in the language of instruction at school.

International evidence also suggests that the impact of socio-economic background on student performance is greater in countries, such as Slovakia, that have highly differentiated education systems than in other countries. So as to reduce segmentation, the authorities have encouraged the integration of technical secondary schools (55% of students), which prepare students for tertiary education, and vocational secondary schools (20% of students), which lead to early labour-market entry. *This process should be taken further by also encouraging the integration of technical secondary schools and grammar schools, with the general education courses common to both tracks being offered jointly. Moreover, the age of selection into general and vocational tracks should be delayed, until 16.* This would reduce socio-economic segregation in schools and would increase the amount of general education received by vocational secondary school students, providing them with a stronger foundation for subsequent learning.

Raising teacher quality would also improve achievement, especially for children with learning difficulties. The government has increased teacher salaries significantly in the past three years from very low levels by international comparison to attract better quality candidates and is considering further increases that would bring salaries in relation to average earnings near to the OECD average. Particularly large increases are planned for foreign-language teachers to overcome shortages, although there are also shortages of mathematics and science teachers. For higher salaries to be as effective as possible in improving teaching quality, *the authorities should ensure that recruitment and selection mechanisms are well designed, that initial teacher education prepares candidates well, and that teachers are encouraged continuously to upgrade their practice.* School leadership also needs to be strong and to be given flexibility to manage while being held accountable for outcomes. *In this framework, it is essential that school managers be given the competence for hiring and firing teachers. Moreover, the largest salary increases should be used to attract high quality teachers to schools with children from disadvantaged socio-economic backgrounds. The policy of focussing larger pay increases on foreign-language teachers should be generalised to other subjects where there are skill shortages.*

Vocational secondary school education should be made more pertinent to labour-market requirements

Vocational secondary schools lost touch with enterprises following the fall of communism. In the virtual absence of apprenticeship training, applied learning takes place in vocational schools, often using outdated equipment. To make vocational secondary education more relevant to labour-market requirements, *greater employer involvement should be sought both in terms of curricula development and practical training (more apprenticeships)*. The automobile industry provides an encouraging example of how such education can be turned around with greater employer involvement. The measures discussed above to raise achievement and reduce the impact of socio-economic background more generally would also help to prepare students in these schools better for the labour market.

Tertiary education needs to be made more attractive for technical secondary school graduates

A relatively high proportion of technical secondary school graduates, who are qualified to enter university, do not in fact go on to tertiary education. One reason for this is that there are few relatively short (2-3 years) occupationally oriented courses (i.e., tertiary-type B programmes), which are likely to be attractive to many students from the (large) technical secondary school track. *Priority should be given to developing such programmes*. Another tertiary-education barrier for technical secondary school graduates is that they often fail to get high enough scores in university entrance exams to be admitted as full-time students, who do not pay tuition fees, to the most popular universities. In these circumstances, applicants can apply as part-time students paying “unofficial” fees (around €1 000 per year in the most popular universities), in which case they have a much higher chance of being accepted, or of going to a less attractive university. To reduce this barrier to participation and to make the financing of tertiary education fairer, *unofficial fees should be banned. Moreover, the government should reconsider its policy of not introducing tuition fees for full-time students as this reduces incentives for efficiency in the tertiary education sector and undermines social equity, the greatest benefits going to the better off. Any such fees should be aligned for full-time and part-time students and be set so as to make a significant contribution to costs in light of the high tertiary earnings premium in Slovakia and the limited progression in the tax system. In the event that (official) tuition fees were introduced, loans with income-contingent repayments, as in a number of other OECD countries, should be made available to ensure that liquidity constraints do not exclude some students and to reduce the risk on returns to private investment in tertiary education.*

Sector specific product market regulation and shortcomings in public sector efficiency still hold back productivity performance

While general economic regulation is conducive to competition, the cost to businesses of administrative regulation is still high in some instances. Regulation in the professional services and in network industries needs to become more conducive to competition.

Government ownership is still high in network industries. Measures mentioned below would intensify product market competition and could raise the purchasing power of labour earnings, aggregate employment and productivity, as well as the resilience of the economy to shocks:

- Competition is not yet established in the energy market. Measures to overcome fragmentation of markets in the region along national borders would offset the impact of high market concentration. *Inter alia, the transmission network over which energy demand and supply are balanced should be extended beyond national borders in co-operation with neighbouring countries. A short-term power trading facility should be established seeking co-operation with the Czech Republic.* Measures to prevent non-price discrimination need to be strengthened. *The network regulator should oblige network operators to make information on network access conditions widely available to market entrants. The regulator should impose more specific obligations on the gas and electricity network operator. For example, rules on the sharing of network connection costs should be set. Authorisation procedures for the construction of new power plants should be streamlined. Further entry of private capital should be encouraged as part of a strategy to make framework conditions more conducive to competition.*
- Regulation of the telecommunications sector needs to encourage competition more vigorously. Government ownership of the telecommunications incumbent can give rise to perceptions of conflicts of interest. The lack of budgetary independence of the regulator compromises its independence, which may further deter market entry of competitors. *Delays in the introduction of remedies to foster competition in fixed line telephony services should be reduced. The government share in the telecommunications incumbent operator should be privatised. The independence of the telecommunications regulator should be strengthened by moving its budget out of the budget of the Ministry of Transport.*
- The preconditions for competition in the railway industry need to be put in place. Government subsidies are directly disbursed to the government-owned passenger transport operator, which discourages market entry. *The subsidies should instead be used to lower high network access prices or be made contestable through the tendering of public service obligations.*
- Administrative burdens on enterprises create entry barriers. For example, different payment procedures are in place for the payment of various social security contributions. Costs of dealing with licenses also appear high by international comparison. These costs should be reduced and *payment procedures for social security contributions should be unified.*
- Deregulation of professional services needs to continue. Compulsory chamber membership should be abolished. The chambers of the professions should not have powers to take decisions concerning the regulation of activities of professional enterprises. Entry requirements with regard to experience that are specific to setting up a business should be abolished. Restrictions on the legal form of business should be eased.
- Management capacity and accountability of the judicial sector still needs to be strengthened. While legislation has been introduced to increase the share of public procurement advertised through a contract notice, scope remains to improve competition. *Public sector reform needs to continue to strengthen contract enforcement and improve competition in public procurement.*

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The Secretariat's draft report was prepared for the Committee by David Carey and Andres Fuentes under the supervision of Andreas Wörgötter.

The previous Survey of the Slovak Republic was issued in September 2005.

BASIC STATISTICS OF THE SLOVAK REPUBLIC (2005)

THE LAND

Area (km ²)	49 035	Inhabitants in major cities (end-2004)	
Agricultural area (km ²)	24 330	Bratislava	425 155
		Kosice	235 006
		Presov	163 743
		Nitra	163 764

THE PEOPLE

Population (thousands)	5 387
Inhabitants per km ²	110
Average annual population growth (1995-2005, per cent)	0.1
Infant mortality (per thousand live-births)	7.2
Life expectancy: Males	70.1
Females	77.9
Registered unemployment, per cent of the labour force	14.3
LFS unemployment, per cent of the labour force	16.2
Employment (thousands, <i>Labour Force Survey</i>)	2 216

PRODUCTION

GDP (billion SKK)	1 471
GDP per capita (in US\$, PPP exchange rate)	15 983
Gross capital formation (per cent of GDP)	29.2

THE GOVERNMENT

Per cent of GDP		Composition of the National Council of the Slovak Republic (June 2006)	Number of seats
General government revenue	33.9	Movement for a Democratic Slovakia (HZDS)	15
General government expenditure	37.1	Slovak Democratic and Christian Union (SOKU)	31
Gross public debt (Maastricht definition)	34.5	SMER	50
		Hungarian Coalition Party (SMK)	20
		Christian Democrat movement (KDH)	14
		Slovak National movement	20
		Total	150

FOREIGN TRADE

Exports of goods and services, % of GDP	77.3	Imports of goods and services, % of GDP	82.4
Main exports of goods (% of total):		Main imports of goods (% of total):	
Machinery and transport equipment	44.6	Machinery and transport equipment	37.7
Manufactured products	35.3	Manufactured products	28.6
Chemical products	5.8	Chemical products	9.6
Others	14.3	Others	24.1

THE CURRENCY

Monetary unit: Slovak koruna	
Currency units per US dollar (period average):	
Year 2006	29.7
February 2007	26.4
Currency units per euro (period average):	
Year 2006	37.2
February 2007	34.5