

Croatia Business Forecast Report Q1 2015

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Abstracts

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Core Views

Croatia's economy will continue along a low growth trajectory over the next few quarters, and may even remain in recession for a seventh consecutive year in 2015. We believe Croatia will eventually need an EU/IMF loan arrangement to help cover its budget deficit and implement much needed structural reforms. However, this is unlikely to happen until at least 2016.

Croatia's trade deficit will begin expanding amidst weak exports and a slight recovery in domestic demand. This will ensure that the current account surplus begins shrinking over the coming years. Inflationary pressures will remain weak in Croatia. The central bank will remain focused on kuna stability to anchor inflation expectations and protect the country's large FX loan liability.

Croatia's dire domestic economy will continue eroding support for the ruling Kukuriku coalition. The economy would need to post a remarkable turnaround for the coalition to have any chance of winning re-election in the 2015 parliamentary elections.

Major Forecast Changes

Our real GDP forecasts have been lowered to an estimated -0.8% in 2014 and 0.4% in 2015, from -0.6% and 0.6% previously. This reflects an even bleaker outlook for domestic demand. We have revised down our forecasts for the kuna to average HRK7.6400/EUR in 2014, from HRK7.6700/EUR previously, on the back of robust tourism receipts in the first half of the year.

Contents

Executive Summary
Core Views
Major Forecast Changes
Key Risks To Outlook

CHAPTER 1: POLITICAL OUTLOOK

SWOT Analysis

BMI Political Risk Index

Domestic Politics

No Way Back For The Government

Croatia's governing coalition has little chance of winning the 2016 parliamentary elections. Reversing declining living standards and reviving the economy will prove impossible, eroding support for the government.

Table: Political Overview

Long-Term Political Outlook

EU Convergence To Pay Dividends Over Long Term

While we expect Croatia's long-term political risk profile to continue improving following its accession to the EU, we caution that further progress and reforms are needed for the country to realise its full potential. We highlight the key challenges that could threaten stability in Croatia over the next 10 years, and outline three possible long-term scenarios for the country.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis

BMI Economic Risk Index

Economic Activity

Economy To Stagnate As Bailout Gets Closer

Croatia's economy will stagnate in 2015 and 2016. Real GDP growth will lag behind the rest of the EU, as domestic demand is constrained by a lack of progress tackling competitiveness issues. The impacts of an increasingly likely EU/IMF aid deal could tip the country back into recession at some point over the next five years.

Table: Economic Activity

Fiscal Policy

Sliding Towards EU/IMF Help

Favourable financing conditions will allow Croatia to cover its budget deficit in 2014 and 2015. But Croatia will eventually need an EU/IMF aid package to plug funding gaps, as a deteriorating credit profile increases borrowing costs and restricts demand for government debt. Loan conditionality will help Croatia implement the painful structural reforms needed to make the country more competitive.

Table: Fiscal Policy

Balance Of Payments

Surpluses Unlikely To Last

Croatia's current account surplus will return to deficit over the coming years, as imports slowly recover and exports are restricted by competitiveness issues. This suggests limited hope of Croatia exporting its way out of its current economic malaise.

Table: Balance Of Payments

Monetary Policy

Central Bank Will Struggle To Ward Off Deflation

Croatia's 'euroised' economy will restrict monetary policy to exchange rate targeting. The central bank will therefore struggle to boost demand and prices away from deflationary territory, posing risks to our already dire outlook for consumer spending.

Table: Monetary Policy

Exchange Rate Policy

HRK: Depreciation On The Cards

Declining tourism receipts will contribute to kuna weakness over the winter months, with subdued demand for Croatian assets then contributing to the unit's depreciation against the euro over the long term. Nevertheless, the government and households' large FX liability means the central bank will be prepared to step in to prevent excessive currency weakness.

Table: Currency Forecast

Banking Sector

Banking Sector On Firmer Foundations

The recovery of Croatia's banking sector will move onto a firmer footing in 2015, in spite of subdued lending and profits. Steady deposits mean banks are becoming less reliant on funding from foreign parents, while healthy capital buffers imply the sector is well positioned to cope with any unforeseen credit shocks.

CHAPTER 3: 10-YEAR FORECAST

The Croatian Economy To 2023

A Sluggish Recovery In The Years Ahead

With EU membership achieved in July 2013 and some convergence gains still to be realised, we maintain a slightly better long-term view on the Croatian economy. We caution, however, that ongoing difficulties in the eurozone and a more protracted economic recovery present key risks to this outlook over the longer term.

Table: Long-Term Macroeconomic Forecasts

CHAPTER 4: OPERATIONAL RISK

Operational Risk Index

Operational Risk

Table: Operational Risk

Transport Network

Table: Emerging European Transport Network Risks

Economic Openness

Table: Economic Openness Risk

Table: Top Five Products Imported (USDmn), 2007-2013

Table: Top Five Trade Partners Product Exports (USDmn), 2007-2013

CHAPTER 5: KEY SECTORS

Oil & Gas

Table: Headline Forecasts

Table: Oil Production

Table: Oil Production

Table: Gas Production

Table: Gas Production

Tourism

Table: Inbound Tourism

Table: Outbound Tourism

Other Key Sectors

Table: Pharma Sector Key Indicators

Table: Telecoms Sector Key Indicators

Table: Defence and Security Sector Key Indicators

Table: Infrastructure Sector Key Indicators

Table: Food and Drink Sector Key Indicators

Table: Autos Sector Key Indicators

Table: Freight Key Indicators

CHAPTER 6: BMI GLOBAL ASSUMPTIONS

Global Outlook

Big Emerging Market Revisions

Table: Global Assumptions

Table: Developed States, Real GDP Growth, %

Table: BMI VERSUS BLOOMBERG CONSENSUS REAL GDP GROWTH
FORECASTS, %

Table: Emerging Markets, Real GDP Growth, %

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