

Croatia Business Forecast Report Q4 2014

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Abstracts

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Core Views

Croatia will remain in recession in 2014, with growth set to be undermined by weak consumer spending.

Unless significant structural reforms are implemented to improve export competitiveness and increase labour market flexibility, we believe the recovery will lag behind Europe. Government finances are in a dire state, with a growing public debt load and lack of progress tackling the fiscal deficit likely to weigh on Croatia's credit risk profile. A euroised economy will continue limiting the central bank's ability to influence lending and spending, which partially underpins our weak outlook for household spending. The ruling Kukuriku coalition's poor performance in the May EU Parliament elections has weakened the government's position, limiting its appetite for reform.

Major Forecast Changes

We have revised down our forecast for real GDP to decline by 0.7% in 2014 and grow by 0.6% in 2015, from a fall of 0.3% and growth of 0.7% previously, remaining firmly below consensus on growth in the process.

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Key Risks To Outlook

CHAPTER 1: POLITICAL OUTLOOK

SWOT Analysis

BMI Political Risk Ratings

Domestic Politics

Reform Momentum To Remain Sluggish

The results of the EU parliament elections in May will increase tensions within the governing coalition, with the Kukuriku coalition likely to come under increased pressure to slow the pace of fiscal adjustment in the country. However, the dire state of the economy will ensure that the government's popularity continues to fall.

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

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BMI Economic Risk Ratings

Economic Activity

Recovery To Lag Behind Europe

Croatia's economic outlook is one of the least attractive in the EU, with growth set to remain painfully weak unless significant structural reforms are implemented. Household spending will be the main factor holding back the recovery, due to a lack of progress on deleveraging and steady erosion of disposable incomes.

Table: Economic Activity

Balance Of Payments

Weak Economy To Keep Current Account In Surplus

Although Croatia will post current account surpluses in 2014 and 2015, this will reflect weak domestic demand rather than improving export competitiveness. The composition of financial account flows will also limit the potential benefits of these surpluses over the next few quarters.

Table: Balance Of Payments

Fiscal Policy

Fiscal Threat To Recovery

Subdued revenues and lack of government reforms will widen Croatia's budget deficit over the coming quarters, and contribute to EU fiscal deficit targets being missed. Alongside a growing public debt load, sluggish progress shrinking the deficit now will restrict the government's ability to support growth over the long term.

Table: Fiscal Policy

Monetary Policy

Subdued Demand To Keep A Lid On Inflation

Although higher spending during the summer tourist season and base effects from a period of low inflation last year will pull Croatia out of deflation over the next few months, weak domestic demand will restrict headline price growth. We forecast inflation to average just 0.9% in 2014 and 1.7% in 2015.

Table: Monetary Policy

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Don't Be Fooled By Kuna Strength

Although seasonal tourism receipts will help prop-up the Croatian kuna over the summer, the currency will depreciate against the euro over the next few years. Weak exports, subdued demand for Croatian assets and a large net international investment liability will contribute to the currency weakening to HRK7.6400/EUR in 2014 and HRK7.6800/EUR in 2015.

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Croatia's banking sector will improve in 2014, as steady deposit growth underpins a recovery in bank lending. Healthy capital buffers also suggest the sector is well positioned to deal with any unforeseen shocks.

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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.

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