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Slovakia Business Forecast Report Q2 2014

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Abstracts

Core Views

Prime Minister Robert Fico will continue to benefit from his party's outright majority in parliament, which has eased the policy formation and implementation process. While this is positive for political stability in the short term, it does not provide much space for consensus politics, with Fico's tax and welfare reforms likely to keep investors cautious.

The short-term economic picture has brightened as export growth remained solid amid a slowdown in regional growth, and household spending showed the first signs of a recovery. The government will continue with its fiscal consolidation plan, with a shrinking deficit likely to buoy market sentiment. Creeping public debt will remain a concern for the authorities, however.

Major Forecast Changes

We have revised up our real GDP growth forecast for 2014 and 2015 to 2.2% and 2.8% respectively, from 2.0% and 2.6% previously. This is based on strong industrial production and retails sales readings in H213 that point to a more broad based economic recovery taking hold.

Our forecast for Slovakia's fiscal trajectory has been revised to reflect the governments updated medium-term budget objectives, which include a slower pace of deficit consolidation. While we previously saw the budget deficit falling to 2.1% of GDP by 2015, our forecast currently stands at 2.6%.

Key Risks To Outlook

The risks to our short-term growth forecast are well balanced, andlargely based on

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ongoing uncertainty over the regional economy. With exports in 2013 representing approximately 100.1% of GDP, Slovakia’s economy is vulnerable to any shifts in external demand. The emphasis on revenue-boosting measures to achieve significant fiscal consolidation leaves the deficit reduction programme vulnerable to weaker-than-expected growth while also threatening investment inflows.

Contents

Executive Summary
Core Views
Major Forecast Changes
Key Risks To Outlook

CHAPTER 1: POLITICAL OUTLOOK

SWOT Analysis
BMI Political Risk Ratings
Domestic Politics
Fico Presidency Puts Majority At Risk
Slovakian Prime Minister Robert Fico's decision to run for president in 2014 could have negative long-run implications for the Direction- Social Democracy party's dominant political position, as Fico's popularity has largely driven its strong electoral showings in recent years. However, we expect a high degree of policy continuity until general elections in 2016, with fiscal consolidation remaining a top priority.
Table: Political Table
Long-Term Political Outlook
Convergence With West Remains Core View
We expect Slovakia to continue to converge with Western European policies and standards of living over the next ten years as the small economy has benefitted greatly from inclusion in the bloc. However, we stress that the country will face a number of challenges to political stability including corruption, relations with the eurozone, ethnic tensions and population decline.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis
BMI Economic Risk Ratings
Economic Activity
Rising Exports To Spur Domestic Demand Recovery
We forecast real GDP growth in Slovakia to reach 2.2% and 2.8% in 2014 and 2015, respectively, on the back of improving external demand and a recovery in industrial production and exports. However, in contrast to previous years, the shape of growth will be come more weighted towards domestic demand, implying a diminishing contribution of net exports as imports rise.
Table: GDP BY EXPENDITURE

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Balance Of Payments

Rebalancing Has Further To Run

Slovakia's current account surplus will peak at 3.2 % of GDP in 2015 before narrowing gradually over the long term, as domestic demand growth drives a narrowing of the trade surplus. Although the external account surplus precludes a reliance on foreign capital, foreign direct investment will remain key to future export growth.

Table: BALANCE OF PAYMENTS (Euro)

Fiscal Policy

Falling Deficit Masks Fiscal Risks

Although we forecast Slovakia's fiscal deficit to fall to 2.8% of GDP in 2014 and 2.6% of GDP in 2015, we see important risks to the country's medium-to long-term consolidation path stemming from an overreliance on temporary and one-off revenue raising measures.

Table: FISCAL POLICY

Regional Exchange Rate Policy

Euro Strength Unsettling The ECB

Passive monetary tightening and improved investor sentiment will compound policy inertia from the ECB has keep the euro strong heading into 2014. However, weak economic growth, high unemployment, euro strength, deflation risks, a potential LTRO-cliff and anaemic structural reform are becoming increasingly unpalatable for policymakers. As such, we expect substantial monetary intervention in 2014. If this comes in the form of an LTRO top-up, then the euro will initially hold firm before sliding by end-year as growth will remain weak. If, however, the ECB opts for negative deposit rates (a far more extreme option), expect a sharp and disorderly euro correction.

Table: Eurozone Currency Forecast

Regional Monetary Policy

ECB Cut: Pushing On A String

A cut in the ECB's refinancing rate will do little to ease monetary policy in the eurozone, given the fractured credit transmission channel and passive tightening resulting from banks repaying LTRO funds. While there are few easy options to ease policy in the near term, we warn that if the long running disinflationary trend evolves into full blown deflation, the ECB may have to look at more aggressive forms of policy stimulus.

Operational Risk

CHAPTER 3: 10-YEAR FORECAST

The Slovak Economy To 2023

Lower Trend Growth Ahead

Macroeconomic stability and institutional convergence with Western norms will be bolstered in the long term by Slovakia's eurozone membership. However, we believe the drawbacks of having the euro will outweigh the benefits, limiting potential growth in the next decade. Nevertheless, we expect real GDP to average 2.6% over our 10-year forecast period to 2023, well above eurozone averages.

Table: Long-Term Macroeconomic Forecasts

CHAPTER 4: BUSINESS ENVIRONMENT

SWOT Analysis
BMI Business Environment Risk Ratings
Business Environment
Introduction
Institutions
Table: BMI BUSINESS AND OPERATION RISK RATINGS
Table: BMI LEGAL FRAMEWORK RATING
Table: LABOUR FORCE QUALITY
Table: EMERGING EUROPE – ANNUAL FDI INFLOWS
Table: TRADE AND INVESTMENT RATINGS
Market Outlook
Table: Top Five Export Destinations (US$mn)

CHAPTER 5: KEY SECTORS

Autos
Table: Auto Sales, 2010-2017
Table: Auto Trade, 2010-2017
Table: Auto Production, 2010-2017
Food & Drink
Table: Food Consumption Indicators – Historical Data & Forecasts, 2010-2017
Table: Alcoholic Drinks Value/Volume Sales – Historical Data & Forecasts, 2010-2017
Table: Mass Grocery Retail Sales By Format – Historical Data & Forecasts, 2010-2017
Other Key Sectors
Table: Oil and Gas Sector Key Indicators
Table: Pharma Sector Key Indicators
Table: Freight Key Indicators
Table: Telecoms Sector Key Indicators
Table: Defence and Security Sector Key Indicators
Table: Infrastructure Sector Key Indicators

CHAPTER 6: BMI GLOBAL ASSUMPTIONS

Global Outlook
Momentum To Continue In H114
  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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