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Research Update:
Republic of Montenegro 'BB/B' Ratings Affirmed; Outlook Negative On Risks To External Financing

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Research Update:

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Overview

- The risks arising from a slowdown in Europe are significant, especially given Montenegro's reliance on foreign direct investment to finance the large current account deficits.
- Although the banking sector has reduced its external liabilities significantly during the last three years, its still-high level of external leverage leaves the economy vulnerable if banks stop cross-border interbank lending.
- We are affirming the rating on the Republic of Montenegro at BB/B.
- The negative outlook reflects the likelihood of a downgrade if Montenegro has difficulty in meeting its 2012 external financing requirement.

Rating Action

On Dec. 13, 2011, Standard & Poor's Ratings Services affirmed its 'BB' long-term and 'B' short-term sovereign credit ratings on the Republic of Montenegro. The outlook remains negative. Montenegro's transfer and convertibility (T&C) assessment is unchanged at 'AAA'.

Rationale

The ratings on the Republic of Montenegro balance the country's weak external position and lack of monetary flexibility against its high levels of prosperity, its stable political environment (anchored by good prospects for EU accession), and its moderate government debt burden, compared with similarly rated sovereigns.

Montenegro experienced a recession in 2009 and has seen slow growth and contracting credit since then. Despite this, the country is still running a large current account deficit, estimated at 22% of GDP in 2011. The current account has declined from 50% of GDP in 2008 and 30% in 2009, owing to a 40% fall in goods imports from its peak in 2008. In our opinion, the large current account deficit in Montenegro is to some extent a structural phenomenon and represents high investments needs that will, in the medium-to-long term, raise the productive capacity of the economy, if investments are managed efficiently.

That said, these deficits expose the nation to refinancing risks. We project that the 2012 gross external financing requirement will be 84% of current account receipts. This figure comprises a projected current account deficit of just over €600 million and amortization of long-term external debt and the rollover of short-term external debt (estimated at a combined €1.1 billion). We expect that Montenegro will finance this external financing requirement through foreign direct investment, through unrecorded transfers and investments related to tourism, and by the main external debtors refinancing their maturing external obligations. The main external debtors include: Crnogorska komercijalna banka (a member of the OTP group), Podgoricka banka Societe Generale Group, Erste Bank, NLB Montenegrobanka, Hypo Alpe Adria Bank, Aluminum Plant Podgorica, and Elektroprivreda Crne Gore.

The government has unilaterally adopted the euro as its currency. Montenegro is not part of the European Economic and Monetary Union (eurozone), and thus has no voice in the ECB's monetary policy deliberations and has no access to the ECB as a lender of last resort. Domestic banks, however, have only slightly over 10% market share in loans and we expect the foreign banks operating in Montenegro to be supported by their parent banks. Although using the euro limits monetary policy flexibility, it has facilitated large inflows of FDI and tourism and has lowered transaction costs with trading partners. It also eliminates foreign exchange risk, although not external refinancing risk, for residents borrowing in euros.

The Montenegrin economy is recovering, following a hard landing in 2009. After having peaked at 26%, nonperforming loans as a share of total loans declined to 18% in October 2011. In 2012, we expect the economy to grow by less than 1%, given the international economy, although a single large foreign investment could significantly boost output above our forecast.

Tourism has not been affected by the international downturn and we expect it will continue to support growth in the coming years. The biggest downside growth risks include the worsening growth outlook in the eurozone or renewed deterioration in bank balance sheets. In the medium term, the potential for growth is significant. However, given the importance of investment in driving growth, medium-term growth depends on the continuation of government reform to increase the flexibility in the labor market and further improve the business environment.

Lower growth has weakened budgetary performance in recent years, but we expect to see consolidation in the near term. After widening to 5.7% of GDP in 2009, the general government fiscal deficit has steadily declined and we expect it to come close to balance by 2014. Government debt has increased significantly over the past three years, after a period of rapid decline. We estimate that net general government debt will be 41% of GDP in 2011. The structure of debt in Montenegro has low currency risk; about 90% of debt is in euros and, given the concessional nature of a large portion of the debt, interest payments are low, at an estimated 3% of general government revenues.

The recovery rating on Montenegro's foreign currency debt (which includes euro-denominated obligations, as the local monetary authorities have no influence over the common currency) is '3', indicating our view that post-default recovery would be in the 50%-70% range. The default scenario centers on the consequences of a prolonged period of balance of payment pressure, but assumes the euro will remain the medium of exchange.

Outlook

The negative outlook reflects the likelihood of a downgrade if Montenegro has difficulty in meeting its 2012 external financing requirement. In this scenario, we would expect growth to decline and the government debt to rise, reversing the recent consolidation efforts.

Ratings could stabilize at current levels following further reforms of the labor market and business environment, if external financing risks do not materialize. Some of these reforms stem from the government's preparation for EU candidacy. Successful reforms would improve economic competitiveness, diversify the industrial base, raise medium-term growth prospects, and attenuate external imbalances.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
  Criteria For Determining Transfer And Convertibility Assessments, May 19, 2009
  Introduction Of Sovereign Recovery Ratings, June 14, 2007

Ratings List

Ratings Affirmed

Montenegro (Republic of)	
Sovereign Credit Rating	BB/Negative/B
Transfer & Convertibility Assessment	AAA
Senior Unsecured	BB

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