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Research Update:

Republic of Montenegro 'B+/B' Ratings Affirmed On Economic Growth Potential; Outlook Stable

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Overview

- We anticipate that Montenegro's economy will grow an average of 3.4% over 2015-2018 supported by an increase in investment activity.
- We are therefore affirming our 'B+/B' ratings on Montenegro.
- The stable outlook reflects a balance of risks from worsening external, fiscal, and general government debt metrics against the country's growth potential over the coming 12 months.

Rating Action

On May 15, 2015, Standard & Poor's Ratings Services affirmed its 'B+/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Montenegro. The outlook is stable.

Rationale

Our ratings on Montenegro are constrained by the country's relatively low income levels (we estimate per capita GDP at $6,200 in 2015), high external indebtedness relative to peers, and the lack of monetary policy flexibility arising from the country's unilateral adoption of the euro.

The construction of the Bar-Boljare highway has just started and we expect this project will support economic growth over the next five years. While on one hand we expect net imports to increase, on the other hand we anticipate investment activity, especially in the tourism and energy sector, will pick up strongly. We therefore expect real GDP to rise by 3.2% in 2015 and by 3.5% on average until the end of 2018. Downside risks to our growth forecast could materialize if large-scale investment projects, including the highway, were to stall, or if a deep recession in Russia greatly affected Montenegro's economy through lower tourism receipts.

According to our projections, Montenegro's general government debt is set to rise further, peaking at 73% of GDP in 2018. Despite the authorities' substantial fiscal consolidation efforts in recent years, the construction of the Bar-Boljare highway and drawdown of the €688 million loan (24% of 2015 GDP) will sharply increase the deficit and debt burden over the next five years. We expect the general government deficit to surpass 6% of GDP this year before gradually narrowing to about 4% of GDP in 2018, as the underlying fiscal position--not including highway-related expenditures--continues to improve through tax reform and the government's efforts to shrink the grey economy. The government's recent decisions to lift the pension freeze and to reduce the so-called crisis tax--a surtax on monthly incomes more than €720--among other measures, point to the risk of a loosening fiscal stance ahead of the 2016 elections.

Local government finances are prone to occasional build-ups of arrears and pose an additional risk (at 4% of GDP in 2014) to the overall fiscal position. We understand, however, that the authorities are planning to address the problem with assistance from international financial institutions.

A large portion of the highway project will be financed through the Chinese Exim bank loan. It has favorable conditions, such as a six-year grace period on principal payments, but biannual interest payments of the U.S. dollar-denominated loan will commence in July 2015. Foreign exchange risks due to depreciation of the euro against the U.S. dollar are limited over the period of interest payments, but risks will significantly increase when principal payments begin.

We expect net foreign direct investment (FDI) to average just under 11% of GDP over 2015-2018. Large energy sector investment projects, when completed, could make Montenegro a net energy exporter and slightly improve its large current account deficit (17.6% of GDP in 2015). Material exposure to FDI-inflows from Russia and concentration of FDI-inflows into real estate have made Montenegro vulnerable to sudden reversals of capital flows. Real estate related FDI-inflows declined by more than 10% in 2014. Gross external financing needs remain high at 150% of current account receipts plus usable reserves through 2018. Likewise, narrow net external debt averages 200% of current account receipts over the period to 2018. Moreover, owing to high external refinancing needs and a low ability to absorb external shocks, Montenegro is exposed to changes in market sentiment, which may be exacerbated by a liftoff in U.S. interest rates and increased volatility in financial markets globally.

Large, persistent errors and omissions (over 11% of GDP in 2014) are an indicator of poor external data quality. In our view, these errors and omissions largely reflect unrecorded tourism export revenues and the underestimation of the stock of remittances, among other factors. This may mean that the current account deficit and external leverage indicators, measured in current account receipts, are overstated. But this does not change our view that external finances are a major credit weakness.

Domestic companies continue to face tight lending conditions demonstrated by high interest rate spreads. High, yet declining, nonperforming loans (16.7% of total loans at end-March 2015) further weigh on banks' appetite to lend. Credit growth was negative last year, but we expect it to pick up as the economy gains steam. This trend may be further helped by the recent granting of three new bank licenses, which may lead to interest rate spreads declining as well as implementation of the so-called Podgorica Approach, a process intended to foster voluntary out-of-court restructuring of nonperforming loans.

Montenegro's twin deficits are an even bigger source for concern, given the country's unilateral use of the euro as its currency. Despite increased cooperation with the European Central Bank (ECB), the country is not part of the eurozone (European Economic and Monetary Union) and Montenegrin banks have no access to ECB liquidity facilities. The government's policy options are further constrained by shrinking domestic credit and a relatively undeveloped capital market.

Outlook

The stable outlook reflects our view of Montenegro's balanced risks between sound growth potential on the one hand and a deteriorating path of fiscal metrics on the other, which we expect to remain unchanged over the next 12 months. However, it also reflects that we do not expect the fiscal metrics resulting from the highway construction project to deteriorate beyond our expectations, thanks to fiscal consolidation efforts.

We could lower the ratings on Montenegro if:

- The country's fiscal metrics deteriorate further than we currently envisage. This could result from cost overruns related to the highway construction, further costs incurred in relation with legal proceedings and restructuring at KAP, the aluminum plant, or a loosening of the fiscal stance, potentially from expenditure overruns from lower levels of government.
- The country finds it harder to roll over its external debt.
- Large-scale FDI projects stall or do not materialize at all, as this would depress Montenegro's growth prospects.

We could raise the ratings if we see Montenegro's economic growth picking up faster than we anticipate in conjunction with a decline in the country's government and external debt.

Key Statistics

Table 1

Republic of Montenegro Selected Indicators

	2008	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
Nominal GDP (bil. US$)	4.52	4.14	4.11	4.50	4.05	4.42	4.48	3.87	3.73	3.94	4.17
GDP per capita (US$)	7,306	6,686	6,630	7,244	6,514	7,109	7,198	6,227	5,992	6,327	6,682
Real GDP growth (%)	6.9	(5.7)	2.5	3.2	(2.5)	3.3	1.5	3.2	3.3	3.5	3.5
Real GDP per capita growth (%)	6.8	(5.8)	2.4	3.1	(2.6)	3.3	1.4	3.1	3.2	3.4	3.4
Change in general government debt/GDP (%)	5.1	8.2	4.2	6.6	6.9	10.4	5.5	6.4	5.3	4.6	4.2
General government balance/GDP (%)	(0.4)	(5.7)	(4.9)	(4.4)	(5.4)	(5.3)	(1.5)	(6.4)	(5.3)	(4.6)	(4.2)
General government debt/GDP (%)	29.0	38.2	40.9	45.9	54.0	61.5	66.2	69.7	71.5	72.3	72.6
Net general government debt/GDP (%)	26.4	31.9	36.0	43.7	51.3	59.5	63.4	67.1	69.1	70.0	70.4
General government interest expenditure/revenues (%)	1.5	1.9	2.4	3.7	4.5	4.9	5.8	5.7	6.0	6.0	6.0
Other dc claims on resident nongovernment sector/GDP (%)	89.5	78.9	69.7	58.2	57.9	55.5	54.5	53.0	51.3	50.2	49.2

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Table 1

Republic of Montenegro Selected Indicators (cont.)

	2008	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
CPI growth (%)	8.6	3.4	0.5	3.1	4.2	2.2	(0.7)	1.0	2.0	2.3	2.3
Gross external financing needs/CARs plus usable reserves (%)	194.9	206.6	175.8	158.5	164.4	154.1	153.0	147.3	149.1	149.8	150.8
Current account balance/GDP (%)	(49.8)	(27.9)	(22.9)	(17.7)	(18.7)	(14.6)	(15.4)	(17.6)	(19.4)	(19.5)	(19.9)
Current account balance/CARs (%)	(102.0)	(63.5)	(48.3)	(33.1)	(33.1)	(27.2)	(28.9)	(31.4)	(33.8)	(34.1)	(35.0)
Narrow net external debt/CARs (%)	76.9	85.9	200.7	174.6	185.9	185.2	180.1	196.6	205.0	199.3	195.7
Net external liabilities/CARs (%)	208.0	323.4	459.8	405.8	455.7	462.3	473.7	538.1	568.9	562.6	560.2

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CPI--Consumer price index. CARs--Current account receipts. f--Forecast. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Montenegro Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Weakness
Fiscal assessment: flexibility and performance	Weakness
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Central And Eastern Europe Debt Report 2015: Borrowing To Decrease To EUR119 Billion, March 5, 2015
- Central And Eastern Europe Sovereign Rating Trends 2015, Jan. 22, 2015
- Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that fiscal risk had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Ratings	
	To	From
Montenegro (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	B+/Stable/B	B+/Stable/B
Transfer & Convertibility Assessment		
T&C Assessment	AAA	AAA

Ratings List Continued...

Senior Unsecured		
Local Currency	B+	B+

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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