

RESEARCH

Research Update:

Republic of Montenegro L-T Rating Raised to 'BB+' On Improved Growth Prospects; Outlook Stable

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Rationale

On March 27, 2007, Standard & Poor's Ratings Services raised its long-term ratings on the Republic of Montenegro to 'BB+' from 'BB'. At the same time, the 'B' short-term rating was affirmed. The outlook is stable.

The upgrade is based on Montenegro's significantly improved growth prospects owing to strong investment spending and improving public finances.

Montenegro's real GDP growth is estimated to have surpassed 8% in 2006, on the back of strong domestic demand, and growth in the construction, banking, and tourism sectors.

The country's smooth path to independence in 2006 significantly reduced political risk, triggering high foreign direct investment (FDI) inflows in real estate, tourism, and other sectors, estimated at 34% of GDP in 2006. Further social security reforms, the completion of privatizations, strong FDI, and infrastructure investment are expected to sustain annual GDP growth at an average of 6% in the medium term.

The government's fiscal strategy also supports the upgrade, as evidenced by a general government surplus of about 4% of GDP in 2006 (excluding payments made to clear past budget arrears and the recognition of the first wave of restitution obligations). In the medium term, however, this surplus is expected to decrease to approximately 2% of GDP. The general government debt-to-GDP ratio will rise in 2007, owing to the one-off issuance of the remaining restitution bonds (estimated at about 9% of GDP in 2007), which will settle all outstanding property claims from Montenegro's turbulent past. This debt ratio is then expected to decline rapidly, however, to 36% of GDP in 2009. Moreover, the prevalence of concessional loans will keep the interest burden very low.

The completion of Stabilization and Association Agreement talks with the EU (the first step toward eventual EU membership) earlier this year provides strong impetus for further economic and political reforms. Moreover, the cohesion of Montenegro's ruling coalition has improved following the September 2006 elections.

The ratings are constrained by large external imbalances and the government's short track record in dealing with economic pressures that may emerge from external shocks, in particular, fluctuations in aluminum prices and downturns in tourism. Owing to strong construction-related imports and investment in the tourism sector, the current account deficit significantly widened, reaching an estimated 30% of GDP in 2006. It is expected to narrow, however, to 10% of GDP by 2010, following a slowdown in investment as well as rising tourism receipts. Strong FDI coverage of the external gap and Montenegro's use of the euro are mitigating factors, which provide protection from an exchange rate crisis.

Outlook

The stable outlook on Montenegro reflects the expectation that economic reform, fiscal consolidation, and strong investment will continue, and the prospect of EU integration will remain a driver for further reforms and ongoing political stabilization. Regional political developments, and in particular the final status of Kosovo, may moderately affect Montenegro's political and economic environment.

Further tax and labor market reform leading to strong economic growth and a rapidly declining public debt burden would contribute to increased creditworthiness. Sustained FDI inflows, in particular to the tourism and energy sectors, would also improve Montenegro's prospects of being raised to investment grade.

Conversely, if the country's external imbalances fail to readjust and

there is a rapid rise in external debt, this could place downward pressure on ratings. There is also the possibility of overheating in the stock and property markets, which could stunt economic growth in the medium term, and therefore also poses a potential risk to the ratings.

Ratings List

	To	From
Sovereign credit ratings	BB+/Stable/B	BB/Positive/B

Additional Contact: Sovereign Ratings;
SovereignLondon@standardandpoors.com

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