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**Summary:**

# Montenegro (Republic of)

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## Summary:

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**Credit Rating:** BB+/Stable/B

## Rationale

Standard & Poor's Ratings Services has affirmed its 'BB+' long-term and 'B' short-term sovereign credit ratings on the Republic of Montenegro. At the same time, Standard & Poor's also affirmed its 'AAA' transfer and convertibility assessment. The outlook is stable.

The ratings on Montenegro are constrained by external imbalances which have been fuelled by rapid credit growth and rising incomes. The ratings are supported by strong growth, the government's budgetary surplus, political stabilization, and prospects for EU accession.

Montenegro's real GDP growth is estimated at 7.5% in 2007, owing to a boom in investment and services, in particular in the tourism sector. This should raise Montenegro's GDP per capita to an estimated \$5,200 in 2007, compared to the 'BB' median of \$2,931.

The country's independence in 2006 minimized political risk, while EU prospects, accelerated by the signing of the Stabilization and Association Agreement (the first step toward EU membership) in October 2007, provide strong impetus for further reforms.

Owing to a strong windfall of revenues, the general government generated a surplus of at least 7% of GDP in 2007, which will decrease to 2% of GDP by 2010. The issuance of restitution bonds (at 6% of GDP in 2007) that will settle outstanding property claims, will keep gross debt at 36% of GDP in 2007, and above 30% by 2010. The predominance of concessional loans will keep the interest burden low.

The ratings are constrained by external imbalances and the government's short track record in dealing with economic pressures. The construction boom and rapid credit expansion (at 130% of GDP annually since 2006) triggered high imports, which resulted in a current account deficit of 27% of GDP in 2007. This will narrow gradually to a still unsustainable 16% of GDP by 2010, following a slowdown in investment and rising tourism receipts. Net FDI covers around 75% of the gap, which, in tandem with the use of the euro, is a mitigating factor preventing a currency sell-off. However, rapid credit expansion poses a risk if the contingent liability materializes or if a sudden disruption of credit flows triggers recession.

Given the monetary policy limitations under the euro, fiscal policy is the main instrument in managing domestic demand. This includes fiscal control, and the government's deposits, estimated at below 10% of GDP. The imposition of lending limits to curb rapid credit growth is expected to moderate imbalances, while strong growth in bank deposits (and a loan-to-deposit ratio around 100%) has so far moderated the financial sector external indebtedness.

## Outlook

The stable outlook on Montenegro reflects our expectation that the government will pursue economic and fiscal policies that address Montenegro's sizeable external imbalances. It is expected that the prospect of EU accession will remain a key driver for further reforms. Regional political developments, in particular the unresolved Kosovo issue, may moderately affect Montenegro's political and economic environment.

Strong economic growth, rising exports, and a rapidly declining public debt burden would contribute to further improvements in Montenegro's creditworthiness. Sustained net FDI inflows, particularly to the tourism and energy sectors, would also be supportive.

Conversely, should the country's external imbalances continue to mount, resulting in a rapid rise in external debt, potentially fuelled by a continued surge in banking credit, this could place downward pressure on the ratings. The overheating in the stock and property markets, if it continues, could stunt economic growth in the medium term, and therefore also poses a risk to the ratings.

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