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Montenegro – Credit Outlook



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The credit outlook is negative reflecting the country's deteriorating economic environment, fiscal risks associated with the immediate economic deterioration and associated contingent liabilities. There are further concerns that the country could experience a liquidity crunch unless additional foreign capital is secured!

Montenegro fell into recession in the first half of the year when the economy shrank by 3.5%. Badly affected by the global economic crisis, the end of the global property boom and the lack of liquidity in the banking sector, the economic recession will likely cause a decline in government revenues, leading to higher government debt that will persist over time. Moreover, problems in the manufacturing and banking sectors could lead to higher debt as the government supports troubled companies.

The global economic crisis is also threatening the viability of the two largest exporters in the country, KAP (Aluminum smelter, Russian-owned KAP, is the country's largest exporter, with 40 % of industrial production; it is creating losses because of low global metal prices and it has already halved its production for 2009) and Nikšićka Željezara (Steel mill).

The banking sector has had difficult times following a period of major loans to fuel economic expansion in Montenegro. Last December, the Government extended a 44-million euro bail-out loan to its second largest bank, Prva Banka.



Banks' Non Performing Loan ratios have been rising and there is a substantial exposure to the rapidly slowing down construction sector. Public confidence remains fragile, and a blanket deposit guarantee introduced in October 2008 slowed but did not stop deposit withdrawals. However, all parent banks have supported their subsidiaries with additional funding thus far, thus partly offsetting the drain on deposits.

Subsequently, the government may struggle to fund its entire borrowing requirements from private creditors in the current international environment. Unless there is a significant improvement in the European banking sector over the next few months, the government may be forced to seek financial support from official sources, such as the IMF – an IMF program would open up the possibility of supplementary macro-fiscal support from the European Union (EU). Thus, the recent decision by the EU to commence an evaluation of Montenegro's readiness to become an official candidate country is positive.

Fiscal plans are likely to undermine fiscal stability. Plans for cuts in tax and contribution rates and increases in capital and social expenditure have substantially increased the structural deficit in 2009 and will further increase it in 2010, leading to rapidly rising public debt. Moreover, there are substantial contingent liabilities linked to the blanket guarantee of bank deposits, potential recapitalization of banks, the loss making aluminum plant, and longer term aging pressures. And the fiscal stimulus is unlikely to be very effective, given the large share of imports, narrow production base, and tight credit conditions.



Rapid wage growth, in the context of the euro peg, is reducing the competitiveness of the economy. **Continued erosion in competitiveness will ultimately undermine Montenegro's attractiveness as a destination for FDI further, making it more difficult to broaden the production base of the economy.**

After expanding by 7.7% in 2008, Pytheas predicts that the economy shall fail to grow at all this year, forcing the country to borrow up to 300 million Euros (about 10% of GDP) or even more.

Heavily dependent on foreign investments and loans, the Government is betting its hopes to a number of government tenders in forthcoming months, including tender for the development of Montenegro's longest beach in Ulcinj, hoping one or two big deals could bring in billions of Euros in the years ahead.

Investors are also called for a key highway, the country's main port in Bar, its railways and flag carrier Montenegro Airlines but the chances of bringing off something big in the middle of the global capital shortage are minimized.

With more than a million visitors a year, tourism revenues make a quarter of GDP. But tourist numbers declined in summer 2009 amid a collapse of the Russian economy, which for long represented a key Montenegrin target market. Direct flights from Moscow enticed hundreds of Russians to buy weekend houses along the coast, dramatically driving up real estate prices during 2007 and mid-2008 but this is not any more the case.

It is estimated that the Montenegrin government's Debt/GDP ratio could increase to almost 50% in 2010 from under 30% in 2007-08, while future economic growth rates will definitely be lower than recently experienced; as a result, the government's debt ratios will probably remain at an elevated level for some time.

Real GDP Growth	
Year	%
2001	1.1
2002	1.9
2003	2.5
2004	4.4
2005	4.2
2006	8.6
2007	10.7
2008	7.7
2009*	-4.0
2010*	-2.0

On the other hand, the stable monetary regime (Montenegro has adopted the Euro as its official currency since 2002) and long-term prospects for economic diversification and convergence, the EU accession process should promote a gradual strengthening of institutions over time. **Ongoing structural reform and further European economic integration should also sustain gradual income convergence towards the EU average, although this process could take several decades.**

*Estimate

Important also to note that 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.

Montenegro has made significant progress in overhauling its economy. The last five years have seen inflation performance improved through the adoption of the euro as sole legal tender; banking sector restructuring; significant privatization; strengthened market infrastructure; and progress in fiscal consolidation. The authorities' objective is to create a business friendly, open economy with low taxes and minimal state interference, and to integrate the country in Atlantic-European structures.

Reform efforts have been rewarded, particularly following independence, by strong foreign investor interest. There have been large FDI inflows primarily into the tourism sector and associated real estate, and banking. Real estate sales to foreign investors have generated strong wealth effects, contributed to a sharp increase in bank deposits, and boosted domestic demand. Alongside, construction has boomed. Credit growth has soared, stimulated by surging deposits and keen competition in the largely foreign owned banking sector.



Policy should focus on maintaining financial sector and fiscal stability, while continuing to improve the regulatory and institutional framework. In addition to macroeconomic stability, sustained growth will require improvements to public infrastructure and administration, the business environment, and the flexibility of the labor market.

Fiscal policy should be guided by a net debt anchor, and supported by a medium term expenditure framework to help entrench countercyclical policy. A well designed medium term expenditure framework would create scope for the free operation of automatic stabilizers while supporting consolidation efforts. **In order to be credible, the expenditure envelope should be underpinned by the development of a coherent planning framework backed by tangible measures and expenditure reforms.**

Continued vigilance and strong implementation of prudential measures will be needed to enhance bank soundness. Welcome steps already taken include tighter reserve requirements, temporary credit ceilings, a centralized credit registry, and higher solvency ratios for banks with high credit growth. **Moreover, tighter capital, liquidity, and provisioning rules established in through 2009 should continue, which should help strengthen banks' resilience to shocks.** Reducing the lag in repaying deposits from failed banks would also increase confidence in the deposit insurance system.

Future economic growth will depend critically on further improvement of the regulatory framework and institutions. Increased labor market flexibility and a substantial reduction in red tape at the municipality level are needed to support private sector development. And firm implementation of electricity sector reforms is needed to improve the efficiency and reliability of electricity production. Moreover, some additional resources in statistics will also go a long way in improving economic policymaking.

Opinion: The Montenegrin economy has achieved impressive results over the past several years. Ambitious structural reforms, substantial capital inflows, dynamic developments in the banking sector, and strong fiscal performance positioned Montenegro as one of the fastest growing European countries. Average annual GDP growth in the last four years was around 8 percent. However, Montenegro, a small, open economy, is not immune to global economic developments.

The Global financial turmoil and recession will continue to have a substantial adverse impact on confidence, credit growth, tourism, and FDI inflows. Thus, the sharp deceleration in growth is expected to continue well into 2010. Moreover, over the medium term only a modest rebound in growth is expected, as FDI and credit growth are unlikely to return to the extremely high levels observed in recent years. Cooling demand will also have a substantial adverse impact on fiscal revenues, and the fiscal position will be under more pressure.

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