



MONTENEGRO

2018 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

May 2018

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on March 7, 2018, with the officials of Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 4, 2018.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

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International Monetary Fund
Washington, D.C.



Press Release No. 18/187
FOR IMMEDIATE RELEASE
May 21, 2018

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2018 Article IV Consultation with Montenegro

On May 18, 2018 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro¹ and considered and endorsed the Staff Appraisal on a lapse-of-time basis.²

Montenegro's economy is growing strongly, boosted by the implementation of large investment projects, including the construction of the Bar-Boljare highway. Growth should continue over the medium term, albeit at a more moderate pace as highway construction ends. Staff projects the economy to expand by 3 percent in 2018 and 2½ percent in 2019, with fiscal consolidation also acting as a moderate drag on growth.

While the implementation of large publicly financed infrastructure projects has added to economic growth, the accompanying use of fiscal resources has contributed to a large increase in government debt, which reached 75 percent of GDP in 2017. Large refinancing needs over 2019-21 have also been a source of fiscal vulnerability.

Recognizing the need to reduce public debt, the government is continuing the implementation of its medium-term fiscal consolidation strategy, announced in 2017. Most of the fiscal measures have already been implemented, and the underlying fiscal position improved in 2017. If carried out in full, the strategy will considerably strengthen the fiscal position, generating a primary fiscal surplus of 4½ percent of GDP by 2020, allowing government debt to fall to 53 percent of GDP by 2020.

Conditions in the banking sector continue to strengthen, with improving asset quality, recovering credit growth, and high liquidity. However, the sector appears to be crowded, presenting a challenge for bank profitability.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

The lack of an independent currency and limited fiscal space constrain Montenegro's ability to absorb shocks, which underscores the need for an improvement in economic flexibility to sustain growth over the long run. Low labor productivity and employment levels and a large informal sector limit potential growth. The government's plans to reform labor laws and the labor tax wedge provide an opportunity to improve the flexibility of labor market outcomes, boost participation rates, and reduce informality.

Executive Board Assessment

Economic growth should remain strong in 2018, notwithstanding fiscal consolidation, and maintain momentum over the medium term. Growth should slow moderately as fiscal consolidation continues and highway construction ends next year, but the possible supply side boost of the highway section and other large investment projects should sustain growth.

The authorities are appropriately focused on fiscal adjustment to lower government debt to safer levels. While infrastructure development is needed, the construction of the first section of the Bar-Boljare highway has had a key role in raising debt to high levels. The authorities' front-loaded fiscal adjustment is appropriately timed to complete the underlying fiscal adjustment before construction of the highway concludes. Fiscal space does not exist to finance the remaining phases of the highway with debt, and the authorities should ensure that the completion of the highway via PPP meets standard cost-benefit criteria and does not introduce large contingent liabilities.

The medium-term fiscal adjustment plan is well specified and socially balanced, and concerted political efforts will be needed to maintain fiscal discipline. The authorities legislated most of the fiscal measures in 2017, and most of the underlying adjustment should be completed this year. If the plan continues to be implemented, government finances will regain a sustainable footing. Staff projects a primary surplus of 4½ percent of GDP in 2020, leading general government debt (including guarantees) to fall quickly after peaking at 80 percent of GDP in 2019. The maintenance of primary surpluses after 2020 will be necessary for debt to fall rapidly, although surpluses could decline to around 3 percent of GDP. To support sound fiscal policy decisions in the future, the authorities should strengthen fiscal institutions, including fiscal rules and budgetary processes.

Over the medium term, the authorities should implement fiscal reforms to improve the composition of revenues and expenditures. The authorities should implement a strategy to right-size the public-sector workforce and implement a civil service reform. Central oversight over local government finances should be strengthened, and municipalities' incentives and capacity to raise their own revenues should be increased. Tightening eligibility for early retirement should strengthen pension sustainability, and shifting pensions to wage valorization and CPI indexation would improve long-term fiscal and social sustainability. The authorities should also review the fiscal cost of tax exemptions. Taken together, these reforms would increase fiscal space over the medium term for greater high-productivity capital spending and well-targeted social spending or provide offsets for unforeseen fiscal slippages, which are a domestic risk.

The authorities should continue their efforts to improve the health of the financial sector. The authorities have closed supervisory gaps by bringing non-bank financial institutions under the supervision of the central bank. While the overall banking sector is stable, the authorities should steadfastly implement supervisory action plans for weak banks and intervene, if necessary. Asset quality reviews would improve loan classification and provisioning practices and should be implemented as soon as possible. The authorities should also adopt a definition of non-performing loans that does not exclude impaired assets that have adequate collateral. With many banks relative to the size of the market, the authorities should be cautious in granting new banking licenses and promote consolidation. The authorities should continue to improve the AML/CFT framework and seek to implement the outstanding recommendations of the 2015 FSAP.

A comprehensive strategy is needed to improve labor market outcomes and raise productivity growth. Montenegro faces competitiveness challenges, and its external position is weaker than that consistent with medium-term fundamentals. Structural labor market impediments discourage greater labor force participation and the generation of formal sector employment, and the authorities should implement a unified strategy by reducing the labor tax wedge, reforming the withdrawal of social benefits, and adopting amendments to the labor law that balance the need for worker protection with a needed increase in labor market flexibility. The authorities should also review the involvement of the state in the economy to ensure that it is limited to areas of market failures and strengthen the framework for public-private-partnerships to minimize the risk of large liabilities being transferred to the public sector.

It is expected that the next Article IV consultation with Montenegro will be held on the standard 12-month cycle.

Montenegro: Selected Economic Indicators

	2014	2015	2016	2017	2018	2019
				Prel.	Proj.	Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	1.8	3.4	2.9	4.4	3.0	2.4
Nominal GDP (in millions of euro)	3,458	3,655	3,954	4,237	4,492	4,692
Industrial production	-11.5	8.2	-2.9	-4.5	...	...
Tourism (Overnight stays)	-9.2	5.3	8.4	10.5	...	...
Unemployment rate (in percent)	18.0	17.6	17.7	16.1	...	...
Consumer prices (average)	-0.7	1.5	-0.3	2.4	2.8	1.8
Consumer prices (end of period)	-0.3	1.4	1.0	1.9	2.7	1.8
Average net wage (12-month)	-0.5	0.7	4.0	2.3	...	...
General government finances (percent of GDP) ¹						
Revenue and grants	43.5	40.4	41.3	40.9	43.4	42.4
Expenditure	44.2	46.6	47.5	47.8	46.1	44.4
Overall fiscal balance	-0.7	-6.2	-6.2	-7.0	-2.7	-2.0
Primary fiscal balance	1.6	-3.8	-4.0	-4.5	-0.7	0.1
General government gross debt	63.4	68.8	66.4	67.2	72.5	70.9
General gov't gross debt (authorities' definition) ²	59.9	66.1	64.4	65.3	70.7	69.2
General gov't debt, including loan guarantees	71.5	76.2	73.9	74.6	80.1	78.2
Monetary sector (end-period, percent change)						
Bank credit to private sector	-0.4	2.2	6.4	8.4	7.2	7.5
Enterprises	-2.5	1.7	1.6	6.1	...	...
Households	1.7	2.7	11.1	10.4	...	...
Private sector deposits	6.1	9.0	6.0	15.1	...	...
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-15.2	-13.2	-18.1	-18.9	-18.8	-17.6
Foreign direct investment	10.2	16.9	9.4	11.2	11.3	11.3
External debt (end of period, stock) ³	163.1	161.8	158.8	159.7	164.2	166.3
REER (CPI-based; average change, in percent; - indicates depreciation)	-0.1	1.8	0.4	-1.9	...	...

Sources: Montenegro authorities; and IMF staff estimates and projections

^{1/} Includes extra-budgetary funds and local governments, but not public enterprises.

^{2/} The authorities do not include the arrears of local government in their definition of general government gross debt.

^{3/} Staff estimates, as private debt statistics are not officially published.



MONTENEGRO

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

May 4, 2018

KEY ISSUES

Background: The economy has grown strongly since 2015, bolstered by large investment projects and buoyant tourism. Banking sector health continues to improve, with private credit growing and balance sheets strengthening. While the construction of the first phase of a major highway project has boosted economic growth, it has also raised government debt, with a cost of nearly $\frac{1}{4}$ of GDP. To strengthen fiscal sustainability, in 2017 the authorities began implementing a well-specified medium-term fiscal adjustment strategy, in line with staff advice.

Outlook and risks: Economic growth should moderate to 3 percent in 2018, with some drag from fiscal consolidation, before slowing again in 2019 as highway construction ends. Government debt should peak in 2018 and decline rapidly thereafter, if the authorities adhere to their fiscal adjustment strategy until 2020. The maintenance of debt on a strong downward path depends critically on the authorities' ability to maintain fiscal discipline beyond 2020 with sizeable though declining primary surpluses.

Policy recommendations

Fiscal policy: The authorities should maintain spending discipline and continue to implement in full their fiscal consolidation strategy, which is mindful of social protection needs, aiming to deliver a primary fiscal surplus of $4\frac{1}{2}$ percent of GDP by 2020. To promote budget discipline over the medium term, fiscal institutions should be strengthened. The authorities should also implement reforms to public sector employment, the pension system, and local government finances.

Financial sector: The authorities should forcefully implement supervisory actions plans to strengthen the non-systemic weak banks and intervene, if necessary. An independent system-wide asset quality review would aid in the early identification of risks, and the authorities should improve the definition of non-performing loans. The banking system appears crowded, and measures to promote consolidation would be beneficial.

Structural reforms: A comprehensive strategy is needed to increase formal employment and boost labor force participation. Integrated reforms are needed to reduce the labor tax wedge, alter the design of social benefits, and review employment policies. State involvement in the economy should be reviewed, and public private partnerships should be designed to minimize the risk of large contingent fiscal liabilities.

Approved By
Jörg Decressin (EUR)
and Yan Sun (SPR)

Discussions were held in Podgorica February 21 - March 7, 2018. The team consisted of Martin Petri (head), Marco Arena, William Lindquist, and Marzie Taheri Sanjani (all EUR). Ms. Kalezic (OED) joined most of the meetings. The team met with the authorities (Central Bank of Montenegro, plus Ministries of Economy, Finance, Transportation, Labor, and Public Administration), private sector representatives (unions, employers, and banks), the diplomatic community, and international agencies (EC, EBRD, and UNDP). HQ support was provided by Min Song and Brett Stewart (EUR).

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CONTEXT

1. Montenegro is a small, open, euroized economy with high public debt and significant dependence on tourism and external financing. The economy is concentrated in tourism, real estate, and agriculture. Rigid labor markets, weak demographics, and low labor-force participation and productivity constrain economic growth. While fiscal adjustment began in 2017, public expenditure is elevated, and the Bar-Boljare highway project (Box 1) has significantly increased public debt. With unilateral euroization, there is no independent monetary policy. Montenegro began EU accession negotiations in 2012 and has opened 30 of 35 negotiating chapters, with three provisionally closed. In October 2016, the incumbent ruling party (together with coalition partners) won a slim majority in parliament. The ruling party candidate won the April 2018 presidential election.

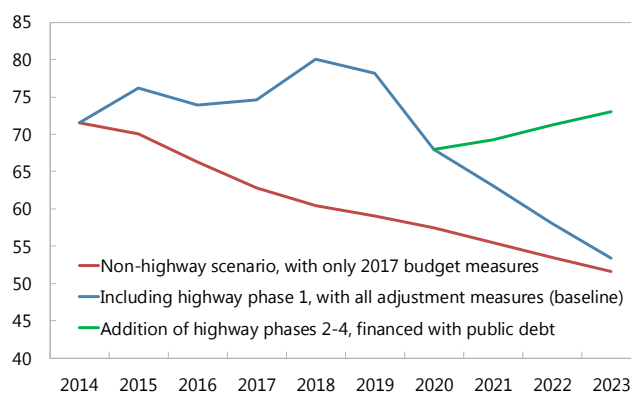
Box 1. Montenegro's Highway Project

The Bar-Boljare highway will connect Montenegro's coast with Serbia. Only the first 41-km segment connecting Podgorica with the northern municipality Kolašin, at a cost of nearly €1 billion, is currently under construction. The remaining 136 km would likely cost somewhat more than the first segment, which includes the most difficult terrain. Phases 2 and 3 would link the highway to the Serbian border and are still in design phases, and phase 4 would connect to the port of Bar (none of them in the baseline). An eventual corridor to Belgrade requires Serbia to extend a road currently under construction an additional 100 kilometers to the border, but this project is still in the conceptual design phase.

China Road and Bridge Corporation started construction of the first segment in 2015, with completion expected in 2019. Domestic contractors are allocated 30 percent of the work. China Ex-Im Bank is providing a USD-denominated loan for 85 percent of the total cost of the first phase of €809 million (19 percent of 2017 GDP). However, because the USD subsequently appreciated and the currency risk was not hedged, the total cost has increased by 13 percent. The loan carries a 2 percent interest rate and a 20-year repayment period, with a six-year grace period on principal payments (which begin in 2021).

Had the highway (phase 1) not been built, Montenegro's debt-to-GDP ratio would have declined to 59 percent of GDP in 2019 instead of rising to 78 percent of GDP, and the medium-term fiscal adjustment strategy adopted in 2017 would not have been necessary to return debt to sustainable levels. Financing phases 2-4 with public debt would again endanger debt sustainability.

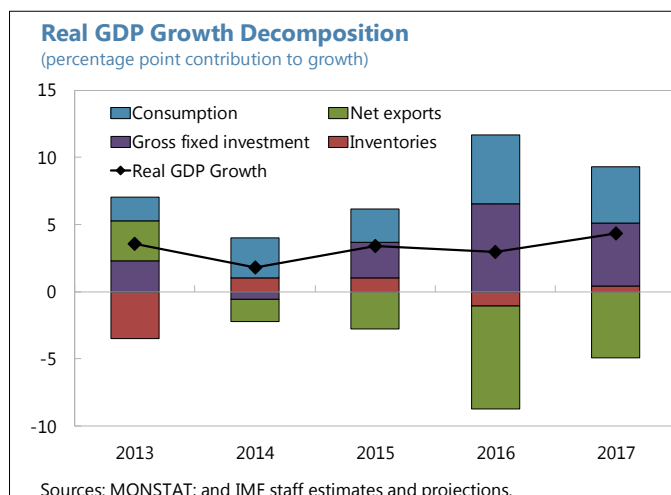
General Government Debt with Guarantees
Percent of GDP



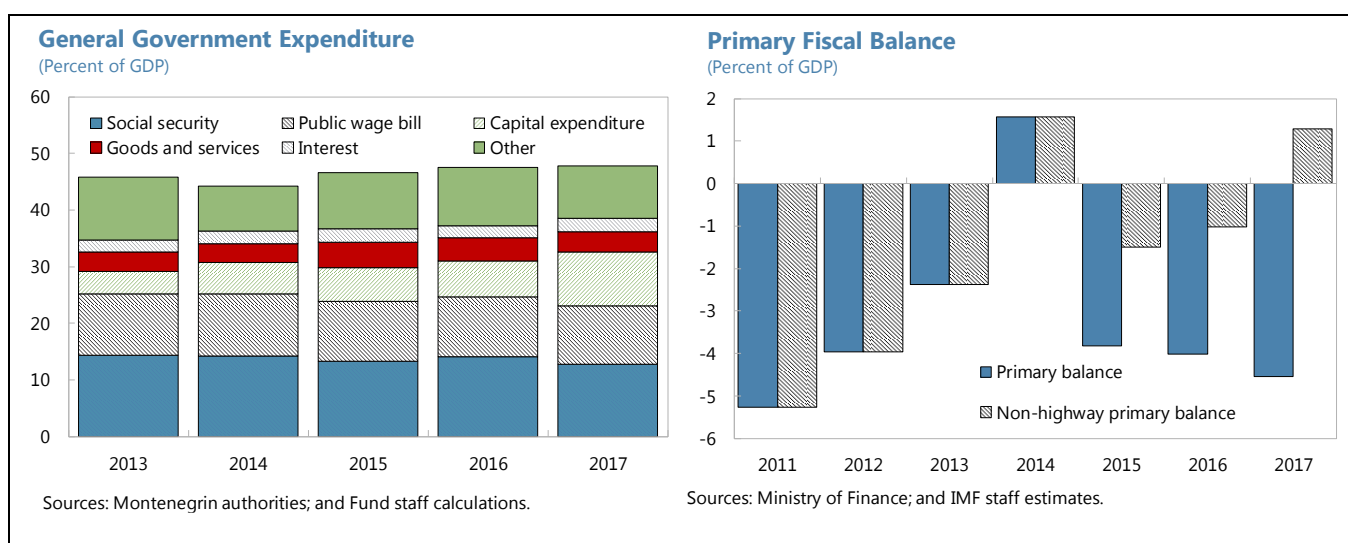
Sources: Montenegrin authorities; and IMF staff projections.

RECENT DEVELOPMENTS

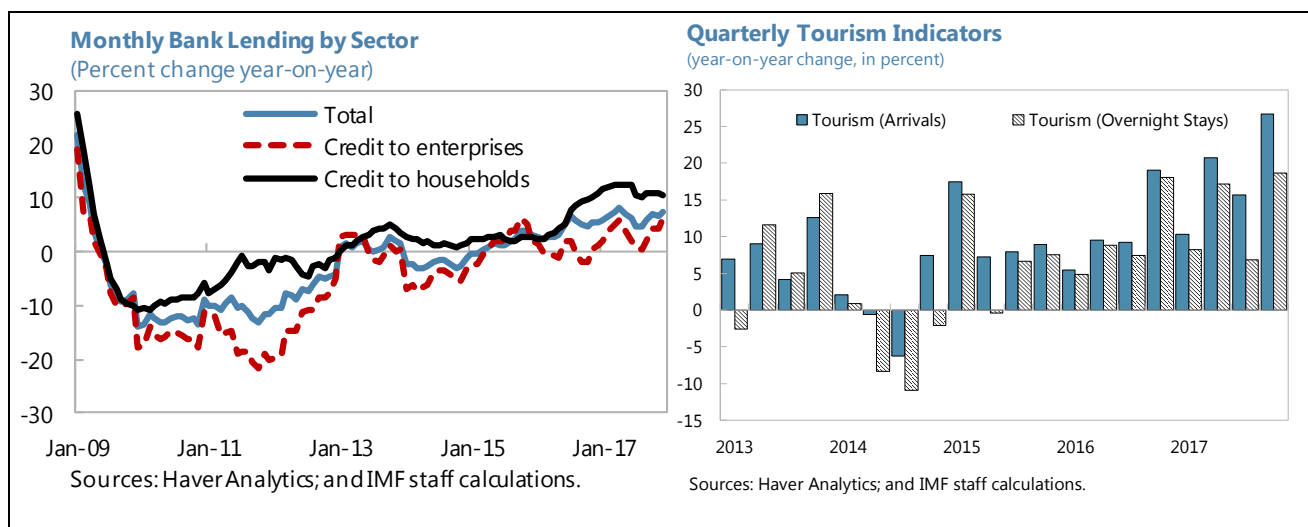
2. Economic developments in 2017 were favorable, with an acceleration in economic growth. After expanding 2.9 percent in 2016, the economy grew 4.4 percent in 2017, driven by highway construction and a strong tourism season. Inflation increased from 1.0 to 1.9 percent (end of period) in 2017, driven primarily by increases in prices of fuel, cigarettes, and accommodation. The unemployment rate declined to 16 percent from 18 percent in 2016. Driven by a partial public-sector wage freeze, wage growth slowed to 2.3 percent from 4.0 percent in 2016.



3. While the fiscal deficit increased in 2017, adjustment measures began to show results. The overall fiscal deficit increased from 6.2 percent of GDP in 2016 to 7.0 percent of GDP in 2017, driven by an increase in highway expenditures. The underlying fiscal picture improved, however, as current spending fell by 2¾ percentage points (p.p.) of GDP, driven by fiscal adjustment measures, including a freeze/reduction in public sector wages and reforms to a social benefit for mothers. Tax revenues increased by 0.5 p.p. of GDP due to excise tax increases and the proceeds of a tax debt rescheduling program. Thus, the non-highway primary balance improved from a deficit of 1.1 percent of GDP in 2016 to a surplus of 1.2 percent of GDP in 2017. General government gross debt (including guarantees) increased 1 p.p. to 75 percent of GDP.



4. The health of the banking sector continues to improve. Non-Performing Loans (NPLs) fell from 11 percent of total loans to 8 percent during 2017.¹ Following a prolonged post-crisis contraction, private sector credit expanded for the third year at a moderate rate of 8 percent. Credit growth to enterprises was weaker at 6 percent, while credit to households expanded 10 percent. Bank profitability increased but remained modest, with low returns on assets (0.9 percent) and equity (7.4 percent). Capital ratios exceed regulatory minima, though with some variation across institutions. Banks are highly liquid.



5. External imbalances remain elevated in the context of high investment-related imports. The current account deficit increased by 1 p.p. in 2017 to 19 percent of GDP. Goods and (especially) services exports grew but were outpaced by import growth, driven by fuel, investment-related goods, and food and electricity. Montenegro enjoyed another strong tourism season, with overnight stays increasing 11 percent on average. FDI increased 1½ p.p. to 11 percent of GDP, covering 60 percent of the current account deficit. With net government external borrowing of 6 percent of GDP, Montenegro continues to rely heavily on external financing. External debt increased 1½ p.p. to 160 percent of GDP.

OUTLOOK AND RISKS

6. Strong economic growth should continue in 2018, notwithstanding fiscal adjustment. The economy is projected to expand 3 percent, driven by domestic demand. With highway spending to remain near 2017 levels, private investment—rather than public investment—and consumption should drive growth, with net exports acting as a drag.

¹ The authorities are working on a new NPL methodology under which the estimated end-2017 figure would be 7.3 percent.

Figure 1. Montenegro: Real Sector Developments

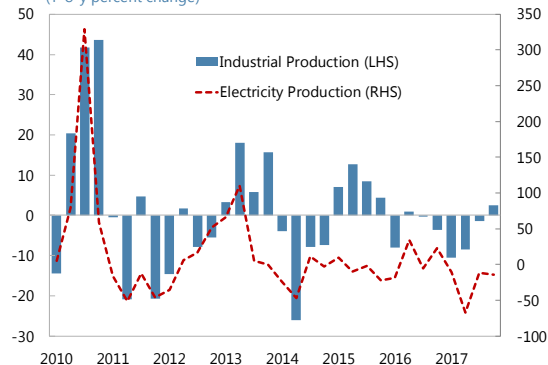
Construction activity and tourism both performed strongly in 2016 and 2017....

Indicators of Economic Activity
(Y-o-y percent change)



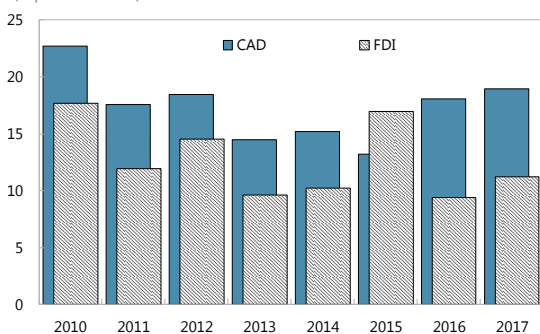
...though industrial and electricity production have yet to return to steady growth.

Industrial Production
(Y-o-y percent change)



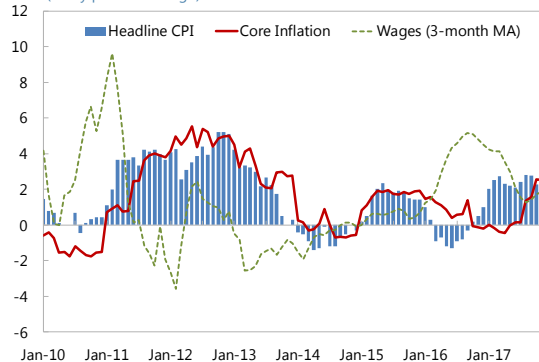
The current account deficit, roughly half financed by FDI, stayed at an elevated level in 2017.

Current Account Deficit and Foreign Direct Investment
(in percent of GDP)



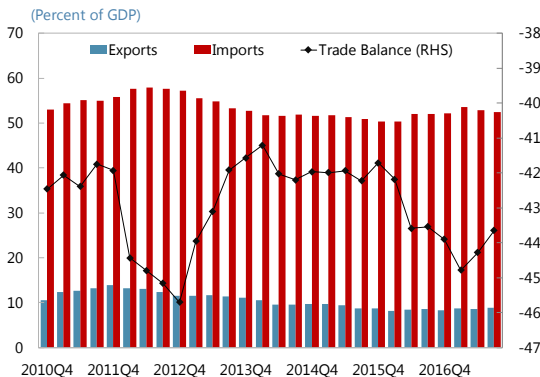
Inflation has increased, but wage growth has slowed as the impact of past public-sector wage increases waned.

Inflation and Wage Developments
(Y-o-y percent change)



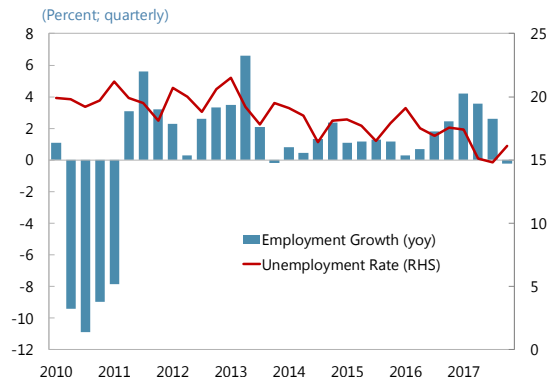
Imports for tourism, investment, and consumption dwarf a small goods export base.

Merchandise Trade
(Percent of GDP)



Employment growth has increased in recent quarters, modestly lowering a still-high unemployment rate.

Labor Market Indicators
(Percent; quarterly)

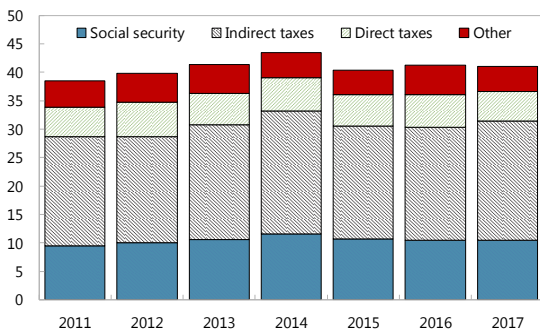


Sources: CBM; Monstat; and IMF staff estimates.

Figure 2. Montenegro: Fiscal Developments

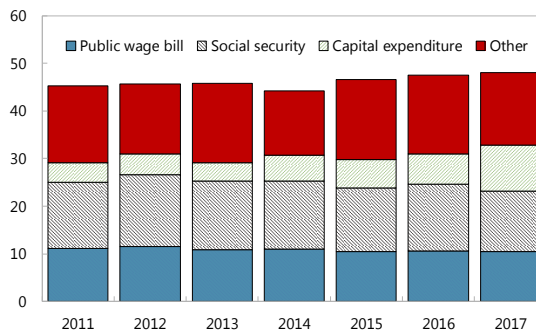
Excise tax increases supported revenues in 2017...

Composition of Government Revenue
(percent of GDP)



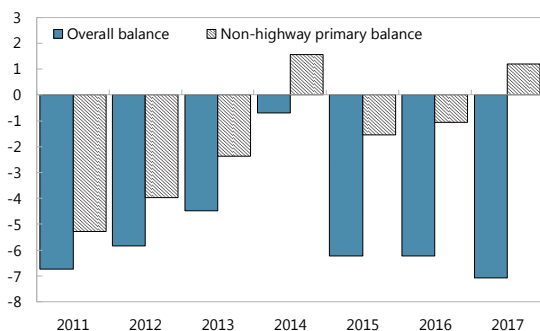
...while social benefit reforms accommodated an increase in highway spending...

Composition of Government Expenditure
(percent of GDP)



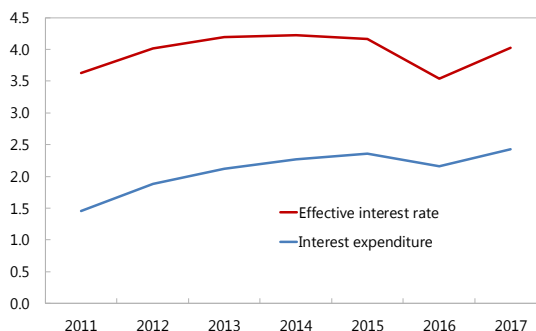
...containing the increase in the overall fiscal deficit in 2017, while the non-highway primary balance improved.

Overall Fiscal Balance and Non-Highway Primary Balance
(percent of GDP)



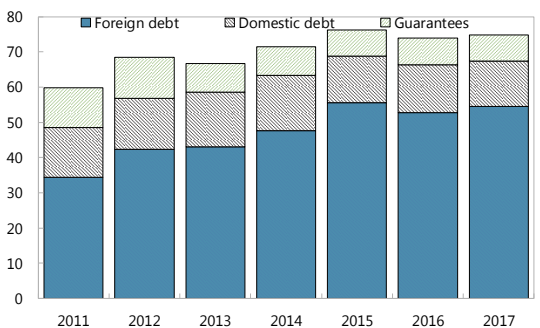
Rising debt has increased interest expenditures, though the effective interest rate has been fairly stable.

Effective Interest Rate and Expenditure
(in percent, percent of GDP)



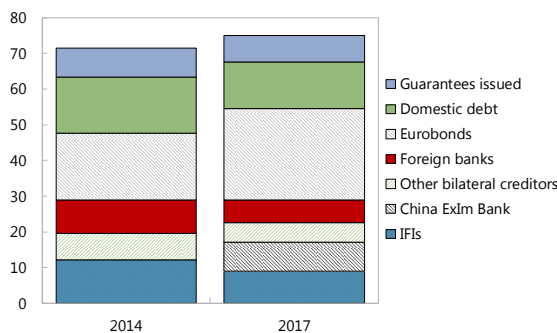
Strong nominal growth has stabilized government debt in 2016-2017, despite large fiscal deficits.

General Government Debt Including Guarantees
Percent of GDP



The highway project has made China Ex-Im Bank an important new creditor.

General Government Debt, by Creditor
(percent of GDP)

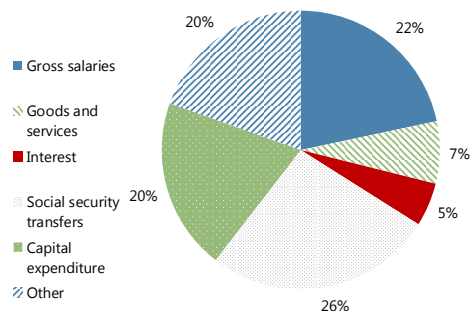


Sources: Ministry of Finance; and IMF staff estimates.

Figure 3. Montenegro: Public Expenditures

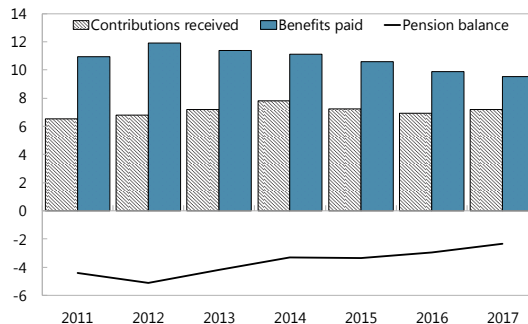
Social security and wages are a large share of expenditures.

Composition of General Government Expenditure, 2017



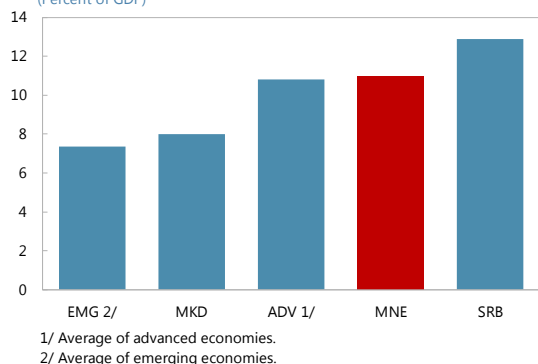
Pension expenditures remain above contributions ...

Pension Funding Gap
(percent of GDP)



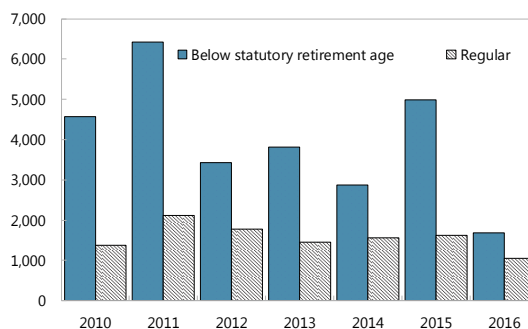
...and are high by international comparison ...

Pension Expenditure
(Percent of GDP)



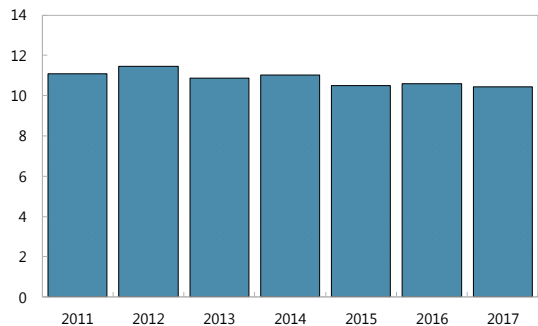
... driven in part by large numbers of early retirements in recent years.

New Old-Age Pensioners



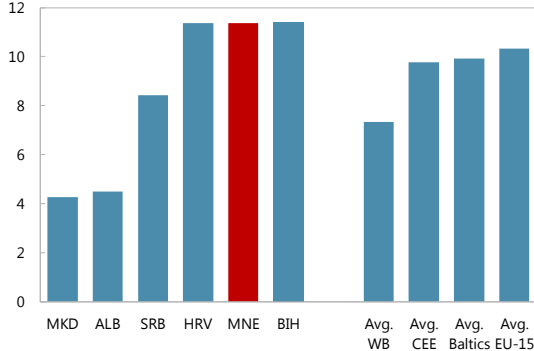
A wage freeze and partial wage cut reduced the wage bill somewhat in 2017 ...

Public Wage Expenditure
(percent of GDP)



... though the public-sector wage bill remains high.

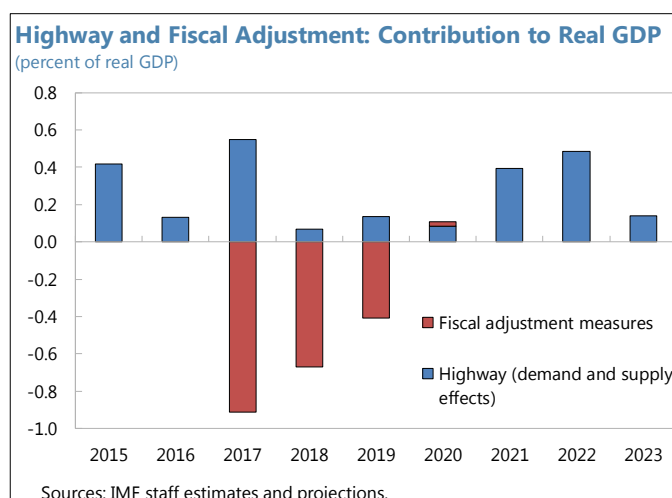
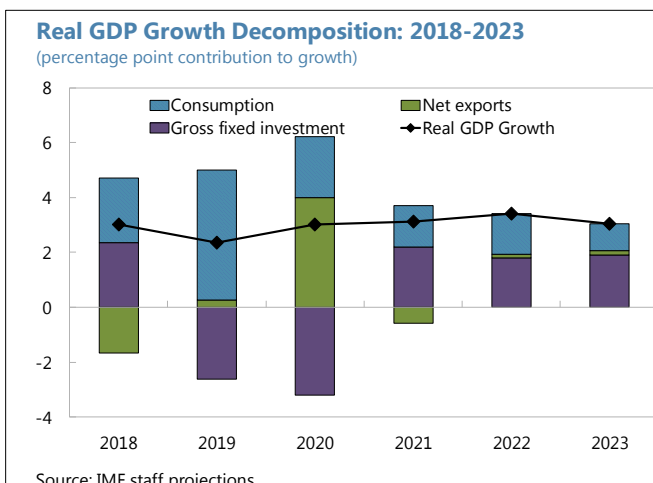
Compensation of Employees, 2016
(Percent of GDP)



Sources: Montenegrin authorities; and IMF staff estimates.

Over the medium term, growth should slow as highway construction ends in 2019 and then accelerate from 2020 as fiscal adjustment ends and supply-side effects from the highway begin. Over 2018-2023, growth might average 3 percent, higher than the 2 percent average of the last decade and estimated longer-run potential growth (Box 2).

- Highway impact:* The highway will add to output through demand effects – moderated by the high import content – until construction ends in 2019. Because construction in 2018 will not accelerate substantially, however, the contribution to *growth* will moderate. After completion in 2019, supply effects will begin, though the low economic rate of return (due to low traffic projections) decreases the boost compared to a typical project. Staff estimates that total GDP in 2023 will be about 3 p.p. of 2014 GDP higher with the highway than without it.²
- Fiscal adjustment:* Further fiscal adjustment measures of 1¼ percent of GDP will be implemented in 2018, compared to 1¾ percent of GDP in 2017, with a further ¾ percent of GDP in 2019. Assuming a fiscal multiplier of -0.5, the positive highway effects will only partially offset the fiscal adjustment drag.



7. Tax increases should boost inflation in 2018, and the current account deficit will remain elevated. Inflation is projected to increase to 2¾ percent (end-of-period), with a 2 p.p. VAT increase and excise increases adding approximately 1 p.p. to inflation. With euroization, inflation should be contained around 2 percent over 2019-23. The current account deficit is projected to remain at 19 percent of GDP in 2018 before moderating to 12 percent on average over 2020-23.

8. Government debt is projected to peak in 2018 and decline rapidly thereafter. As highway spending winds down after 2019, the budget is projected to move into surpluses exceeding 2 percent of GDP. General government debt with guarantees would peak at 80 percent of GDP in 2018 before declining to 53 percent of GDP by 2023, if the fiscal consolidation is sustained.

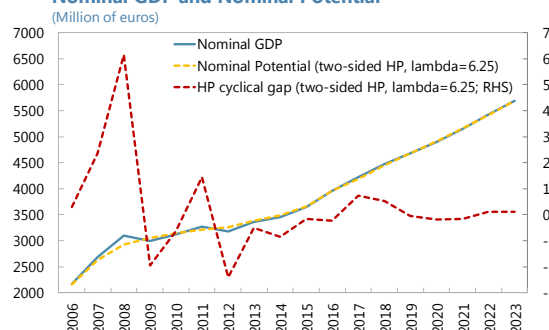
² See 2017 Selected Issues Paper (SIP) "Accounting for the Highway in the Macroeconomic Framework".

Box 2. Potential Growth and Output¹

The output gap has closed, and the economy is currently operating slightly above potential. Both in 2017 and 2018, output is estimated to be almost 1 percent above potential. The output gap is assumed to be closed by 2023.

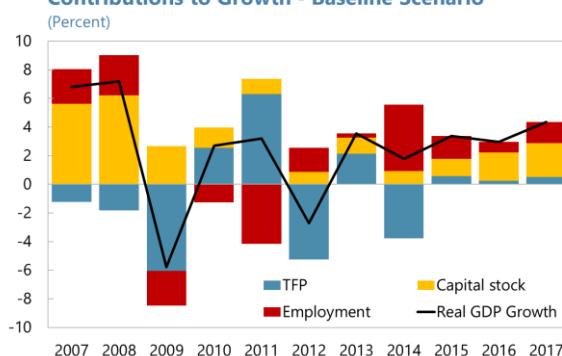
Standard growth accounting suggests that capital accumulation will drive long-term growth. Growth over 2006-17 was 3 percent on average, where capital contributed 2.2 percent, labor 1.3 percent, and total factor productivity (TFP) -0.5 percent. Low TFP partly reflects large negative shocks during the 2009 and 2012 recessions. Going forward, in the absence of structural reform, TFP growth is likely limited, but could improve greatly with structural reforms, including due to EU accession. Negative demographic trends will lower growth prospects. In the baseline, average growth could fall to about ¾ percent over 2018-50. Considering various scenarios, the best policy-based average growth with improvements to TFP, education, labor markets, and investment would be around 2 percent (see graph), and more on a per-capita basis.

Nominal GDP and Nominal Potential



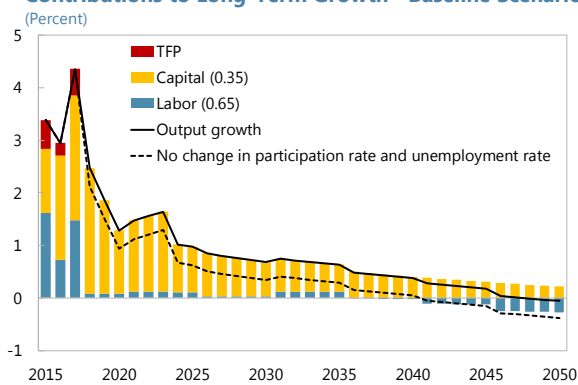
Sources: Haver Analytics; and IMF staff estimates.

Contributions to Growth - Baseline Scenario



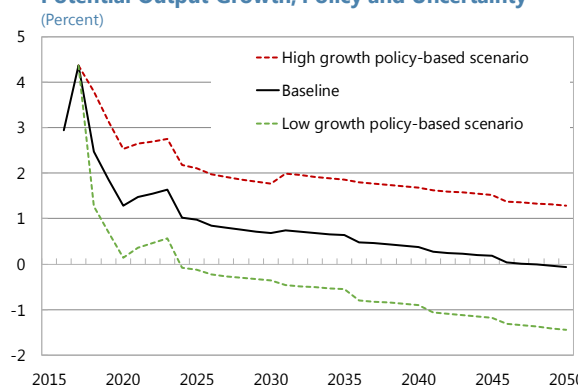
Sources: Statistical Office of Montenegro; UN Population Prospects 2017; and IMF staff estimates.

Contributions to Long-Term Growth - Baseline Scenario



Sources: Monstat; UN Population Prospects 2017; and IMF staff projections.

Potential Output Growth, Policy and Uncertainty



Sources: Monstat; UN Population Prospects 2017; and IMF staff projections.

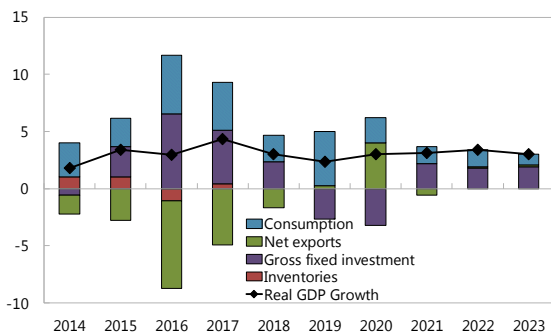
¹ See SIP for details.

Figure 4. Montenegro: Medium-Term Projections, 2014-23

Growth is being driven primarily by investment.

Real GDP Growth Decomposition

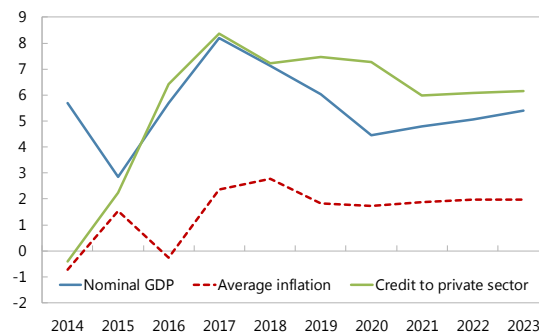
(in percent)



Inflation is contained, and credit growth is recovering.

Growth of Nominal GDP, Prices, and Credit to Private Sector

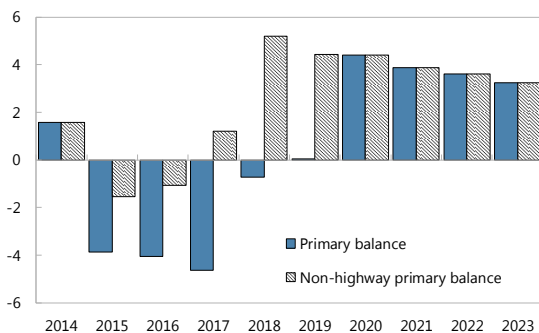
(in percent)



Fiscal consolidation measures are expected to produce a primary balance of 4½ percent of GDP by 2020.

Primary Fiscal Balance

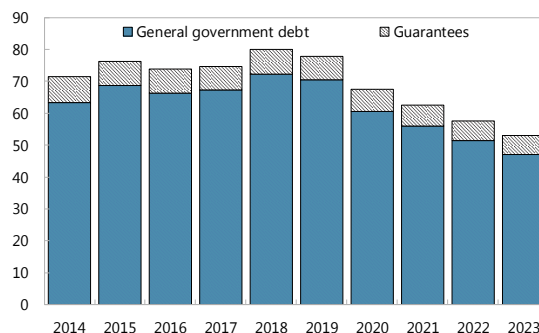
(Percent of GDP)



General government debt is expected to peak in 2018 at 80 percent of GDP and decline thereafter.

General Government Debt Including Guarantees

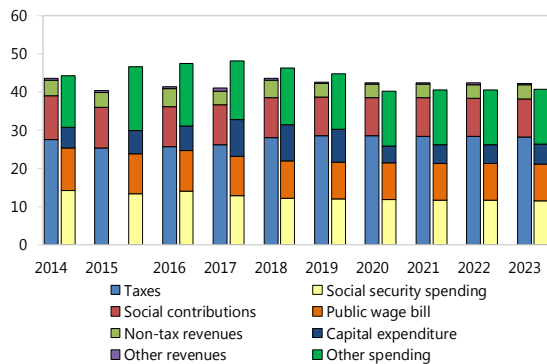
(Percent of GDP)



The authorities aim to raise revenues, while the end of highway construction will lower spending.

General gov't revenues and expenditures

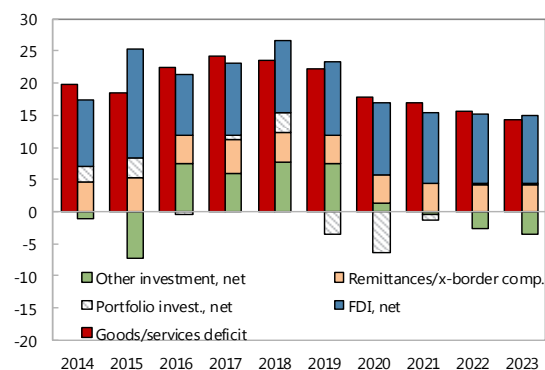
(Percent of GDP)



FDI will remain the largest financing item for the large deficit in goods and services in the BOP.

Goods/Services Deficit and Major Financing Items

(Percent of GDP)



Sources: Montenegrin authorities; and IMF staff projections.

9. The medium-term outlook is subject to significant external and domestic risks.

- *External risks are mainly to the downside.* The successful liability management operation (LMO, see below) carried out in April has significantly reduced refinancing risks over 2019-21 and thus Montenegro's exposure to a possible global financial tightening. However, the current account deficit is projected to stay elevated through the medium term, underscoring Montenegro's dependence on FDI and foreign financing. Reliance on tourism also makes it vulnerable to a downturn in external demand, particularly from Europe. On the upside, further improvements in global growth could have positive spillovers.
- *Domestic risks mostly relate to the authorities' ability to sustain fiscal consolidation.* Despite the resolve shown recently, Montenegro does not have a strong track record of sustained fiscal consolidation, and the government has a slim majority in parliament (though parliamentary elections are not expected until 2020). Large, unexpected budget overruns (on judicial claims, state-owned enterprises (SOEs), or ad-hoc decisions to increase wages or social benefits) have jeopardized fiscal adjustment historically.³ Similarly, the authorities might be tempted to finance the completion of the highway with debt (see DSA).

POLICY DISCUSSIONS

10. Policy discussions focused on four key challenges: (i) ensuring the continued implementation of the fiscal adjustment strategy while successfully refinancing maturing Eurobonds; (ii) improving the composition of fiscal revenues and expenditures and strengthening the fiscal policy framework; (iii) safeguarding financial sector stability and supporting financial development; and (iv) improving competitiveness, labor markets, and the business and governance environment.

A. Fiscal Policies

11. Public debt rose quickly in Montenegro after the global financial crisis. General government debt (including guarantees) doubled from 36 percent of GDP in 2008 to 72 percent of GDP in 2014. The decision to build the first highway phase and the approval in 2016 of an ill-targeted and costly mothers' benefit and large public-sector wage increases increased the deficit, and government debt reached 74 percent of GDP in 2016.

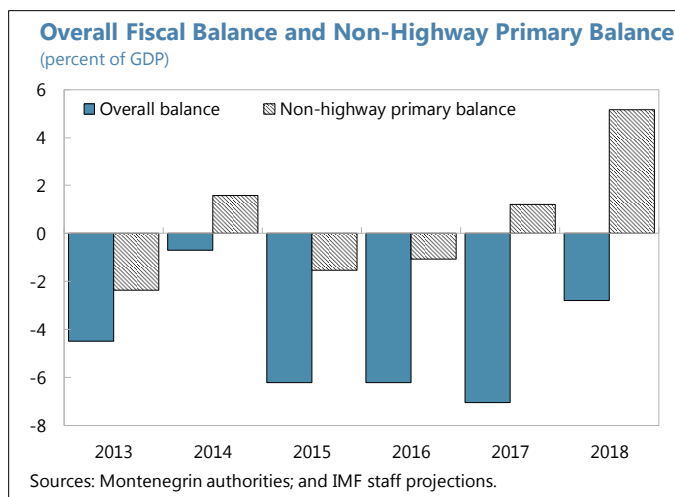
12. Cognizant of the risks of rising debt and looming refinancing needs, the authorities began significant fiscal adjustment in 2017. The 2017 budget already contained 1¼ percent of GDP in permanent fiscal adjustment measures. In mid-2017, the authorities adopted—in line with staff advice—a medium-term fiscal strategy with an additional 2¾ percent of GDP in measures to be implemented from 2017-20. Most of the measures were legislated in 2017. The adjustment is front loaded, with 3 percent of GDP in measures implemented in 2017-18. Revenue increases account for about 2/3 of the measures, centered around increases in the VAT and excises. Regarding

³ Judicial claims averaged 1 percent of GDP over 2013-17. Staff projects 0.6 percent of GDP on average over 2018-23.

expenditures, reforms to the mothers' benefit saved about $\frac{3}{4}$ percent of GDP, while a partial wage freeze is projected to lower the public-sector wage bill by nearly 1 percent of GDP by 2020.

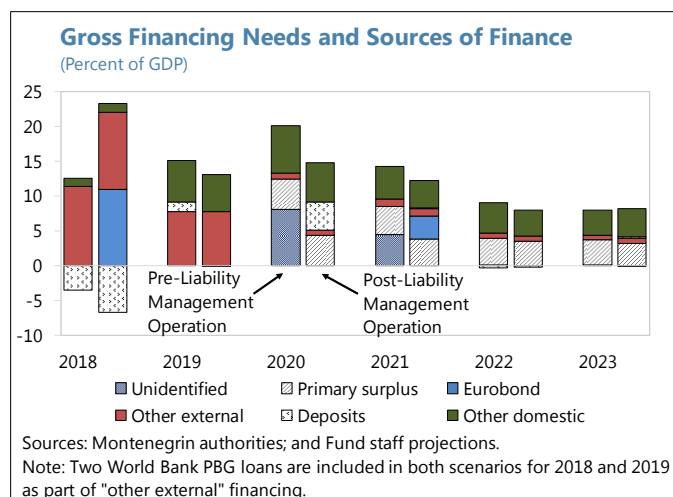
13. The 2018 budget is consistent with the fiscal strategy.

The standard VAT rate increased from 19 to 21 percent, and excises increased further. The continued implementation of a tax-debt rescheduling program—showing strong results since its mid-2017 start—will add about $\frac{1}{2}$ percent of GDP in revenues in 2018. Public-sector wages remain largely frozen, though the number of workers increased in 2017, and some wage drift will occur due to seniority. The authorities have also budgeted for several one-off expenditures, including support for state-owned Montenegro Airlines and new expenditures due to NATO membership. The non-highway primary balance should strengthen significantly to 5.2 percent of GDP (4.5 percent of GDP without a one-off dividend from the electricity company, EPCG),⁴ and the overall deficit should decline from 7 percent of GDP to 2.8 percent of GDP. Net debt (adjusted for government deposits) is projected to fall by 1 percent of GDP, though gross debt will rise by 5 p.p. due to pre-financing of 2019–20 external debt amortizations.



14. The authorities have taken steps to improve the debt maturity profile and reduce refinancing risks.

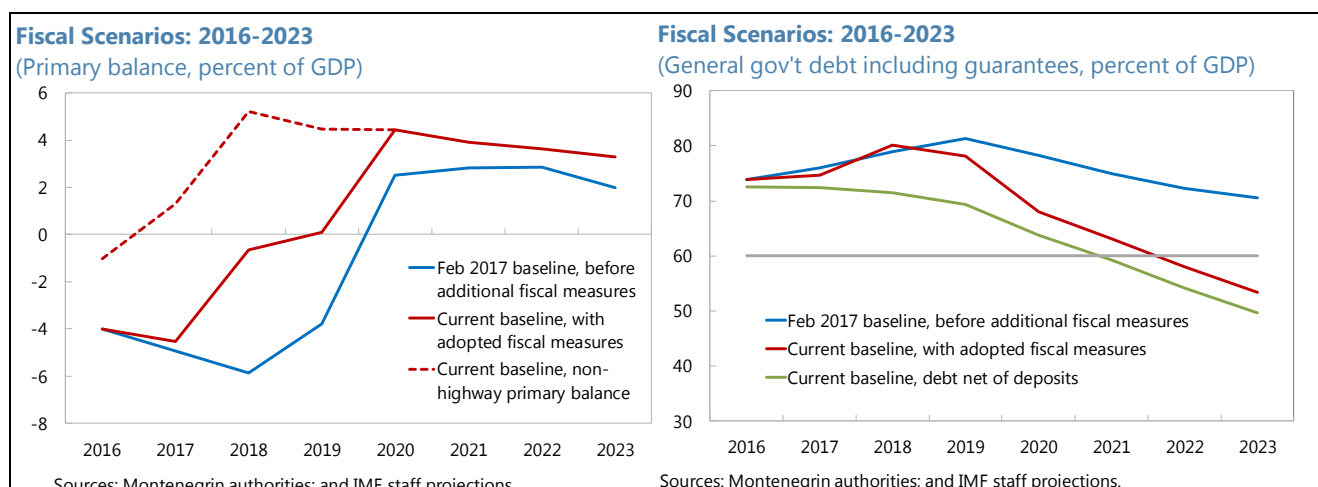
With €1 billion (nearly $\frac{1}{4}$ of GDP) in Eurobond maturities over 2019–21, the authorities faced significant refinancing risks. The authorities addressed these risks by, first, securing a €250 million (5 $\frac{1}{2}$ percent of GDP) loan from a consortium of international banks utilizing a World Bank Policy-Based Guarantee (PBG). This loan will help amortize the €280 million Eurobond maturing in 2019. With an amortizing payment structure and 12-year maturity (with a 4-year grace period on principal), the loan also improves the debt maturity profile. Second, they successfully executed a LMO in April, issuing a new 7-year €500 million Eurobond, which includes the exchange of €362 million of the 2019–21 Eurobonds. Montenegro would likely complete its medium-term financing needs with one additional smaller (€150–200 million) Eurobond in 2020/2021.



⁴ The private investor in EPCG exercised a put option, which requires the government to repurchase 42 percent of EPCG's shares for €250 million. The buyback does not impact the fiscal deficit but increases debt until re-privatization.

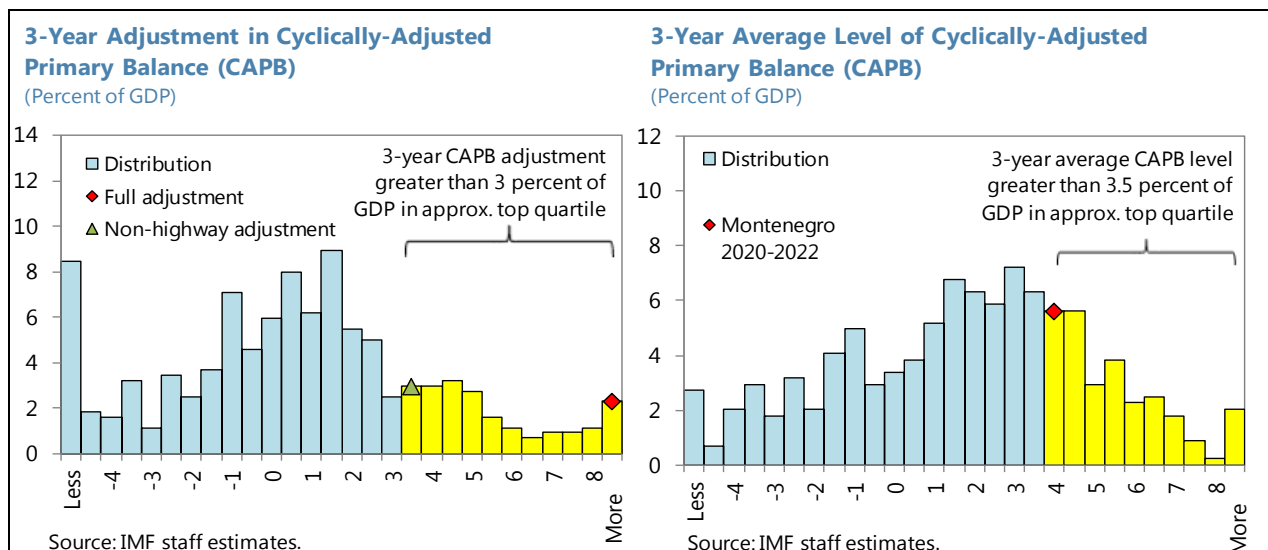
Table 1. Montenegro: Staff Assessment of Fiscal Adjustment Measures 1/						
Permanent fiscal impact (percent of GDP)						
Non-highway budget measures:						
Measure	2017	2018	2019	2020	Total	Approved
Fuel excise increase 2/	0.68	...	...	...	0.68	0.68
VAT increase	...	0.95	...	...	0.95	0.95
Cigarette, coal, alcohol, and sugar drinks excises	0.08	0.32	0.30	0.11	0.80	0.80
Tax debt rescheduling 3/	0.34	-0.11	-0.04	-0.04	0.15	0.15
Contributions from previously employed mothers 4/	0.04	0.07	-0.10	...	0.01	0.01
VAT impact of excise increases	0.02	0.09	0.06	0.03	0.19	0.19
Total revenue measures	1.16	1.32	0.22	0.10	2.79	2.79
Public sector wage bill 5/	0.22	0.67	0.20	-0.12	0.97	0.67
Savings from "Mothers' Law" reforms	0.48	0.12	0.15	0.07	0.82	0.82
Pension reform 6/	...	...	...	...	...	...
Reduction in discretionary spending	0.22	-0.12	0.09	0.06	0.25	-0.12
Total expenditure measures	0.91	0.67	0.44	0.01	2.03	1.37
Total measures	2.07	1.99	0.65	0.10	4.82	4.15
Additional budgeted spending 7/	-0.22	-0.62	0.44	-0.02	-0.42	-0.84
Total measures, net of new spending	1.85	1.38	1.09	0.08	4.40	3.31
Increase in social spending (social assistance)	-0.02	-0.03	-0.11	...	-0.16	-0.16
Recommended new capital spending	...	...	-0.17	-0.13	-0.30	...
Total measures, net of new/recommended spending	1.82	1.34	0.81	-0.05	3.93	3.15
Highway budget measures:						
Reduction in highway-related capital spending 8/			1.28	4.15	5.44	5.44
Total projected fiscal adjustment, including highway	1.82	1.34	2.10	4.11	9.37	8.59
Sources: Montenegrin authorities; and Fund staff estimates and projections.						
1/ In this table, a positive (+) sign indicates an improvement in the fiscal balance, while a negative (-) sign represents the opposite. A positive entry followed by "..." indicates a permanent impact in year 1, with no further impact in year 2 relative to a scenario without fiscal adjustment.						
2/ Fuels excise was increased as part of the 2017 budget.						
3/ The tax debt rescheduling raised a large amount of revenues in 2017, but these revenues are not permanent. Negative signs in later years indicate that the amount raised will be smaller than the previous year.						
4/ Social contributions made by government for mothers who received the social benefit and were previously employed. This is offset by equivalent spending by the government to make the contributions.						
5/ Includes the savings from partial wage freeze relative to alternative scenario with wage increases.						
6/ The authorities intend to implement pension reforms, which would generate savings, but these savings have not yet been integrated into staff's projections.						
7/ Includes support for Montenegro Airlines and other spending not envisioned in June 2017 spending projections.						
8/ Beginning in 2019, highway expenditures will begin to decline, and spending should stop in 2020, producing an automatic improvement in the fiscal balance.						

15. If the fiscal strategy is implemented, government debt would fall quickly after 2019. In combination with an additional $\frac{3}{4}$ percent of GDP in fiscal measures, the reduction in highway spending in 2019 will create room for additional non-highway capital spending. The non-highway primary balance should remain near $4\frac{1}{2}$ percent of GDP. With completion of the highway, a primary fiscal surplus of $4\frac{1}{2}$ percent of GDP should be achieved in 2020. The projected fiscal impulse will be quite contractionary in 2020 as highway spending ends, but the adjustment in the non-highway budget will be complete (see Box 3). After 2020, the authorities could relax the primary surplus towards 3 percent of GDP by increasing capital spending on high-return projects. After peaking at 80 percent of GDP in 2018, general government debt with guarantees would decline to 53 percent of GDP in 2023.



16. While the anticipated fiscal adjustment is large, there are precedents of similar adjustments. Between 2017-20, the cyclically-adjusted primary balance will improve by $9\frac{1}{2}$ percent of GDP, an adjustment that would be in the top 2 percent for such a three-year period out a sample of advanced and emerging economies from 1990-2011. The adjustment in the non-highway cyclically-adjusted primary balance will be much smaller, however, at $3\frac{1}{2}$ percent of GDP, which would be in the 18th percentile, indicating a large-but-not-unprecedented adjustment. The average primary balance of 4 percent of GDP over 2020-22 would be in the 23th percentile.

17. Only strong fiscal institutions can provide the confidence that the very large fiscal adjustment will be carried out as currently planned. The Law on Budget and Fiscal Responsibility (LBFR) limits the budget deficit to 3 percent of GDP and public debt to 60 percent of GDP. It has facilitated a return to debt sustainability but did not prevent past slippages. A true medium-term budget framework should be implemented, with more binding medium-term expenditure limits and the need to reconcile and justify expenditure changes. The LBFR's expenditure rules restrict the nominal growth rate of current spending to real GDP growth, which is unrealistic and not always followed. The authorities could consider an overall expenditure limit based on the medium-term budget in a revised LBFR. The Ministry of Finance must assess any legislation with budgetary consequences and submit a supplemental budget if necessary.

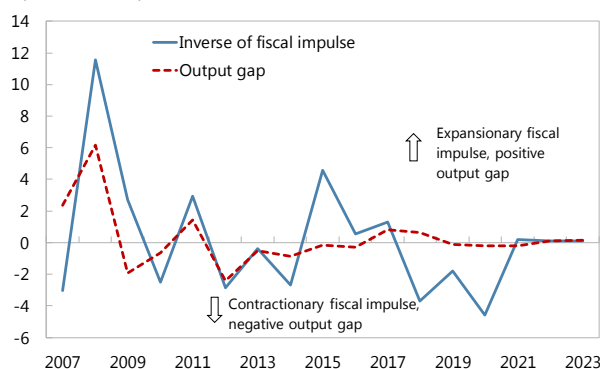


Box 3. Fiscal Pro-Cyclicality and Fiscal Impulse¹

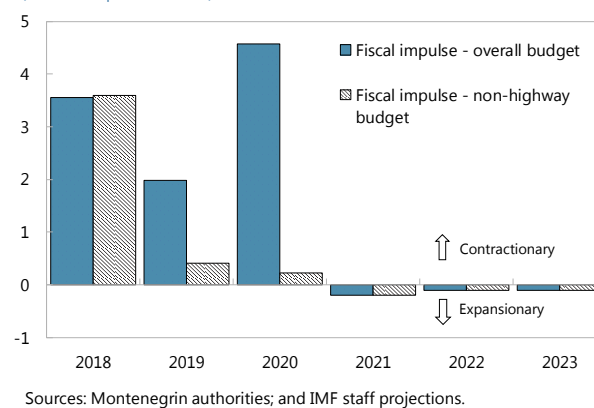
Structural fiscal balance and fiscal impulse analysis suggests that fiscal policies have been pro-cyclical in Montenegro. Until 2016, the fiscal impulse had generally been expansionary when output was above potential, and contractionary when output was below potential. Growing revenues created pressures to spend, and financing constraints prevented counter-cyclical spending during downturns.

The current fiscal adjustment plan, however, is appropriately tuned to the economic cycle. With output slightly above potential, the fiscal adjustment over 2018-20 will be counter-cyclical. The non-highway budget will continue strong adjustment in 2018-19, and in 2020, the end of highway spending will represent a large negative fiscal impulse. In this sense, the adjustment of the non-highway budget is being appropriately phased to avoid coinciding with the end of highway spending, avoiding an even larger drag on growth in 2020.

Fiscal Pro-Cyclicality (Percent of GDP)



General Government Fiscal Impulse (Percent of potential GDP)



¹ See the SIP for more details.

18. The authorities should consider additional medium-term reforms to improve the composition of revenues and expenditures. Such reforms would create fiscal space to increase social and capital spending and bolster growth and labor market outcomes in the medium term. They could also serve as contingency measures should there be slippages in the fiscal adjustment.

- *Tax policies:* Tax exemptions, especially for the VAT, risk undermining the tax base and should be rationalized, and corporate profit tax holidays should be reduced. The use of multiple positive VAT rates and zero-rating of intermediate inputs should be reviewed, taking into account distributional impacts.
- *Public sector wage bill:* The overall public-sector wage bill remains high compared to peers. While the authorities intend to severely limit wage increases in the near term, a more comprehensive strategy is required to reduce the wage bill and assume tighter control over employment levels throughout the entire public sector.
- *Pension reform:* Eligibility for early retirements should be tightened. The authorities should also valorize pensions by wages and index benefits to inflation. These two reforms would produce near-term savings. The valorization of pensions by wages raises pension spending in the long run but is essential to ensure that replacement rates remain socially sustainable.
- *Municipal finances:* Several municipalities have significant debts and very high wage costs. Central oversight should be strengthened, and incentives and capacity for municipalities to raise their own revenues, particularly on real estate, should be increased.

Authorities' Views

19. The authorities broadly agreed with staff's fiscal projections and outlined plans to address several structural fiscal issues. They believed that fiscal adjustment measures were yielding the anticipated results and concurred that the measures should place debt on a firm downward path. The authorities also pointed to their recent success in securing the World Bank PBG-backed bank loan and issuing a new Eurobond as evidence that their strategy would maintain market access and facilitate the completion of the medium-term fiscal financing program. The authorities believe that their fiscal strategy already includes contingency measures and consider staff projections to be conservative.

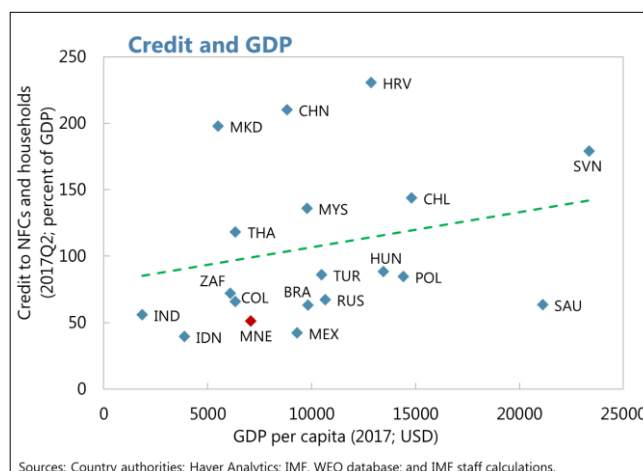
- The authorities broadly agreed with staff's economic growth assumptions and revenue projections. However, they projected a general government primary surplus greater than 7 percent of GDP in 2020, based on lower spending on wages, social security transfers, capital expenditures, and transfers to other public-sector institutions.
- The authorities have published a Medium-Term Debt Strategy and intend to develop the domestic government debt market further, which will require regulatory coordination with the Securities Commission and stock exchange. On tax policy, they intend to quantify the fiscal cost of tax exemptions.

- The authorities are currently assessing the number of public employees and plan to adopt by end-June 2018 a plan to reach optimum staffing levels. A pension reform that would restrict early retirements and modify the formula for valorization/indexation should be adopted in 2018. On municipal finances, the authorities plan to amend the law on local government finances in 2018 to change the distribution of funds from the central government to promote the distribution of revenues according to need and incentivize own-source revenues where possible.
- The authorities agreed that fiscal space did not exist to assume further debt to continue the Bar-Boljare highway. They plan to complete the highway through a concession or public-private partnerships (PPPs) and are preparing the legal framework for PPPs.

B. Financial Sector Policies

20. The banking system continues to improve. System-level liquidity and profitability increased in 2017, partially reflecting declining nonperforming loans (NPLs). At end-2017, the aggregate solvency ratio was 16 percent, well above the legal minimum of 10 percent. The NPL ratio fell by 17 p.p. from a peak of 25 percent in 2011. Provisioning continues to improve with 57 percent of NPLs provisioned, though further improvements are needed. The share of liquid assets is high at 25 percent of total assets. Profitability has improved, with return on equity at 7 percent.

21. Credit growth is firming but remains subdued. Lending to the private sector increased by 8 percent in 2017, while corporate credit grew by 6 percent. Lending activities were geared towards the household sector and the government. Total credit to the private sector was 49 percent of GDP in 2017, which is below the average of countries with similar per-capita income. While banks are highly liquid, they are cautious in approving new loans, given the legacy of bad loans and impaired balance sheets. The lack of bankable projects also constraints credit growth.



22. Credit risk is the main risk in the financial sector. The lack of an efficient legal framework for collateral execution, court proceedings, and liquidation processes increases credit risk. Strengthening land ownership registration and improving the credit registry would help banks to better assess borrowers' eligibility and lower credit risks. Better accounting practices for SMEs could improve their access to bank services. A Central Bank of Montenegro (CBM) system-level stress test suggests that market risk is currently low.

Financial System Overview (End of 2016)

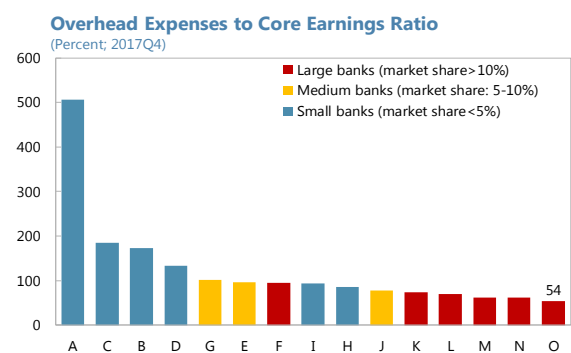
	Asset size (million of euros)	Number of institutions	Share in total assets of sub- sector (percent)	Share in total financial sector assets (percent)
Financial Corporations (FC) Sector				
Central Bank of Montenegro				
Other depository corporations (ODC)				
Commercial banks				
Domestically controlled	980.9	6	26	23
Foreign controlled	2,809.3	9	74	67
Total ODCs	3,790.3	15	100	91
Other financial corporations (OFC)				
Insurance companies	196.7	11	50	5
Pension funds	0.6	2	0	0
Other financial intermediaries	195.0	19	50	5
Leasing companies	45.2	4	12	1
Micro-credit finance institutions	55.6	6	14	1
Investment funds	94.2	9	24	2
Total OFCs	392.2	32	100	9
Total Financial Sector	4,182.5	47	0	100

Source: Central Bank of Montenegro.

23. Montenegro has many banks compared to its market size. Fixed costs are high, reflecting regulatory requirements and IT system costs, resulting in losses for some small banks. A smaller set of more profitable banks could be supervised more closely and might result in a stronger system overall. New licenses should only be given investors with a business plan that would significantly contribute to the development and efficiency of the overall banking system. The authorities should consider increasing minimum capital for banks, which might facilitate a consolidation.

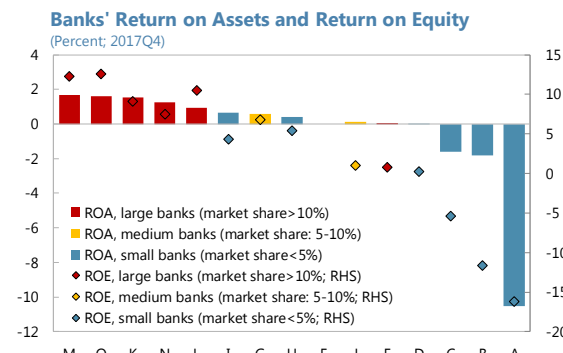
Montenegro: Measures of Bank Profitability

Overhead expenses exceed core earnings for several small banks.



Source: Central Bank of Montenegro.

Small banks tend to have a low/negative return on equity.

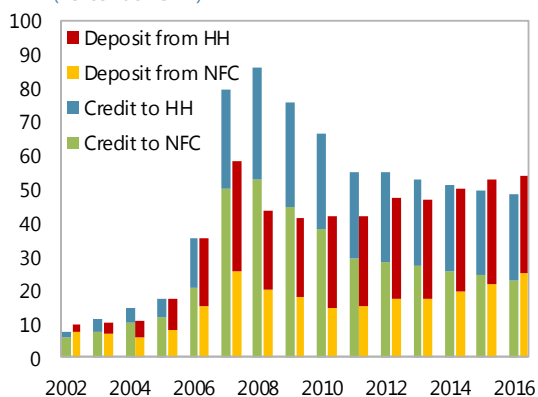


Source: Central Bank of Montenegro.

Figure 5. Montenegro: Financial Sector Developments

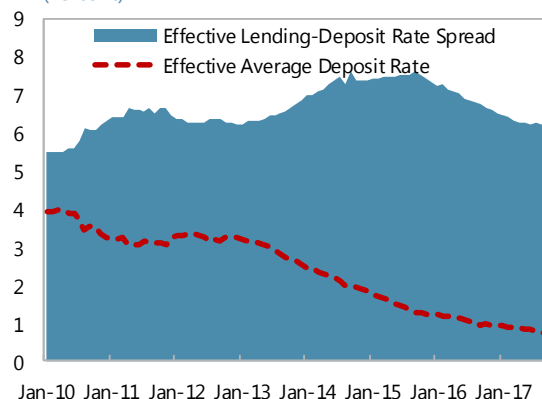
Deposits have recovered after the recession of 2011....

Banks' Deposits and Credits
(Percent of GDP)



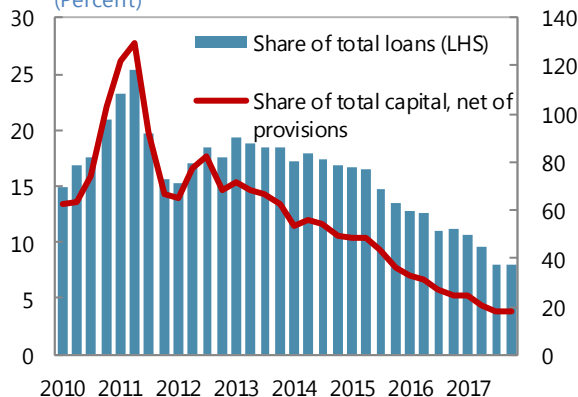
...and lending spreads have begun to decline, trailing declining deposit returns.

Bank Lending-to-Deposit Rate Spread
(Percent)



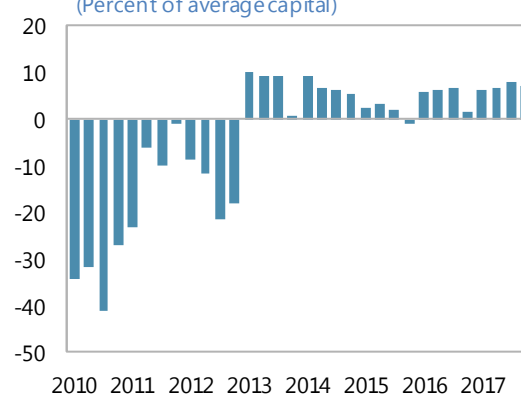
NPL levels have fallen steadily.

Non-Performing Loans
(Percent)



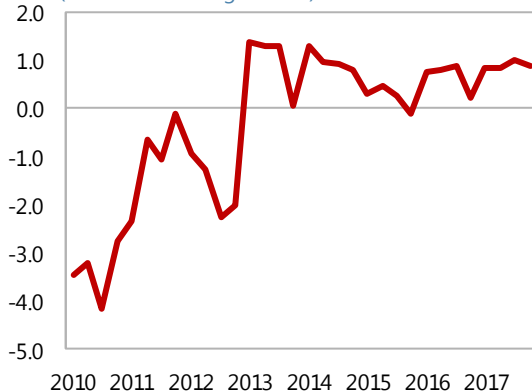
Banks have returned to profitability...

Banks' Net Profits
(Percent of average capital)



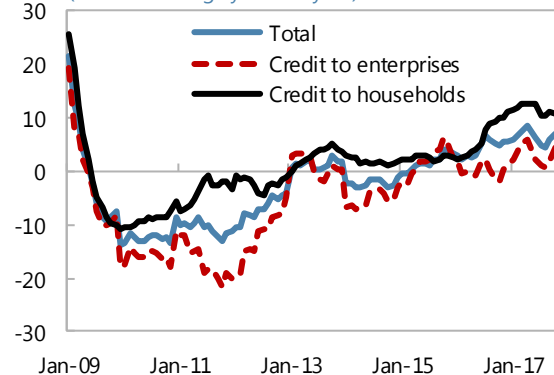
...though the return on assets remains low...

Banks' Net Profits
(Percent of average assets)



...and credit growth has recovered to moderate levels.

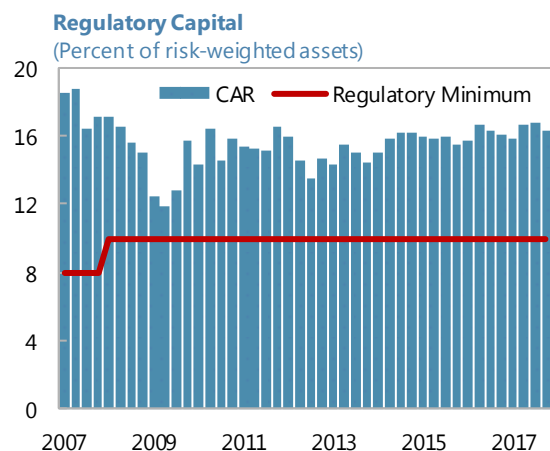
Bank Lending by Sector
(Percent change year-on-year)



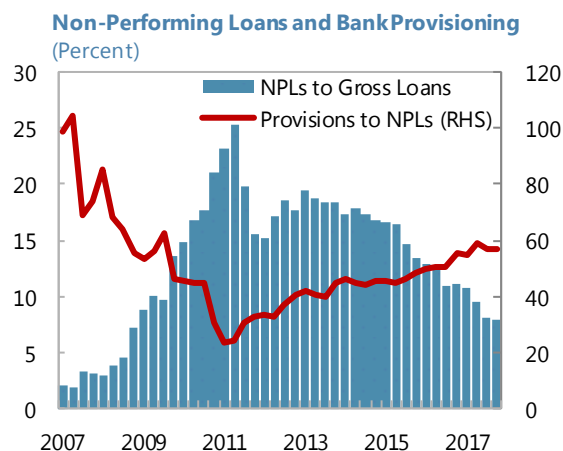
Sources: CBM; and IMF staff calculations.

Figure 6. Montenegro: Banking Sector

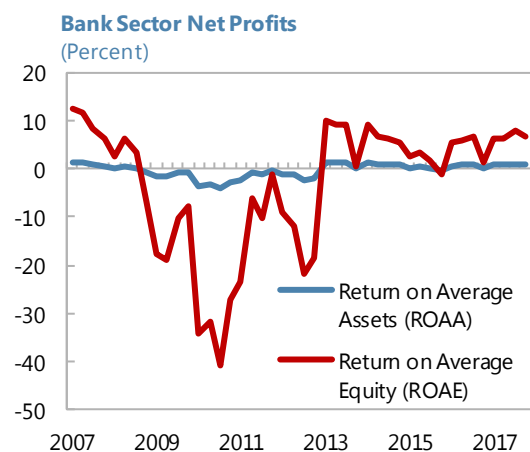
Bank capitalization has exceeded regulatory minima....



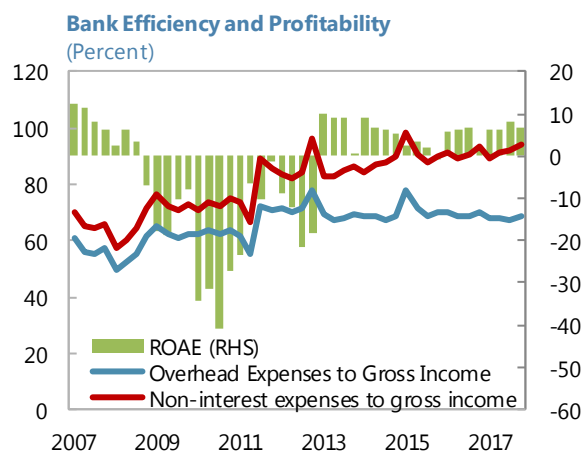
...but the quality of assets has improved only slowly.



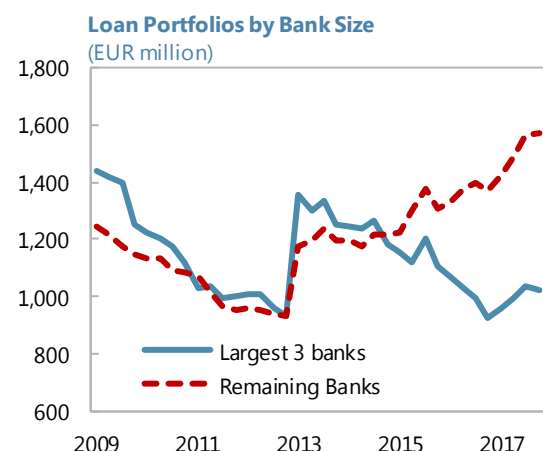
Banks struggle to remain profitable....



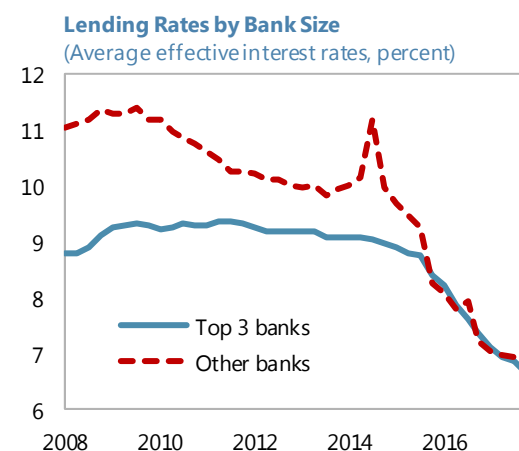
...and to contain operating costs....



...as the sector has become more competitive...



...and interest rates have declined across the board.



Sources: CBM; and IMF staff calculations.

24. While NPL levels have fallen, the CBM should take further steps to strengthen banks' balance sheets. The CBM should adopt an NPL definition that does not permit improved classification based on adequate collateral. Supervisors are improving their capacity to challenge banks' real-estate collateral valuations, but there might be under-provisioning, particularly for smaller banks. The CBM should implement an asset quality review, which could be useful for identifying weak banks.

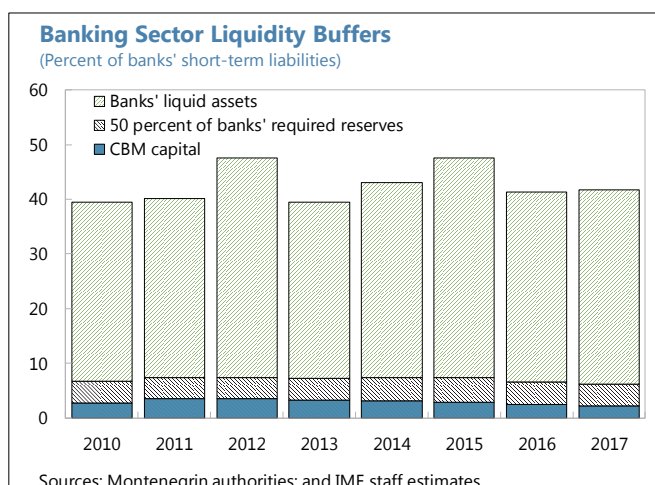
25. The authorities have improved the legal framework for financial supervision. Laws adopted in 2017 have strengthened the independence of the CBM and closed nonbank supervisory gaps by bringing nonbank financial institutions under CBM supervision. The authorities have also drafted laws to align Montenegro with the EU framework for bank resolution and recovery. The CBM introduced International Financial Reporting Standards (IFRS-9) in 2018, which should result in more stringent provisioning practices. There was progress in the implementation of many FSAP recommendations (Annex 6).

26. The authorities should intervene early and forcefully in nonviable banks or those in substantial non-compliance with supervisory requirements. Three small, non-systemic banks with qualified audits are subject to supervisory action plans, which resulted in significant improvements in two banks but only partial improvements in another. The CBM should not delay intervention in any bank that does not comply with supervisory requirements.

27. Euroization severely limits lender-of-last-resort tools of the CBM and requires high liquidity buffers. With liquid assets of 36 percent of short-term liabilities, banks are highly liquid, but the CBM's own resources to provide Emergency Liquidity Assistance (ELA) are limited (see SIP for details). In 2017, the CBM Council adopted a decision outlining conditions for liquidity loans, which can be granted on an intraday, overnight, or short-term (up to six months) basis. In a crisis, banks could draw on their required reserves, but the CBM itself could

only use its capital position (which only comprises 2 percent of banks' short-term liabilities) to provide liquidity. The fiscal authorities, however, are the ultimate backstop and should create a dedicated ELA subaccount at the CBM to provide government resources, if necessary. With the recent accumulation of government deposit buffers, resources are available in principle and should be maintained as fiscal and ELA buffers (see DSA and External Sector Assessment). To supplement its ELA resources, the CBM could explore obtaining credit lines from international financial institutions.

28. A continual strengthening of the AML/CFT framework is needed, including to support anti-corruption efforts. The CBM has prepared amendments to the Law on Prevention of Money Laundering and Terrorist Financing and shared them with the EC and MONEYVAL for review. The



amendments aim to address deficiencies highlighted through the Mutual Evaluation Report by extending customer due diligence requirements to legal arrangements and designated non-financial businesses and professions. In addition to adopting the new amendments, the authorities should strengthen the guidance to financial and non-financial institutions on identifying, reporting, and pursuing suspicious transactions related to Politically Exposed Persons, including when they are the beneficial owners of companies. Financial fraud should be effectively investigated and prosecuted.

Authorities' Views

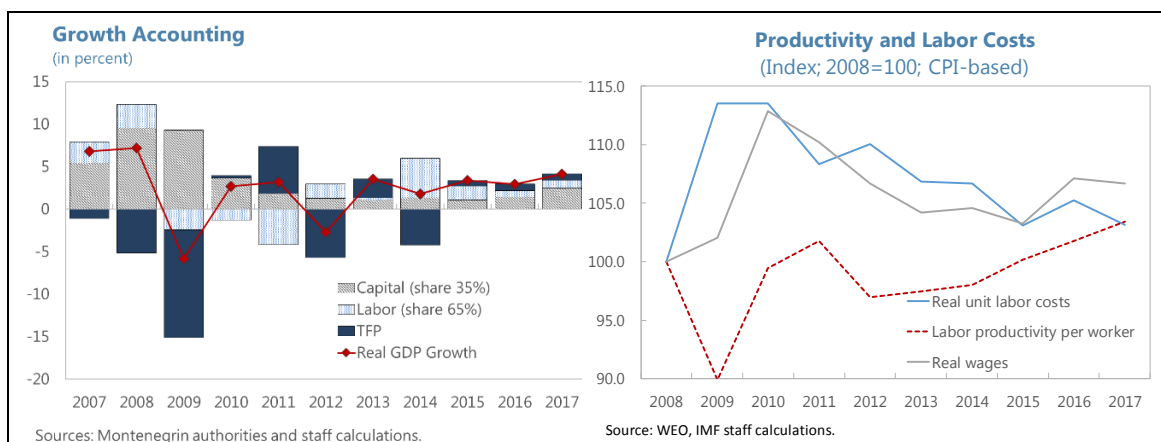
29. The authorities stressed that the banking system was stable, solvent, and highly liquid, and they expected continued improvement. They agreed that reducing credit risk, improving the legal framework for collateral execution, and reducing information asymmetries would be needed to improve the efficiency of the banking system. They noted recent efforts to improve the CBM's credit registry and intend to further improve its timeliness and expand its coverage to nonbank financial institutions, the tax authority, and utilities. The CBM is considering options to expand ELA resources.

30. The authorities wished to be cautious in sequencing staff's recommended actions in bank supervision and regulation. They believed that they are improving the legal framework significantly but that these efforts require substantial staff resources to implement. They also believed that the implementation of IFRS-9 is a significant task for banks and the CBM, and they wished to avoid introducing a new NPL definition and rolling out AQRs at the same time. The CBM intends to phase in a new definition for NPLs gradually and implement an AQR in 2019.

31. The authorities intend to monitor weak banks intensively and intervene, if necessary. While the CBM preferred for weak banks to implement the necessary steps to recover, it stood ready to intervene if it became clear that a return to profitability was not possible. On the number of banks in the system, the CBM emphasized that several of the small banks served niche functions and contributed to the overall system. The authorities will consider staff's proposal to increase the minimum capital of banks.

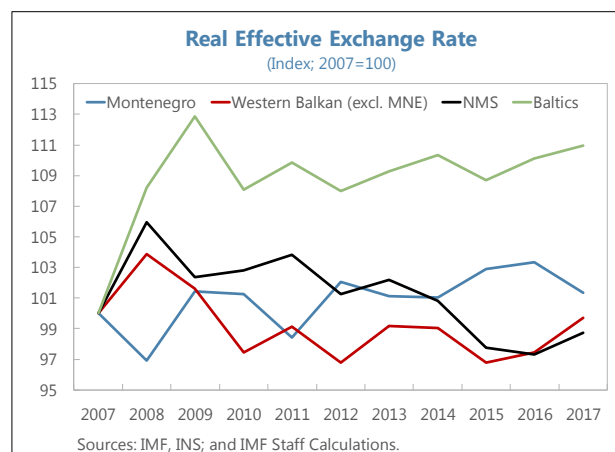
C. Structural Reforms

32. Low productivity, weak competitiveness, and labor market rigidities are persistent concerns. TFP growth has been weak in recent years, and Montenegro has relied on labor-intensive activities to achieve growth. A high share of tourism and labor-intensive industries in exports may have contributed to low productivity growth, although it is expected that the large investments in tourism and energy and to some extent the highway will have positive payoffs.

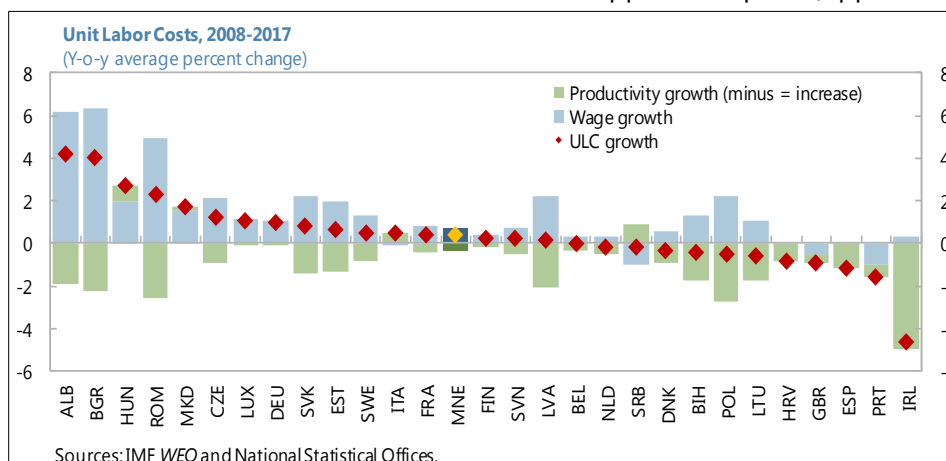


33. Persistent double-digit current account deficits and relatively high consumption levels suggest competitiveness concerns.

Since 2007, the REER has appreciated by 1 percent, which contrasts with the depreciation of 0.3 percent and 1.3 percent, respectively, in other Western Balkan countries and new EU member states. Econometric approaches assessing the degree of misalignment of the real exchange rate yield conflicting results. The EBA-lite REER regression model estimates the REER to be undervalued by 17 percent, while the current account regression model suggests the REER is overvalued by 18 percent. On



balance, staff believes that the real exchange rate is overvalued by 10 percent due to persistently large current account deficits and weak export performance. From a medium-term perspective (2008-17), unit labor costs have not increased, even showing a decline in recent years, but labor productivity has only shown a modest increase. The external position is weaker than suggested by medium-term fundamentals and desirable policies. The planned fiscal adjustment should help reduce current account deficits. Gross international reserves appear adequate (Appendix II).



34. Labor market outcomes have been weak. Despite an increase in recent years, participation is low. The inactivity rate is about 37 percent (for ages 15-64), which is lower than the average for other Western Balkan countries but much higher than the average for EU countries and New Member States. The unemployment rate, while declining in recent years, remains high at 16 percent. About 80 percent of the unemployed in Montenegro were out of work for more than a year on average, reflecting more structural than cyclical characteristics. The informal economy employs about ¼ of the workforce, suggesting labor markets are too rigid and provide little incentive to join the formal sector.

35. A comprehensive strategy is needed to address informal employment and labor force inactivity. There are cross-cutting underlying factors including tax policy, the design of social benefits, and employment policy that call for a unified strategy to improve labor market outcomes.

Tax Policy

36. At around 40 percent, the tax wedge on labor is relatively high. Given the absence of a basic income allowance, and minimal progressivity of the personal income tax, very little variation by income is observed in the total tax wedge. At the same time, social benefits and transfers are often completely foregone or severely taxed away when workers enter the formal market, implying high effective marginal tax rates.

37. The authorities should reduce the tax wedge, especially on low income earners, with a gradual withdrawal of social assistance benefits. Reducing the level and variance of the tax wedge on labor will be critical to lower incentives for under-declaration and increase formalization and labor force participation. The latter could be achieved through the re-introduction of a basic allowance for wage income and/or through targeted earned income tax credits or lower employer contributions. In addition, when beneficiaries of social assistance and family benefits enter the formal labor market, their assistance should be withdrawn gradually to encourage formal work. These reforms should be made revenue-neutral through increased environmental taxes or lower tax expenditures.

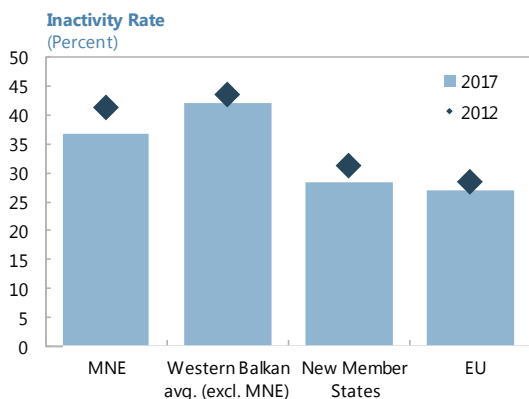
Labor Law

38. The Labor Law should provide a balance between the protection of work and facilitating new employment. A draft new Labor Law would simplify procedures for dismissal of employees and extend the duration of fixed-term contracts to 36 months. Some elements could be further refined to increase flexibility, declaration of work, and labor participation (see Appendix III and SIP for details):

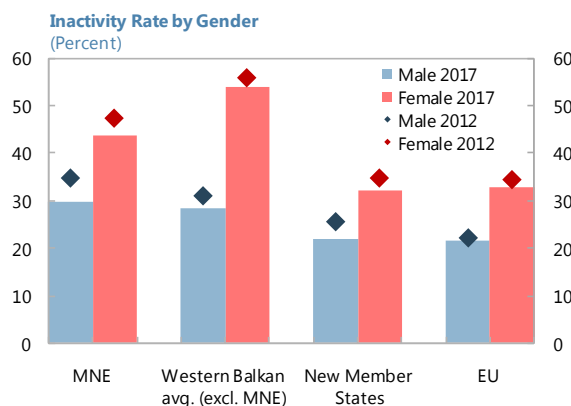
- *Establishing employment relationship:* An employee should be allowed to work for more than one employer.

Figure 7. Labor Market Developments

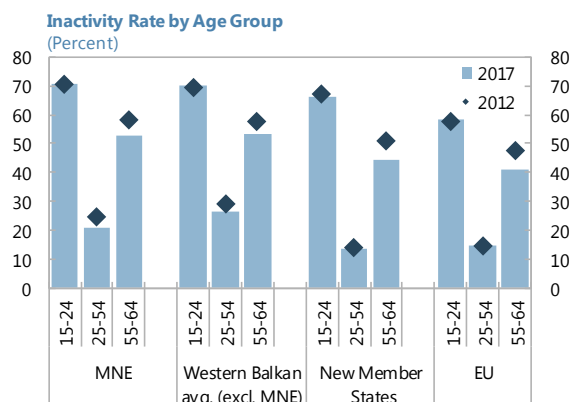
Despite a decline in recent years, the lack of participation in the labor market is high by European standards.



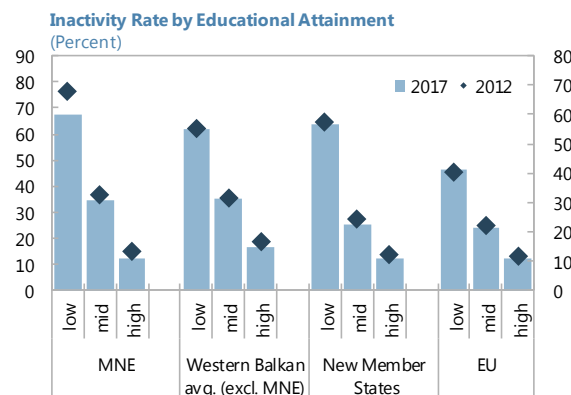
...and is lower among women...



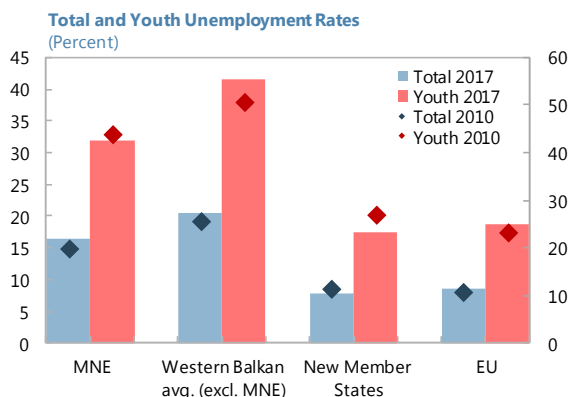
...youth (between 15 and 24 years)...



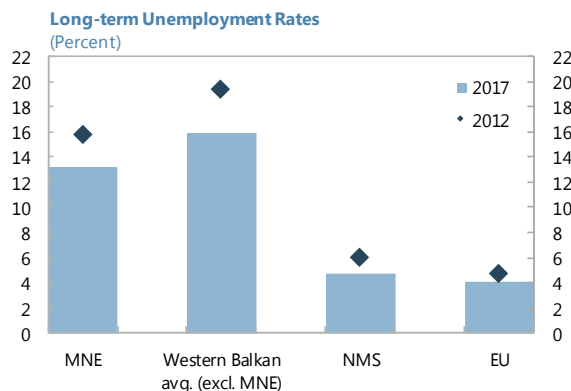
...and those with low education.



The unemployment rate is high, especially for youth...



...reflecting more structural rather than cyclical characteristics.



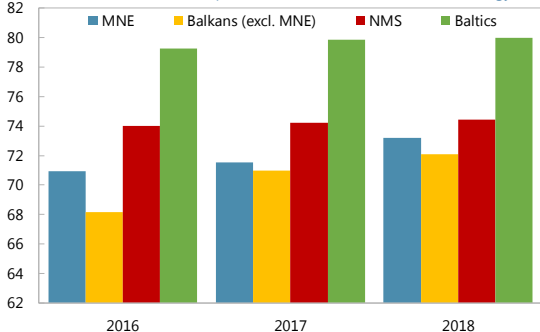
Sources: Eurostat; World Bank; and IMF staff calculations. Data for 2017 is 2017Q1/Q2 average.

Figure 8. Montenegro: Structural Reform Policies

Perceptions of business environment are improving along with peers...

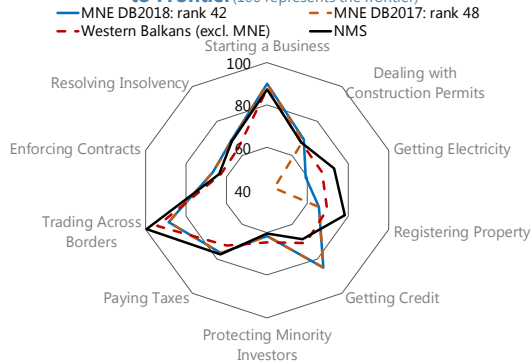
Perception of Ease of Doing Business

(Distance to frontier; 100 represents the frontier; DB17-18 methodology)



...while Montenegro is perceived to still lag the region in trading across borders and getting electricity.

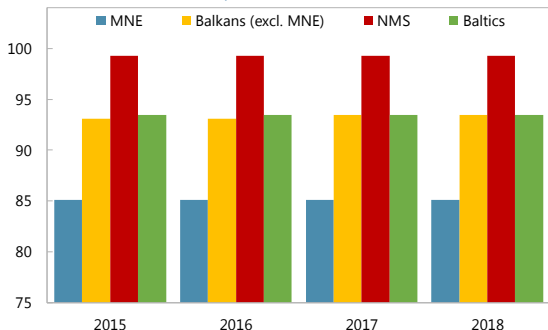
Perception of Business Environment, Distance to Frontier



High indirect costs are worsening price competitiveness....

Time to Export: Border Compliance

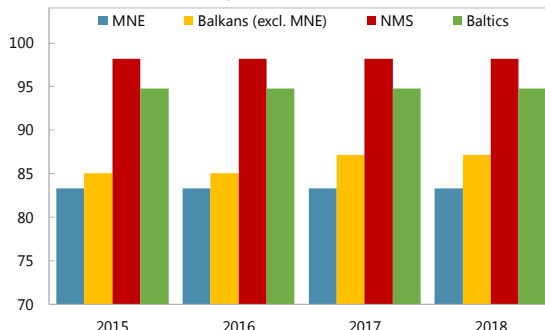
(Distance to frontier; 100 represents the frontier)



...while high administrative costs are burdening exporters.

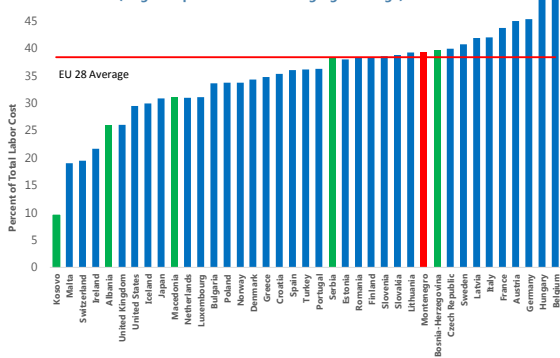
Time to Export: Documentary Compliance

(Distance to frontier; 100 represents the frontier)



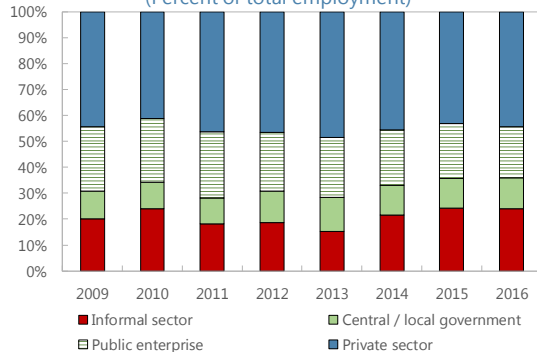
Taxes on labor are relatively high in Montenegro.

Labor Tax Wedge by countries, 2016
(single 67 percent of the average gross wage)



Reducing the labor tax wedge is critical to increase formalization and labor force participation.

Employment by Sector
(Percent of total employment)



Sources: Doing Business database, World Bank (Charts 1-4); Jousten and Jankulov Suljagic (2018) (Chart 5); MONSTAT (Chart 6); and IMF staff calculations.

- *Internal organization and systematization:* The requirement that all firms have a rulebook on the internal organization and classification of jobs could be a burden to SMEs, for which a brief description and/or specification of the work in the employment contract would be sufficient.
- *Termination of employment:* Employment contracts should not automatically terminate at 67 years of age, if the employer and employee wish to continue.
- *Addressing informal employment:* In the draft law, if an inspector finds a worker without a formal contract, the worker receives an open-ended one. Compliance and enforcement is a necessary but not sufficient condition to reduce informal employment. The authorities should design a system of incentives focused on the formalization of economic activities, which also involves employment and tax policies.

39. The General Collective Agreement (GCA) should also be revised. Collective agreements should be time bound, with possibility of extension by consent of parties. Labor regulations need to provide reasonable flexibility at the firm level to adjust to different economic situations, especially recessions. Under the GCA, the minimum wage is to be multiplied by a set of coefficients depending on the education level of an employee, potentially generating multiple minimum wages in the economy. It also seems to imply that any change in the minimum wage could have significant repercussions on overall wage growth, particularly in the public sector and for pensions.

40. State involvement in the economy should be reviewed. Some public enterprises do not appear to solve market failures and impose a continuous drain on the budget. The authorities should accelerate privatization within an appropriate regulatory framework. Some municipal SOEs should be merged for efficiency gains. With the exit of a foreign investor in EPCG, the authorities should hold a transparent tender for the sale of the company shares. Given intentions to expand concessions, the framework for PPPs should be strengthened to avoid transferring residual fiscal risks to the government.

Authorities' Views

41. The authorities agree that the labor tax wedge is high. They are analyzing the issue with IMF technical assistance and hope to implement a reform in the near future. They expressed a desire for any tax reforms to be revenue neutral. The authorities believe that the draft Labor Law is aligned with the EU Acquis. They consider the draft Law to be consistent with the objective of achieving labor market flexibility by reducing administrative barriers for employment (flexi-security). The authorities also noted that the conditions for modifying the GCA do not exist, because the social partners need to agree to the proposed changes.

42. While the authorities see a larger role for the state in the economy, they agree on the need for transparency of privatization processes and improving the framework for PPPs. They are working to restructure Montenegro Airlines—which they believe is critical for Montenegro's tourism industry—and believe that it can be financially viable. They intend to resell EPCG shares to a

private investor through a transparent process. The authorities are also drafting a new Law on PPPs and are seeking comments of the IFIs on the draft. IFC is advising them on airport concessions.

STAFF APPRAISAL

43. Economic growth should remain strong in 2018, notwithstanding fiscal consolidation, and maintain momentum over the medium term. Growth should slow moderately as fiscal consolidation continues and highway construction ends next year, but the possible supply side boost of the highway section and other large investment projects should sustain growth.

44. The authorities are appropriately focused on fiscal adjustment to lower government debt to safer levels. While infrastructure development is needed, the construction of the first section of the Bar-Boljare highway has had a key role in raising debt to high levels. The authorities' front-loaded fiscal adjustment is appropriately timed to complete the underlying fiscal adjustment before construction of the highway concludes. Fiscal space does not exist to finance the remaining phases of the highway with debt, and the authorities should ensure that the completion of the highway via PPP meets standard cost-benefit criteria and does not introduce large contingent liabilities.

45. The medium-term fiscal adjustment plan is well specified and socially balanced, and concerted political efforts will be needed to maintain fiscal discipline. The authorities legislated most of the fiscal measures in 2017, and most of the underlying adjustment should be completed this year. If the plan continues to be implemented, government finances will regain a sustainable footing. Staff projects a primary surplus of 4½ percent of GDP in 2020, leading general government debt (including guarantees) to fall quickly after peaking at 80 percent of GDP in 2019. The maintenance of primary surpluses after 2020 will be necessary for debt to fall rapidly, although surpluses could decline to around 3 percent of GDP. To support sound fiscal policy decisions in the future, the authorities should strengthen fiscal institutions, including fiscal rules and budgetary processes.

46. Over the medium term, the authorities should implement fiscal reforms to improve the composition of revenues and expenditures. The authorities should implement a strategy to right-size the public-sector workforce and implement a civil service reform. Central oversight over local government finances should be strengthened, and municipalities' incentives and capacity to raise their own revenues should be increased. Tightening eligibility for early retirement should strengthen pension sustainability, and shifting pensions to wage valorization and CPI indexation would improve long-term fiscal and social sustainability. The authorities should also review the fiscal cost of tax exemptions. Taken together, these reforms would increase fiscal space over the medium term for greater high-productivity capital spending and well-targeted social spending or provide offsets for unforeseen fiscal slippages, which are a domestic risk.

47. The authorities should continue their efforts to improve the health of the financial sector. The authorities have closed supervisory gaps by bringing non-bank financial institutions under the supervision of the central bank. While the overall banking sector is stable, the authorities should steadfastly implement supervisory action plans for weak banks and intervene, if necessary. Asset quality reviews would improve loan classification and provisioning practices and should be implemented as soon as possible. The authorities should also adopt a definition of non-performing loans that does not exclude impaired assets that have adequate collateral. With many banks relative to the size of the market, the authorities should be cautious in granting new banking licenses and promote consolidation. The authorities should continue to improve the AML/CFT framework and seek to implement the outstanding recommendations of the 2015 FSAP.

48. A comprehensive strategy is needed to improve labor market outcomes and raise productivity growth. Montenegro faces competitiveness challenges, and its external position is weaker than that consistent with medium-term fundamentals. Structural labor market impediments discourage greater labor force participation and the generation of formal sector employment, and the authorities should implement a unified strategy by reducing the labor tax wedge, reforming the withdrawal of social benefits, and adopting amendments to the labor law that balance the need for worker protection with a needed increase in labor market flexibility. The authorities should also review the involvement of the state in the economy to ensure that it is limited to areas of market failures and strengthen the framework for public-private-partnerships to minimize the risk of large liabilities being transferred to the public sector.

49. It is expected that the next Article IV consultation with Montenegro will be held on the standard 12-month cycle.

Table 2. Montenegro: Selected Economic Indicators, 2013-23
(Under current policies)

	2013	2014	2015	2016	2017	2017	2018	2018	2019	2020	2021	2022	2023
					Last SR	Prelim.	Last SR			Projections			
Real economy													
Nominal GDP (millions of €)	3,362	3,458	3,655	3,954	3,970	4,237	4,187	4,492	4,692	4,917	5,165	5,444	5,718
Gross national saving (percent of GDP)	5.1	5.0	6.9	8.0	7.8	10.4	9.9	11.1	9.6	10.0	11.6	13.4	15.2
Gross investment (percent of GDP)	19.6	20.2	20.1	26.1	27.9	29.3	31.1	29.9	27.2	23.4	24.2	24.6	25.2
Unemployment rate (percent)	19.5	18.0	17.6	17.7	...	16.1	...	...	...	...	...	...	...
	(percent change)												
Real GDP	3.5	1.8	3.4	2.9	3.0	4.4	2.8	3.0	2.4	3.0	3.1	3.4	3.0
Industrial production	10.7	-11.5	8.2	-2.9	...	-4.5	...	...	...	...	...	...	...
Tourism													
Arrivals	6.6	-2.6	8.5	10.2	...	18.2	...	...	...	...	...	...	...
Nights	7.1	-9.2	5.3	8.4	...	10.5	...	...	...	...	...	...	...
Consumer prices (period average)	2.2	-0.7	1.5	-0.3	2.1	2.4	2.6	2.8	1.8	1.7	1.9	2.0	2.0
Consumer prices (end of period)	0.3	-0.3	1.4	1.0	1.6	1.9	2.6	2.7	1.8	1.8	1.9	2.0	2.0
GDP deflator (percent change)	2.1	1.0	2.2	5.1	2.2	2.7	2.6	2.9	2.0	1.7	1.9	1.9	1.9
Average net wage (12-month)	-1.7	-0.5	0.7	4.0	...	2.3	...	...	...	...	...	...	...
Money and credit (end of period)													
Bank credit to private sector 1/	1.9	-0.4	2.2	6.4	7.5	8.4	6.4	7.2	7.5	6.0	6.5	6.2	6.2
Enterprises	0.3	-2.5	1.7	1.6	...	6.1	...	...	...	...	...	...	...
Households	3.7	1.7	2.7	11.1	...	10.4	...	...	...	...	...	...	...
Private sector deposits	1.8	6.1	9.0	6.0	...	15.1	...	...	...	...	...	...	...
General government finances 2/													
	(as percent of GDP)												
Revenue and grants	41.3	43.5	40.4	41.3	43.5	40.9	45.1	43.4	42.4	42.3	42.2	42.1	42.0
Expenditure	45.8	44.2	46.6	47.5	50.0	47.8	50.7	46.1	44.4	39.8	40.0	40.0	40.1
Overall fiscal balance	-4.5	-0.7	-6.2	-6.2	-6.4	-7.0	-5.6	-2.7	-2.0	2.5	2.2	2.1	1.9
Cyclically adjusted overall fiscal balance	-4.2	-0.3	-6.1	-6.1	...	-7.3	...	-3.0	-1.9	2.6	2.3	2.1	1.8
Primary balance	-2.4	1.6	-3.8	-4.0	-3.9	-4.5	-2.9	-0.7	0.1	4.4	3.9	3.6	3.3
Domestic financing (net)	2.1	-0.3	-2.2	-0.1	-0.3	0.1	0.1	-7.8	-0.1	5.1	1.0	0.9	0.4
Privatization receipts	0.8	0.3	0.3	0.3	0.2	0.2	0.2	-1.4	1.6	0.1	0.0	0.0	0.0
General government gross debt	58.7	63.4	68.8	66.4	71.6	67.2	73.6	72.5	70.9	61.1	56.5	51.8	47.4
General government gross debt (authorities' definition) 3/	55.2	59.9	66.1	64.4	69.1	65.3	71.3	70.7	69.2	59.4	55.0	50.3	46.0
General government debt, including loan guarantees	66.7	71.5	76.2	73.9	79.3	74.6	81.0	80.1	78.2	68.0	63.1	58.1	53.4
General government net debt, including guarantees 4/	58.0	62.1	67.2	65.0	...	65.1	...	63.9	62.1	56.8	52.6	48.0	43.8
Balance of payments													
Current account balance	-14.5	-15.2	-13.2	-18.1	-20.2	-18.9	-21.2	-18.8	-17.6	-13.4	-12.6	-11.3	-10.1
Foreign direct investment	9.6	10.2	16.9	9.4	10.3	11.2	10.4	11.3	11.3	11.3	11.1	10.8	10.6
External debt (end of period, stock)	156.4	163.1	161.8	158.8	169.8	159.7	173.5	164.2	166.3	158.6	155.4	150.3	144.7
REER (CPI-based; annual average change, in percent)													
(- indicates depreciation)	-0.9	-0.1	1.8	0.4	...	-1.9	...	...	...	...	...	...	...
Memorandum:													
GDP per capita (USD)	7,189	7,390	6,517	7,028	...	7,678	...	...	...	...	...	...	...
Nominal GDP Growth (in percent)	5.7	2.8	5.7	8.2	5.2	7.1	5.5	6.0	4.5	4.8	5.0	5.4	5.0
Real output gap (percent of potential GDP)	-0.5	-0.9	-0.2	-0.3	...	0.8	...	0.6	-0.1	-0.2	-0.2	0.1	0.1
Gross international reserves in millions of USD	584	661	734	846	925	1,037	967	1,454	1,532	1,308	1,356	1,402	1,447
Months of imports	2.5	3.0	3.3	3.5	...	3.7	...	4.8	5.1	4.2	4.2	4.2	4.2
Overall balance excluding Highway Project (in percent GDP)	-4.5	-0.7	-3.9	-3.2	-0.6	-1.1	0.9	3.2	2.4	2.5	2.2	2.1	1.9

Sources: Ministry of Finance; Central Bank of Montenegro; Statistical Office of Montenegro; and IMF staff estimates and projections.

1/ A change in classification in off-balance sheet items has resulted in a structural break in 2012; the annual changes for credit growth in 2013 are distorted by the change in methodology.

2/ Includes extra-budgetary funds and local governments, but not public enterprises.

3/ The authorities do not include the arrears of local governments in their definition of general government gross debt.

4/ General government debt, including guarantees, net of central and local government deposits

Table 3. Montenegro: Savings and Investment Balances, 2013-23

(Under current policies; percent of GDP, unless otherwise noted)

	2013	2014	2015	2016	2017 Last SR	2017 Prelim.	2018 Last SR	2018	2019	2020	2021	2022	2023
								Projections					
Gross national savings	5.1	5.0	6.9	8.0	7.8	10.4	9.9	11.1	9.6	10.0	11.6	13.4	15.2
Non-government	7.6	2.3	9.2	9.8	7.3	10.0	7.3	6.4	4.9	4.8	5.9	7.5	9.2
Government	-2.5	2.7	-2.3	-1.8	0.5	0.4	2.6	4.7	4.7	5.1	5.7	5.8	6.0
Gross domestic investment	19.6	20.2	20.1	26.1	27.9	29.3	31.1	29.9	27.2	23.4	24.2	24.6	25.2
Non-government	15.7	14.8	14.1	19.7	18.7	19.8	20.5	20.6	18.6	19.0	19.4	19.7	20.1
Government	3.9	5.5	6.0	6.4	9.2	9.6	10.6	9.4	8.6	4.4	4.8	4.9	5.2
Savings - investment balance	-14.5	-15.2	-13.2	-18.1	-20.1	-18.9	-21.1	-18.8	-17.6	-13.4	-12.6	-11.3	-10.1
Non-government	-8.0	-12.5	-4.9	-10.0	-11.4	-9.7	-13.2	-14.2	-13.7	-14.1	-13.4	-12.2	-10.8
Government	-6.4	-2.7	-8.3	-8.1	-8.7	-9.2	-7.9	-4.6	-3.9	0.7	0.8	0.9	0.8
Current account balance	-14.5	-15.2	-13.2	-18.1	-20.2	-18.9	-21.2	-18.8	-17.6	-13.4	-12.6	-11.3	-10.1
Foreign direct investment (net)	9.6	10.2	16.9	9.4	10.3	11.2	10.4	11.3	11.3	11.3	11.1	10.8	10.6
External debt	156.4	163.1	161.8	158.8	169.8	159.7	173.5	164.2	166.3	158.6	155.4	150.3	144.7
Consumption	100.5	99.6	98.4	96.4	96.9	94.9	94.6	93.6	94.9	94.4	92.8	90.9	89.0
Non-government	81.0	80.2	79.2	76.8	78.8	76.2	76.9	77.1	79.0	78.5	76.6	74.5	72.5
Government	19.5	19.4	19.2	19.6	18.1	18.7	17.7	16.6	16.0	16.0	16.2	16.4	16.5

Sources: Statistical Office of Montenegro; Ministry of Finance; and IMF staff estimates and projections.

Table 4. Montenegro: Contribution to Real Gross Domestic Product, 2013-23
(Contribution to real GDP growth)

	2013	2014	2015	2016	2017 Last SR	2017 Prelim.	2018 Last SR	2018	2019	2020	2021	2022	2023
								Projections					
Gross domestic product	3.5	1.8	3.4	2.9	3.0	4.4	2.8	3.0	2.4	3.0	3.1	3.4	3.0
Consumption	1.8	2.9	2.5	5.1	1.1	4.2	0.8	2.3	4.7	2.2	1.5	1.5	1.0
Government	0.3	0.3	0.4	0.2	-1.8	0.3	0.1	-1.8	-0.2	0.5	0.8	0.9	0.6
Private	1.5	2.6	2.1	4.9	2.9	4.0	0.7	4.1	4.9	1.7	0.7	0.6	0.3
Investment	-1.2	0.5	3.7	5.5	4.1	5.1	4.9	2.3	-2.6	-3.2	2.2	1.8	1.9
Gross fixed capital formation	2.3	-0.6	2.6	6.6	4.1	4.7	4.9	2.3	-2.6	-3.2	2.2	1.8	1.9
Government	-0.3	1.8	0.8	0.9	3.5	4.1	1.8	0.1	-0.6	-4.6	0.7	0.3	0.5
Private	2.6	-2.4	1.8	5.6	0.6	0.6	3.2	2.2	-2.0	1.4	1.5	1.5	1.4
Changes in inventories	-3.5	1.1	1.0	-1.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports	3.0	-1.6	-2.8	-7.7	-2.3	-4.9	-2.9	-1.7	0.3	4.0	-0.6	0.1	0.2
Exports	0.0	-0.5	4.0	1.8	1.8	1.9	1.7	1.8	1.3	1.4	1.5	1.7	1.5
Goods	0.5	-1.5	-1.3	0.7	0.6	-0.5	0.4	0.5	0.2	0.3	0.3	0.4	0.3
Services	-0.5	0.9	5.3	1.1	1.2	2.4	1.4	1.3	1.0	1.1	1.2	1.3	1.2
Imports	2.9	-1.1	-6.8	-9.5	-4.1	-6.8	-4.7	-3.5	-1.0	2.5	-2.1	-1.5	-1.4
Goods	1.1	-1.2	-3.9	-7.5	-3.4	-5.8	-4.0	-2.9	-0.7	2.5	-1.7	-1.2	-1.1
Services	1.8	0.1	-2.9	-2.0	-0.7	-1.0	-0.7	-0.6	-0.3	0.0	-0.4	-0.4	-0.3

Sources: Statistical Office of Montenegro; Ministry of Finance; and IMF staff estimates and projections.

Table 5. Montenegro: Consolidated General Government Fiscal Operations, 2013-23 1/
(Millions of euro, GFSM 2014)

	2013	2014	2015	2016	2017	2017	2018	2018	2018	2019	2020	2021	2022	2023
					Last SR		Last SR		Projections					
1. Revenue	1,381	1,497	1,469	1,630	1,724	1,726	1,886	1,944	1,982	2,071	2,175	2,285	2,391	
Taxes	864	950	926	1,013	1,107	1,104	1,226	1,253	1,331	1,393	1,461	1,533	1,603	
Personal income tax	124	137	136	160	170	146	179	157	168	169	177	185	192	
Corporate income tax	41	45	42	45	50	49	53	58	58	60	63	65	67	
Property taxes	14	15	15	13	14	15	15	16	17	18	19	20	21	
Value added tax	429	498	457	501	540	549	615	637	672	704	739	776	811	
Excises	161	156	170	183	214	225	240	256	280	299	314	331	347	
Taxes on international trade	22	22	23	24	25	25	27	27	28	29	30	32	34	
Local government taxes	67	71	76	77	81	86	86	92	95	100	105	110	116	
Other taxes	5	6	7	9	12	9	12	11	14	14	15	15	14	
Social security contributions	357	401	392	414	453	442	481	470	470	491	516	544	572	
Nontax revenues	152	137	138	186	143	149	161	201	167	175	184	194	204	
Grants	10	9	14	17	21	30	17	20	14	12	13	13	13	
2. Expense	1,404	1,350	1,479	1,624	1,622	1,615	1,681	1,646	1,673	1,734	1,810	1,902	1,988	
Gross salaries and other personal income	380	395	403	434	445	453	446	454	462	488	512	540	568	
Use of goods and services	140	140	188	187	175	173	180	180	182	188	209	231	248	
Interest payments	71	78	86	85	100	103	111	92	99	96	86	82	80	
Subsidies to enterprises	18	19	20	28	28	29	29	28	29	30	32	34	35	
Other current outflows	35	37	45	51	50	54	60	59	53	56	58	61	64	
Social security transfers	483	492	488	556	565	539	581	544	562	579	603	627	653	
Other transfers	153	154	230	263	240	243	250	267	263	273	286	300	314	
Repayment of guarantees	107	18	0	0	0	0	0	0	0	0	0	0	0	
Reserves	16	16	19	21	19	22	23	22	23	24	25	26	28	
3. Gross operating balance (= 1 - 2)	-23	147	-10	6	102	111	205	298	310	337	365	383	403	
4. Net acquisition of nonfinancial assets	124	181	212	247	360	398	438	415	398	209	243	261	289	
Capital revenue	-9	-7	-8	-4	-4	-6	-5	-7	-7	-7	-8	-8	-8	
Capital expenditure	132	189	220	251	364	405	442	421	405	217	250	268	297	
5. Net lending (+) / borrowing (-) (= 3 - 4)	-147	-34	-221	-241	-258	-288	-233	-117	-88	128	122	122	114	
6. Net acquisition of financial assets	-34	9	32	-11	-15	32	-11	366	-39	-209	2	11	7	
Domestic	-34	9	32	-11	-15	32	-11	366	-39	-209	2	11	7	
Currency and deposits	-11	31	37	-3	-7	34	-5	296	30	-209	-4	5	1	
Loans	4	-10	4	4	-2	7	1	5	6	6	6	6	6	
Equity and investment fund shares	-27	-12	-10	-11	-6	-9	-7	65	-75	-5	0	0	0	
7. Net incurrence of liabilities	196	117	186	200	240	293	186	483	49	-336	-120	-112	-108	
Domestic	58	19	-43	76	-19	37	1	-54	23	43	46	51	22	
Foreign	139	98	229	123	258	256	185	537	26	-379	-166	-163	-130	
8. Discrepancy (= 5 - 6 + 7) 2/	83	74	-67	-31	-4	-26	-36	0	0	0	0	0	0	
Memorandum items:														
Primary balance	-76	44	-135	-155	-158	-185	-122	-24	11	224	208	204	194	
Nonhighway primary balance	-76	44	-50	-37	75	62	149	240	215	224	208	204	194	
Current balance	-33	138	-23	-11	81	80	188	278	296	325	351	370	390	
Nominal general government debt	1,972	2,191	2,513	2,625	...	2,848	...	3,258	3,329	3,003	2,920	2,821	2,711	
Nominal gen. gov. debt, with guarantees	2,241	2,473	2,784	2,923	...	3,160	...	3,598	3,668	3,343	3,260	3,161	3,051	
Nominal GDP	3,362	3,458	3,655	3,954	3,970	4,237	4,187	4,492	4,692	4,917	5,165	5,444	5,718	

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ Historical discrepancy refers to differences between reported financing and that derived from monetary and debt data. Projected discrepancy refers to unidentified future financing needs.

Table 6. Montenegro: Consolidated General Government Fiscal Operations, 2013-23 1/
(in percent of GDP, GFSM 2014)

	2013	2014	2015	2016	2017	2017	2018	2018	2019	2020	2021	2022	2023
					Last SR	Prelim.	Last SR				Projections		
1. Revenue	41.1	43.3	40.2	41.2	43.4	40.7	45.0	43.3	42.2	42.1	42.1	42.0	41.8
Taxes	25.7	27.5	25.3	25.6	27.9	26.1	29.3	27.9	28.4	28.3	28.3	28.2	28.0
Personal income tax	3.7	4.0	3.7	4.0	4.3	3.4	4.3	3.5	3.6	3.4	3.4	3.4	3.4
Corporate income tax	1.2	1.3	1.2	1.1	1.3	1.2	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Property taxes	0.4	0.4	0.4	0.3	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	12.8	14.4	12.5	12.7	13.6	13.0	14.7	14.2	14.3	14.3	14.3	14.2	14.2
Excises	4.8	4.5	4.7	4.6	5.4	5.3	5.7	5.7	6.0	6.1	6.1	6.1	6.1
Taxes on international trade	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	2.0	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Other taxes	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.2
Social security contributions	10.6	11.6	10.7	10.5	11.4	10.4	11.5	10.5	10.0	10.0	10.0	10.0	10.0
Nontax revenues	4.5	4.0	3.8	4.7	3.6	3.5	3.8	4.5	3.6	3.6	3.6	3.6	3.6
Grants	0.3	0.3	0.4	0.4	0.5	0.7	0.4	0.5	0.3	0.2	0.3	0.2	0.2
2. Expense	41.8	39.0	40.5	41.1	40.9	38.1	40.1	36.6	35.6	35.3	35.0	34.9	34.8
Gross salaries and other personal income	11.3	11.4	11.0	11.0	11.2	10.7	10.7	10.1	9.9	9.9	9.9	9.9	9.9
Use of goods and services	4.2	4.1	5.1	4.7	4.4	4.1	4.3	4.0	3.9	3.8	4.0	4.3	4.3
Interest payments	2.1	2.3	2.4	2.2	2.5	2.4	2.6	2.1	2.1	2.0	1.7	1.5	1.4
Subsidies to enterprises	0.5	0.5	0.6	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Other current outflows	1.0	1.1	1.2	1.3	1.3	1.3	1.4	1.3	1.1	1.1	1.1	1.1	1.1
Social security transfers	14.4	14.2	13.3	14.1	14.2	12.7	13.9	12.1	12.0	11.8	11.7	11.5	11.4
Other transfers	4.6	4.4	6.3	6.6	6.0	5.7	6.0	5.9	5.6	5.6	5.5	5.5	5.5
Repayment of guarantees	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
3. Gross operating balance (= 1 - 2)	-0.7	4.3	-0.3	0.2	2.6	2.6	4.9	6.6	6.6	6.9	7.1	7.0	7.0
4. Net acquisition of nonfinancial assets	3.7	5.2	5.8	6.2	9.1	9.4	10.5	9.2	8.5	4.3	4.7	4.8	5.0
Capital revenue	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital expenditure	3.9	5.5	6.0	6.4	9.2	9.6	10.6	9.4	8.6	4.4	4.8	4.9	5.2
5. Net lending (+) / borrowing (-) (= 3 - 4)	-4.4	-1.0	-6.1	-6.1	-6.5	-6.8	-5.6	-2.6	-1.9	2.6	2.4	2.2	2.0
6. Net acquisition of financial assets	-1.0	0.2	0.9	-0.3	-0.4	0.7	-0.3	8.2	-0.8	-4.2	0.0	0.2	0.1
Domestic	-1.0	0.2	0.9	-0.3	-0.4	0.7	-0.3	8.2	-0.8	-4.2	0.0	0.2	0.1
Currency and deposits	-0.3	0.9	1.0	-0.1	-0.2	0.8	-0.1	6.6	0.6	-4.3	-0.1	0.1	0.0
Loans	0.1	-0.3	0.1	0.1	0.0	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Equity and investment fund shares	-0.8	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	1.4	-1.6	-0.1	0.0	0.0	0.0
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Net incurrence of liabilities	5.8	3.4	5.1	5.0	6.0	6.9	4.4	10.8	1.0	-6.8	-2.3	-2.1	-1.9
Domestic	1.7	0.6	-1.2	1.9	-0.5	0.9	0.0	-1.2	0.5	0.9	0.9	0.9	0.4
Foreign	4.1	2.8	6.3	3.1	6.5	6.0	4.4	12.0	0.5	-7.7	-3.2	-3.0	-2.3
8. Discrepancy (= 5 - 6 + 7) 2/	2.5	2.1	-1.8	-0.8	-0.1	-0.6	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance	-2.2	1.3	-3.7	-3.9	-4.0	-4.4	-2.9	-0.5	0.2	4.6	4.0	3.8	3.4
Nonhighway primary balance	-2.2	1.3	-1.4	-0.9	1.9	1.5	3.6	5.3	4.6	4.6	4.0	3.8	3.4
Current balance	-1.0	4.0	-0.6	-0.3	2.0	1.9	4.5	6.2	6.3	6.6	6.8	6.8	6.8

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ Historical discrepancy refers to differences between reported financing and that derived from monetary and debt data. Projected discrepancy refers to unidentified future financing needs.

Table 7. Montenegro: Consolidated General Government Fiscal Operations, 2013-23 1/
(Millions of euro)

	2013	2014	2015	2016	2017	2017	2018	2018	2019	2020	2021	2022	2023
					Last SR		Last SR			Projections			
Total revenues and grants	1,390	1,505	1,477	1,635	1,728	1,732	1,890	1,951	1,989	2,078	2,182	2,293	2,400
Total revenues	1,380	1,495	1,464	1,617	1,707	1,702	1,873	1,930	1,975	2,066	2,169	2,279	2,386
Current revenues	1,372	1,488	1,456	1,613	1,703	1,696	1,869	1,924	1,968	2,059	2,161	2,272	2,378
Taxes	864	950	926	1,013	1,107	1,104	1,226	1,253	1,331	1,393	1,461	1,533	1,603
Personal income tax	124	137	136	160	170	146	179	157	168	169	177	185	192
Corporate income tax	41	45	42	45	50	49	53	58	58	60	63	65	67
Taxes on turnover of real estate	14	15	15	13	14	15	15	16	17	18	19	20	21
Value added tax	429	498	457	501	540	549	615	637	672	704	739	776	811
Excises	161	156	170	183	214	225	240	256	280	299	314	331	347
Taxes on international trade	22	22	23	24	25	25	27	27	28	29	30	32	34
Local government taxes	67	71	76	77	81	86	86	92	95	100	105	110	116
Other taxes	5	6	7	9	12	9	12	11	14	14	15	15	14
Social security contributions	357	401	392	414	453	442	481	470	470	491	516	544	572
Nontax revenues	152	137	138	186	143	149	161	201	167	175	184	194	204
Duties	33	21	21	19	20	20	21	21	22	23	24	25	27
Fees	68	71	76	120	74	80	88	95	98	103	108	114	120
Other revenues	50	45	41	47	50	49	52	85	47	49	52	55	57
Capital revenues	9	7	8	4	4	6	5	7	7	7	8	8	8
Grants	10	9	14	17	21	30	17	20	14	12	13	13	13
Total expenditures and net lending	1,541	1,529	1,703	1,879	1,984	2,027	2,124	2,073	2,083	1,956	2,066	2,176	2,291
Total expenditures	1,537	1,539	1,699	1,875	1,986	2,020	2,123	2,067	2,077	1,950	2,061	2,170	2,285
Current expenditures	1,404	1,350	1,479	1,624	1,622	1,615	1,681	1,646	1,673	1,734	1,810	1,902	1,988
Gross salaries	365	381	383	419	429	439	430	440	447	471	496	523	549
Other personal income	15	14	20	15	16	14	17	15	15	16	17	18	19
Goods and services	116	115	163	161	148	147	151	153	154	158	172	186	201
Current maintenance	24	25	25	26	28	26	29	27	28	30	37	45	47
Interest payments	71	78	86	85	100	103	111	92	99	96	86	82	80
Rent	8	9	9	10	11	10	11	9	10	10	11	11	12
Subsidies to enterprises	18	19	20	28	28	29	29	28	29	30	32	34	35
Other outflows 2/	27	28	37	41	39	44	49	50	44	46	47	50	52
Social security transfers	483	492	488	556	565	539	581	544	562	579	603	627	653
Other transfers	153	154	230	263	240	243	250	267	263	273	286	300	314
Repayment of guarantees	107	18	0	0	0	0	0	0	0	0	0	0	0
Reserves	16	16	19	21	19	22	23	22	23	24	25	26	28
Capital expenditures	132	189	220	251	364	405	442	421	405	217	250	268	297
Non-highway capital expenditures	132	189	135	132	131	158	172	157	201	217	250	268	297
Highway capital expenditures	0	0	85	119	233	247	271	264	204	0	0	0	0
Net lending	4	-10	4	4	-2	7	1	5	6	6	6	6	6
Overall Balance	-151	-24	-226	-244	-256	-295	-234	-122	-94	122	116	116	108
Financing	234	98	158	214	256	268	234	122	94	-122	-116	-116	-108
Domestic financing	69	-11	-80	79	-12	3	6	-350	-7	252	50	47	22
Central bank financing (- deposit increase)	12	-13	-5	0	7	-24	5	-291	-18	216	3	-6	-1
Net borrowing from other sources	57	2	-75	80	-19	27	1	-59	11	36	47	52	23
Commercial bank financing	68	-14	102	129	...	50	...	-53	-8	-9	25	55	26
Change in deposits (- increase)	-1	-17	-32	4	...	-10	...	-5	-12	-7	1	1	1
Bank loans, net	61	-41	-14	16	...	68	...	-43	-21	29	-1	54	25
Bank purchases of securities, net	8	44	148	109	...	-8	...	-6	25	-30	25	0	0
Non-bank financing, net	-11	17	-177	-49	...	-23	...	-5	20	45	22	-3	-3
Foreign financing	139	98	229	123	258	256	185	537	26	-379	-166	-163	-130
Disbursements	191	210	661	325	405	353	279	1,000	366	37	225	37	37
Amortization	-53	-113	-322	-310	-146	-136	-94	-463	-329	-416	-366	-200	-167
Change in foreign accounts receivable 3/	0	0	-110	108	0	38	0	0	-11	0	-25	0	0
Privatization receipts	27	12	10	11	6	9	7	-65	75	5	0	0	0
Unidentified 4/	0	0	0	0	4	0	36	0	0	0	0	0	0
Discrepancy 5/	-83	-74	67	31	0	26	0	0	0	0	0	0	0
Memorandum items:													
Primary balance	-80	54	-140	-159	-156	-192	-123	-30	5	218	202	199	188
Nonhighway primary balance	-80	54	-55	-40	77	55	148	235	209	218	202	199	188
Nonhighway overall balance	-151	-24	-141	-126	-23	-48	37	142	110	122	116	116	108
Current balance	-33	138	-23	-11	81	80	188	278	296	325	351	370	390

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ According to GFSM 1986, payments of loan guarantees or related to court rulings are recorded as government expenses.

3/ To reflect pre-payments made for construction of Bar-Boljare highway that exceed the pace of actual capital expenditure.

4/ Refers to financing needs for which specific sources have not yet been identified; however, this does not constitute a financing gap.

5/ Historical discrepancy is the difference between reported financing and that derived from monetary and debt data.

Table 8. Montenegro: Consolidated General Government Fiscal Operations, 2013-23 1/
(in percent of GDP)

	2013	2014	2015	2016	2017	2017	2018	2018	2019	2020	2021	2022	2023
					Last SR	Prelim.	Last SR				Projections		
Total revenues and grants	41.3	43.5	40.4	41.3	43.5	40.9	45.1	43.4	42.4	42.3	42.2	42.1	42.0
Total revenues	41.0	43.2	40.0	40.9	43.0	40.2	44.7	43.0	42.1	42.0	42.0	41.9	41.7
Current revenues	40.8	43.0	39.8	40.8	42.9	40.0	44.6	42.8	42.0	41.9	41.8	41.7	41.6
Taxes	25.7	27.5	25.3	25.6	27.9	26.1	29.3	27.9	28.4	28.3	28.3	28.2	28.0
Personal income tax	3.7	4.0	3.7	4.0	4.3	3.4	4.3	3.5	3.6	3.4	3.4	3.4	3.4
Corporate income tax	1.2	1.3	1.2	1.1	1.3	1.2	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Taxes on turnover of real estate	0.4	0.4	0.4	0.3	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	12.8	14.4	12.5	12.7	13.6	13.0	14.7	14.2	14.3	14.3	14.3	14.2	14.2
Excises	4.8	4.5	4.7	4.6	5.4	5.3	5.7	5.7	6.0	6.1	6.1	6.1	6.1
Taxes on international trade	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	2.0	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Other taxes	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.2
Social security contributions	10.6	11.6	10.7	10.5	11.4	10.4	11.5	10.5	10.0	10.0	10.0	10.0	10.0
Nontax revenues	4.5	4.0	3.8	4.7	3.6	3.5	3.8	4.5	3.6	3.6	3.6	3.6	3.6
Capital revenues	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants	0.3	0.3	0.4	0.4	0.5	0.7	0.4	0.5	0.3	0.2	0.3	0.2	0.2
Total expenditures and net lending	45.8	44.2	46.6	47.5	50.0	47.8	50.7	46.1	44.4	39.8	40.0	40.0	40.1
Total expenditures	45.7	44.5	46.5	47.4	50.0	47.7	50.7	46.0	44.3	39.7	39.9	39.9	40.0
Current expenditures	41.8	39.0	40.5	41.1	40.9	38.1	40.1	36.6	35.6	35.3	35.0	34.9	34.8
Gross salaries	10.9	11.0	10.5	10.6	10.8	10.4	10.3	9.8	9.5	9.6	9.6	9.6	9.6
Other personal income	0.4	0.4	0.5	0.4	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Goods and services	3.5	3.3	4.5	4.1	3.7	3.5	3.6	3.4	3.3	3.2	3.3	3.4	3.5
Current maintenance	0.7	0.7	0.7	0.7	0.7	0.6	0.7	0.6	0.6	0.6	0.7	0.8	0.8
Interest payments	2.1	2.3	2.4	2.2	2.5	2.4	2.6	2.1	2.1	2.0	1.7	1.5	1.4
Rent	0.2	0.2	0.2	0.3	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises	0.5	0.5	0.6	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Other outflows 2/	0.8	0.8	1.0	1.0	1.0	1.0	1.2	1.1	0.9	0.9	0.9	0.9	0.9
Social security transfers	14.4	14.2	13.3	14.1	14.2	12.7	13.9	12.1	12.0	11.8	11.7	11.5	11.4
Other transfers	4.6	4.4	6.3	6.6	6.0	5.7	6.0	5.9	5.6	5.6	5.5	5.5	5.5
Repayment of guarantees	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capital expenditures	3.9	5.5	6.0	6.4	9.2	9.6	10.6	9.4	8.6	4.4	4.8	4.9	5.2
Non-highway capital expenditures	3.9	5.5	3.7	3.3	3.3	3.7	4.1	3.5	4.3	4.4	4.8	4.9	5.2
Highway capital expenditures	0.0	0.0	2.3	3.0	5.9	5.8	6.5	5.9	4.4	0.0	0.0	0.0	0.0
Net lending	0.1	-0.3	0.1	0.1	0.0	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Overall Balance	-4.5	-0.7	-6.2	-6.2	-6.4	-7.0	-5.6	-2.7	-2.0	2.5	2.2	2.1	1.9
Financing	7.0	2.8	4.3	5.4	6.4	6.3	5.6	2.7	2.0	-2.5	-2.2	-2.1	-1.9
Domestic financing	2.1	-0.3	-2.2	2.0	-0.3	0.1	0.1	-7.8	-0.1	5.1	1.0	0.9	0.4
Central bank financing (- deposit increase)	0.4	-0.4	-0.1	0.0	0.2	-0.6	0.1	-6.5	-0.4	4.4	0.1	-0.1	0.0
Net borrowing from other sources	1.7	0.1	-2.1	2.0	-0.5	0.6	0.0	-1.3	0.2	0.7	0.9	1.0	0.4
Commercial bank financing	2.0	-0.4	2.8	3.3	...	1.2	...	-1.2	-0.2	-0.2	0.5	1.0	0.5
Change in deposits (- increase)	0.0	-0.5	-0.9	0.1	...	-0.2	...	-0.1	-0.3	-0.1	0.0	0.0	0.0
Bank loans, net	1.8	-1.2	-0.4	0.4	...	1.6	...	-1.0	-0.5	0.6	0.0	1.0	0.4
Bank purchases of securities, net	0.2	1.3	4.1	2.8	...	-0.2	...	-0.1	0.5	-0.6	0.5	0.0	0.0
Non-bank financing, net	-0.3	0.5	-4.9	-1.2	...	-0.6	...	-0.1	0.4	0.9	0.4	-0.1	-0.1
Foreign financing	4.1	2.8	6.3	3.1	6.5	6.0	4.4	12.0	0.5	-7.7	-3.2	-3.0	-2.3
Disbursements	5.7	6.1	18.1	8.2	10.2	8.3	6.7	22.3	7.8	0.8	4.4	0.7	0.6
Amortization	-1.6	-3.3	-8.8	-7.8	-3.7	-3.2	-2.2	-10.3	-7.0	-8.5	-7.1	-3.7	-2.9
Change in foreign accounts receivable 3/	...	...	-3.0	2.7	0.0	0.9	0.0	0.0	-0.2	...	...	...	...
Privatization receipts	0.8	0.3	0.3	0.3	0.2	0.2	0.2	-1.4	1.6	0.1	0.0	0.0	0.0
Unidentified 4/	0.0	0.0	0.0	0.0	0.1	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Discrepancy 5/	-2.5	-2.1	1.8	0.8	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance	-2.4	1.6	-3.8	-4.0	-3.9	-4.5	-2.9	-0.7	0.1	4.4	3.9	3.6	3.3
Nonhighway primary balance	-2.4	1.6	-1.5	-1.0	1.9	1.3	3.5	5.2	4.5	4.4	3.9	3.6	3.3
Nonhighway overall balance	-4.5	-0.7	-3.9	-3.2	-0.6	-1.1	0.9	3.2	2.4	2.5	2.2	2.1	1.9
Current balance	-1.0	4.0	-0.6	-0.3	2.0	1.9	4.5	6.2	6.3	6.6	6.8	6.8	6.8
General government debt (gross)	58.7	63.4	68.8	66.4	71.6	67.2	73.6	72.5	70.9	61.1	56.5	51.8	47.4
Gen. govt debt, including guarantees	66.7	71.5	76.2	73.9	79.3	74.6	81.0	80.1	78.2	68.0	63.1	58.1	53.4

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government and local governments.

2/ According to GFSM 1986, payments of loan guarantees or related to court rulings are recorded as government expenses.

3/ To reflect pre-payments made for construction of Bar-Boljare highway that exceed the pace of actual capital expenditure.

4/ Refers to financing needs for which specific sources have not yet been identified; however, this does not constitute a financing gap.

5/ Historical discrepancy is the difference between reported financing and that derived from monetary and debt data.

Table 9. Montenegro: Summary of Accounts of the Financial System, 2013-18
(Millions of euro)

	2013	2014	2015	2016	2017	2017	2018	2018
					Last SR		Last SR	Proj.
I. Central Bank								
Net foreign assets	395	514	641	780	815	877	850	1167
Assets	424	545	674	803	838	898	873	1188
Liabilities	29	31	33	23	23	21	23	21
Net domestic assets	-297	-408	-525	-651	-679	-733	-707	-1014
Net credit to the nonfinancial public sector	-12	-25	-30	-31	-31	-58	-31	-350
Of which: general government	-12	-25	-30	-31	-31	-58	-31	-350
Net credit to the banking system	-319	-416	-525	-654	-646	-709	-658	-701
Required reserves	-150	-171	-196	-226	-193	-234	-206	-237
Giro account	-169	-245	-329	-427	-452	-474	-452	-464
Claims on depository institutions	-1	0	0	-1	-1	-1	-1	-1
Other assets net	34	33	31	34	-3	34	-17	36
Deposits included in broad money	39	46	55	65	69	78	72	82
Equity	59	60	61	64	67	66	71	70
II. Banking System								
Net foreign assets	-162	-74	-152	-290	-301	-246	-311	-313
Assets	561	613	591	527	610	615	695	611
Liabilities	723	687	743	818	910	861	1,006	924
Net domestic assets	2,172	2,176	2,365	2,627	2,746	2,817	2,898	2,934
Net assets held in the central bank	318	415	524	653	645	708	658	701
Net credit to nonfinancial public sector	33	-59	-25	-9	-23	12	275	-41
Of which: general government	129	94	173	281	269	316	275	263
Credit to the private sector	1,777	1,770	1,810	1,926	2,070	2,087	2,203	2,238
Other domestic assets	43	49	56	57	53	10	-237	36
Liabilities	2,010	2,103	2,213	2,336	2,447	2,571	2,928	2,883
Private sector deposits	1,481	1,571	1,712	1,813	1,935	2,086	2,403	2,379
Other items, net	529	531	501	523	512	485	524	504
o/w capital	390	441	465	497	531	530	561	540
III. Consolidated System								
Net foreign assets	233	440	489	490	515	630	539	853
Net domestic assets	1,875	1,768	1,840	1,976	2,067	2,084	2,192	1,920
Net credit to the nonfinancial public sector	21	-84	-56	-40	-53	-46	244	-391
Of which: general government	117	68	142	250	238	258	244	-87
Credit to the private sector	1,777	1,770	1,810	1,926	2,070	2,087	2,203	2,238
Other net domestic assets	76	82	86	90	50	44	-255	73
Liabilities	2,049	2,148	2,268	2,402	2,516	2,649	3,000	2,966
Equity capital of the central bank	59	60	61	64	67	66	71	70
IV. Ratios								
Net assets held in CBCG/Deposits	21.5	26.4	30.6	36.0	33.3	33.9	27.4	33.1
Effective required reserves ratio	10.1	10.9	11.4	12.5	10.0	11.2	8.6	11.2
Credit to private sector / GDP	52.9	51.2	49.5	48.7	52.1	49.3	52.6	49.8
Banks' capital / credit to private sector	21.9	24.9	25.7	25.8	25.6	25.4	25.5	24.1
CBCG reserves / bank deposits	28.6	34.7	39.4	44.3	43.3	43.0	36.3	56.1
Banks' foreign liabilities / credit to private sector	40.7	38.8	41.1	42.5	44.0	41.3	40.0	41.3
Memo item:								
Broad money	1,697.8	1,851.7	2,052.9	2,248.7	2,515.6	2,574.2	2,659.8	2,663.2
BM growth	5.2	9.1	10.9	9.5	11.9	14.5	5.7	3.5

Sources: Central Bank of Montenegro; and IMF staff estimates and projections.

Table 10. Montenegro: Balance of Payments, 2013-23
(Millions of euro)

	2013	2014	2015	2016	2017	2017	2018	2018	2019	2020	2021	2022	2023
					Last SR	Prelim.	Last SR				Projections		
Current account balance	-487	-526	-483	-715	-802	-799	-889	-846	-827	-659	-651	-614	-576
Trade balance	-1,329	-1,376	-1,464	-1,657	-1,791	-1,860	-1,925	-1,939	-1,967	-1,871	-1,931	-1,970	-2,008
Exports	396	357	325	345	381	377	398	402	417	435	455	477	501
Imports	-1,724	-1,734	-1,789	-2,003	-2,172	-2,236	-2,323	-2,341	-2,384	-2,306	-2,385	-2,448	-2,508
Services account	653	690	789	769	804	836	846	881	928	996	1,055	1,124	1,192
Receipts	994	1,031	1,214	1,255	1,321	1,362	1,394	1,436	1,502	1,579	1,663	1,758	1,852
Expenditures	-341	-340	-425	-486	-517	-526	-548	-555	-573	-582	-608	-635	-661
Income account	66	46	93	53	56	88	59	72	73	74	76	78	79
Compensation of employees, net	185	194	214	224	236	234	249	248	259	271	285	300	316
Investment income, net	-120	-148	-122	-171	-180	-146	-190	-176	-186	-197	-209	-222	-237
Current transfers, net	123	114	99	120	130	136	131	140	138	142	149	155	161
Government, net	22	24	4	24	29	27	25	25	18	15	16	15	14
Other sectors (remittances), net	101	90	95	96	101	109	106	115	121	126	133	140	147
Capital and financial account	464	399	464	651	649	753	694	983	715	306	505	459	411
Foreign direct investment, net	324	354	619	372	409	474	435	506	531	557	573	590	605
Portfolio investment, net	42	84	112	-19	-41	26	-43	135	-163	-314	-50	8	8
General government	82	149	217	74	0	0	0	129	-169	-321	-57	0	0
Amortization	0	13	187	180	0	0	0	362	169	321	227	0	0
Disbursements	0	280	500	300	0	0	0	491	0	0	170	0	0
Other investment, net	95	-40	-267	298	281	253	302	342	347	63	-18	-139	-202
Public sector	-43	-34	113	-37	258	252	185	408	195	-58	-108	-163	-130
General government	-43	-34	113	-37	258	252	185	408	195	-58	-108	-163	-130
Amortization	53	100	135	130	146	136	94	101	160	95	139	200	167
Disbursements	191	-70	161	25	405	353	279	509	366	37	55	37	37
Change in foreign accounts receivable 3/	0	0	-110	108	0	38	0	0	-11	0	-25	0	0
Commercial banks	71	-62	36	151	10	-55	10	67	62	59	55	54	54
Other sectors	68	57	-416	184	12	56	107	-133	90	62	36	-30	-126
Errors and omissions	100	246	144	224	184	144	194	153	160	167	176	185	194
Unidentified financing 1/	0	0	0	0	4	0	36	0	0	0	0	0	0
Change in official reserves (- denotes increase)	-77	-118	-126	-161	-35	-98	-35	-290	-48	186	-30	-30	-30
Memorandum items					(percent of GDP)								
Current account balance	-14.5	-15.2	-13.2	-18.1	-20.2	-18.9	-21.2	-18.8	-17.6	-13.4	-12.6	-11.3	-10.1
Trade balance	-39.5	-39.8	-40.0	-41.9	-45.1	-43.9	-46.0	-43.2	-41.9	-38.1	-37.4	-36.2	-35.1
Exports	11.8	10.3	8.9	8.7	9.6	8.9	9.5	8.9	8.9	8.8	8.8	8.8	8.8
Imports	-51.3	-50.1	-48.9	-50.6	-54.7	-52.8	-55.5	-52.1	-50.8	-46.9	-46.2	-45.0	-43.9
Services account	19.4	20.0	21.6	19.4	20.2	19.7	20.2	19.6	19.8	20.3	20.4	20.6	20.8
Receipts	29.6	29.8	33.2	31.7	33.3	32.2	33.3	32.0	32.0	32.1	32.2	32.3	32.4
Payments	-10.1	-9.8	-11.6	-12.3	-13.0	-12.4	-13.1	-12.3	-12.2	-11.8	-11.8	-11.7	-11.6
Income account	1.9	1.3	2.5	1.3	1.4	2.1	1.4	1.6	1.6	1.5	1.5	1.4	1.4
Current transfers, net	3.7	3.3	2.7	3.0	3.3	3.2	3.1	3.1	2.9	2.9	2.9	2.8	2.8
Foreign direct investment, net	9.6	10.2	16.9	9.4	10.3	11.2	10.4	11.3	11.3	11.3	11.1	10.8	10.6
Portfolio investment, net	1.2	2.4	3.1	-0.5	-1.0	0.6	-1.0	3.0	-3.5	-6.4	-1.0	0.1	0.1
Other investment, net	2.8	-1.1	-7.3	7.5	7.1	6.0	7.2	7.6	7.4	1.3	-0.3	-2.6	-3.5
General government	-1.3	-1.0	3.1	-0.9	6.5	5.9	4.4	9.1	4.2	-1.2	-2.1	-3.0	-2.3
Other sectors	2.0	1.7	-11.4	4.7	0.3	1.3	2.5	-3.0	1.9	1.3	0.7	-0.6	-2.2
Errors and omissions	3.0	7.1	4.0	5.7	4.6	3.4	4.6	3.4	3.4	3.4	3.4	3.4	3.4
Gross external debt 2/ of which: Government	156.4	163.1	161.8	158.8	169.8	159.7	173.5	164.2	166.3	158.6	155.4	150.3	144.7
Real goods import growth	-1.3	2.0	6.5	12.2	5.1	8.7	6.0	4.1	1.0	-3.6	2.6	1.8	1.7
Real goods export growth	4.9	-10.2	-10.3	6.6	5.4	3.7	3.4	4.9	2.3	2.8	2.9	3.3	3.2
Real service export growth	3.2	3.2	17.7	3.1	3.7	6.9	4.0	3.7	2.9	3.2	3.4	3.7	3.4

Sources: Central Bank of Montenegro; and IMF staff estimates and projections.

1/ Unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified; however, this does not constitute a financing gap.

2/ This includes only estimates of private external debt as private debt statistics are not officially published. There is also a series break in 2014 equal to approximately 2 p.p. of GDP due to the lack of availability of local government external debt data before 2014.

3/ To reflect pre-payments made for construction of Bar-Boljare highway that exceed the pace of actual capital expenditure.

Table 11. Montenegro: Financial Soundness Indicators of the Banking Sector, 2010-2017

	2010	2011	2012	2013	2014	2015	2016	2017				
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	
Capital adequacy												
Regulatory capital as percent of risk-weighted assets	15.9	16.5	14.7	14.4	16.2	15.5	16.1	15.9	16.6	16.8	16.4	
Capital as percent of assets	10.6	10.9	10.3	13.4	14.2	13.3	12.9	13.1	12.9	12.8	12.3	
Asset composition and quality												
Distribution of bank credit by borrower												
Central government, local government, government agencies	2.1	4.9	4.8	6.7	5.2	4.6	5.3	7.0	7.1	6.5	7.3	
Funds	0.1	0.5	0.2	0.0	0.2	0.1	0.1	0.1	0.0	0.0	0.0	
State-owned companies	2.7	2.8	3.1	2.1	1.8	1.7	1.3	1.3	1.1	1.2	1.1	
Private companies, entrepreneurs	54.8	47.7	47.6	35.7	34.9	36.5	37.9	37.3	36.7	33.5	35.2	
Banks	0.0	0.0	0.0	15.8	16.7	15.5	10.6	10.1	11.2	16.1	12.9	
Financial Institutions	0.4	0.5	0.1	0.2	0.4	0.4	0.5	0.4	0.4	0.4	0.4	
Citizens	37.1	40.5	41.3	35.6	37.2	37.8	41.6	41.2	41.0	40.1	41.0	
Credit cards	2.2	2.1	2.1	1.4	1.2	1.0	0.7	0.7	0.7	0.6	0.6	
Other	0.6	0.9	0.8	2.6	2.6	2.5	2.0	2.0	1.7	1.6	1.5	
Distribution of bank credit by sectoral economic activity												
Agriculture, hunting, fishing	0.4	1.2	1.6	1.5	1.6	2.0	1.3	1.2	1.4	1.2	1.0	
Mining and energy	2.5	1.8	1.9	2.0	1.3	1.5	1.3	1.2	1.1	1.2	1.3	
Civil engineering	8.1	6.7	6.6	4.9	5.5	6.4	7.2	7.5	7.2	7.6	7.7	
Trade	22.9	20.7	19.7	19.0	20.1	18.5	15.5	15.8	15.1	13.8	14.8	
Services, tourism	7.4	6.1	6.8	4.0	4.3	5.6	7.1	7.2	7.5	7.2	7.2	
Transport, warehousing, communications	3.0	3.1	3.0	3.6	3.1	3.7	2.8	2.7	2.5	3.3	2.8	
Finance	1.7	2.7	2.2	2.1	0.8	1.0	0.9	0.9	1.2	0.8	0.8	
Real estate trading	3.0	2.3	2.3	1.5	1.3	1.0	1.1	0.8	1.2	1.0	0.5	
Administration, other public services	3.1	4.3	4.2	12.0	10.2	8.7	9.4	11.1	11.2	11.1	11.5	
Consumer loans	39.3	42.6	43.4	44.5	47.3	47.5	49.3	47.9	48.1	50.3	49.0	
Other	9.0	8.4	8.4	5.0	4.5	4.2	4.1	3.8	3.4	2.7	3.3	
Asset quality												
Non-performing loans (NPL), in percent of gross loans	21.0	15.5	17.6	18.4	16.8	13.4	11.1	10.7	9.5	8.1	8.0	
Provisions, in percent of NPL	30.7	32.8	40.2	44.7	45.6	48.3	55.5	54.6	58.8	56.6	57.0	
Provisions, in percent of total loans	6.4	5.1	7.1	8.2	7.6	6.5	6.2	5.9	5.6	4.6	4.5	
NPL net of provisions, in percent of capital	102.8	66.9	68.0	62.4	49.3	36.3	24.8	24.8	20.5	18.2	18.0	
Earnings and profitability												
Gross profits, in percent of average assets (ROAA)	-2.7	-0.1	-2.0	0.1	0.8	-0.1	0.3	0.9	0.9	1.1	0.9	
Gross profits, in percent of average equity capital (ROAE)	-27.0	-0.6	-18.1	0.9	5.7	-0.5	1.9	6.7	6.9	8.4	7.4	
Net profits, in percent of average assets (ROAA)	-2.8	-0.1	-2.0	0.1	0.8	-0.1	0.2	0.8	0.8	1.0	0.9	
Net profits, in percent of average capital (ROAE)	-27.3	-1.1	-18.3	0.5	5.4	-0.9	1.5	6.4	6.5	8.0	7.0	
Net interest margin 1/	4.9	4.8	5.0	4.3	4.5	4.5	4.3	1.0	2.0	3.1	4.0	
Gross income, in percent of average assets	5.4	5.2	5.2	5.2	5.2	10.1	4.7	1.2	2.3	3.4	4.6	
Net interest income, in percent of gross income	71.6	70.5	73.1	68.2	72.4	70.4	72.6	70.8	71.7	70.1	68.8	
Non-interest income, in percent of gross income	28.4	29.5	26.9	31.8	27.7	29.6	27.4	29.2	28.3	29.9	31.2	
Net fee income, in percent of net interest income	30.3	28.6	24.2	32.5	31.5	30.9	30.2	27.5	29.5	32.4	33.5	
Trading income, in percent of gross income	6.7	9.4	9.2	9.7	4.9	7.9	5.4	9.7	7.1	7.2	8.2	
Aggregate overhead expenses, in percent of gross income	64.0	70.7	77.7	69.1	71.0	69.9	70.3	67.6	68.2	67.5	68.3	
Non-interest expenses to gross income	75.0	85.6	96.5	86.2	90.1	90.0	98.7	98.5	98.0	92.2	94.2	
Liquidity												
Liquid assets, in percent of total assets	19.1	19.9	24.0	20.0	22.2	24.8	24.5	20.3	21.2	25.8	25.3	
Liquid assets, in percent of short-term liabilities	32.9	32.8	40.1	32.2	35.7	40.1	34.8	29.0	29.9	36.5	35.6	
Deposits, in percent of assets	60.8	64.7	70.5	71.6	74.2	76.1	76.1	75.6	75.2	76.9	78.4	
Loans, in percent of deposits	122.9	107.6	94.0	105.8	95.1	85.4	79.3	82.9	84.6	82.4	79.1	
Sensitivity to market risk												
Off-balance sheet operations, in percent of assets	429.5	464.0	370.5	319.7	293.1	274.0	202.6	205.0	198.1	187.5	189.3	
Original maturity of assets (in percent of total)												
Less than 3 months	34.4	21.5	32.1	38.7	43.2	42.8	39.9	35.8	36.7	40.2	38.9	
3 months to 1 year	17.2	28.2	23.4	16.6	16.0	13.6	13.1	14.5	13.7	12.5	13.8	
1 to 5 years	33.6	35.4	31.5	31.6	28.9	31.1	33.9	36.4	36.1	34.4	34.4	
Over 5 years	14.8	14.9	13.0	13.1	12.0	12.5	13.1	13.3	13.5	12.9	12.9	
Original maturity of liabilities (in percent of total)												
Less than 3 months	38.5	21.9	31.3	40.4	38.9	33.1	55.0	59.9	60.3	52.5	58.9	
3 months to 1 year	27.1	47.1	27.9	31.7	34.0	38.7	26.3	21.1	21.7	17.3	22.6	
1 to 5 years	24.4	23.4	23.8	22.9	21.3	22.0	14.6	14.8	14.1	12.9	15.4	
Over 5 years	10.0	7.7	4.3	5.0	5.7	6.2	4.0	4.2	4.0	3.0	3.2	

Source: Central Bank of Montenegro.

1/ Net interest income in percent of interest bearing assets.

Annex I. Risk Assessment Matrix ^{1/}

(Scale – High, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Structurally weak growth in key advanced economies	High Low productivity growth (U.S., euro area and Japan), high debt, and failure to fully address crisis legacies by undertaking structural reforms amidst persistently low inflation (euro area and Japan) undermine medium-term growth.	High A protracted slowdown in the EU and neighboring countries could adversely impact the appetite for external and public financing (especially FDI flows and tourism infrastructure developments). A protracted period of low inflation in the Euro Area, if imported to Montenegro, would adversely impact debt dynamics, consumption, and bank profitability.	<ul style="list-style-type: none"> • Let automatic fiscal stabilizers work, within limited fiscal space. • Accelerate structural reforms to increase competitiveness and reduce structural bottlenecks that impede credit to the private sector.
Tighter global financial conditions	High Against the backdrop of continued monetary policy normalization and increasingly stretched valuations across asset classes, an abrupt change in global risk appetite (e.g., due to higher-than-expected inflation in the U.S) could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	Medium Montenegro is highly reliant on external financing, but financing needs are covered until 2020. Gross public financing needs average 12 percent of GDP in 2018–21. Montenegro just finalized a successful liability management operation and will likely return to the Eurobond market in 2020 or 2021.	<ul style="list-style-type: none"> • Let automatic fiscal stabilizers work, within limited fiscal space. • Continue to implement the medium-term fiscal consolidation plan that puts debt on a strongly downward trajectory. Intensify adjustment if tighter conditions are permanent. • Continue implementing the medium-term debt strategy with an emphasis on developing the domestic bond market.
Intensification of the risks of fragmentation/security dislocation in part of the Middle East, Africa, Asia, and Europe, leading to socio-	High Intensification of conflicts in the Middle East and Africa could lead to sharp rises in migrant flows into Europe. The lack of a common cooperative policy to deal with asylum seekers and other migrants to the European Union (EU) could deepen political divisions. In particular, if refugee flows surge again, the	Medium Given important tourism and real estate links, such restrictive developments could undermine FDI inflows and thus weaken growth prospects, depress real estate prices, and further limit Montenegro's capacity to absorb shocks. Montenegro is not a transit	<ul style="list-style-type: none"> • Let automatic fiscal stabilizers work, within limited fiscal space. • Speed up structural reforms to improve the business environment and competitiveness. • Intensify reforms to improve the labor markets with a focus on job creation.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
economic disruptions.	unaddressed problems related to the relocation of refugees within the Union could resurface. Border controls could restrict movement of goods, services and labor in the single market. Limited integration of asylum seekers into the labor force could raise unemployment rates, put pressure on national budgets, and put social cohesion at risk.	country for refugees and thus the direct impact should be muted.	<ul style="list-style-type: none"> Accelerate policies to facilitate the resolution of problem loans and encourage a revitalization of bank lending.
Insufficient fiscal discipline	Medium The authorities do not have strong track record concerning fiscal consolidation. The highway remains a source of fiscal pressures. It will be politically difficult to maintain the primary surpluses needed to keep public debt on a strong downward path. The ruling coalition has a small majority in parliament.	High Given high public debt, a loss of fiscal discipline could lead to future financing difficulties and potentially result in debt sustainability problems.	<ul style="list-style-type: none"> Sustain medium-term fiscal consolidation plans; reduce public wage and pension expenditure over time, strengthen tax administration, and reduce tax exemptions. Improve public communication regarding the need for fiscal adjustment. Ensure that any further phases of the highway are not financed with public debt.
Delays and withdrawals from capital investment projects	Medium Ongoing geopolitical tensions, weak administrative procedures on land development, and concerns regarding fiscal sustainability could threaten capital investments in tourism and industry.	Medium Construction and activity associated with large-scale investment projects (both tourism and infrastructure based) are key drivers of growth.	<ul style="list-style-type: none"> Sustain the medium-term fiscal consolidation effort to safeguard fiscal sustainability and implement structural reforms to improve the business environment and strengthen anti-corruption and AML/CFT frameworks.
Supervisory action plans fail to improve the banks with qualified audit reports	Medium Inability of weak banks to comply with minimum supervisory requirements and with required capital increases.	Medium The failure to address weak banks could negatively affect perceptions of the banking system's stability.	<ul style="list-style-type: none"> Steadfastly implement agreed supervisory action plans. Require shareholders to contribute additional capital. Adjust action plans as needed and require intervention in the absence of a viable business plan or material non-compliance. Ensure a clear public communication strategy to ringfence any spillovers from any necessary interventions in weak banks.

Annex II. Public Debt Sustainability Analysis

Debt is sustainable under the baseline if the authorities implement their fiscal strategy, but sustainability and financing risks remain significant. General government debt (including guarantees) increased from 36 percent of GDP in 2006 to 75 percent of GDP in 2017. In the baseline, gross debt is projected to peak at 81 percent of GDP in 2018, although net debt (adjusted for government deposits) already declines by 1 percentage point of GDP in 2018 as the authorities are pre-financing Eurobonds falling due over 2019-21. Gross debt would fall to 53 percent of GDP in 2023, based on front-loaded fiscal adjustment measures and the end of highway spending that will improve the fiscal deficit substantially by 2020. The projected debt trajectory is highly susceptible to shocks, especially a negative economic growth shock, but declines under all standard scenarios. Gross financing needs remain high, though the liability management operation earlier this year has reduced financing needs over 2019-21. Under the baseline scenario, in which the authorities fully implement their fiscal adjustment plan, debt begins a strong downward trend in 2020, but the authorities would still have to manage finances carefully to maintain market access.

Baseline and Realism of Projections

- Background.** Public debt is reported on a gross basis and includes only general government debt and government-issued guarantees, which comprised 7.4 percent of GDP in 2017.¹ A key driver of the increase in public debt since 2014 has been an external loan to fund construction of the first section of the Bar-Boljare highway. Denominated in U.S. dollars, this loan is projected to increase the foreign currency share of public debt to 23 percent by 2020 from 4 percent in 2014.
- Macroeconomic assumptions.** Growth is projected to slow to 3 percent in 2018, below average growth in 2016-17, as the pace of highway construction will provide a lower boost to growth and fiscal adjustment measures provide some drag. Growth is projected to slow marginally to 2¾ percent in 2019-20 as highway construction winds down. Growth would then increase above 3 percent in 2021-23 as the modest supply-side effects of the highway begin.
- Fiscal scenario.** Staff's baseline projections assume the full implementation of the additional fiscal measures outlined in the authorities' fiscal adjustment strategy over 2018-20, with the non-highway primary balance improving by 3¼ percentage points of GDP. These adjustment measures and the path of highway spending explain the decline and subsequent improvement in the primary balance over 2015-2020. Staff projects that the authorities' fiscal consolidation plan, if fully implemented, will result in a primary surplus of 4½ percent of GDP in 2020, when the primary balance will adjust sharply upward more than 4 percentage points

¹ Existing government guarantees are mostly directed to infrastructure and SMEs, often in conjunction with the EBRD. Since peaking at 11.6 percent of GDP in 2012, guarantees fell to 7.4 percent of GDP in 2017, as the authorities have been more cautious in issuing new guarantees. Data on public enterprise debt is not available.

of GDP due to the completion of the first phase of the highway. Staff's baseline medium-term fiscal scenario assumes that the government does not take on additional debt to construct further phases of the Bar-Boljare highway.

- Pre-financing of Eurobond amortizations:** The authorities completed in early 2018 two financing operations to pre-finance coming Eurobond amortizations. Leveraging a World Bank Policy-Based Guarantee (PBG), they borrowed €250 million from a syndicate of international banks, with a 2.95 percent interest rate and 12-year maturity. They also issued a seven-year €500 million Eurobond, of which €362 million was used to buy back existing Eurobonds set to mature in 2019-21. The Eurobond carries a coupon rate of 3.375 percent. These two operations will increase government deposits at the central bank by 6.5 percent of GDP, which will later be used to amortize the remaining Eurobonds in 2019 and 2020.² The baseline also includes a second World Bank Policy-Based Guarantee (PBG) with a lower leverage for €140 million in 2019. The authorities should be able to roll over the remaining 2021 Eurobond by issuing a new €150-200 million Eurobond in 2020/21. As a result, staff now projects medium-term fiscal financing needs to be fully met. Furthermore, the amortization of more expensive previous Eurobonds (which carried coupon rates as high as 5.75 percent) and replacement with lower rate loans (PBG loan, recent Eurobond, and China Ex-Im loan for the highway) is projected to lower the government's effective interest rate from 3.9 percent in 2017 to 2.8 percent by 2020.
- Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high as debt exceeded the 70 percent of GDP benchmark for the first time in 2014. Debt only falls below the benchmark in the baseline projections in 2020 and expands in some shock scenarios. Gross financing needs exceed the 15 percent benchmark in 2018, though the liability management operation has reduced medium-term refinancing risks. Public debt held by non-residents (mostly Eurobonds and the Chinese Ex-Im loan) also constitutes a vulnerability. Economic growth shocks have a very large impact on the debt profile.
- Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) in 2007–2015 suggest on average an optimistic bias in staff's past projections, possibly due to the impact of the Great Recession. The median forecast error for the primary balance suggests that staff projections have been in line with outcomes on average. With a large projected adjustment in the cyclically-adjusted primary balance, the key risks are high dependence on external financing and vulnerability to macro shocks. However, the projected adjustment in the primary balance of 9 percent of GDP over 2017-20 includes the reduction in highway spending. The primary balance without the highway adjusts by 3¼ percentage points of GDP over the same period. Most of the underlying fiscal adjustment should be completed by end-2018.

² After the amortization of the Eurobonds, the authorities should maintain a deposit buffer equal to one month of expenditure. The baseline scenario assumes that the authorities maintain this buffer going forward.

- **Domestic debt markets.** Further development of the domestic government debt market could mitigate future financing risks. The stock of government securities is small and consists primarily of T-bills, which are mostly held by domestic banks. A more regular offering of longer-maturity domestic bonds would permit the diversification of financing sources and provide new financial instruments for insurance companies, corporates, banks, and retail customers. This has been partly integrated into the baseline.

Alternative Scenarios

Alternative scenarios show worse outcomes, reflecting historically weak fiscal outcomes and the beginning of a phased adjustment. Under the historical scenario, in which projections are based on the average level of the primary balance over the past ten years, a primary deficit of 3.4 percent of GDP over 2019–23 would lead debt to increase to 87 percent of GDP by 2023. If the primary balance were to stay at the projected 2018 level of -0.7 percent (when fiscal adjustment would not yet be complete), debt would fall slowly to 71 percent of GDP by 2023, compared to 53 percent of GDP in the baseline scenario.

Shocks and Stress Tests

Debt and gross financing needs would be lower than current levels under all standard stress tests. Stress tests indicate that growth shocks would have a substantial effect on the debt path. Fiscal shocks, including a decision to fund the remaining phases of the highway with debt, would also have a major impact on fiscal sustainability.

Montenegro-specific Stress Tests

- **Highway Phases 2-4.** In this scenario, the authorities decide to proceed with the debt-financed construction of the second-fourth phases of the Bar-Boljare highway, which staff assumes would cost €1.2 billion, equally spent over 2021–23.³ Assuming a low spending multiplier of 0.2 during the construction phase because at least 70 percent of the inputs are imported and modest supply effects upon completion (the same assumptions as for the first phase), economic growth would increase $\frac{3}{4}$ percentage point on average in 2021–23 relative to the baseline. In this scenario, the primary balance declines in line with highway spending, and the public debt ratio increases to 73 percent of GDP by 2023 (compared to 53 percent in the baseline). Gross financing needs peak at 17 percent of GDP in 2023, 12 percentage points higher than in the baseline. This demonstrates that the authorities cannot afford to take on new debt to complete the remainder of the highway over the medium term.

³ The authorities have signed an MOU with CBRC expressing their mutual interest in completing the highway on a PPP basis. While it does not prevent other parties from participating in an eventual tender, the MOU could risk deterring other interested parties from participating in a tender.

Standard Stress Tests

- **Growth shock.** Under this scenario, real output growth rates are lowered during 2019 and 2020 by one standard deviation (3.7 percentage points), also lowering inflation and raising interest rates. The public debt ratio increases peaks at 84 percent of GDP in 2019 before falling to 65 percent of GDP in 2023, while the gross financing needs ratio in 2020 increases 6 percentage points of GDP relative to the baseline.
- **Interest rate shock.** This scenario examines the implications of an increase in interest rates on new debt by 388 basis points (the difference between the maximum past effective interest rate and the average interest rate in the projection period) in 2019–23. Debt increases by 3 percentage points in 2023 in this scenario relative to the baseline, while financing needs increase by 1 percentage point of GDP in 2023.
- **Combined macro shock.** This scenario comprises a recession in 2019 and 2020, a 388 basis-point increase in interest rates, a real exchange rate shock, and a sharp rise in expenditures in 2019–20. It pushes the debt-to-GDP ratio up by 8 percentage points to 87 percent of GDP in 2019 and substantially increases gross financing needs.
- **Financial contingent liability shock.** Expenditures increase in 2019 equivalent to 10 percent of the size of the banking sector, combined with a shock to GDP and interest rates. The shock results in a sharp increase in the debt ratio to 89 percent of GDP in 2019. Meanwhile, gross financing needs would peak at 20 percent of GDP in 2019 and stay well above the baseline over the medium term.
- **Primary balance shock.** This scenario assumes an expenditure shock and a rise in interest rates leading to a 2 p.p. deterioration in the primary balance over 2019–20. The combined shocks lead to deterioration in the debt ratio by about 3 percent of GDP by 2023, while the impact on gross financing needs peaks at 3 percentage points of GDP in 2019.
- **Real exchange rate shock.** The scenario assumes a 13 percent depreciation of the real exchange rate in 2019. The debt ratio would fall marginally from the baseline, because the impact from a larger GDP deflator on total debt outweighs the increase in the relatively modest foreign currency debt. This depends critically on the assumption of an exchange rate pass-through to inflation of 25 percent.

Figure 1. Montenegro: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

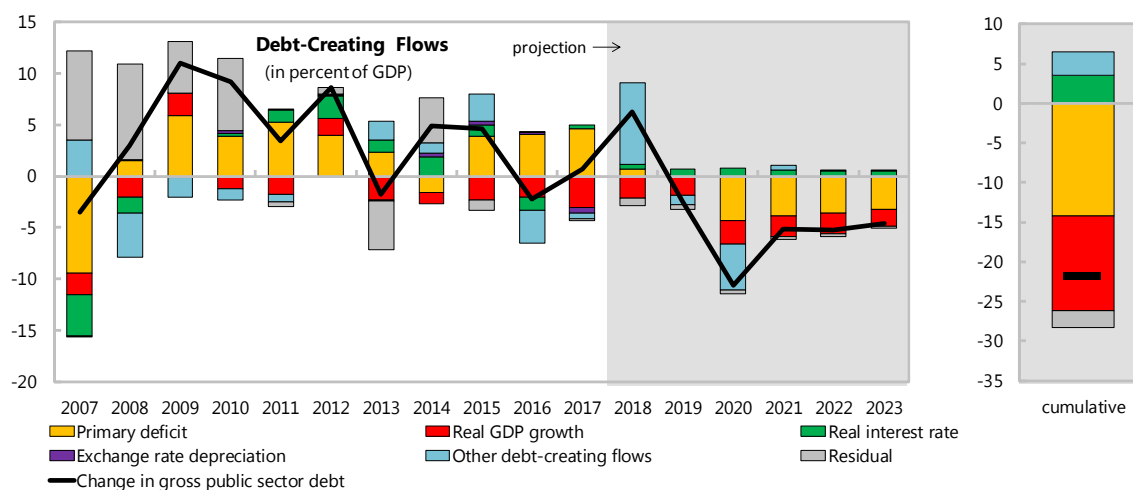
Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of April 06, 2018		
	2007-2015 ^{2/}	2016	2017	2018	2019	2020	2021	2022	2023			
Nominal gross public debt	57.3	73.9	74.6	80.8	78.3	67.7	62.5	57.3	52.8	Sovereign Spreads		
Of which: guarantees	7.2	7.5	7.4	7.6	7.2	6.9	6.6	6.2	5.9	EMBIG (bp) ^{3/} 252		
Public gross financing needs	7.1	22.8	15.3	17.3	12.3	10.8	8.0	4.2	4.8	5Y CDS (bp) n.a.		
Real GDP growth (in percent)	2.2	2.9	4.4	3.0	2.4	3.0	3.1	3.4	3.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.8	5.1	2.7	2.9	2.0	1.7	1.9	1.9	1.9	Moody's	B1	B1
Nominal GDP growth (in percent)	6.3	8.2	7.1	6.0	4.5	4.8	5.0	5.4	5.0	S&Ps	B+	B+
Effective interest rate (in percent) ^{4/}	3.3	3.4	3.9	3.6	3.0	2.8	2.8	2.8	2.9	Fitch	n.a.	n.a.

-5.1

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023		
Change in gross public sector debt	4.4	-2.2	0.7	6.2	-2.5	-10.7	-5.1	-5.2	-4.6	-21.8	
Identified debt-creating flows	1.2	-2.3	0.8	7.0	-2.1	-10.3	-4.8	-5.0	-4.3	-19.6	
Primary deficit	1.7	4.1	4.6	0.7	0.0	-4.4	-3.8	-3.6	-3.2	-14.3	-1.1
Primary (noninterest) rev. and grants	43.5	41.3	40.8	43.4	42.4	42.2	42.2	42.1	41.9	254.2	
Primary (noninterest) expenditure	45.2	45.4	45.5	44.1	42.3	37.9	38.4	38.5	38.7	239.9	
Automatic debt dynamics ^{5/}	-0.7	-3.2	-3.2	-1.7	-1.2	-1.5	-1.4	-1.5	-1.1	-8.4	
Interest rate/growth differential ^{6/}	-0.7	-3.4	-2.7	-1.7	-1.2	-1.5	-1.4	-1.5	-1.1	-8.4	
Of which: real interest rate	0.3	-1.3	0.3	0.4	0.7	0.8	0.6	0.5	0.5	3.5	
Of which: real GDP growth	-1.0	-2.1	-3.0	-2.1	-1.8	-2.2	-2.0	-2.0	-1.7	-11.9	
Exchange rate depreciation ^{7/}	0.1	0.1	-0.6	...	...	...	...	...	...	...
Other identified debt-creating flows	0.1	-3.1	-0.6	7.9	-1.0	-4.5	0.4	0.1	0.0	3.0	
Privatization and deposits (negative)	-0.8	-0.4	0.3	7.9	-1.2	-4.5	-0.1	0.1	0.0	2.3	
Contingent liabilities	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Use of foreign account receivable	0.3	-2.7	-0.9	0.0	0.2	0.0	0.5	0.0	0.0	0.1	
Residual, including asset changes ^{8/}	3.2	0.0	-0.1	-0.7	-0.4	-0.3	-0.3	-0.2	-0.2	-2.2	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as Public enterprises.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+gm)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

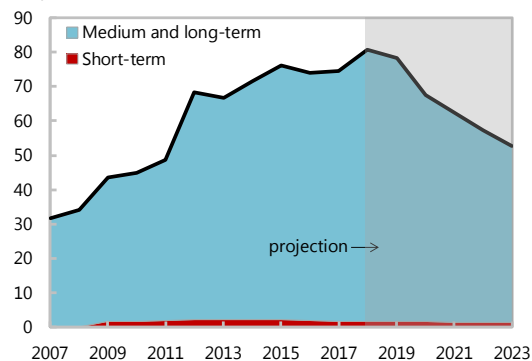
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Montenegro: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

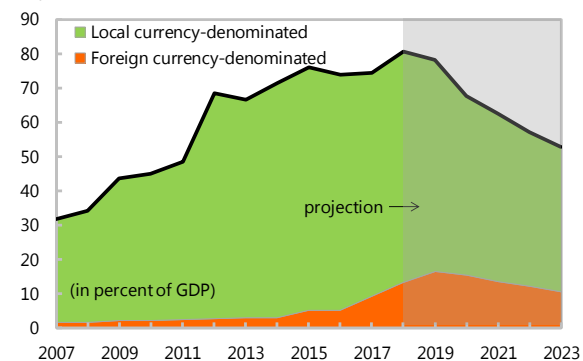
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

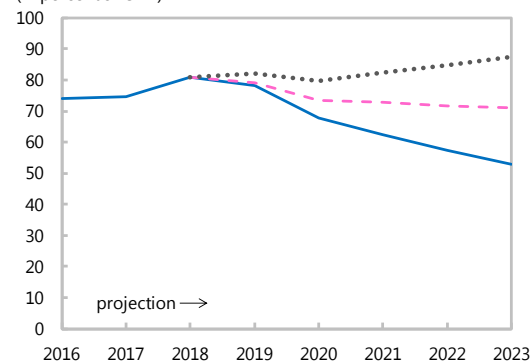


Alternative Scenarios

— Baseline Historical - - - Constant Primary Balance

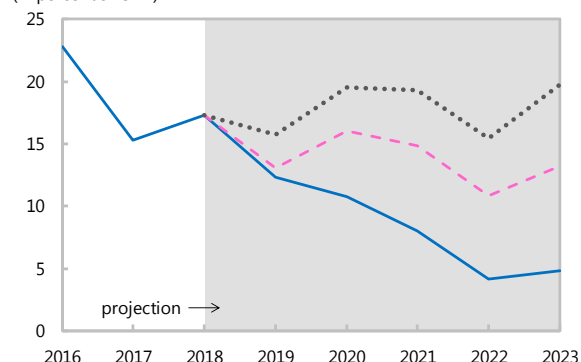
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



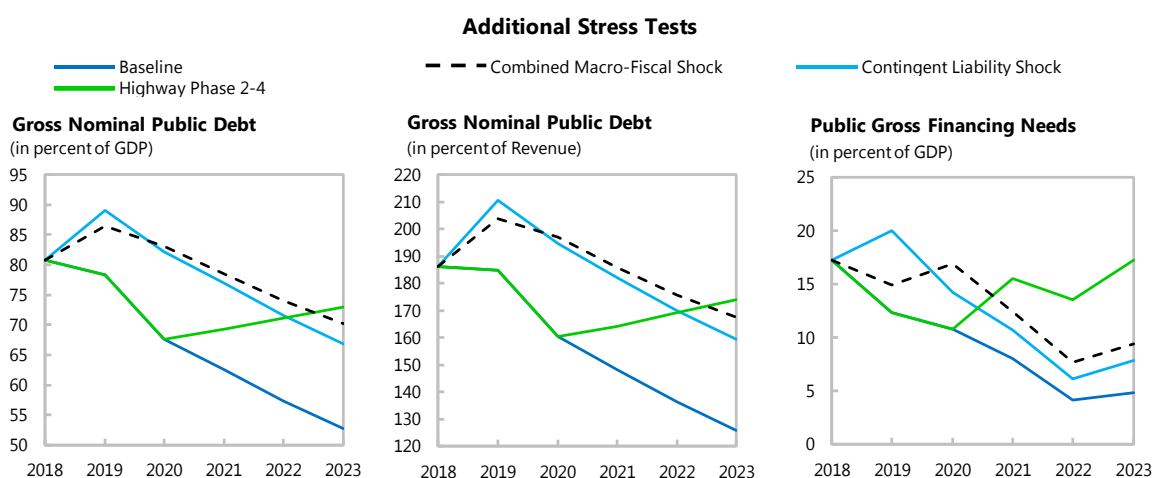
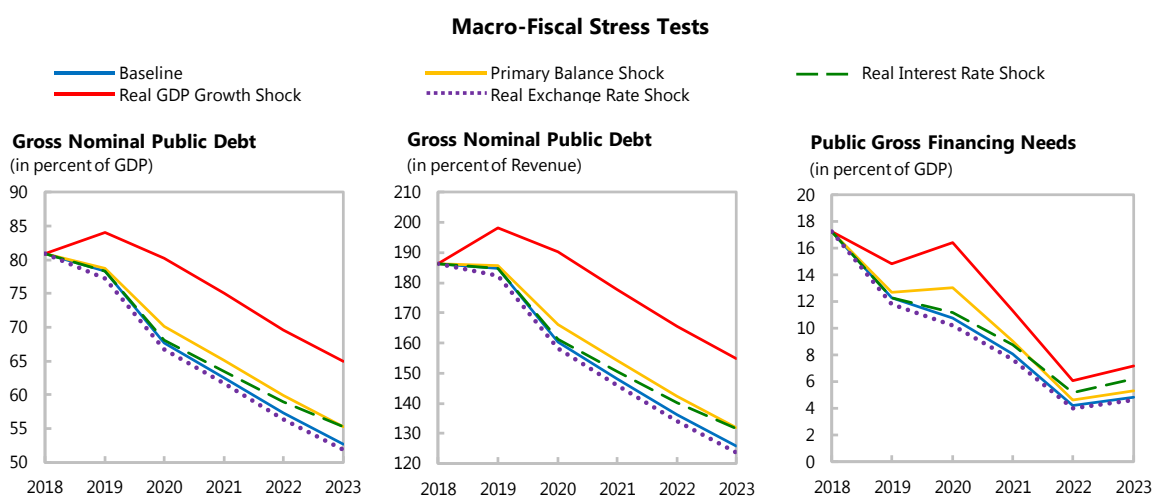
Underlying Assumptions

(in percent)

	2018	2019	2020	2021	2022	2023
Baseline Scenario						
Real GDP growth	3.0	2.4	3.0	3.1	3.4	3.0
Inflation	2.9	2.0	1.7	1.9	1.9	1.9
Primary Balance	-0.7	0.0	4.4	3.8	3.6	3.2
Effective interest rate	3.6	3.0	2.8	2.8	2.8	2.9
Constant Primary Balance Scenario						
Real GDP growth	3.0	2.4	3.0	3.1	3.4	3.0
Inflation	2.9	2.0	1.7	1.9	1.9	1.9
Primary Balance	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	3.6	3.0	2.8	2.9	3.0	3.1
Historical Scenario						
Real GDP growth	3.0	2.1	2.1	2.1	2.1	2.1
Inflation	2.9	2.0	1.7	1.9	1.9	1.9
Primary Balance	-0.7	-3.4	-3.4	-3.4	-3.4	-3.4
Effective interest rate	3.6	3.0	2.8	2.9	3.1	3.3

Source: IMF staff.

Figure 3. Montenegro: Public DSA – Stress Tests



Underlying Assumptions (in percent)

	2018	2019	2020	2021	2022	2023		2018	2019	2020	2021	2022	2023
Primary Balance Shock							Real GDP Growth Shock						
Real GDP growth	3.0	2.4	3.0	3.1	3.4	3.0	Real GDP growth	3.0	-1.3	-0.7	3.1	3.4	3.0
Inflation	2.9	2.0	1.7	1.9	1.9	1.9	Inflation	2.9	1.1	0.8	1.9	1.9	1.9
Primary balance	-0.7	-0.4	2.2	3.8	3.6	3.2	Primary balance	-0.7	-2.0	0.7	3.8	3.6	3.2
Effective interest rate	3.6	3.0	2.8	2.9	2.9	3.0	Effective interest rate	3.6	3.0	2.9	3.1	3.1	3.2
Real Interest Rate Shock							Real Exchange Rate Shock						
Real GDP growth	3.0	2.4	3.0	3.1	3.4	3.0	Real GDP growth	3.0	2.4	3.0	3.1	3.4	3.0
Inflation	2.9	2.0	1.7	1.9	1.9	1.9	Inflation	2.9	6.5	1.7	1.9	1.9	1.9
Primary balance	-0.7	0.0	4.4	3.8	3.6	3.2	Primary balance	-0.7	0.0	4.4	3.8	3.6	3.2
Effective interest rate	3.6	3.0	3.4	3.8	4.2	4.5	Effective interest rate	3.6	3.0	2.8	2.8	2.8	2.9
Combined Shock							Contingent Liability Shock						
Real GDP growth	3.0	-1.3	-0.7	3.1	3.4	3.0	Real GDP growth	3.0	-1.3	-0.7	3.1	3.4	3.0
Inflation	2.9	1.1	0.8	1.9	1.9	1.9	Inflation	2.9	1.1	0.8	1.9	1.9	1.9
Primary balance	-0.7	-2.0	0.7	3.8	3.6	3.2	Primary balance	-0.7	-7.0	4.4	3.8	3.6	3.2
Effective interest rate	3.6	3.0	3.4	4.0	4.5	4.8	Effective interest rate	3.6	3.2	3.1	3.1	3.2	3.2

Source: IMF staff.

Figure 4. Montenegro: Public DSA Risk Assessment

Heat Map

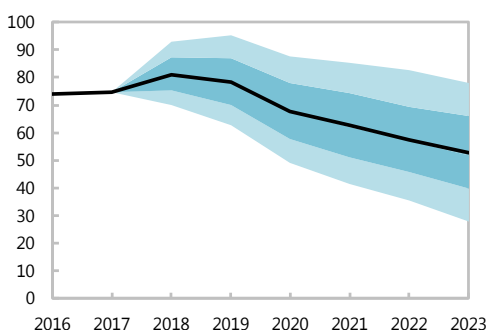
Debt level ^{1/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs ^{2/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile ^{3/}	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

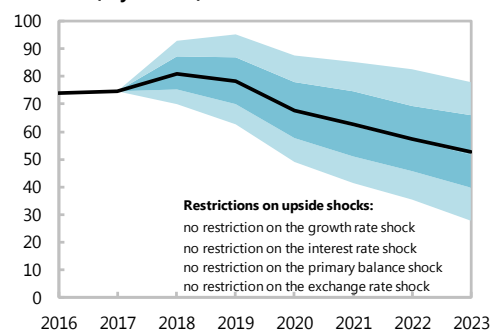
(in percent of GDP)

— Baseline Percentiles: ■ 10th-25th ■ 25th-75th ■ 75th-90th

Symmetric Distribution

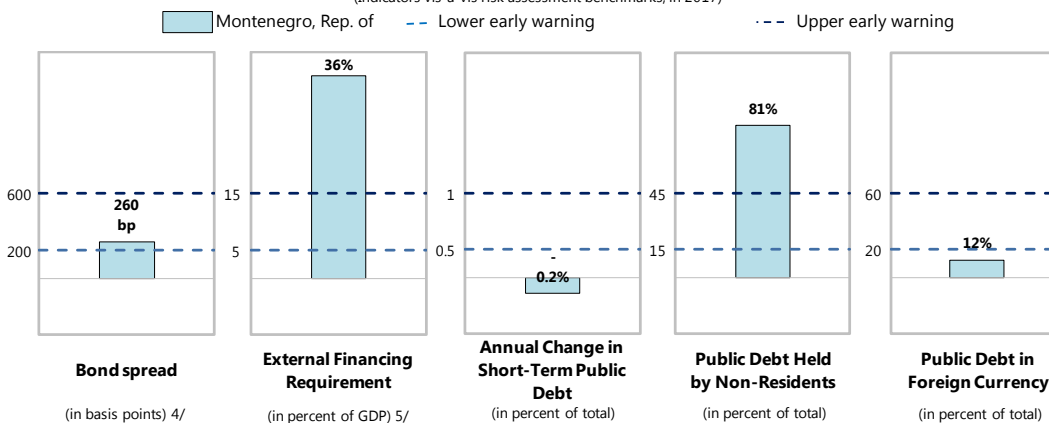


Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are:

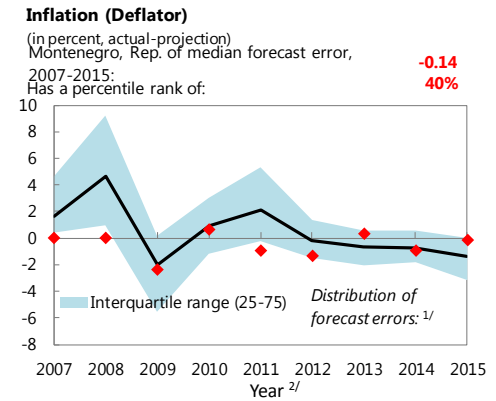
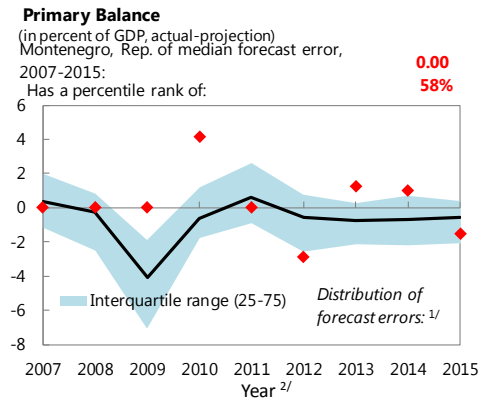
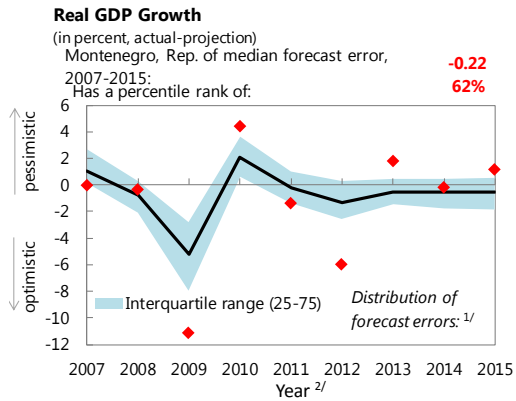
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 06-Jan-18 through 06-Apr-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

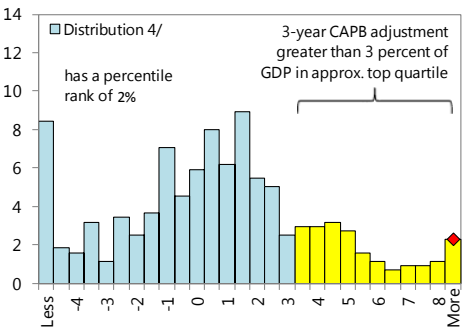
Figure 5. Montenegro: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

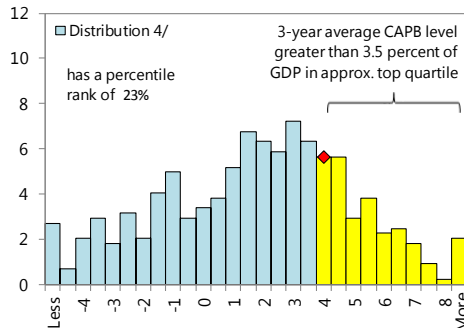


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

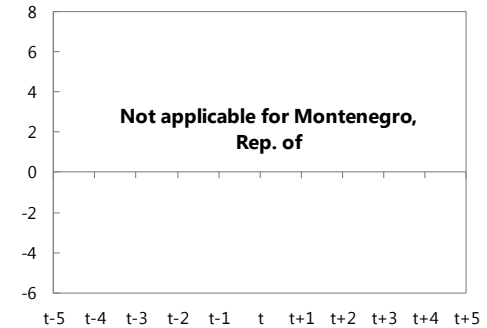


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis ^{3/}

Real GDP growth
(in percent)



Source : IMF Staff.

^{1/} Plotted distribution includes all countries, percentile rank refers to all countries.

^{2/} Projections made in the spring WEO vintage of the preceding year.

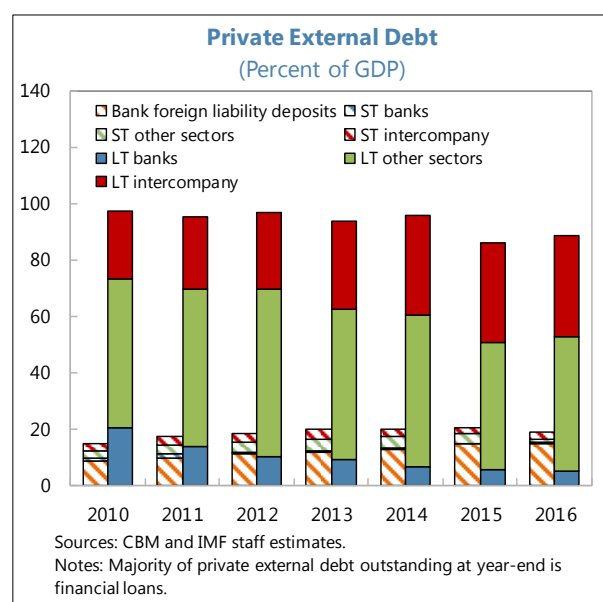
^{3/} Not applicable for Montenegro, Rep. of, as it meets neither the positive output gap criterion nor the private credit growth criterion.

^{4/} Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex III. External Debt Sustainability Analysis

External debt has increased by about 38 percentage points of GDP since 2007, to an estimated 160 percent of GDP in 2017. This was driven partly by the sharp increase in the public external debt ratio, which almost tripled over this period and comprises 34 percent of total external debt. Under the baseline, external debt is projected to peak at 166 percent of GDP, before declining to 145 percent in 2023. The projected debt trajectory is highly sensitive to various shocks, particularly to a non-interest current account shock (e.g. export of services), to an economic growth shock, and to a depreciation of the euro. Montenegro's heavy dependence on external financing reinforces the importance of fiscal and structural reforms to safeguard market access.

At about 160 percent of GDP at end-2017, external debt is projected to increase to 166 percent of GDP by 2019, before declining to 145 percent of GDP by 2023. One-third of the external debt is government debt, which grew by about 24 percentage points since 2010, and about one-half falls into the non-bank private sector (inter-company debt to a large extent). Non-government long-term debt has fallen over the past few years, around 7 percentage points since 2014, and its composition has improved as the share of more stable inter-company loans increased, while short-term external debt has shown a small decline.¹ Recently, and going forward, most of the increase in external debt is due to government debt, which is related to the construction of the highway.



Shocks and Stress Tests

Standardized stress tests indicate that external debt is particularly sensitive to a variety of shocks. Current account shocks—possibly on account of highway project cost overruns—and a combined deterioration in the macroeconomic environment would also impact external sustainability, with significant implications for gross financing needs. In addition, external debt would be sensitive to a depreciation of the euro.

Standard Stress Tests

- **Growth shock.** Under this scenario, baseline real GDP growth is permanently reduced by a one-half standard deviation calculated over the recent 10-year period ending in 2017. This

¹ Further details on the composition of intercompany debt are not available, but it is likely related to large investment projects in tourism and energy.

corresponds to an average growth rate during 2019–23 of 1.1 percent, compared with baseline average growth of 3.0 percent. Under this scenario, the external debt ratio increases by 10 percentage points (compared to the baseline) to 156 percent of GDP in 2023.

- **Interest rate shock.** This scenario examines the implications of an increase in nominal external interest rates on new debt (relative to the baseline) by a one-half standard deviation during 2019–23. Stable average external interest rates historically imply only a modest average increase in interest rates of 20 basis points in this scenario and, consequently, an increase in external debt by 2.0 percentage points to 146 percent of GDP by 2023.
- **Non-interest current account shock.** This scenario permanently increases the non-interest current account by one-half standard deviation in 2019–23. Given historically-variable current account deficits, this amounts to an increase of 5.4 percentage points. In the absence of offsetting non-debt-creating flows, external debt increases by about 25 percentage points to 170 percent of GDP by 2023.
- **Combined macro shock.** This scenario comprises a permanent $\frac{1}{4}$ standard deviation shock applied to the real interest rate, the growth rate, and the current account deficit during 2019–23. The combined shock pushes the external debt ratio up by about 20 percentage points to 164 percent of GDP and increases gross financing needs by 4.5 percent of GDP, on average, over 2019–23 relative to the baseline.
- **Real exchange rate shock.** The scenario assumes a one-time 30 percent devaluation in the real exchange rate in 2019 applied to the estimated stock of external debt in foreign currency (not in euros). For the public sector, this is mainly related to the construction of the highway, which represents $\frac{1}{4}$ of public external debt. For the private sector, in the absence of data on currency breakdown, we have assumed that 100 percent is non-euro external debt, which results in an upper-bound estimate of the impact. Given the large stock of external debt, the shock increases the external debt-to-GDP ratio by 13 percentage points of GDP in 2019. Gross financing needs are correspondingly higher, by 8 percentage points of GDP, on average, over 2019–23 relative to the baseline.

Table 1. Montenegro: External Debt Sustainability Framework, 2013-2023

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -14.7	
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023		
Baseline: External debt	156.4	163.1	161.8	158.8	159.7	164.2	166.3	158.6	155.4	150.3	144.7		
Change in external debt	-1.3	6.7	-1.3	-3.0	0.9	4.5	2.1	-7.6	-3.2	-5.1	-5.6		
Identified external debt-creating flows (4+8+9)	-3.6	0.7	-12.5	-3.6	-2.9	3.0	2.6	-2.7	-3.2	-4.6	-4.9		
Current account deficit, excluding interest payments	11.1	12.0	10.5	16.0	16.5	16.1	14.9	10.6	9.8	8.4	7.2		
Deficit in balance of goods and services	20.1	19.8	18.5	22.5	24.2	23.6	22.1	17.8	17.0	15.6	14.3		
Exports	41.3	40.1	42.1	40.5	41.0	40.9	40.9	40.9	41.0	41.1	41.2		
Imports	61.4	60.0	60.6	62.9	65.2	64.5	63.0	58.7	58.0	56.6	55.4		
Net non-debt creating capital inflows (negative)	-9.6	-10.2	-16.9	-9.4	-11.2	-11.3	-11.3	-11.3	-11.1	-10.8	-10.6		
Automatic debt dynamics 1/	-5.1	-1.1	-6.1	-10.2	-8.2	-1.9	-1.0	-2.0	-1.9	-2.2	-1.4		
Contribution from nominal interest rate	3.4	3.2	2.7	2.0	2.4	2.7	2.7	2.8	2.8	2.9	2.9		
Contribution from real GDP growth	-5.3	-2.7	-5.2	-4.4	-6.5	-4.6	-3.7	-4.8	-4.7	-5.0	-4.3		
Contribution from price and exchange rate changes 2/	-3.2	-1.6	-3.5	-7.9	-4.1	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	2.4	6.0	11.2	0.6	3.8	1.5	-0.5	-5.0	0.0	-0.5	-0.8		
External debt-to-exports ratio (in percent)	378.3	406.3	384.1	392.5	389.2	401.3	406.7	387.4	379.1	366.0	351.6		
Gross external financing need (in billions of US dollars) 4/	0.9	1.0	1.2	1.5	1.5	2.0	1.9	1.9	1.9	1.8	1.8		
in percent of GDP	26.1	29.2	33.7	39.0	35.8	10-Year	10-Year	43.7	40.2	38.3	37.0	33.0	31.7
Scenario with key variables at their historical averages 5/						164.2	165.9	162.7	164.6	165.9	167.0	-19.7	
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Nominal GDP (US dollars)	3.4	3.5	3.7	4.0	4.2			4.5	4.7	4.9	5.2	5.4	5.7
Real GDP growth (in percent)	3.5	1.8	3.4	2.9	4.4	2.1	3.7	3.0	2.4	3.0	3.1	3.4	3.0
GDP deflator in US dollars (change in percent)	2.1	1.0	2.2	5.1	2.7	2.6	2.2	2.9	2.0	1.7	1.9	1.9	1.9
Nominal external interest rate (in percent)	2.3	2.1	1.8	1.4	1.6	2.2	0.5	1.8	1.7	1.7	1.9	1.9	2.0
Growth of exports (US dollar terms, in percent)	3.9	-0.1	10.9	3.9	8.7	4.6	9.7	5.7	4.4	4.9	5.2	5.6	5.3
Growth of imports (US dollar terms, in percent)	-2.1	0.4	6.7	12.4	11.0	2.9	14.8	4.9	2.1	-2.3	3.6	3.0	2.8
Current account balance, excluding interest payments	-11.1	-12.0	-10.5	-16.0	-16.5	-18.6	10.7	-16.1	-14.9	-10.6	-9.8	-8.4	-7.2
Net non-debt creating capital inflows	9.6	10.2	16.9	9.4	11.2	15.6	7.8	11.3	11.3	11.3	11.1	10.8	10.6

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

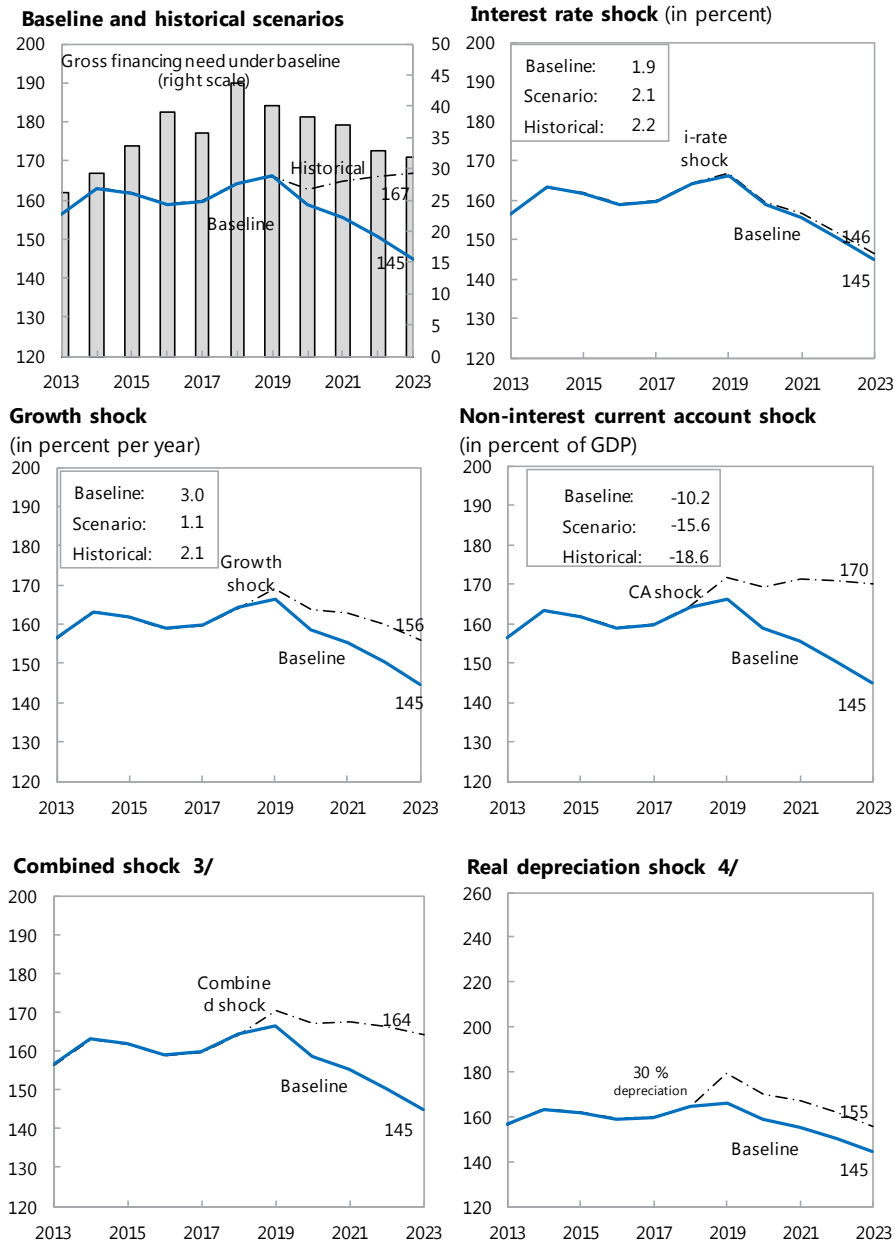
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Montenegro: External Debt Sustainability: Bound Tests ^{1/2/}
 (External debt in percent of GDP)



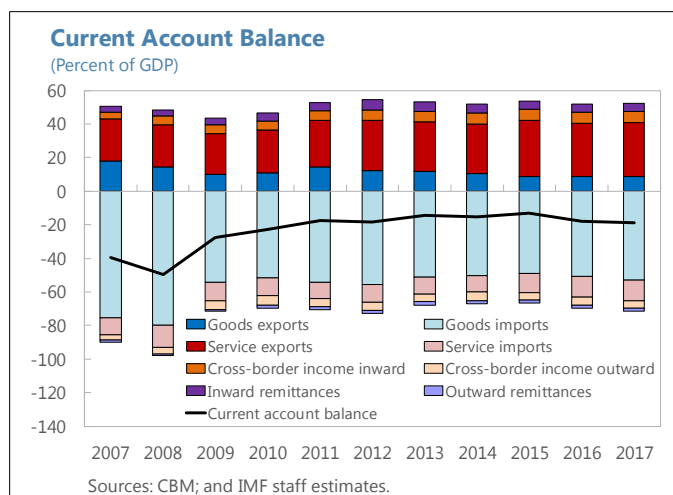
Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2018.

Annex IV. External Sector Assessment

Staff assesses that Montenegro's external position in 2017 was weaker than implied by fundamentals and desirable policies. A real exchange rate depreciation driven by wage restraint and productivity improvements based on structural reforms to strengthen competitiveness would help reduce imbalances over the medium term.

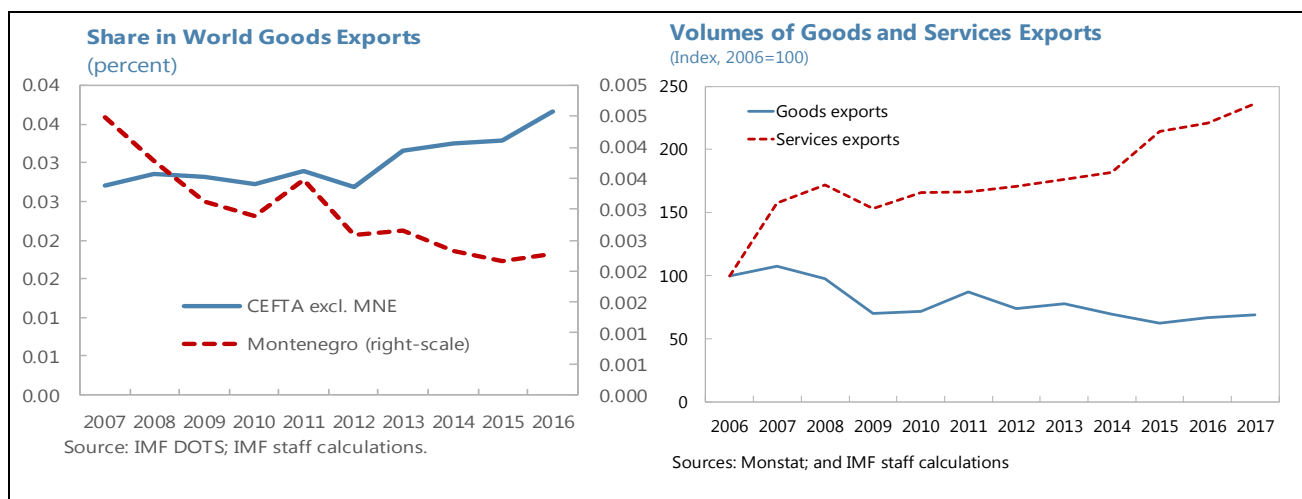
1. Large current account deficits have persisted for years and reached about 19 percent of GDP in 2017.

After peaking at nearly 50 percent of GDP in 2008, the current account deficit has persisted at a level between 15 to 20 percent of GDP. In 2017, the current account deficit reached 19 percent of GDP, boosted by the importation of construction goods for large-scale infrastructure projects, which more than offset the tourism-driven service trade surplus. From a savings-investment perspective, non-government savings and non-government investment increased from 2016 by 0.3 percent of GDP and 0.1 percent of GDP, respectively. The current account deficit is projected to remain at 19 percent of GDP in 2018. Most FDI is occurring in the tourism and energy sectors and should eventually increase Montenegro's export capacity.



2. Montenegro's goods export performance has been weak, though service exports have been robust, led by tourism.

Montenegro's goods export volume is estimated to have declined by 36 percent between 2007 and 2017, principally due to a reduction in aluminum exports after the closure of KAP (aluminum smelter). Montenegro's share in world goods exports has fallen since 2007, while its regional peers have seen expanding market shares. Services exports have increased steadily, more than doubling since 2007, driven by strong increases in tourism.



Current Account

3. The current account model of the EBA-lite framework suggests that the current account deficit is larger than that suggested by medium-term fundamental and desirable policies.

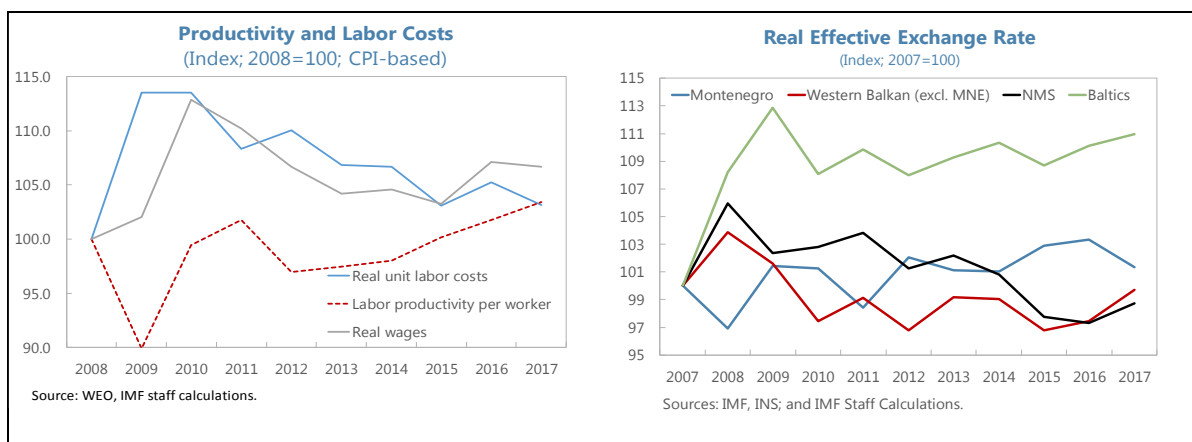
The model estimated an unadjusted current account gap of -9.5 percent of GDP for 2017, with a cyclically-adjusted norm of -9.6 percent of GDP. The model likely overestimates the current account norm for Montenegro compared to the average country in the EBA-lite sample due to country-specific factors not captured in the model, unavailable data (such as capital control index), and the limited time range of the data (only 12 annual observations). If the highway project (which partly explains the increase in the current account deficit since 2016) is treated as a one-off factor, the structural account deficit is estimated at 16.1 percent of GDP, implying an adjusted current account gap of 6.5 percent of GDP in 2017 and a REER overvaluation of 18 percent.

	<i>Standard Version</i>	<i>With Adjustment</i>
Actual CA	-18.9	-18.9
Cyclically adjusted CA	-19.1	-16.1
CA norm	-9.4	-9.4
CA gap	-9.5	-6.5
o/w policy gap	1.5	1.5
Elasticity	-0.37	-0.37
REER gap (percent)	25.7	17.6

Source: IMF staff estimates

Exchange Rate Indicators

4. The real effective exchange rate (REER) has appreciated modestly since 2007, and the EBA-lite REER model estimates the REER to be undervalued by 17 percent. Since 2007, the REER has appreciated 1 percent, which contrasts with the observed depreciation of 0.3 percent in other Western Balkan countries and 1.3 percent in EU member states. In 2017, the REER registered a depreciation of 1.9 percent, driven by low inflation differentials. From a medium-term perspective (2008-17), unit labor costs have not increased much (even showing a decline in recent years), but labor productivity growth has been mostly stagnant. While the EBA-lite REER regression model estimates the REER to be undervalued by 17 percent, data limitations make an accurate estimation of the REER norm difficult for Montenegro.

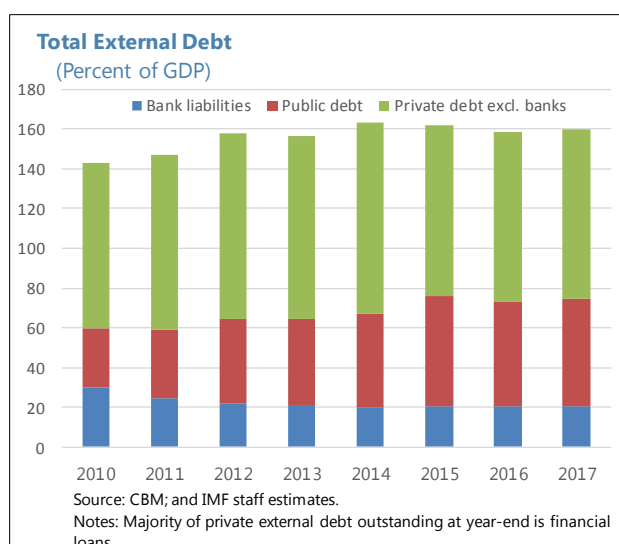


5. Considering current account and exchange rate indicators, staff assesses the external position of Montenegro to be weaker than fundamentals and desirable policy settings. The EBA-lite REER model estimates the REER to be undervalued by 17 percent, while the current account regression model suggests that the REER is overvalued by almost 18 percent. On balance, staff believes that the real exchange rate is overvalued by 10 percent due to persistently large current account deficits, high unit labor costs, stagnant productivity stagnates, and weak export performance. A real depreciation through wage restraint and productivity improvements from structural reforms to strengthen competitiveness would help reduce economic imbalances over the medium term. The large current account deficits partly reflect large fiscal deficits. The current account should improve as the authorities continue implementing the fiscal adjustment strategy, particularly once the spending on the highway ends.

Foreign Asset and Liability Position

6. The authorities are in the early stages of constructing international investment position (IIP) statements.

An IMF TA mission visited Montenegro in December 2017 and assessed that the data quality and methodological expertise of the CBM are high and sufficient to produce IIP by mid-2018. In the absence of comprehensive IIP data, staff cannot assess the underlying vulnerabilities related to foreign assets and liabilities. Despite current data limitations, gross external debt is estimated to have reached 160 percent of GDP in 2017 and is projected to peak around 166 percent of GDP in 2019. One-third of external debt is government debt, which increased 12 percentage points of GDP since 2012. One-half of government debt corresponds to the non-bank private sector (mostly Eurobonds). Short-term debt of the private sector (maturing in less than one year) averaged 5 percent of GDP in 2015-16.



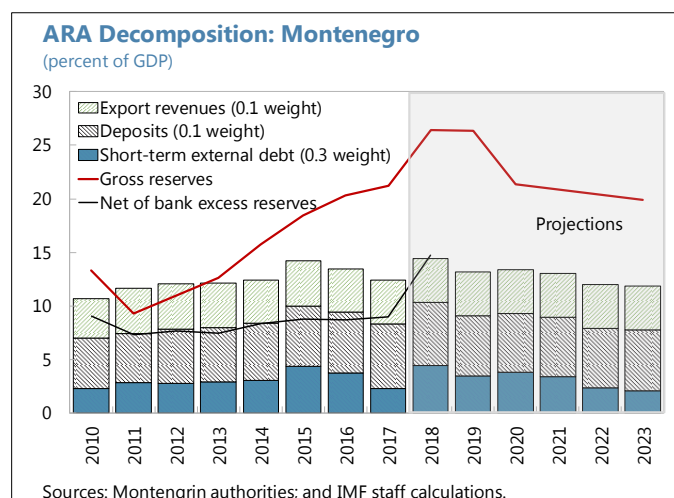
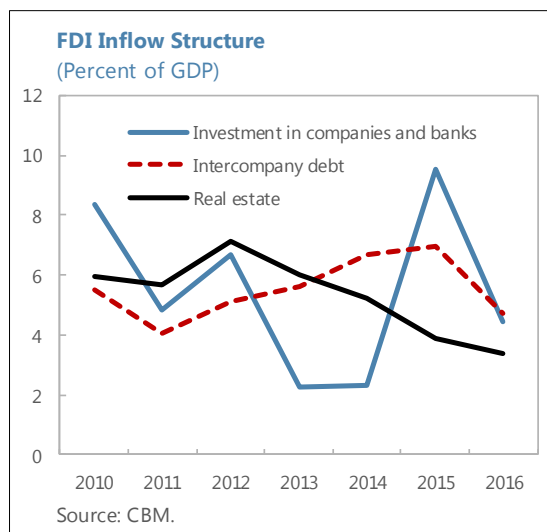
Capital and Financial Account Flows

7. FDI inflows finance most of the current account deficit. Annual net FDI has averaged 13 percent of GDP since 2010, compared to an average current account deficit of 17 percent of GDP during this period. Since 2012, FDI inflows related to real estate purchases have almost halved to 3.5 percent of GDP, while intercompany debt and investments in companies and banks have

increased. Large government Eurobond issuances have increased net portfolio investment as government financing needs have grown, and other investment flows also increased in 2015-17 as the government received large external loans from China Ex-Im Bank for highway construction and an international syndicated bank loan in 2017 for fiscal financing needs. After significant deleveraging of banks' external liabilities over 2009-2012, banks' external liabilities have been declining slowly since 2013.

8. Montenegro's gross international reserves are estimated to be adequate.

Montenegro has adopted the euro as its currency, which provides a strong monetary anchor but does not permit access to the Eurosystem. Reserves stood at 21 percent of GDP at end-2017, above standard rules of thumb (months of import cover, short-term external debt, and bank deposits). Montenegro's reserves are estimated at 170 percent of the standard IMF metric for reserve adequacy at end-2017 and are projected to exceed the ARA metric in 2018 even after subtracting excess reserves (see Appendix II for further details).



Annex V. Implementation of Past IMF Recommendations

In the 2017 Article IV consultation, Directors stressed the importance of continued fiscal adjustment to reduce debt and meet financing needs, sustained efforts to strengthen the financial sector, and fiscal and structural reforms to support higher and more inclusive growth.

Key recommendations	Implemented Policies
<i>Fiscal Policies</i>	
Implement fiscal consolidation strategy, aiming to deliver a primary fiscal surplus of 4½ percent of GDP by 2020.	The authorities have continued the implementation of their fiscal adjustment strategy, which has already resulted in significant improvements in the non-highway primary balance. Revenue performance in 2017 was broadly consistent with the fiscal strategy, and non-highway expenditure developments were in line with the strategy. The 2018 budget is consistent with the fiscal strategy, with the implementation of the VAT increase and further excise increases, and the authorities have maintained discipline over public sector wages since 2017.
Reform public sector employment, the pension system, and local government finances. Reduce the labor tax wedge by shifting some taxation to coal excises.	The new Ministry of Public Administration is currently assessing the optimal number of public sector employees (at both the central and local government levels). The authorities have not implemented reforms to the pension system but intend to approve a reform by the end of 2018. Amendments to the law on local government finances are currently under discussion. The authorities are studying the issue of the labor tax wedge with technical assistance from the Fiscal Affairs Department.
<i>Financial Sector Policies</i>	
Implement policy recommendations from the FSAP to address financial sector vulnerabilities, including an independent asset quality review (AQR) for banks and measures to enhance emergency liquidity assistance (ELA) and bank resolution capacity.	The authorities advanced implementation on several FSAP recommendations, including through the approval of key legislation. They have been considering options to strengthen ELA capacity, which has improved due to the government's deposit accumulation. The central bank tentatively plans to carry out an AQR in 2019.
Supervisory action plans (SAPs) for problem banks should be implemented forcefully.	The central bank has implemented SAPs for three banks with qualified audits. For one bank that has not increased capital as

Key recommendations	Implemented Policies
<p>The authorities should consider measures to promote consolidation of the banking system such as an increase in the minimum amount of capital.</p>	<p>required, the central bank will formulate next steps in the context of its supervisory action plan for the bank.</p> <p>The central bank is studying the proposal but has not made any decisions. The CBM is considering whether consolidation could be useful in improving the efficiency and stability of the banking system.</p>
<p>Structural Policies</p> <p>Improve labor market flexibility and the investment environment and reduce non-wage disincentives to employment. Maintain discipline over public sector wages to ensure cost competitiveness.</p>	<p>The authorities are preparing a new labor law that would aim to improve labor market flexibility, increase labor market participation, and reduce informal employment. The authorities have contained public sector wage growth in 2017-18.</p>

Annex VI. Implementation of FSAP Recommendations

Recommendations	Timing ¹	Progress
Prepare and implement time-bound supervisory action plans for vulnerable banks (CBM).	I	Done. Supervisory Action Plans (SAPs) for vulnerable banks were adopted, and the banks report to the CBM. On-site examinations of two of the three vulnerable banks were conducted in 2017, and one vulnerable bank is subject to daily examination.
Conduct an Asset Quality Review for all banks to determine adequacy of provisions (CBM).	I	Not Done. The authorities intend to implement an AQR in 2019. They argue that banks first should comply with the relevant EU directives, and transition to IFRS-9 before an AQR.
Introduce a macroprudential mandate taking into account the institutional setup, and establish pertinent policies and a toolkit consistent with EU/ESRB framework (MOF/CBM/FSC).	MT	In progress. A framework for macroprudential policy has been prepared and is expected to be adopted by 2018Q2.
Introduce effective consolidated supervision (CBM). Improve the regulatory and supervisory framework for liquidity and credit risks (CBM).	NT, I	Not Done. The authorities have prepared for these recommendations under the umbrella of “Twinning Project” financed by the EU and expect to start it in April 2018. They plan to implement these recommendations after the adoption of a new Banking Law, by end 2018.
Tighten prudential norms for identification, classification, and reclassification of nonperforming assets (CBM).	NT	In progress. The Decision on minimum standards for banks credit risk management was amended, the transition to IFRS-9 has started in January 2018, and a new Decision on chart of accounts for banks and the Decision on reporting to the CBM were adopted. However, the rest is waiting for the adoption of the new Banking Law.

¹ “I-Immediate” is within one year; “NT-near-term” is 1–3 years; “MT-medium-term” is 3–5 years.

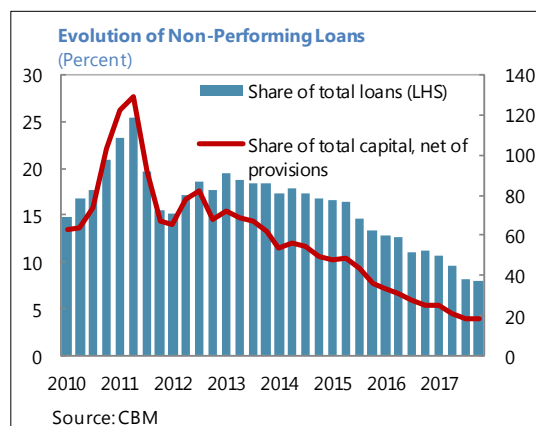
Recommendations	Timing ¹	Progress
Adopt risk-based supervision (ISA).	I	Not done. Development of a risk assessment framework is an on-going progress. Further steps in risk-based supervision will be taken after the adoption of a new Insurance Law.
Incrementally implement Solvency II (ISA).	NT	Not done. Further and more comprehensive implementation of Solvency II will be achieved after adopting a new Insurance Law.
Strengthen the CBM's oversight function over FMI (CBM).	NT	Done. At the end of October 2015, the CBM adopted a Decision establishing the "Framework for Payment System Oversight."
Implement risk mitigation measures to minimize liquidity risks in the RTGS system and to eliminate the possibility of partial unwinding in the DNS system (CBM).	I	<p>In progress. This recommendation is in implementation phase.</p> <p>Payment System Department: The recommendation will be implemented through changes of the Operational rules of Payment System.</p> <p>Financial and Banking Operations Department: The recommendation will be implemented through the operationalization of the procedure for liquidity loans.</p>
Finalize national risk assessment and ensuing action plan, and ensure that high money laundering /terrorist financing risks are adequately mitigated (CBM).	NT	Done. The national risk assessment has been adopted in 2015. In July 2017, the government adopted the 12th report on the implementation of the Strategy for the Prevention and Suppression of Terrorism, Money Laundering and Terrorism Financing 2015-2018 and measures from the Action Plan 2017-2018. In November 2017, the CBM prepared a report on implementation of measures from the Action plan for the period Jan-Nov 2017, which was submitted to the Administration for the Prevention of Money Laundering and Terrorist Financing.
Strengthen the voluntary debt-restructuring framework (MOF).	I	Done. As part of strategy for lowering NPLs, two regulations have been adopted and implemented: i) Law on Voluntary Financial Restructuring of Debts towards Financial Institutions with the

Recommendations	Timing ¹	Progress
		implementation, which was amended in June 2017; ii) Amendments to the Decision on Minimum Standards for Credit Risk Management in Banks.
Amend the personal bankruptcy regime to clarify creditors' rights regarding existing and future loans secured by mortgages (MOF).	I	Done. Personal bankruptcy regime has been amended.
Set strict and objective criteria for determining the systemic importance of banks to determine eligibility for capital support (CBM/MOF).	NT	In progress. The CBM is preparing guidelines for determining the systemic importance of banks, which will be adopted within the Twinning project, likely by the end of 2018.
Strengthen resolution-funding options (MOF).	NT	In Progress. In 2017, the CBM adopted drafts of the Bank Resolution Law and the Law on Amendments to the Banking Law, which implement the Directive 2914/49EC on the recovery and resolution framework. These drafts have been submitted for parliamentary approval.
Organize a dedicated resolution unit within the CBM, and initiate bank-specific resolution planning, prioritizing the weakest CAMEL-rated banks (CBM).	I	In Progress. The recommendation will be implemented after the adoption of the Bank Resolution Law, followed by training of personnel.
Implement risk-based contributions and shorten the pay-out term for DPF (DPF/MOF).	NT	In Progress. New Deposit Protection Law is in the drafting phase and is planned to be adopted in 2018.
Streamline ELA policies and strengthen safeguards to protect the CBM's financial autonomy (CBM/MOF).	NT	Done. CBM's financial autonomy was strengthened by adopting the Law on Amendments to the Central Bank of Montenegro Law. Furthermore, the CBM adopted a decision on detailed conditions for granting liquidity loans to banks in 2017, and established a Credit Risk Management Committee as an advisory body.
Strengthen the FSC's focus on its crisis preparedness and management mandate complementing its financial stability mandate (FSC).	I	Not Done. The authorities are considering potential solutions in the coming period.

Appendix I. Impediments to Credit Deepening

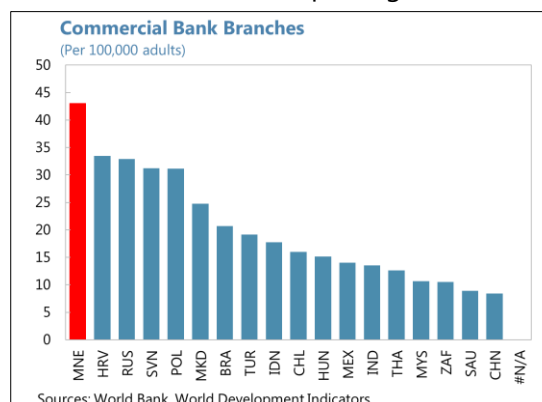
Credit growth in Montenegro has disappointed for nearly a decade following the Global Financial Crisis, suppressing investment and potential growth. Higher credit growth would be desirable, but institutional challenges and crisis legacies dampen the extension of growth-promoting credit creation.

1. The presence of NPLs on banks' balance sheets weighs on lending to the real economy. NPLs continue to decline but remain moderately high, with considerable variation across banks. Much of the decline is due to the sale of NPLs to asset management companies owned by foreign parent banks. NPLs require higher provisioning, which lowers banks' profits, increases capital requirements, and increases funding costs.



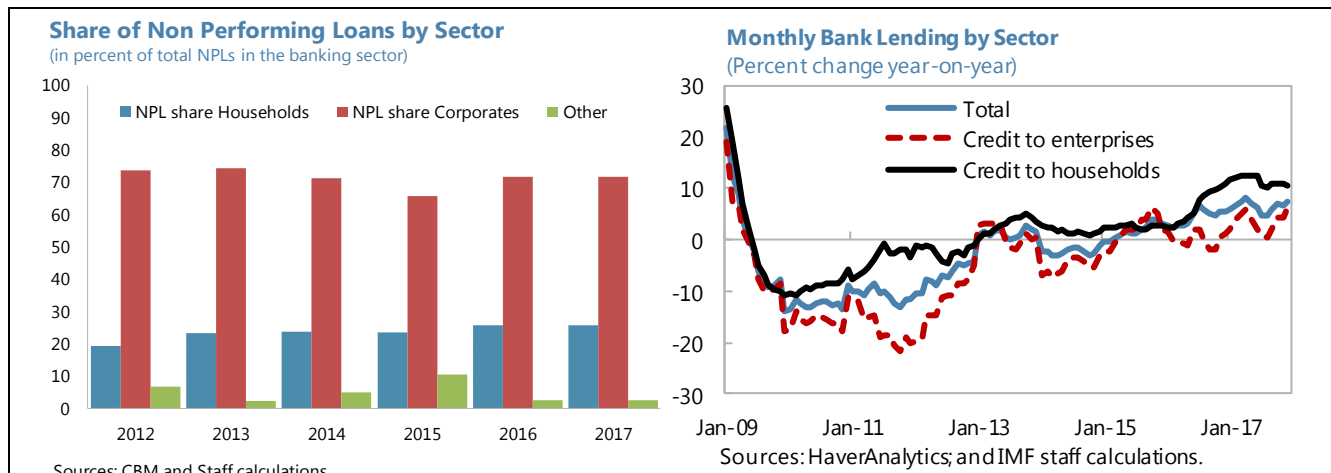
2. Future provisioning needs related to regulatory requirements may weigh on credit growth. Banks value financial assets in accordance with IAS-39 and apply additional CBM imposed prudential filters. These filters will continue after the transition to IFRS9, which might require additional provisioning. Currently, regulatory provisions for loans and receivables at the system level amounted to 76 percent in 2017-Q3 with a wide variation between banks, from 0 to 219 percent.

3. The banking system seems crowded and fierce competition over a small pool of qualified borrowers is lowering profit margins. The SME sector's financial reporting is underdeveloped, and the legal framework for land-ownership registration is weak, limiting the stock of eligible collateral. Thus, standard lending to the corporate sector is difficult. In addition, the state-owned Investment and Development Fund (IDF) offers subsidized loans to SMEs, further limiting the pool of bank clients and driving down profitability. Large private investment projects also frequently receive financing from abroad further reducing bankable projects.

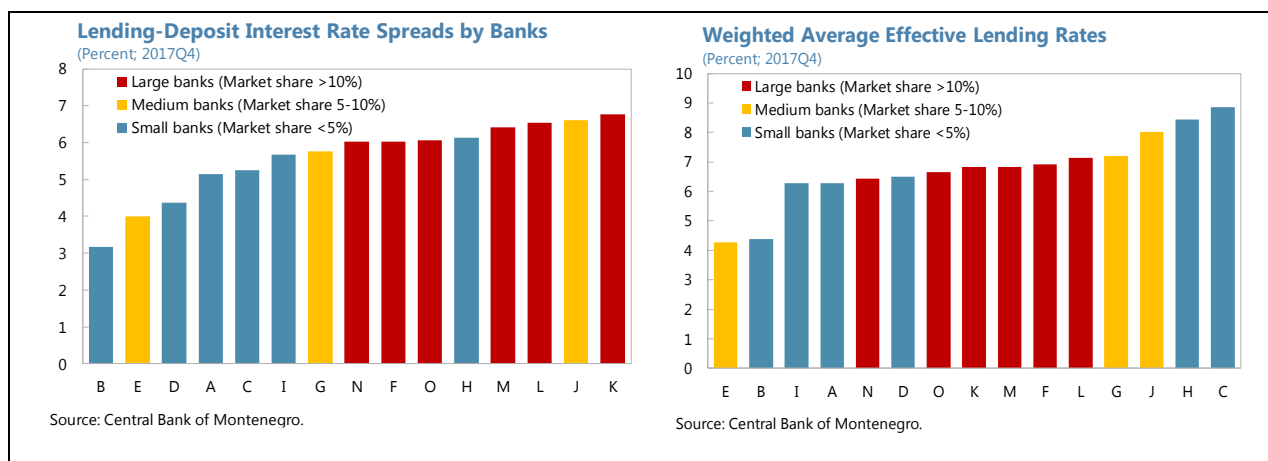


4. Existing bankruptcy laws and the low effectiveness of the judicial system create uncertainty in the lending process. Weaknesses in the legal framework for debt enforcement cause delays in debt collection and raise the cost of credit. Reforms should target improving legal certainty, strengthening credit discipline, and enhancing the supporting institutional infrastructure (including the ongoing improvements to the credit registry).

5. The grey economy is an impediment to greater credit development. The grey economy, especially in tourism, is very large, and many transactions are in cash, which makes it difficult for banks to verify income and repayment capacity. Banks typically do not lend to the informal sector, which accounts for perhaps one quarter of employment.



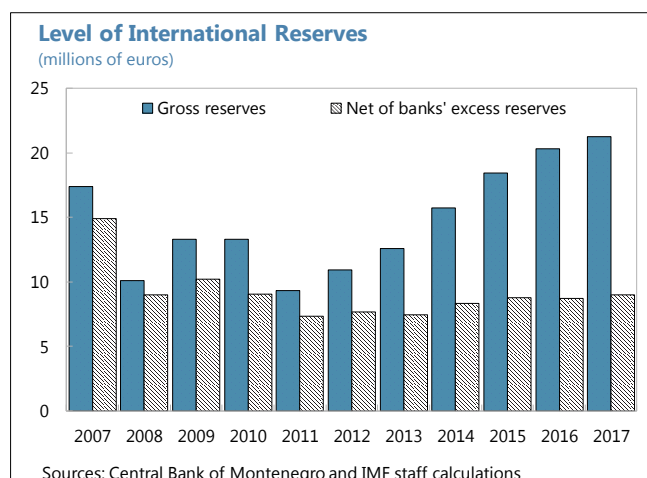
6. High interest rate spreads reduce credit demand. The weighted average effective interest rate on total lending (WAEIR) declined to 7.0 percent in 2017Q3. The CBM cites increased competition as a reason for lower interest rates. Nevertheless, the lending-deposit spread remains high to cover lending risks. There is also a wide variation between banks' WAEIRs.



Appendix II. Reserve Adequacy¹

As Montenegro is a euroized economy lacking a lender of last resort, international reserve adequacy should be assessed not only from a balance of payments perspective but also consider the adequacy of buffers for fiscal financing and bank emergency liquidity assistance (ELA). Gross international reserves appear adequate relative to standard metrics for balance of payments purposes. However, the central banks' own resources for ELA are limited, and government deposits were typically small until the recent liability management operation (LMO). Thus, fiscal buffers and resources for ELA should be increased, preferably by maintaining greater government deposits and creating a government sub-account at the central bank for ELA purposes. The CBM should also use required reserves to ensure that standard reserve adequacy metrics are met.

1. Montenegro's international reserves mainly correspond to banks' required and excess reserves and central government deposits. Due to euroization, any liquid financial claim to nonresidents in convertible foreign currency (including those in euro) on the Central Bank of Montenegro's (CBM's) balance sheet can be considered international reserves. These assets have been funded by the CBM's liabilities to banks (required and excess reserves) and central government deposits. The CBM has no ability to accumulate reserves by issuing domestic currency to purchase foreign currency. At end-2017, the CBM held nearly €900 million (21 percent of GDP) in reserves, more than double the level at end-2013. The growth during this period can mainly be traced to increases in banks' excess reserves, a symptom of the high liquidity of banks. As this level of liquidity may not be present in the future, we also consider a conservative measure of CBM's international reserves without banks' excess reserves, which at end-2017 equaled €380 million (9 percent of GDP).



2. Against IMF-developed reserve adequacy metrics, Montenegro's current level of international reserves appears adequate. We assess reserve adequacy against the standard IMF metric for countries with fixed exchange rates, in which adequate reserves would be the sum of:

$$\text{Reserves} = 10\% \text{ of } X + 30\% \text{ of } \text{STD} + 10\% \text{ of } \text{BM} + 20\% \text{ of } \text{OPL}$$

where X is exports, STD is short-term debt, BM is broad money, and OPL is the stock other external portfolio investment liabilities. We substitute broad money for bank deposits and omit OPL due to current data gaps. We also consider a modified metric tailored to a euroized economy that might need greater coverage of bank deposits due to the lack of lender-of-last-resort facilities. In the

¹ See SIP for details.

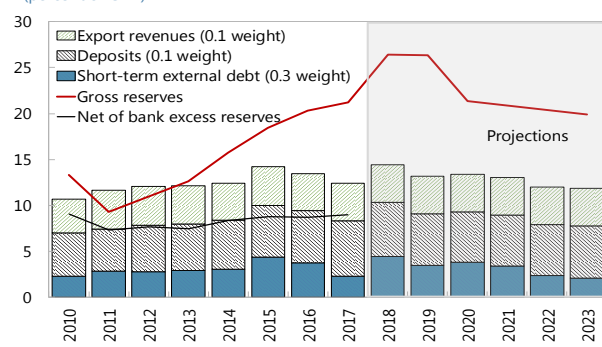
modified metric, we increase the weight on bank deposits to 15 percent. Reserves in the range of 100 to 150 percent of the metric are considered adequate. Against both the standard and modified IMF concepts, end-2017 reserve levels fall within or above the recommended range. In a more conservative scenario without banks' excess reserves, coverage is less comfortable. However, the dominant position of Euro Area banks may overstate the need to cover deposits, as subsidiaries of Euro Area banks likely have access to ECB liquidity facilities via their parents. If we exclude the deposits of Euro Area banks, Montenegro's reserve coverage improves considerably under all scenarios. The CBM should adjust required reserves to ensure that international reserves stay at reasonable levels according to the standard metrics.

Table 1. Montenegro: International Reserve Needs Estimate
(2017, in percent of GDP unless otherwise noted)

Potential sources of liquidity need	ARA Concept	Modified ARA Concept
Exports	4.1	4.1
Short-term external debt	2.2	2.2
Base money (bank deposits)	6.1	9.1
Target	12.4	15.5
Without deposits of euro area banks	8.4	9.4
Available resources:		
Gross international reserves	21.2	
<i>Percent of metric</i>	<i>170%</i>	<i>137%</i>
<i>Percent of metric, w/o euro area banks</i>	<i>253%</i>	<i>226%</i>
Net of bank excess reserves	9.0	
<i>Percent of metric</i>	<i>72%</i>	<i>58%</i>
<i>Percent of metric, w/o euro area banks</i>	<i>107%</i>	<i>95%</i>

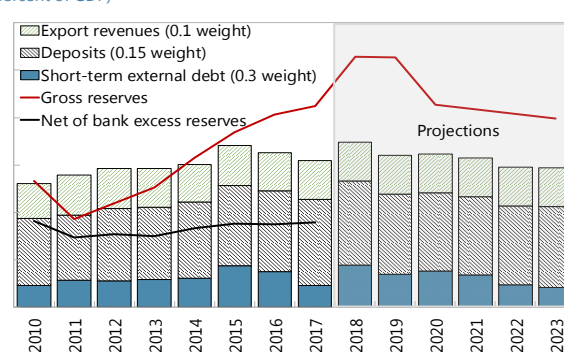
Sources: Montenegrin authorities and IMF staff calculations

ARA Decomposition: Montenegro
(percent of GDP)



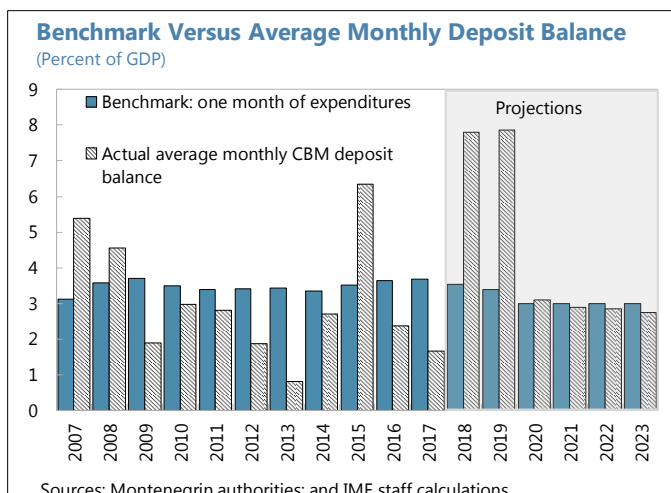
Sources: Montenegrin authorities; and IMF staff calculations.

Modified ARA Decomposition: Montenegro
(percent of GDP)

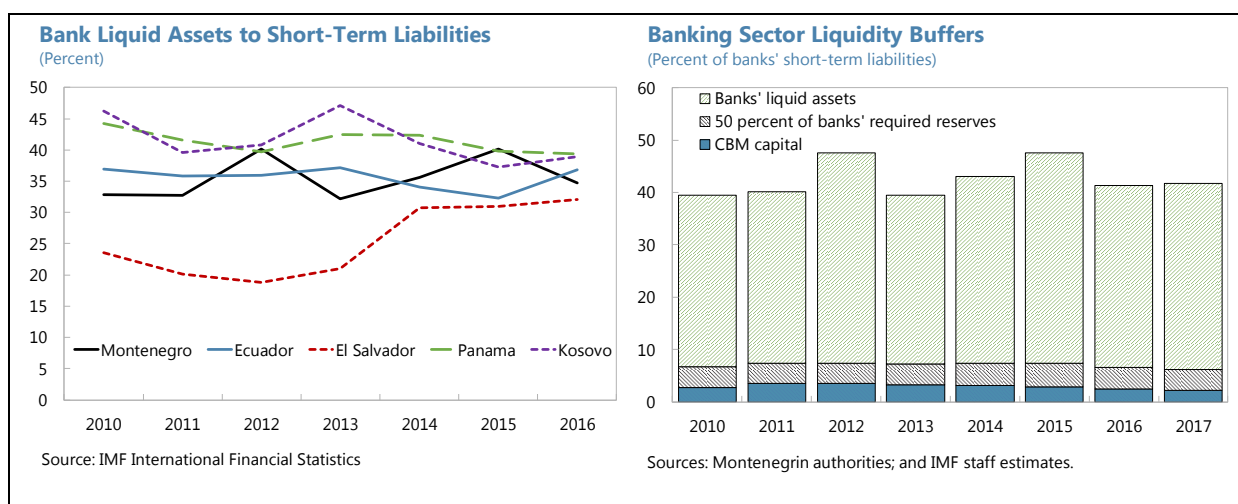


Sources: Montenegrin authorities; and IMF staff calculations.

3. Fiscal buffers have generally fallen short of the benchmark of one month of expenditures. An average monthly government deposit balance in 2017 of €70 million (1.7 percent of GDP) comprised less than half of the benchmark of one month of spending of €150 million (3.6 percent of GDP). Historically, average deposits have stayed below the benchmark. The pre-financing in 2018 of coming Eurobond amortizations resulted in a large deposit increase, giving the authorities the opportunity to maintain deposit buffers for the medium term at the benchmark of one month of expenditures.



4. While overall liquidity buffers in the banking sector currently appear sufficient, the CBM’s own resources for Emergency Liquidity Assistance (ELA) are limited. Banks are liquid in aggregate, with an overall ratio of liquid assets to short-term liabilities of 36 percent. The overall liquidity buffers in the banking sector consist of: (1) banks’ own liquid assets (which include excess reserves and 50 percent of required reserves); and (2) the 50 percent of required reserves that banks cannot withdraw freely and without penalty. In total, these buffers equaled 40 percent of short-term liabilities at the end of 2017. In the future, banks could become less liquid if credit growth accelerates, but the CBM should consider adjusting required reserves to keep ELA resources at prudent levels. Should a bank exhaust its own liquid assets, the CBM’s own resources to provide ELA are limited to its own capital position, which is small at only 2 percent of banks’ short-term liabilities. Even if the short-term liabilities of banks with Euro Area parents (which may provide liquidity to their subsidiaries) are excluded, ELA resources would still only cover 8 percent of short-term liabilities for the remaining banks.



5. The fiscal authorities and the CBM should consider options to bolster ELA resources and fiscal buffers. With the CBM unable to issue domestic currency, the strengthening of buffers will ultimately need to be funded and backstopped by the fiscal authorities.

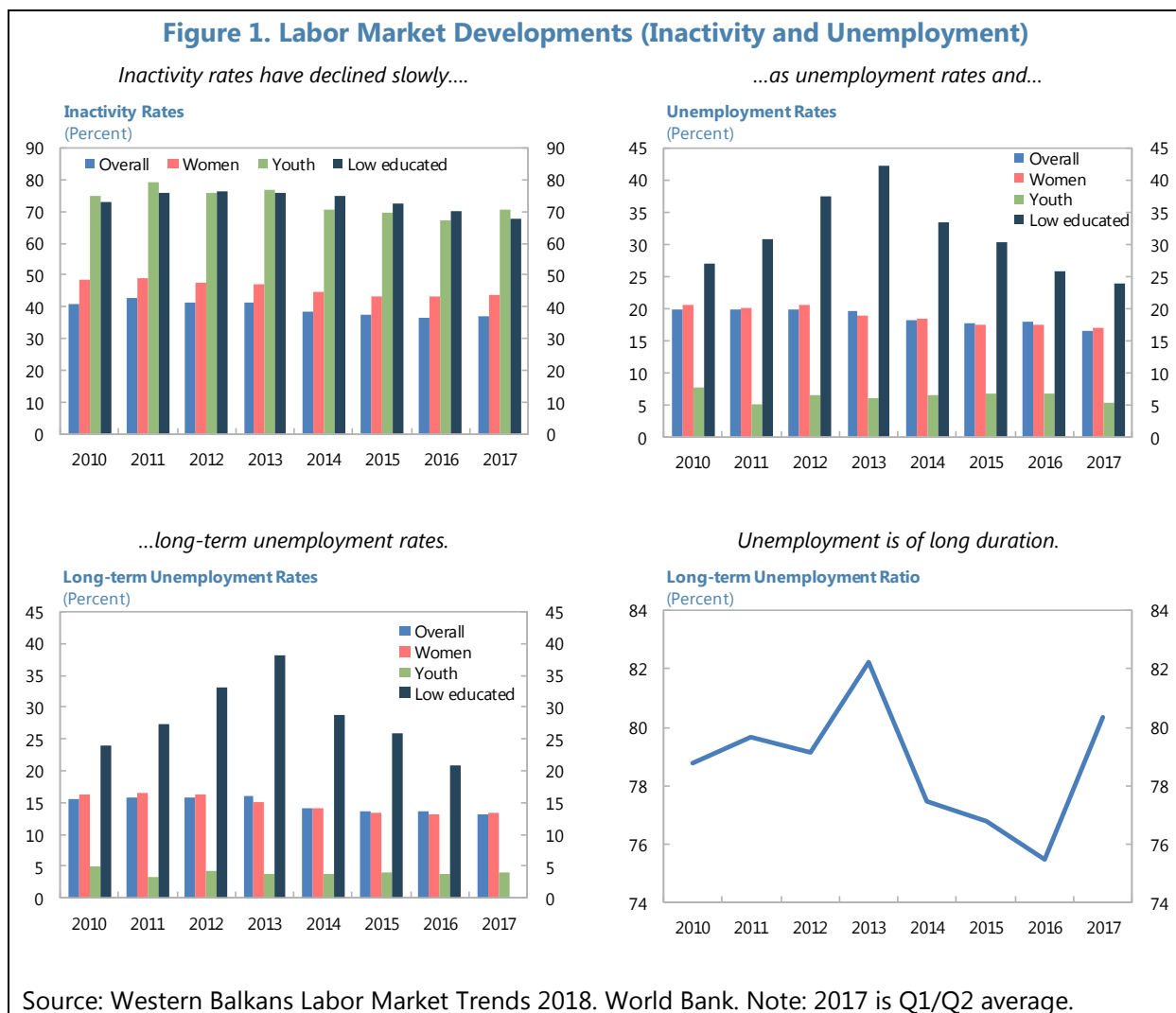
- *Fiscal buffers:* With the pre-financing coming Eurobond amortization, the government's deposits with the CBM increased to well beyond one month of expenditures. The authorities should consider maintaining deposits in line with this benchmark.
- *ELA buffers:* The government should create a dedicated sub-account at the CBM to be used exclusively for ELA purposes. The CBM would use this account at its discretion (with safeguards), and the government should reimburse the CBM for ELA-related losses. Even if not funded immediately, however, the account would serve as recognition that the government is the final backstop for bank liquidity in a euroized economy.

Appendix III. Labor Market Outcomes: Policies and Options¹

Montenegro has weak labor market outcomes by European standards. After providing stylized facts for labor market outcomes, the appendix presents a discussion covering the following dimensions: (i) level of employment protection, (ii) level of labor taxation, (iii) pace of wage growth, including the minimum wage, and (iv) non-employment income support and activation policies.

Labor Market Outcomes

1. The inactivity rate for the working-age population is about 37 percent, which is lower than the average for Western Balkan countries, but much higher than the average for EU member countries and New Member States (NMS). The inactivity rate is higher for women, youth, and individuals with low education.



¹ See SIP for more details.

2. While declining in recent years, the end-2017 unemployment rate of 16 percent, is high and above the average observed in EU and NMS countries. About 80 percent of the unemployed in Montenegro were out of work for more than a year, reflecting more structural than cyclical characteristics.

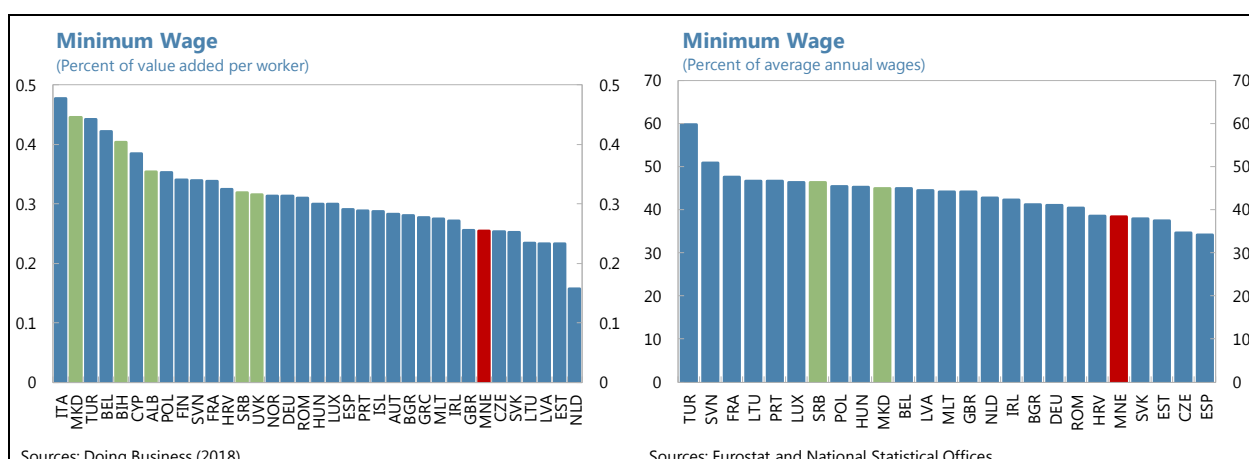
3. About 10 percent of the population (15+) work in the informal sector and half are inactive. According to the UNDP report (2016), observing the structure of employees by status, about 78 percent of employees are formally-employed and 22 percent are informally-employed. About 70 percent of the informally-employed are self-employed. Informally-employed people earn, on average, almost 30 percent less than formally-employed individuals.

How to explain these Labor Outcomes?

4. The individual and collective rigidity indicators are higher than the average for OECD and European countries based on the latest OECD Employment Protection Legislation rigidity index. The new Labor Law should provide a careful balance between the protection of work and job security. Some elements of the current draft Law could be further revised to increase incentives for more flexibility, declaration of work, and labor participation:

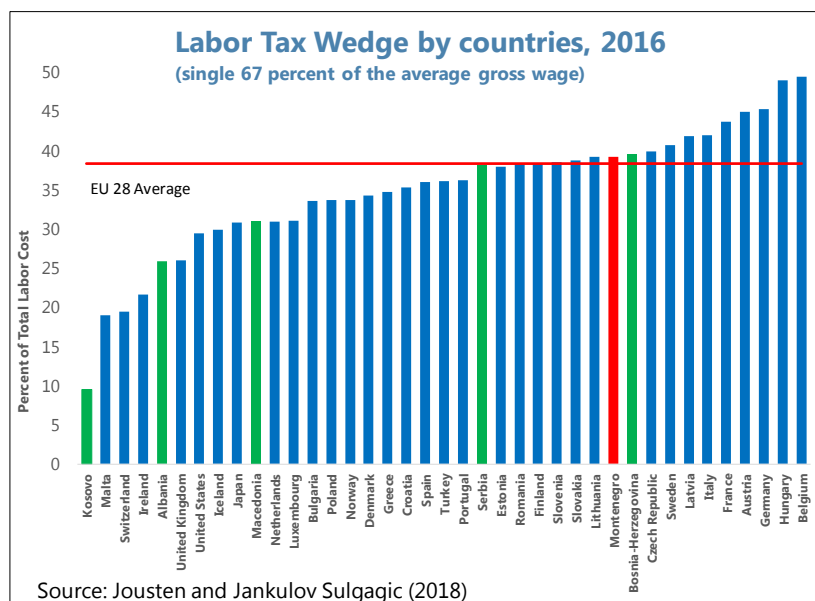
- *Establishing employment relationships.* An employee should be allowed to work for more than one employer even if the additional work is full time.
- *Internal organization and systematization act.* The requirement that all firms need to have a Rulebook regarding the internal organization and classification of jobs might imply a high burden on SMEs. For small firms, it might be sufficient to include a brief description and/or specification of the work in the employment contract.

5. The minimum wage in Montenegro appears to be moderate by some measures. Relative to the average wage and to value-added per worker, the minimum wage in Montenegro ranks low across the sample of European countries. However, in practice there may be multiple minimum wages based on the level of education. This may have an adverse impact on hiring decisions, especially for new workers with higher education levels.



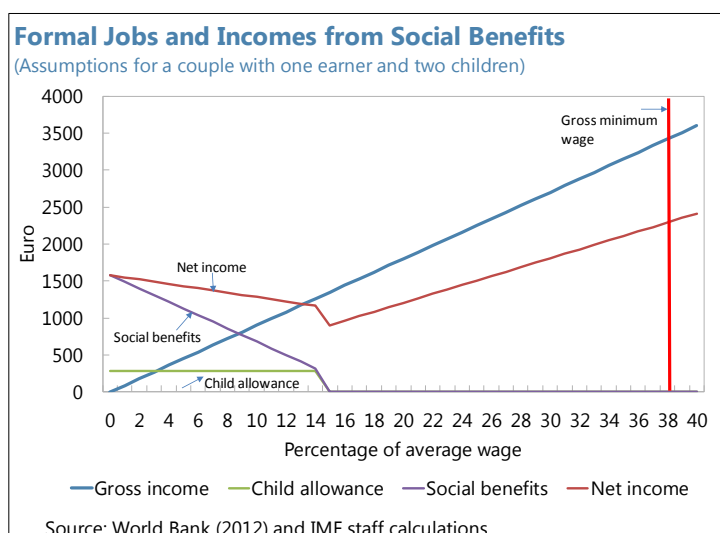
6. At around 40 percent, the tax wedge on labor is relatively high in

Montenegro and largely independent of the income level (lack of progressivity) despite a low personal income tax rate. The effective tax wedge on labor (including the withdrawal of social benefits) generates significant adverse incentives. It discourages formal labor supply and/or labor demand, and contributes to involuntary unemployment and inactivity. Reform options need to consider a reduction of the tax wedge, especially on low income earners, and a gradual withdrawal of social assistance and family benefits.



7. The authorities have implemented different activation policies to improve the knowledge, skills, and competencies of the labor force. However, the implementation of these programs would benefit from better monitoring and assessment.

8. A comprehensive and unified strategy is needed to address the country's labor market outcomes related to inactivity, long-term unemployment, and informality given the potential presence of cross-cutting common factors. Neither the new Labor Law nor changes labor taxation by themselves would significantly improve current labor market outcomes. Close coordination is needed between the Ministry of Finance and the Ministry of Labor to address employment policy, including enforcement of the Labor Code, labor taxes and social benefits.



9. The strategy should better align the education system with future labor demands and avoid simple expensive retraining. In addition, the strategy could provide a useful framework to nurture the cooperation between higher education institutions and employers (e.g. cooperation for curricula design). Active labor market policies can reduce labor market mismatches in the short term, but the education system is key for reducing mismatches in the long term.



MONTENEGRO

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 4, 2018

Prepared By

The European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of February 28, 2018)

Membership Status: Joined January 18, 2007; Article VIII.

General Resources Account:	SDR Million	% Quota
Quota	60.50	100.00
Fund Holdings of Currency	45.65	75.45
Reserve Position	14.85	24.55

SDR Department:	SDR Million	% Allocation
Net cumulative allocation	25.82	100.00
Holdings	18.14	70.23

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.05	0.06	0.06	0.06	0.06
Total	<u>0.05</u>	<u>0.06</u>	<u>0.06</u>	<u>0.06</u>	<u>0.06</u>

Implementation of HIPC Initiative: Not Applicable.

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable.

Exchange Arrangement: Montenegro does not issue its own currency and has been using the euro as legal tender since 2002. It has accepted the obligations under Article VIII, Sections 2, 3, and 4. Montenegro maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except with respect to pre-1992 blocked foreign currency savings accounts and restrictions maintained for security purposes that have not been notified to the Fund.

Latest Article IV Consultation: September 8, 2017 (IMF Country Report No. 17/276).

FSAP Participation: A Financial Sector Assessment Program was initiated in August 2015, jointly with the World Bank, and concluded during the 2015 Article IV consultation. The Executive Board discussed the Financial System Stability Assessment in January 2016.

Technical Assistance in the Past 12 Months:

Department	Timing	Purpose
MCM	Mar-18	Debt Management
FAD	Mar-18	Tax Policy
MCM	Dec-17	Debt Management
STA	Dec-17	External Sector Statistics
STA	Dec-17	Financial Soundness Indicators
FAD	Sep-17	Tax Policy
MCM	Aug-17	Debt Management
FAD	May-17	Public Financial Management
STA	Jun-17	Enhanced General Data Dissemination System
MCM	May-17	Debt Management

In addition, technical assistance was available through regional advisors covering tax administration and public financial management.

Resident Representative: None.

WORLD BANK GROUP RELATIONS

1. Montenegro joined the World Bank Group (WBG) as an independent country in January 2007. The Systematic Country Diagnostic from January 2016 identified the following priority objectives as fundamental for the achievement of the twin goals in Montenegro, around which the new Country Partnership Framework (CPF) is designed:

- (i) Strengthening resilience to shocks and volatility;
- (ii) Reducing unemployment and inactivity, amongst the young; and
- (iii) Facilitating private sector development.

2. The current, third, Montenegro Country Partnership Framework FY16-20 (CPF) has two focus areas: (i) Enhance macroeconomic and financial resilience, whereby the primary objectives are to improve the sustainability and efficiency of public finances, and increase the stability and efficiency of the financial sector; and (ii) Expand access to economic opportunities and jobs, whereby the main objectives are to increase the alignment between skills and labor market demand; strengthen incentives for work; enhance private sector investments and job creation in high-potential sectors; and enhance environmental sustainability.

3. The committed funds currently amount to US\$169.92 million, of which three-fourths remained undisbursed. Under the current CPF, the overall IBRD delivered program approved so far amounts to US\$262 million. Under the previous CPF, IFC committed two long-term finance projects totaling US\$26.5 million in the infrastructure sector. Six IBRD projects are currently active. The portfolio also includes one EU Trust Fund and one regional GEF project.

Montenegro: World Bank Project Portfolio, March 2018				
Project Name	Date, Board App	Net Comm Amt (\$m)	Total Percent Disb.	Percent Disb. Ratio FY18 (as of March 2018)
Higher Education and Research for Innovation and Competitiveness	01/24/2012	15.98	82.0	51.0
Energy Efficiency	12/09/2008	15.67	89.0	100.0
Montenegro Institutional Development and Agriculture Strengthening (IBRD)	04/21/2009	18.79	79.0	15.0
Industrial Waste Management and Cleanup	09/19/2014	68.90	4.0	1.0
Revenue Administration Reform	07/31/2017	15.70	0	0
Montenegro Second Institutional Development and Agriculture Strengthening	01/30/2018	34.89	0	0
		169.92	26.0	3.7

4. Pipeline projects in the new FY19/20 include: (i) Second Fiscal and Financial Sector Resilience Policy Based Guarantee (PBG2), and (ii) Energy Efficiency Project.

5. The World Bank and the IMF teams are exchanging information in the areas of macroeconomic, structural, and financial sector policies. Bank and Fund teams coordinated closely during the preparation of the 2018 Article IV mission and continue providing advice to the

government on the implementation of the Fiscal Strategy adopted in June 2017. The World Bank Group, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input to the IMF on issues such as (i) public expenditure, including pension and health reforms; (ii) business climate and competitiveness, including labor market reform and the resolution of nonperforming loans; (iii) public sector institutions and fiduciary reviews, and (iv) poverty monitoring. Fund and Bank staff have sought each other's input in internal review processes and will continue to maintain a coordinated support to the government's fiscal consolidation reform agenda.

Montenegro: Joint Management Action Plan - Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, January—December 2018			
Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	March 2018	June 2018
2. Bank work program	PBG 2	April, September, December 2018	Mid-2018
3. Joint work program	None	None	
Prepared by World Bank staff. Questions may be addressed to Daria Lavrentieva, Sr. Country Officer (dlavrentieva1@worldbankgroup.org) and Sanja Madzarevic Sujster, Senior Country Economist (smadzarevic@worldbank.org).			

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
<p>General: Data provision has some shortcomings, but is broadly adequate for surveillance. The most affected areas are labor market indicators and government finance statistics. The Statistical Office of Montenegro (MONSTAT) suffers from resource constraints and limited capacity.</p>
<p>Real Sector Statistics: The Statistical Office of Montenegro (MONSTAT) suffers from resource constraints and limited capacity.</p>
<p>National Accounts: MONSTAT compiles annual production and expenditure accounts in current and previous year's prices. The production GDP estimates are reconciled with the expenditure GDP estimates through the supply and use framework (i.e. reconciling supply and use). The quality of the annual GDP is good.</p> <p>Montenegro started disseminating quarterly GDP by production using an indirect method in 2012, but the methodology has room for improvement. The estimates are compiled at an aggregated level (mostly NACE section level). Recent national accounts TA missions have focused on developing robust quarterly GDP estimates by expenditure approach. Quarterly GDP estimates have been compiled for 2010-2017.</p> <p>MONSTAT is participating in a Dutch funded project, delivered by the IMF, which will run until end of 2019 to improve the national accounts. The project will assist MONSTAT to improve coverage of agriculture and services in the quarterly estimates of GDP, and the consistency between the quarterly and annual estimates of GDP.</p> <p>There is need to improve the industrial production index.</p>
<p>Price Statistics: MONSTAT compiles and disseminates a monthly consumer price index that broadly follows international standards. The coverage of the PPI could be expanded to include services.</p>
<p>Labor market statistics: MONSTAT reports labor and wage statistics based on data from the labor force survey (LFS) and administrative sources. The unemployment rate from the LFS is computed according to the ILO definition. The quality of wage indicators is relatively good, but information on foreign employment remains limited. The presence of a large informal sector impedes the accurate assessment of the unemployment rate. Frequent methodological revisions also impair time series analyses.</p>
<p>Government Finance Statistics: Fiscal data are compiled, on a cash basis, by the Ministry of Finance (MOF) based on the new GFS institutional classification, and, since 2006, include data on local governments and social security funds. The latter were merged with the treasury account in 2010. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Although progress is being made, there are still some gaps in coverage, and fiscal data do not include all units that should be classified in general government according to the GFSM 2001/2014 guidelines. Own revenues and associated expenditures of extrabudgetary units (including schools and hospitals) are also excluded. Fiscal data reporting suffer from frequent re-classifications, and the classification of some revenues and expenditures is not fully aligned with GFSM 2001/2014. The MOF has established a unit responsible for data collection for state-owned enterprises, but a satisfactory compilation of the public sector fiscal balance requires significant further effort. Data on enterprises owned by municipalities are rarely available. Data on the stock of local government arrears need to be significantly strengthened and disseminated. Data on stocks of financial assets and liabilities are incomplete.</p>

Montenegro does not report either annual or high frequency *GFSM 2001* based data to the IMF. However, renewed technical assistance aimed at improving fiscal data compilation and reporting to both the IMF and EU resumed earlier this year—STA fielded an initial diagnostic mission to Podgorica in April 2017. Further missions are planned for later in 2018.

Monetary and Financial Statistics: The Central Bank of Montenegro (CBM) reports monthly monetary statistics covering the CBM balance sheet and the balance sheet of commercial banks only. However, the monetary data are reported in non-standardized Report Forms and latest data available are from July 2017.
Financial Soundness Indicators (FSIs): Montenegro does not report FSIs to the IMF. Using technical assistance from STA, the authorities are aiming to report FSIs to the IMF starting later in 2018.

External sector statistics: Balance of payments (BoP) statistics are compiled by the CBM according to the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)*. The CBM adjusts export and import data from MONSTAT from CIF to FOB basis. One of the biggest challenges to the BoP statistics is the large and persistent net errors and omissions –with positive sign. This could be caused by understated inflows, especially in remittances. The CBM has received technical assistance from STA and plans to implement methodological changes that will reduce net errors and omissions. Revised BoP statistics would be released in June 2018.

The CBM, which has lacked the capacity to produce statistics on the International Investment Position (IIP), has received TA on IIP statistics but does not yet disseminate these data. They plan to disseminate IIP in June 2018. Montenegro participates in the IMF's Coordinated Direct Investment Survey (CDIS) reporting inward direct investment positions, but not outward direct investment positions. It has not yet participated in the Coordinated Portfolio Investment Survey (CPIS) or prepared the Reserves Data Template.

II. Data Standards and Quality

Participant in the Fund's Enhanced General Data Dissemination System (e-GDDS) since December 2011. In July 2017 Montenegro received an e-GDDS Implementation mission, and the National Summary Data Page (NSDP) went live in September 2017.

No data ROSC available.

Montenegro: Table of Common Indicators Required for Surveillance

(As of March 28, 2018)

	Date of latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Dec-2017	Jan-2018	M	M	M
Reserve/Base Money	Dec-2017	Jan-2018	M	M	M
Central Bank Balance Sheet	Dec-2017	Jan-2018	M	M	M
Consolidated Balance Sheet of the Banking System	Dec-2017	Jan-2018	M	M	M
Interest Rates ²	Dec-2017	Jan-2018	M	M	M
Consumer Price Index	Feb-2018	Mar-2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2017	Mar-2018	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Jan-2018	Mar-2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Q4-2017	Mar-2018	Q	Q	Q
External Current Account Balance	Q4-2017	Feb-2018	Q	Q	Q
Exports and Imports of Goods and Services	Q4-2017	Feb-2018	Q	Q	Q
GDP/GNP	Q4-2017	Mar-2018	Q	Q	Q
Gross External Debt	--	--	NA	NA	NA
International Investment Position ⁶	--	--	NA	NA	NA

¹Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Includes external gross financial asset and liability positions vis-à-vis nonresidents. The authorities do not currently have the capacity to provide data on gross external debt and the international investment position and have requested IMF TA.

⁷Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).