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Montenegro: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Montenegro

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on February 23, 2011, 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 April 15, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 29, 2011 discussion of the staff report that concluded the Article IV Consultation.

- A statement by the Executive Director for Montenegro.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

MONTENEGRO

Staff Report for the 2011 Article IV Consultation

Prepared by the Staff Representatives for the 2011 Consultation with Montenegro

Approved by Adam Bennett and Tom Dorsey

April 15, 2011

EXECUTIVE SUMMARY

Since independence in 2006, the Montenegrin economy has gone from boom to bust and is only now beginning to recover. Missteps were made during the run-up to the crisis, but the authorities are now working to put the economy on a sounder footing. The 2011 Article IV discussions focused on:

- *Avoiding a relapse into recession*. The recovery is fragile and the policy arsenal has not been replenished. In the short run, policies must aim at restoring the health of the banking system, and removing impediments to restructuring the economy and deleveraging.
- *Anchoring potential growth on a sustainable path*. A strategy centered on enabling private sector-led growth, a smaller government, and deregulation, which would all serve to improve competitiveness, is the prerequisite.
- *Securing the economy's resilience by building policy buffers.* The lack of fiscal space, in particular, at the onset of the crisis severely restricted the authorities' room for maneuver in dealing with it. The crisis proved that large capital and liquidity buffers and sizeable government assets are required.

The authorities broadly agreed with staff's assessment of the economic situation and the key policy recommendations.

Montenegro does not issue its own currency, but has been using the euro as legal tender since 2002, and has accepted the obligations under Article VIII. 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.

The staff team comprising Messrs. Bell (head), Castro, and Stepanyan (all EUR), Lundback (MCM) and Zeng (FAD) visited Podgorica from February 9–23, 2011. Mr. Tomic (Advisor to the Executive Director) joined the discussions. The mission met with Prime Minister Luksic, Minister of Finance Katnic, Central Bank Governor Zugic, other Ministers and senior officials, as well as representatives of the Parliament, financial and business sectors, academia, and trade unions.

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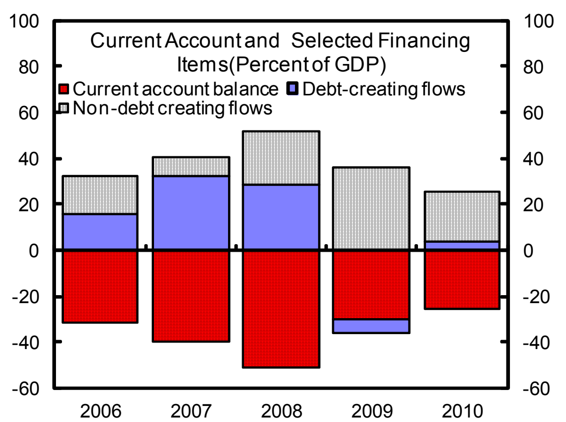
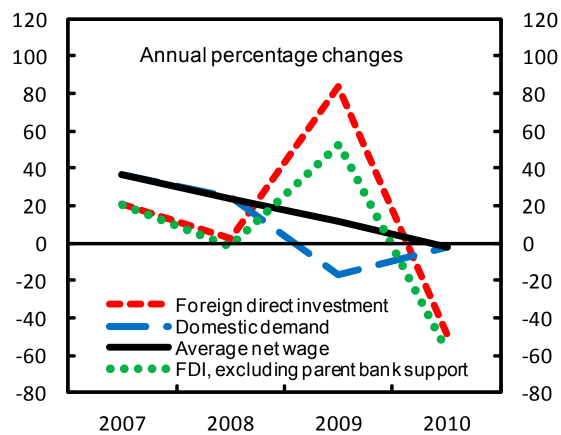
I. BACKGROUND

1. **Since its independence in 2006, Montenegro has experienced an economic and financial roller coaster ride.** The country's abundant potential attracted large capital inflows, an increasing share of which were debt creating. With expectations of rising living standards, the inflows helped fuel a domestic demand boom. Wealth effects made real estate lending and absorption booms mutually reinforcing, and overstretched the nascent financial sector's ability to guard against risks. The economy began to overheat and then, as elsewhere, the inflows juddered to a halt. The result was a sharp decline in output (Tables 1 and 2).

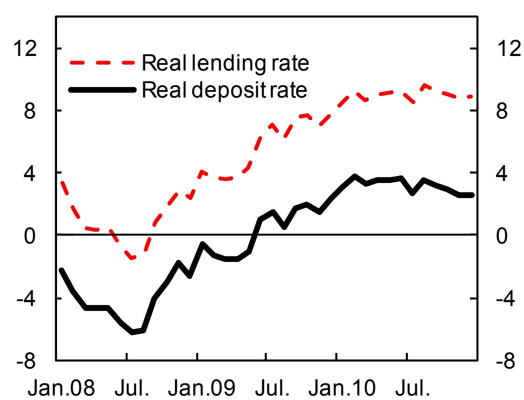




Sources: Central Bank of Montenegro; and IMF staff estimates.

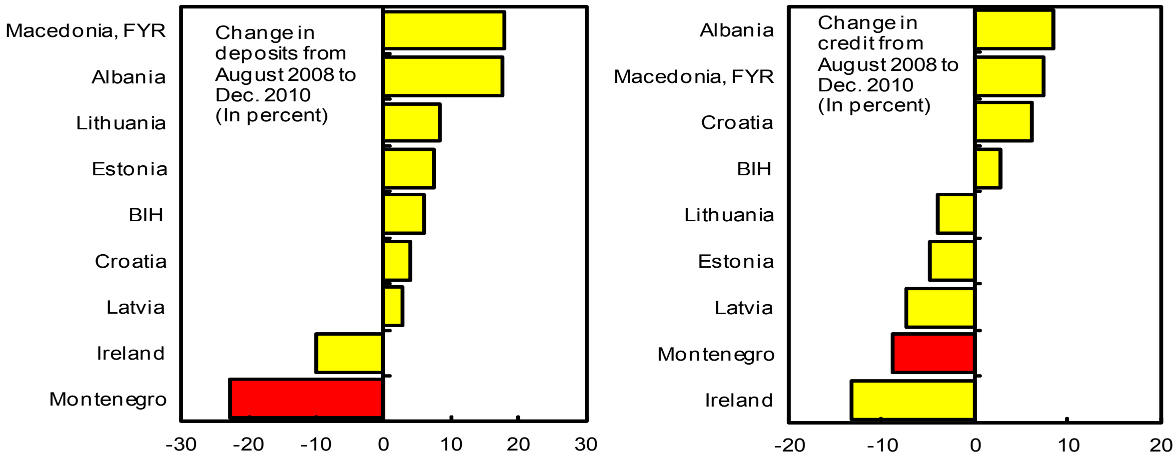
2. **The boom/bust cycle overwhelmed the policy framework.** Huge vulnerabilities were accumulated during the boom when the authorities did not take the opportunity to sufficiently strengthen policy buffers. With policy space exhausted at the beginning of the crisis, the authorities were forced to adopt unconventional policies to mitigate its effects.

- **Unilateral euroization generally imported inappropriate monetary conditions**. During the boom the Central Bank of Montenegro (CBM) raised the cost of credit through higher reserve requirements and tightened supervisory and prudential standards, but credit growth was hardly dented. In the Fall of 2008, banks suffered from a simultaneous run on deposits, loss of access to financing, and deterioration in asset quality (Figure 1 and Table 3). Foreign parent banks met liquidity and solvency needs, but the government stepped in to boost liquidity in a large domestic bank, initially by temporary liquidity injections, and subsequently by the direct placement of public sector deposits.



Source: Central Bank of Montenegro; Fund staff estimates.

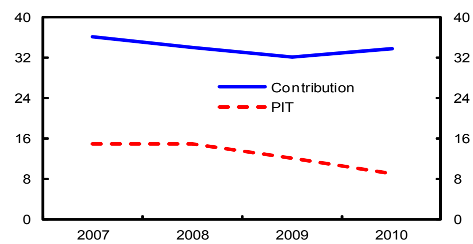
Montenegro has been hit hard by deposit withdrawals and a credit crunch



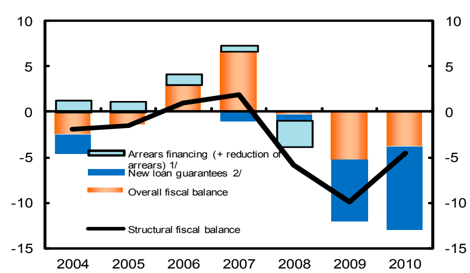
Source: International Financial Statistics.

- **Fiscal reserves were not sufficient**. The early surpluses largely reflected temporarily buoyant tax collections from high imports. Initially, they were placed in the domestic banking system, thereby enabling further credit extension. Then at the peak of the boom period, the fiscal stance relaxed (through tax cuts and public sector wage increases), leading to a structural fiscal deficit of some 6 percent of GDP in 2008. The remaining fiscal buffers were quickly exhausted in the crisis, while large loan guarantees to the aluminum and steel companies created substantial new contingent liabilities. By 2009 public and publicly guaranteed debt had risen to nearly 55 percent of GDP.

Montenegro: Tax and Contribution Rates 1/

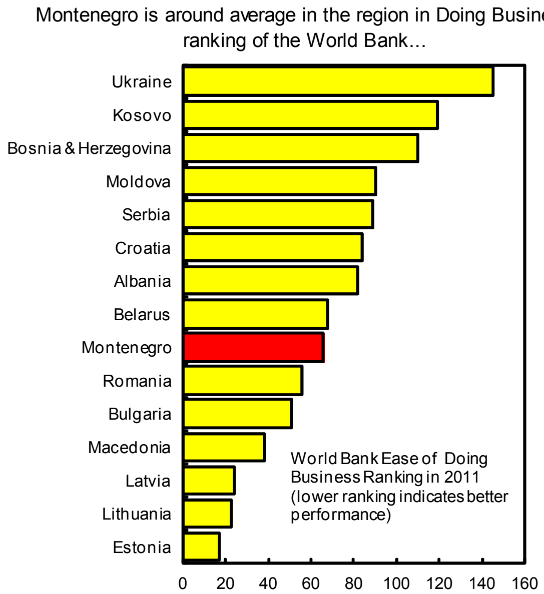


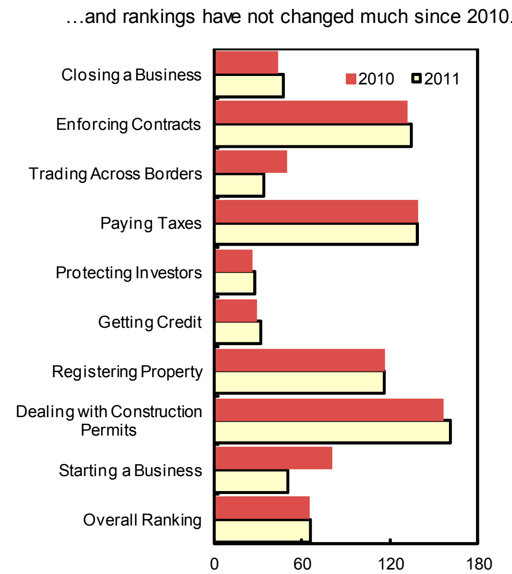
Sources: Country authorities, and IMF staff estimates.
1/ Contributions include pension, health and unemployment insurance. CIT and VAT have remained constant since 2007.



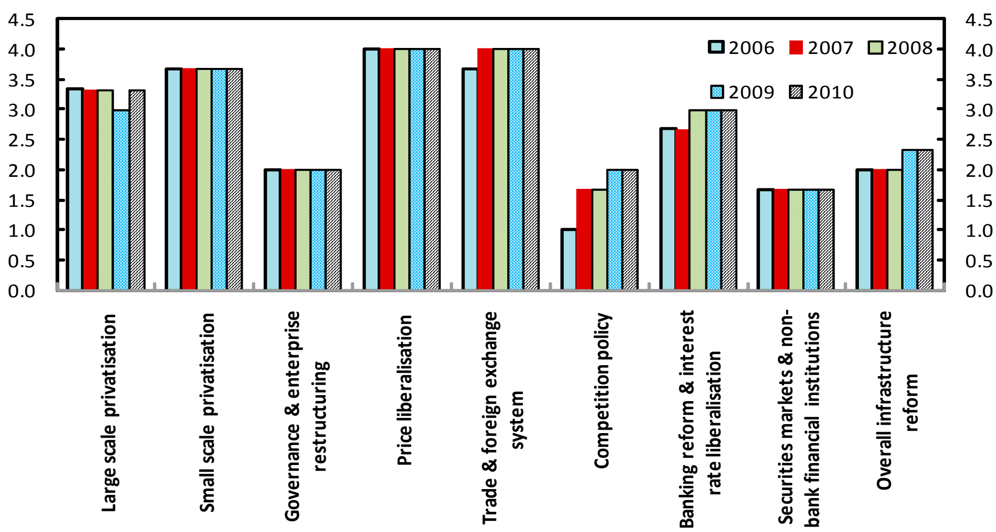
Sources: Country authorities, and IMF staff estimates.
1/ The budget figures switched from cash-basis to accrual-basis starting in 2009.
2/ Only include new agreements signed in 2010 and early agreements with remaining balance in 2010.

- **Some key structural reform priorities were not addressed**. Despite progress in some areas, excessively restrictive employment protections and an unduly rigid centralized collective bargaining system remained in place. This contributed to fast wage growth, limited the flexibility of the corporate sector, and stifled new hiring, thereby raising unemployment. Privatization occurred later than elsewhere in Eastern Europe, and in consequence the interest of bidders was more limited. The large industrial sector legacy enterprises were sold to smaller investors who lost access to new financing during the global crisis, forcing the government to retake a significant equity stake in the aluminum plant in exchange for extending loan guarantees. The electricity company was sold into a thin market in 2009.





Source: World Bank.



Source: Transition Indicators, EBRD 2010.

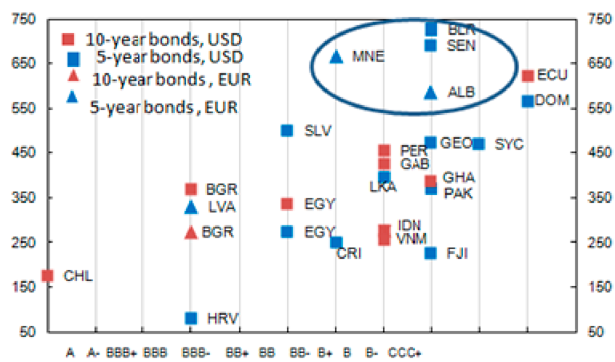
3. **The global crisis thus exerted heavy blows upon the economy.** In addition to the deposit run, the sudden stop in capital inflows also dried up financing for corporates just as the prices of their key export products began to fall sharply. With the very large contractions in industry and construction (Figure 2), the decline in GDP (6 percent) would have been even worse but for the ability of the tourism sector to mostly withstand the downturn.

4. **A tentative recovery is now taking hold**. A good tourism season was followed by resumed metal production, while heavy rains in the region boosted electricity production and exports. After contracting for almost two years, industry began to grow again in the second half of 2010. Nevertheless, industrial production at end-2010 was still considerably below

of its pre-crisis peak. Expected large-scale infrastructure FDI has so far not materialized and construction activity remains depressed. Overall 2010 GDP growth is estimated at 1.1 percent, keeping output below its 2008 level (Figure 3).

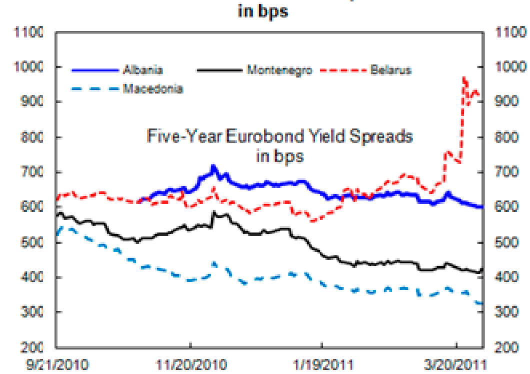
5. **The needed rebalancing of the economy has now begun**. Inflation and wage growth decelerated sharply and the current account deficit halved to around 26 percent of GDP (Figure 4). While most of the adjustment in 2010 was due to a weather related boost in electricity exports and rebounding metals production, the nascent adjustment in costs has also improved competitiveness. The improved fundamentals have also contributed to the September 2010 debut Eurobond issuance of €200 million, subsequent spread tightening, and a further €180 million issuance in April 2011.

Spreads and Sovereign Ratings for First-Time Bond Issuers



Sources: MCM's Debt Management and Debt Markets Monitor.

Five-Year Eurobond Yield Spreads
in bps

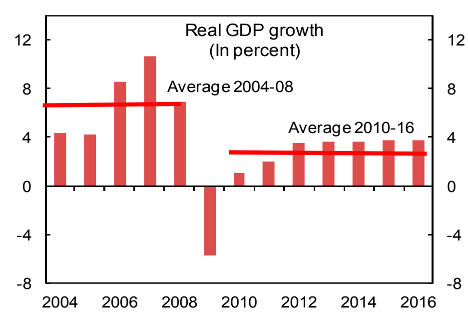


Source: Bloomberg.

6. **The new government is intent on fast reform progress towards EU integration**. In granting of candidate status to Montenegro in fall 2010, the EU called for greater political reform efforts. An end-2010 government reshuffle promoted the Minister of Finance to Prime Minister and strengthened pro-reform forces. The government aims to commence membership negotiations still in 2011.

II. Report on the Discussions

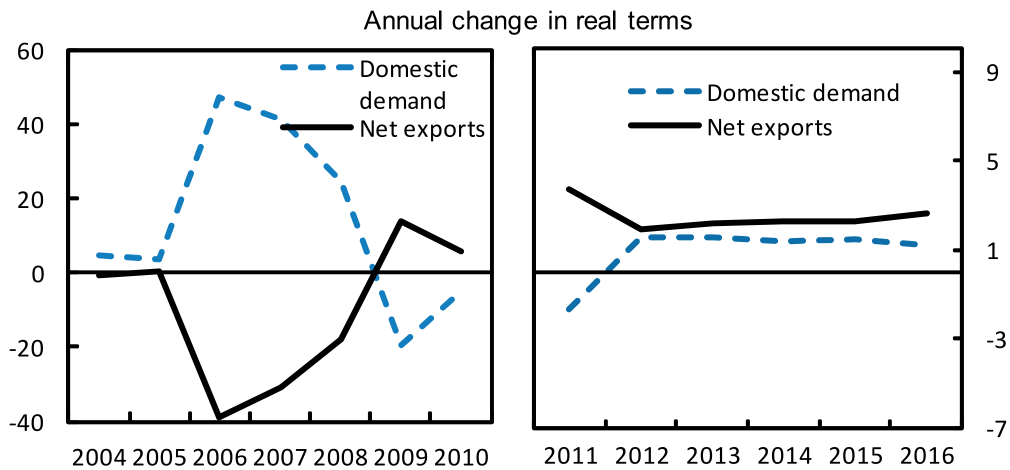
A. Economic Outlook and Risks



Sources: MONSTAT and IMF staff estimates.

7. **The baseline is predicated on continued improvements in cost competitiveness and productivity-raising FDI.** This is expected to drive an external-demand-led recovery—notably a reorientation toward tradable services and restructuring of industry. Projected GDP growth would rise from 2 percent in 2011 to close to 4 percent by 2016. Against the background of tight external and domestic financing conditions, as well as envisaged structural reforms in the context of EU accession, the current account deficit is

projected to shrink to around 9 percent of GDP by 2016, financed by FDI inflows (Table 4). Inflation is expected to remain below that of trading partners, with fiscal tightening putting downward pressure on costs, and structural reforms lowering relatively high retail margins. The authorities broadly agreed with these projections, while noting the wide confidence bands around them.



Sources: Central Bank of Montenegro; IMF staff estimates.

8. **For the near term, key risks are tilted to the downside**, *inter alia*:

- *External environment*, the key source of shocks for an open and small economy. Should there be another sudden stop, the still very large external imbalances are at risk of disruptive adjustment. Renewed sovereign and banking stress in the euro-area periphery could undermine confidence and financing, while more competitive Mediterranean neighbors could increase competition for tourists. Privatizations could prove more difficult.

- *Reform fatigue and legacy structural problems*. Bank restructuring has been uneven, leaving some banks in difficult positions, with potentially adverse implications for intermediation and confidence. The needed household deleveraging could also turn disruptive. The restructuring of heavy industry could run into further problems; already intermittent production stoppages are standing in the way of supplying buoyant global commodity demand, and even current production levels may not be sustained. The political context for continued reform and adjustment could also become more difficult, given the recent decline in incomes.

9. **Avoiding a relapse into recession will thus require strengthening the health of the banking system and removing impediments to restructuring the economy**.

B. Medium-term External Rebalancing

10. **It was agreed that FDI holds the key to re-launching growth**. In order to benefit from the recovery in global capital flows, Montenegro must swiftly redress any impediments to investment (Annex I). FDI should also be complemented by heightened domestic flexibility and cost competitiveness in order to avoid renewed overheating pressures and to help provide the spark for domestic investment, notably in labor-intensive SMEs.

11. **FDI will also be essential for external rebalancing**. While there is a need to boost cost competitiveness, it was agreed that leaving rebalancing to macroeconomic policies alone—which in Montenegro's case would largely amount to engineering an internal devaluation via fiscal and incomes policies—would require an excessive degree of domestic adjustment, if such policies were not accompanied by productivity- and capacity enhancing investment. This is also a reflection of the small size of the economy, as only a handful of projects—which do not have to be large in absolute terms—can drastically alter economic prospects. Thus, the current account in any given period may not be a reliable indicator for such economies, which is also reflected in the inconclusive CGER assessment (Box 1)[1]. Still, staff suggested it would be prudent to consider the real exchange rate to be somewhat overvalued. While not taking a view on the level of the real exchange rate, the authorities stressed that their policy focus on structural reform and fiscal consolidation would improve competitiveness in any event.

12. **Montenegro's attractiveness to investors will depend on reducing macroeconomic and structural vulnerabilities**. The authorities and staff agreed that these tasks are mutually reinforcing; lessened vulnerabilities will help dispel reservations among potential investors, while higher levels of investment could create positive agglomeration effects thereby strengthening fundamentals. Conversely, without buoyant investment, the consolidation task would be harder. Montenegro's EU candidacy should provide a key comparative advantage in attracting investment, and the authorities are eager to quickly commence negotiations.

13. **Provided the required policies are in place, the medium term outlook is favorable**. The authorities and staff agreed that a strategy centered on enabling private sector-led growth, healthy banks, smaller government, and deregulation should form the basis for sustainable growth ahead. The country's unique geography and favorable climate still offer large untapped potential, e.g., in tourism and hydro-electricity. This could well trigger larger-than-currently-projected FDI. Even in this case, though, the above policy recommendations would still be beneficial to lessen the danger of Dutch disease. Discussions on the specific policy requirements are described in the following sections.

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[1] The very few historical comparators with deficits in excess of 30 percent of GDP were all very small economies.

Box 1. External Competitiveness

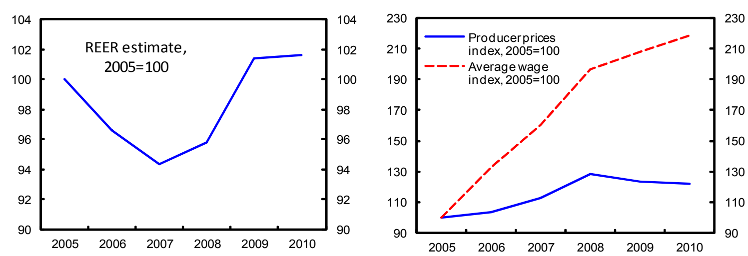
Current Account Balance Gap and Real Exchange Rate Overvaluation
in Macrobalances and External Sustainability Approaches
(in percent of GDP, unless otherwise specified)

	Macrobalance Approach	External Sustainability Approach
Equilibrium balance A	-7.0 [1/]	-10.4
Underlying balance B [2/]	-9.0	-9.0
Gap = A-B	**2.0**	**-1.4**
Mitigating factor **C**: capital transfers	0.0	0.0
Gap net of mitigating factors = A-B-C	**2.0**	**-1.4**
Implied misalignment, in percent (+: overvaluation) [3/]	10.5	-7.4

Source: IMF staff estimates.
1/ Rahman (2008).
2/ Adjusted for transitory elements in savings and investment.
3/ Calculation based on elasticities reported in Isard and Faruqee (1998).

The application of CGER-type methodology in the case of Montenegro does not reveal conclusive evidence of competitiveness problems. However, it should be noted that limitations in terms of data availability and length of sample do not allow the application of the equilibrium real exchange rate approach and introduce a large margin of error in the external sustainability approach. In addition, the estimated equilibrium balance in the external sustainability approach should be taken only as a rough guide because it assumes debt stabilization at an arguably too high level. It should also be noted that the improvement of the external current account in 2009–10 does not so much stem from competitiveness gains, but rather from recovering export production and some import contraction.

CPI-based REER estimates show that after a period of substantial appreciation during 2007–09, the REER has remained broadly unchanged during 2010. Economy-wide wage and producer price data analysis indicate a further erosion of competitiveness, and, as Figure 5 shows, the level seems to be one of the highest in the region.



Sources: Monstat; IMF staff estimates.

Finally, it seems that the tourism sector has managed to achieve continuous gains in its competitiveness ranking which is essential given its growing share in the Montenegrin economy.

The overall competitiveness ranking in tourism has improved substantially

	Overall ranking		Regulatory framework		Business environment and infrastructure		Human, cultural, and natural resources	
	2009	2011	2009	2011	2009	2011	2009	2011
Spain	6	8	29	22	8	10	5	6
Cyprus	21	24	25	23	13	14	37	44
Greece	24	29	18	34	27	29	27	29
Italy	28	27	46	45	26	27	22	15
Malta	29	26	11	9	31	22	52	54
Croatia	34	34	43	42	37	36	43	43
Slovenia	35	33	38	29	33	33	61	53
Slovakia	46	54	34	39	54	57	55	52
Bulgaria	50	48	56	54	48	44	46	51
Montenegro	**52**	**36**	**50**	**32**	**66**	**49**	**35**	**36**
Turkey	56	50	63	66	60	55	44	28
Romania	66	63	61	51	64	66	77	66
Serbia	88	82	78	67	80	84	96	94
Albania	90	71	77	53	104	91	66	61

Source: World Economic Forum.
Note: A rise in the ranking indicates improvement.

C. Boosting Employment

14. **There is consensus on the need to improve the performance of the labor market**. Unemployment is high and participation low (Figure 5). Moreover, a distinct segmentation of the labor market has occurred, with employment of foreign workers serving as the buffer. Thus the headline change of domestic employment understates the decline of actual employment (including that of foreigners). Even so, domestic unemployment has crept up, with anecdotal evidence of a large share being long-term unemployed.

15. **"Insiders" are dominating the policy debate**. Strong employment protection has contributed to low wage flexibility and—in the industrial sector—has effectively stalled restructuring.[2] High costs of layoffs are also a disincentive to new hiring, especially of older workers losing their jobs in restructurings. There are also sizeable impediments to labor supply implied by an unemployment trap as the unemployed stand to lose several social benefits if they accept employment. The recent more-than-doubling of the minimum wage (compared to the previous "minimum price of labor") aggravated this problem by depressing demand for low-skilled workers, further marginalizing this vulnerable group. There are strong political pressures to further tighten employment protection and to limit the application of fixed term contracts, e.g., in a draft revision of the labor law.

16. **The staff argued for employment friendly reform**. The contrasting experiences of the tourism and heavy industry sectors offered salient lessons: the former, in which liberalized foreign employment is essential, was nimble in adjusting to the global recession and registered growth throughout the crisis, whereas the latter is struggling despite global buoyant commodity demand. Staff saw significant scope for raising both labor supply and demand.

- **Labor demand** could be boosted by raising flexibility with a view toward creating and sustaining jobs; for example, the authorities could engage the social partners in order to provide scope for the introduction of temporary opt-out clauses from collective bargaining agreements to allow for emergency restructuring, or to boost the nascent tradable-oriented private sector. Similarly, the recent doubling of the minimum wage should be revisited and excessive employment protection be reduced. Moreover, public sector wage restraint and pension reforms, in addition to their importance for fiscal consolidation, should be used to lead tight economy-wide incomes policies.

- **Labor supply** could commensurately rise if the very high marginal effective taxation of the unemployed was cut. One option is the incorporation of negative income-taxation elements, e.g., an Earned Income Tax Credit (EITC) (Annex II). This

[2] The recent severance package at the aluminium plant amounted up to €20,000, about 2.3 annual wages and more than 400 percent of per capita GDP.

scheme would also provide an incentive for formal employment (as only incomes earned in the formal sector would be benefitting from a cash payment), thereby reducing its costs. The authorities expressed an interest to study the issue and were also looking at targeted active labor market measures to lower skill mismatches.

17. **The business environment needs to be further improved**. The authorities are focusing on upgrading technical and administrative skills of government agencies that provide business services, and streamlining construction licensing by municipalities. Staff welcomed these efforts that targeted key weaknesses documented in surveys, and also noted that improved economic statistics are essential to bolster investment and policy making.

D. Banking and Financial Sector

18. **Redressing solvency issues and improving liquidity were jointly seen as priority tasks**. Confidence is returning, as evidenced by increasing deposits, though they are still below their levels in the third quarter of 2007. However, NPLs have not leveled off and Financial Soundness Indicators have continued to deteriorate (Table 5 and Box 2). There was agreement that the next steps must focus on fully restoring soundness across the system in order to allow for renewed lending growth when credit demand for quality projects returns. Stagnant lending at the current juncture, however, primarily reflected the dearth of such projects and the staff recommended that the authorities continue to resist calls to force credit growth.

19. **With the recently strengthened legal framework, the central bank is in a position to play the central role in safeguarding financial stability.** Key improvements to financial sector legislation were enacted in 2010, including a new Central Bank Law and laws on banks, bank bankruptcy, and deposit insurance. The authorities considered them in line with international best practice, having benefited from Fund, World Bank and EBRD advice. Staff stressed that, endowed with new powers, the CBM must be uncompromising in redressing any weakness in the system. This called for continued high-frequency and risk-based audits, and fast follow up. Adequate solvency and liquidity buffers should be required. Recent temporary regulatory relaxations should be phased out quickly and be replaced with permanent regulations that are fully in line with best international practice. The authorities agreed and pointed to preparations already underway, including their joint discussions with the World Bank on bank restructuring. Staff welcomed efforts to strengthen regulations related to collateral execution (from corporate and households) as well as the envisaged move to IFRS and urged to properly prepare for it.

20. **Bank owners must promptly address any slippages from regulations, especially capital or liquidity shortfalls.** Throughout the last years, foreign parent banks have remained supportive. Meanwhile the ability of domestic owners was impaired owing to the sudden stop. The staff underscored that with resuming

Parent Bank Support

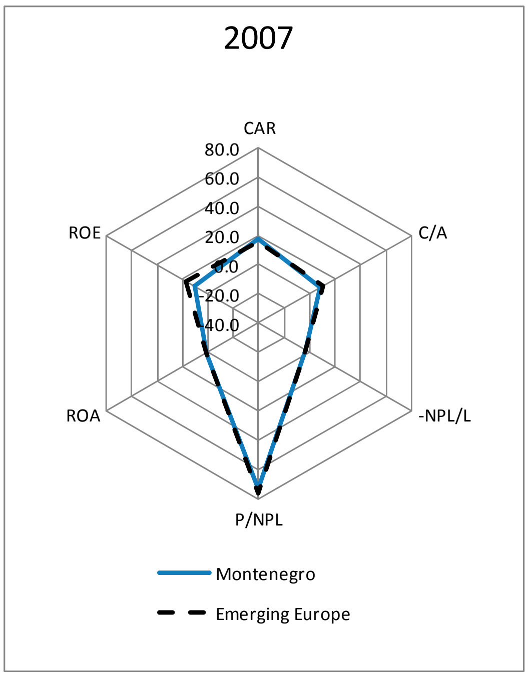
	2008	2009	2010
	(in millions of euro)		
Capital augmentation	24	102	88
Shares	24	45	72
Subordinated debt	0	57	16
Purchase of bad assets	0	111	91
	(in percent of GDP)		
Capital augmentation	0.8	3.4	2.9
Shares	0.8	1.5	2.4
Subordinated debt	0.0	1.9	0.5
Purchase of bad assets	0.0	3.7	3.0

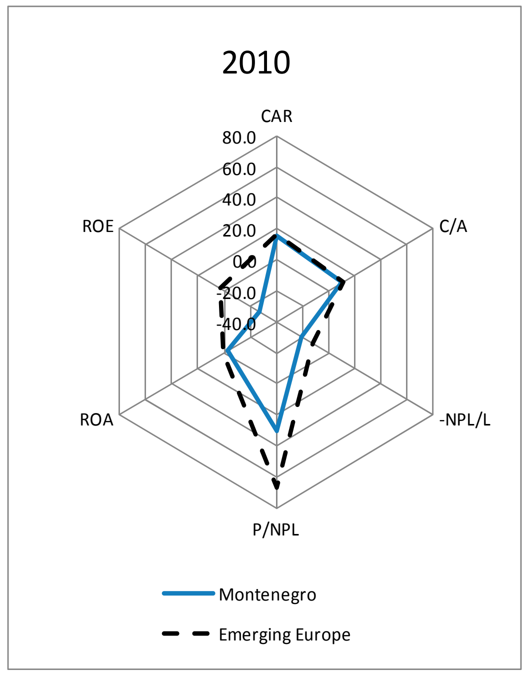
Source: Central Bank of Montenegro

international capital flows, all bank owners should be expected to quickly meet any capital or liquidity calls from now on, or risk immediate and forceful sanctions. The authorities indicated that they were intensively working on a solution for the largest domestic bank that would incorporate these recommendations.

Box 2. Financial Soundness Compared to Other Emerging Europe Countries

The global financial crisis has left the banking system in Montenegro in a worse shape than in emerging Europe in general. At end-2007, before the crises, key Financial Soundness Indicators (FSIs) for Montenegrin banks did not stand out in comparison to the average for other emerging Europe countries, for which FSIs were reported in the Spring 2011 GFSR. However, three years later, in late 2010, the picture is bleaker in Montenegro. While capital to asset ratios have held up, including on account of owners' capital injections, profitability and asset quality indicators have deteriorated much more. Although one must be careful in comparing FSI levels across countries, it is worth noting that the indicators for return on equity and assets, non-performing loans to total loans, and provisions to total loans are the weakest in Montenegro among all of the emerging Europe countries in the GFSR.





All indicators in percent. A larger value for any indicator is better. CAR: Regulatory Capital to Risk-Weighted Assets; C/A: Capital to assets: -NPL/L: the negative of Non-Performing Loans to Total Loans; P/NPL: Provisions to Non-Performing Loans; ROE: Return on Equity; ROA: Return on Assets.

Emerging Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Latvia, Lithuania, Macedonia, FYR, Montenegro, Poland, Romania Serbia Turkey

Source: GFSR.

21. **In any event, reserves need to be rebuilt from low levels**. The empirical results for reserves in a dollarized economy are ambiguous (Box 3). Some dollarized economies have done quite well with relatively few reserves. At the current juncture, the authorities and staff,

Box 3. Liquidity Support in Other Dollarized or Currency Board Countries

In countries where the central bank cannot increase base money supply, the central bank's capacity as a lender of last resort is limited. This is the case in both dollarized economies like Montenegro and Kosovo, but also in countries with a currency board such as Bosnia and Herzegovina, and Bulgaria. Therefore the fiscal authorities have a particularly important financial role in supporting the banking system in times of stress in these countries. The legal and institutional arrangements for this vary. Some countries have more explicit financial arrangements in place, like Bulgaria, while others have tended to rely on temporary measures and legislation.

A key implication is then that the capacity of country to provide liquidity support to solvent or insolvent banks is to a large extent determined by the financial capacity of the government. This is also true for countries with other exchange rate arrangements, but when the central bank is not free to issue new currency, the fiscal position is even more important.

Having said that, even in dollarized settings some liquidity support can still be provided and it is worth looking at some measure of the liquidity support capacity of the CBM compared to central banks in other countries. The most straightforward measure is perhaps to calculate the amount of reserves in relation to deposits in the banking system.

Such a comparison gives a mixed picture, but the CBM's level of reserves are not high (table below). It must be noted that the issuance of a Eurobond in the fall of 2010 significantly boosted reserves in Montenegro. Before the issuance, the level of reserves in relation to deposits had declined significantly in 2010 and was only above the level in Panama. This picture is not altered by looking at net foreign assets instead.

Reserves to Depoists
(in percent)

	Dec. 2009	Aug. 2010	Jan. 2011
Montenegro	22	16	22
El Salvador	32	27	29
Ecuador	23	19	15
Kosovo	33	43	33
Panama 1/	15	12	14

Source: IFS and staff estimates.

1/ Government foreign assets over deposits.

however, saw this model as not well suited for Montenegro; a weakened banking sector and a potentially difficult fiscal financing environment make a higher level of reserves essential. Staff also cautioned that use of the euro placed very tight limits on central bank liquidity support operations, such that redressing banking liquidity and solvency problems could impose large fiscal demands. Aggressive safeguarding of the banking system in line with the authorities' plans is one important requirement to avoid this from happening—including by mandating banks to hold considerably higher capital and liquidity buffers than international norms. But staff argued that the accumulation of fiscal reserves via fiscal consolidation will also be essential to provide an additional backstop for confidence in the system.

E. Fiscal Policy

22. **The budget is the key near-and medium-term policy tool**. In the fully euroized economy, fiscal policy is the only stabilization tool, is critical to backstop banking problems, and has a role to play in boosting the economy's attractiveness to investment. At the current juncture all these objectives call for consolidation. Given the highly open economy, the fiscal multiplier is unlikely to be large in any event; moreover, credible deficit cuts could well improve investor confidence and result in renewed access to cheaper capital.

23. **Fiscal consolidation has commenced, and the authorities' budget targets for 2011 and the medium term are appropriate**. Reflecting mainly significant capital expenditure cuts, the 2010 fiscal deficit is estimated to have declined by 1½ percent of GDP to 3.9 percent (Table 6), though loan guarantees of 3.6 percent were extended to industrial companies. Going forward, the authorities aim at balancing the budget in 2012 and achieving a sizeable surplus thereafter in order to bolster sustainability, lower financing risk, and boost the economy's resilience to shocks. They also envisage a tight-fisted approach to loan guarantees. Staff endorsed these targets, noting that if they were carried over the medium term, public debt could fall below 20 percent of GDP by 2016, boosting growth prospects and building buffers.

Normative Fiscal Adjustment Path
(in percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016
	Act.	Prel.	Budget	Authorities' m.-term targets			Staff proj. 1/	
Overall Balance	-5.3	-3.9	-2.4	0.0	1.7	2.6	2.6	2.6
Primary balance	-4.4	-2.8	-0.9	1.7	3.5	4.4	4.1	3.8
Stock of public debt	40.7	44.1	44.0	39.8	34.4	28.6	23.1	18.6

Source: Ministry of Finance; and Fund staff estimates and projections.
1/ Based on authorities' medium-term targets.

24. **Staff recommended adding robustness to the strategy**, observing that the targets are predicated on keeping the nominal wage bill constant and effecting further cuts in goods and services spending. Against the background of recently rising arrears, staff cautioned that these goals may be overly ambitious on the basis of existing policies. In all, some 1 and 2½ percent of GDP in 2011 and 2012, respectively, in additional measures would likely be required to safeguard adherence to the fiscal targets. The authorities indicated that they would not hesitate to undertake further measures should achievement of their targets be at risk. The subsequent discussions focused on high-quality measures, also with a view to securing significant surpluses after 2012.

Additional Fiscal Measures Needed

	2011	2012
	(in percent of GDP)	
Baseline projection		
Revenues and grants	42.3	42.3
Expenditures and net lendings	45.7	44.8
Overall balance	-3.4	-2.5
Balance target of authorities	-2.4	0
Additional fiscal measures needed		
Under baseline scenario	1.0	2.4
With additional measures implemented in 2011	…	1.4

Source: Country authorities, and IMF staff estimates and projections.

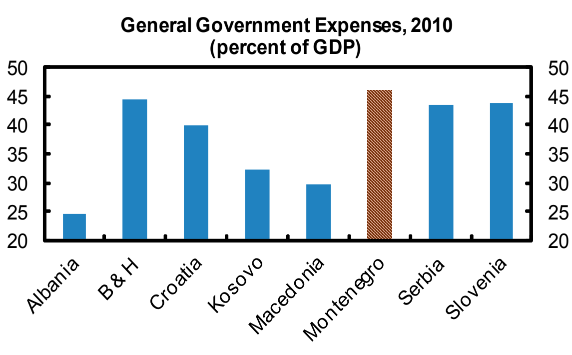
- **Staff saw scope to boost revenue collections in a growth-friendly way**. Property is rather lightly taxed by international comparison, and collections could be boosted by a combination of higher rates, better valuation, and an improved cadastre. Small increases in income- and VAT tax rates could result in significant additional revenue, while still leaving intact Montenegro's regionally favorable taxation regime. Moreover, flanking such increases by reducing poverty traps—for example by introducing an EITC—would provide an important boost for formal employment and tax collection. The authorities stressed that they considered a tax system with a broad base and low flat rates to be an essential comparative advantage. Within this broad principle, they were looking for further base-broadening and tax efficiency improvements and strengthened revenue administration.

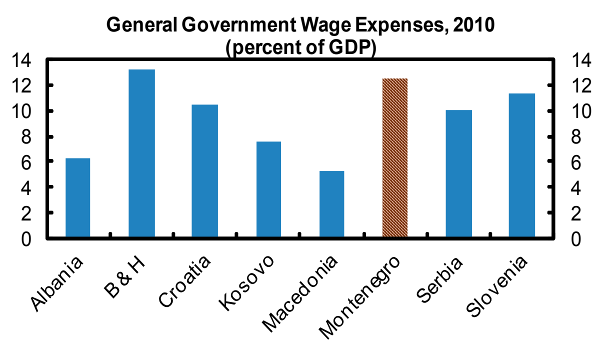
	Personal income tax 1/	Corporate income tax 1/	Value added tax 1/, 2/
		(Tax rates in percent)	
Albania	10	10	20
Bosnia & Herzegovina	9, 10	10	17
Croatia	12, 25, 40	20	23 (10)
Kosovo, Republic of	0-10	10	16
Macedonia, FYR	10	10	18 (5)
Montenegro	9	9	17 (7)
Serbia, Republic of	10, 12, 15	10	18 (8)
Slovenia	16, 27, 41	20	20 (8.5)

Source: Country authorities.

1/ As of 2010.

2/ In parenthses are reduced rates.





Sources: Country statistical yearbooks; World Economic Outlook (WEO); and IMF staff estimates.

- **Expenditure was jointly seen as an area where efficiency savings were possible**. Elevated public expenditure ratios (especially for current spending) are typical for ex-Yugoslav countries; Montenegro's ratios are comparatively high even for this group.

  - There was agreement that the most durable and effective way to bring down the share of public expenditure in GDP is to cut government employment. The large wage bill constitutes a priority in the authorities' consolidation strategy. In order to avoid excessive reliance on wage cuts, which have adverse effects on morale, the government has initiated the process with the requirement that for every new hiring, at least two positions need to be cut. Staff recommended a less decentralized approach to cuts, built around an overall vision of the civil service.

- The recent pension reform marked important progress in improving the long-term sustainability of public finances but staff noted the long implementation period (Box 4). Accelerating the introduction of increased retirement ages and/or reducing the indexation to wages, as well as tightening eligibility criteria, could be considered to make further savings without adverse social implications. In the longer term, a comprehensive reform that establishes a strong link between contributions and benefits could further reduce the tax wedge, as contributions become more like savings rather than taxes.

- The need for direct budget support to private companies has waned. While inconsistent with their past reforms that were predicated on the primacy of the private sector in allocating resources, the authorities noted that such support was inevitable in a severe crisis. Staff suggested that a new reform push, including more flexible labor regulations and boosting banks' resilience are a better way to enable entrepreneurs to restructure.

- Proper control of potential expenditure arrears is essential. The staff stressed that such arrears need to be closely monitored, especially at the municipal level. The authorities' recent transparent high-frequency publication of fiscal statistics, adoption of a single treasury account, and mandatory commitment reporting were welcome.

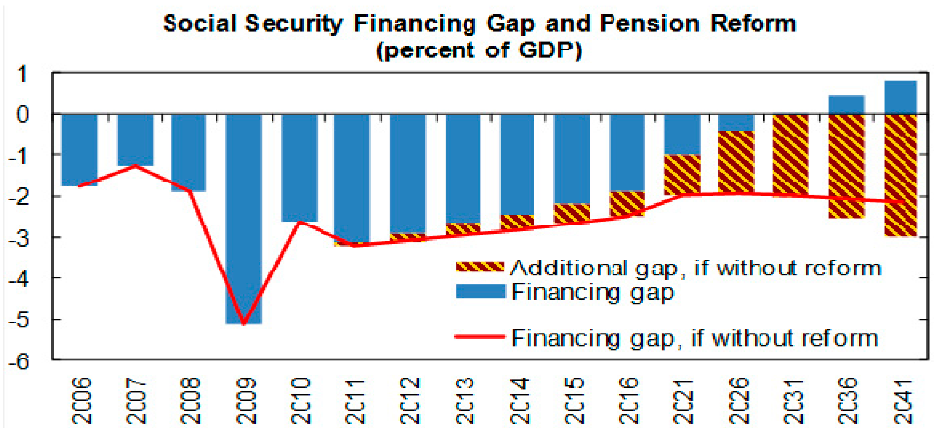
- Capital spending is unlikely to be a further source of savings in the near term. After having borne the brunt of the recent consolidation, staff and authorities agreed that spending should be sufficient to cover key infrastructure needs that are critical to Montenegro's attractiveness to tourists and business. To the extent possible, the authorities emphasized their desire to involve private sector financing via PPPs or concessions, but considered the current environment to be challenging.

25. **Budget financing going forward entails risks.** Eurobond proceeds have met a large part of the 2011 budget financing requirement. Notwithstanding the repeated successful market access in a difficult regional environment, staff cautioned that the uptake of market debt was fast (13 percent of GDP over two years) further underscoring the need for fiscal adjustment in order to secure future market access and repayment capacity. Given the high opportunity cost of budget financing, every effort should be made to place public funds safely, while achieving reasonable returns. With the crisis having passed, staff stressed that

Box 4. Pension Reform

The social security financing gap is one of the biggest fiscal challenges. The financing gap widened sharply from 1.3 percent of GDP in 2007 to 5.1 percent in 2009, to a large extent due to rapid pension benefit increases resulting from court-mandated increases. While adjustments to the compulsory contribution requirement in 2010 reduced the gap to an estimated 2.6 percent of GDP, it still accounted for nearly 70 percent of the overall fiscal deficit in the year. In addition, the need to finance high transfers through contributions largely explains the high tax wedge.

The recent pension reform marked important progress in improving the sustainability of public finances. It included three measures: (i) increase in the retirement age for both men, from 65, and women, from 60, to 67 (the new retirement age for men will be fully implemented in 2025, and for women in 2041); (ii) re-indexation of pension benefits to 75 percent of living cost index and 25 percent of general wage level, compared with 50–50 percent previously; and (iii) reduction in the frequency of pension benefit index calculation, from biannually to once a year.



Sources: Country authorities, and IMF staff estimates and projections.

the placement of public sector funds should now be exclusively governed by prudent financial management principles, rather than with an eye to support banks. The Fund also stood ready to help if needed.

III. Staff Appraisal

26. **Growth is resuming and the recovery is projected to gain momentum.** The recovery is being supported by high world prices and demand for Montenegro's industrial exports, new tourism projects, and increased confidence in the financial system. Accordingly, real GDP is projected to grow some 2 percent in 2011 after an estimated 1.1 percent in 2010, while inflation is expected to remain below the level of that in trading partners.

27. **Substantial risks still linger**. Near-term risks reflect an unfinished reform agenda: poor labor relations and persistent financial problems could yet prevent industry from profiting from the global demand boom; the repair of the banking system is not yet completed; and, notwithstanding recent welcome budget consolidation, fiscal buffers remain depleted. In addition the external environment harbors large risks.

28. **Policies must aim to advance external adjustment in order to make future growth sustainable.** Montenegro's experience demonstrates the crucial importance of persevering with reform, strengthening resilience and building policy buffers. The still very large current account deficit requires improved cost competitiveness and a significant increase in domestic savings. Luckily, Montenegro's large potential can be tapped, such that external rebalancing need not sacrifice growth.

29. **Investment holds the key to economic growth and job creation**. Foreign investment is particularly important. It must be leveraged by improved domestic flexibility and cost competitiveness in order to avoid renewed overheating pressures and to spark off domestic investment, notably in labor-intensive SMEs. The business environment needs to be further improved.

30. **The labor market should be invigorated**. Demands to restrict the flexibility and availability of fixed term contracts must be resisted. The authorities should engage social partners to facilitate the use of opt-out clauses from collective bargaining arrangements. Poverty and unemployment traps need to be addressed and employment protection and severance packages have to become affordable.

31. **Completing the repair of the banking system is the key near-term priority.** Thanks to the authorities' timely actions and the extension of support by parent banks, confidence has begun to return. The next steps should focus on fully restoring soundness across the system in order to allow for renewed lending growth once credit demand for quality projects returns. Adequate solvency and liquidity buffers should be required and recent temporary regulatory relaxations be phased out quickly. The envisaged move to IFRS—properly prepared—is welcome. Owners must promptly address any slippages from regulations, especially capital or liquidity shortfalls or face immediate and forceful central bank intervention in line with the recently strengthened legislation.

32. **Use of the euro requires greater buffers**. Central bank liquidity support operations are severely constrained in the euroized monetary framework, and banking liquidity and solvency problems could thereby easily impose large fiscal demands. Aggressive safeguarding of the banking system, including by mandating higher-than-Basel capital and liquidity buffers is one requirement to avoid this happening, while the accumulation of fiscal reserves is an essential backstop for confidence.

33. **The required fiscal consolidation has commenced, and the authorities' budget targets for 2011 and the medium term are appropriate**. The authorities appropriately aim to balance the budget by 2012 and to achieve a sizeable surplus thereafter. This target will bolster sustainability, lower financing risk, and boost the economy's resilience to unforeseen shocks. In the near term, some 1 and 2½ percent of GDP in 2011 and 2012 in additional high quality measures should be implemented to secure these targets.

34. **There is scope to boost revenue in a growth-friendly way**. Property is rather lightly taxed, and collections could be raised by a combination of higher rates, better valuation, and

an improved cadastre. Small increases in income tax and VAT rates would result in significant additional revenue, while still leaving intact Montenegro's regionally favorable taxation regime. Moreover, flanking rate increases by reducing poverty traps—e.g., by introducing an Earned Income Tax Credit—would provide an important boost for formal employment and tax collection.

35. **Expenditure should be contained in a durable fashion**. Cuts in government employment and tight wage policy are essential to lower the large wage bill. The recent pension reform marked important progress in improving the long-term sustainability of public finances. Accelerating the introduction of increased retirement ages and/or reducing the indexation to wages, as well as tightening eligibility criteria, should be considered to bring its beneficial effects forward. Tight public sector wages and pensions will also help anchor incomes policies to boost external cost competitiveness. Direct budget support to private companies should be eschewed. Close monitoring of potential expenditure arrears is imperative, especially at the municipal level.

36. **Given the high opportunity cost of budget financing, every effort should be made to place public funds safely, while achieving reasonable returns**. With the crisis having passed, the placement of public sector funds should now be exclusively governed by prudent financial management principles, rather than with an eye to support banks. Freeing currently parked deposits can also help reduce the costs and risks involved in tapping capital market.

37. **Further progress on improving the statistical base is essential**. The transparent high-frequency publication of fiscal statistics, adoption of a single treasury account and mandatory commitment reporting are welcome. However, weaknesses in economic statistics continue to hamper economic analysis and policy making. Priority areas for improvement include national accounts, external sector and labor market statistics.

38. It is expected that the next Article IV Consultation will take place based on the standard twelve-month cycle.

Table 1. Montenegro: Selected Economic Indicators, 2007–16
(Under current policies)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.	Projections					
Real economy 1/										
Nominal GDP (millions of €)	2,680	3,086	2,981	3,023	3,111	3,259	3,427	3,610	3,822	4,047
Gross national saving (percent of GDP)	-5.7	-10.0	-3.1	-3.6	-2.5	0.4	3.8	7.3	10.7	14.1
Gross investment (percent of GDP)	32.3	38.2	26.8	22.0	22.0	22.5	23.0	23.0	23.0	23.0
	(Annual percentage change)									
Real GDP	10.7	6.9	-5.7	1.1	2.0	3.5	3.7	3.7	3.8	3.8
Industrial production	0.1	-2.1	-32.2	15.0	...	...	...	...	...	...
Tourism										
Arrivals	18.8	4.8	1.6	6.0	...	...	...	...	...	...
Nights	22.9	6.9	-3.1	5.0	...	...	...	...	...	...
Consumer prices (period average) 2/	4.2	8.5	3.4	0.5	3.1	2.0	1.8	2.0	2.0	2.0
Consumer prices (end of period) 2/	7.7	7.2	1.5	0.7	3.0	1.8	1.8	2.0	2.0	2.0
GDP deflator	12.7	7.7	2.4	0.3	0.9	1.2	1.4	1.6	2.0	2.0
Average net wage (12-month) 3/	19.9	23.4	11.3	-1.8	...	...	...	...	...	...
Money and credit (end of period, 12-month)										
Bank credit to private sector	175.9	24.7	-15.1	-8.9	4.0	...	...	...	...	...
Enterprises	191.0	20.9	-15.4	-15.0	...	...	...	...	...	...
Households	153.7	32.0	-10.9	-7.0	...	...	...	...	...	...
Private sector deposits	76.0	-14.2	-4.1	6.0	6.0	...	...	...	...	...
General government finances (cash) 4/	(In percent of GDP)									
Revenue and grants	47.7	48.3	42.4	42.2	42.3	42.3	42.2	42.1	42.1	42.0
Expenditure (incl. discrepancy)	40.9	48.6	47.7	46.0	45.7	44.8	44.2	43.9	43.6	43.2
Overall balance	6.7	-0.3	-5.3	-3.9	-3.4	-2.5	-2.0	-1.8	-1.6	-1.3
Primary balance	7.8	0.5	-4.4	-2.8	-1.8	-0.8	-0.1	0.4	0.8	1.2
Privatization receipts	4.0	1.2	4.4	0.8	0.7	0.7	0.6	0.6	0.6	0.5
General government gross debt (end of period, stock)	27.5	31.9	40.7	44.1	44.0	42.3	40.5	38.7	36.8	35.4
Balance of payments 1/										
Current account balance, excl. grants	-39.6	-50.9	-30.4	-26.2	-25.4	-23.0	-20.1	-16.6	-13.2	-9.8
Foreign direct investments	20.8	17.9	30.8	17.9	15.4	14.4	13.4	11.9	10.9	9.4
External debt (end of period, stock)	…	…	93.3	98.9	99.3	97.8	94.3	89.3	82.5	73.8
Of which: Private sector 5/	…	…	69.9	68.7	65.7	62.3	58.7	54.6	49.1	41.2
REER (CPI-based; annual average change, in percent)										
(- indicates depreciation)	-2.3	1.5	5.9	0.2	…	…	…	…	…	…
Memorandum:										
Aluminum price (€ per tonne)	1,926	1,752	1,198	1,583	1,655	1,779	1,868	1,957	1,967	1,967

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

1/ In 2007, there is a break in the national accounts and balance of payments data, stemming mainly from the revision of exports and imports.
2/ Cost of living index for 2006-2008.
3/ 2007-2009 wage data have been adjusted to reflect a change in the methodology by Monstat starting January 1, 2010.
4/ Includes extra-budgetary funds and, from 2006, local governments, but not public enterprises.
5/ Estimates, as private debt statistics are not officially published.

Table 2. Montenegro: Macroeconomic Framework, 2007–16

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

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.	Projections					
					(Percent change)					
Real GDP	10.7	6.9	-5.7	1.1	2.0	3.5	3.7	3.7	3.8	3.8
Consumer prices (end-period)	7.7	7.2	1.5	0.7	3.0	1.8	1.8	2.0	2.0	2.0
					(In percent of GDP)					
Gross domestic savings	-8.5	-13.8	-6.2	-6.7	-4.7	-2.0	1.3	4.1	7.2	10.6
Non-government	-22.1	-23.5	-8.9	-8.2	-6.5	-4.6	-1.9	0.8	3.7	6.7
Government	13.6	9.7	2.7	1.5	1.8	2.6	3.1	3.4	3.6	3.9
Gross domestic investment	32.3	38.2	26.8	22.0	22.0	22.5	23.0	23.0	23.0	23.0
Non-government	25.4	28.2	18.3	16.6	16.8	17.3	17.8	17.8	17.8	17.8
Government	7.0	10.1	8.4	5.4	5.2	5.2	5.2	5.2	5.2	5.2
Net factor receipts and transfers from abroad	2.8	3.9	3.0	3.1	2.3	2.4	2.6	3.2	3.4	3.5
Non-government	2.7	3.7	2.7	3.0	2.2	2.3	2.5	3.1	3.4	3.4
Government	0.1	0.1	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Gross national savings	-5.7	-10.0	-3.1	-3.6	-2.5	0.4	3.8	7.3	10.7	14.1
Non-government	-19.5	-19.8	-6.3	-5.2	-4.3	-2.3	0.6	3.9	7.0	10.1
Government	13.7	9.8	3.1	1.5	1.8	2.7	3.2	3.4	3.6	3.9
Non-government national savings minus investment	-44.8	-48.0	-24.6	-21.8	-21.1	-19.6	-17.2	-13.9	-10.8	-7.7
Savings - investment balance	-39.5	-50.6	-30.3	-25.6	-24.5	-22.1	-19.2	-15.7	-12.3	-8.9
Non-government	-46.3	-50.4	-25.0	-21.8	-21.1	-19.6	-17.2	-13.9	-10.8	-7.7
Government	6.7	-0.3	-5.3	-3.9	-3.4	-2.5	-2.0	-1.8	-1.6	-1.3
General government finances										
Revenues and grants	47.7	48.3	42.4	42.2	42.3	42.3	42.2	42.1	42.1	42.0
Expenditures	40.9	48.6	47.7	46.0	45.7	44.8	44.2	43.9	43.6	43.2
Current	33.9	38.5	39.2	40.6	40.5	39.6	39.0	38.7	38.4	38.1
Capital	7.0	10.1	8.4	5.4	5.2	5.2	5.2	5.2	5.2	5.2
Overall balance	6.7	-0.3	-5.3	-3.9	-3.4	-2.5	-2.0	-1.8	-1.6	-1.3
Public debt (gross)	27.5	31.9	40.7	44.1	44.0	42.3	40.5	38.7	36.8	35.4
Current account	-39.5	-50.6	-30.3	-25.6	-24.5	-22.1	-19.2	-15.7	-12.3	-8.9
Foreign direct investment (net)	20.8	17.9	30.8	17.9	15.4	14.4	13.4	11.9	10.9	9.4
External debt (estimate)	…	…	93.3	98.9	99.3	97.8	94.3	89.3	82.5	73.8
Memorandum items:										
Net export of goods and services	-42.3	-54.5	-33.3	-28.7	-26.7	-24.5	-21.7	-18.9	-15.8	-12.4
Nominal GDP (millions of €)	2,680	3,086	2,981	3,023	3,111	3,259	3,427	3,610	3,822	4,047

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

Table 3. Montenegro: Summary of Accounts of the Financial System, 2007–2011
(Millions of euros)

	2007	2008	2009	2010	2011
					Proj.
			I. Central Bank		
Net foreign assets	445	290	347	362	322
Assets	468	313	397	416	377
Liabilities	22	23	51	54	54
Net domestic assets	-395	-227	-285	-297	-257
Net credit to the nonfinancial public sector	-98	-11	-96	-71	-65
Of which: general government	-98	-11	-96	-71	-65
Net credit to the banking system	-342	-262	-238	-276	-241
Required reserves	-259	-217	-134	-134	-142
Giro account	-84	-46	-104	-142	-100
Claims on depository institutions	0	1	1	1	1
Other assets net	45	47	48	49	49
Deposits included in broad money	6	12	13	19	19
Equity	44	51	48	46	46
			II. Banking system		
Net foreign assets	-457	-1,007	-712	-533	-552
Assets	342	250	328	399	371
Liabilities	799	1,257	1,039	932	923
Net domestic assets	2,315	2,738	2,446	2,331	2,429
Net assets held in the central bank	342	262	238	276	242
Net credit to nonfinancial public sector	-220	-265	-115	-67	-19
Of which: general government	-195	-238	-92	-69	-21
Credit to the private sector	2,151	2,683	2,279	2,075	2,158
Other domestic assets	42	59	45	48	48
Liabilities	1,856	1,729	1,732	1,796	1,877
Private sector deposits	1,546	1,326	1,271	1,348	1,429
Other items, net	310	403	461	448	448
o/w capital	237	279	332	313	313
			III. Consolidated system		
Net foreign assets	-11	-718	-365	-171	-230
Net domestic assets	1,920	2,512	2,161	2,034	2,171
Net credit to the nonfinancial public sector	-318	-276	-212	-138	-84
Of which: general government	-293	-249	-189	-140	-86
Credit to the private sector	2,151	2,683	2,279	2,075	2,158
Other net domestic assets	87	105	94	97	97
Liabilities	1,862	1,741	1,745	1,815	1,896
Equity capital of the central bank	44	51	48	46	46
			Ratios		
Reserves ratio	22.1	19.7	18.7	20.5	17.0
Effective required reserves ratio	16.8	16.3	10.6	10.0	10.0
Credit to private sector / GDP	80.2	86.9	76.4	68.6	69.4
Banks' capital / credit to private sector	11.0	10.4	14.6	15.1	14.5
CBCG reserves / bank deposits	30.3	23.6	31.3	30.9	26.4
Banks' foreign liabilities / lending	37.1	46.9	45.6	44.9	42.8

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

Table 4. Montenegro: Balance of payments, 2007-16
(Under current policies)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.			Projections			
					(Millions of euros)					
Current account balance	-1,078	-1,584	-896	-775	-761	-721	-657	-566	-472	-362
Trade balance	-1,607	-2,102	-1,372	-1,315	-1,335	-1,358	-1,384	-1,410	-1,431	-1,441
Exports	483	450	296	357	418	465	501	539	586	634
Imports	-2,091	-2,552	-1,668	-1,671	-1,752	-1,823	-1,885	-1,949	-2,017	-2,076
Services account	439	399	385	446	503	559	639	729	828	938
Receipts	673	751	680	747	807	881	972	1,071	1,181	1,302
Expenditures	-234	-351	-296	-301	-304	-323	-332	-342	-353	-363
Income account	31	46	5	-21	-59	-62	-62	-59	-53	-43
Compensation of employees, net	75	137	150	150	150	155	161	167	172	177
Investment income, net	-43	-91	-144	-171	-209	-216	-223	-226	-226	-221
Current transfers, net	59	73	85	114	130	140	150	174	184	184
Government, net	2	9	5	16	30	30	30	34	34	34
Other sectors, net	57	64	80	98	100	110	120	140	150	150
Capital and financial account	1,440	1,435	850	649	580	568	507	421	350	216
Capital account	-1	0	2	-1	0	0	0	0	0	0
Financial account	1,441	1,435	848	650	580	568	507	421	350	216
Foreign direct investment, net	568	582	1,066	542	480	471	461	431	418	382
Portfolio investment, net	5	-16	-42	8	5	5	10	10	20	30
Other investments, net 1/	868	869	-177	100	95	92	36	-20	-88	-196
General government	-61	-7	141	189	128	111	66	29	22	42
Commercial banks	416	550	-303	-176	19	52	32	75	104	57
Other sectors 1/	513	325	-15	87	-53	-70	-61	-125	-214	-295
Errors and omissions 1/	-211	-6	131	142	142	142	142	142	142	142
Change in official reserves (- denotes increase)	-151	155	-85	-17	40	11	8	4	-20	4
Memorandum items					(Percent of GDP)					
Current account balance	-40.2	-51.3	-30.1	-25.6	-24.5	-22.1	-19.2	-15.7	-12.3	-8.9
Trade balance	-60.0	-68.1	-46.0	-43.5	-42.9	-41.7	-40.4	-39.1	-37.4	-35.6
Exports	18.0	14.6	9.9	11.8	13.4	14.3	14.6	14.9	15.3	15.7
Imports	-78.0	-82.7	-56.0	-55.3	-56.3	-55.9	-55.0	-54.0	-52.8	-51.3
Services account	16.4	12.9	12.9	14.8	16.2	17.1	18.7	20.2	21.7	23.2
Receipts	25.1	24.3	22.8	24.7	25.9	27.0	28.4	29.7	30.9	32.2
Payments	-8.7	-11.4	-9.9	-9.9	-9.8	-9.9	-9.7	-9.5	-9.2	-9.0
Income account	1.2	1.5	0.2	-0.7	-1.9	-1.9	-1.8	-1.6	-1.4	-1.1
Current transfers, net	2.2	2.4	2.9	3.8	4.2	4.3	4.4	4.8	4.8	4.6
Foreign direct investment, net	21.2	18.9	35.8	17.9	15.4	14.4	13.4	11.9	10.9	9.4
Portfolio investment, net	0.2	-0.5	-1.4	0.3	0.2	0.2	0.3	0.3	0.5	0.7
Other investment, net 1/	32.4	28.2	-5.9	3.3	3.0	2.8	1.1	-0.6	-2.3	-4.8
Gross external debt 2/	…	…	93.3	98.9	99.3	97.8	94.3	89.3	82.5	73.8

Sources: Central Bank of Montenegro; and IMF staff estimates.
1/ Currency and deposits held by Other sectors were reclassified from Other investment to Errors and omissions.
2/ This includes only estimates of private external debt as private debt statistics are not officially published.

Table 5. Montenegro: Financial Soundness Indicators of the Banking Sector, 2007–10

	2007	2008	2009	2010			
	Dec.	Dec.	Dec.	Mar.	Jun.	Sept.	Dec.
Capital adequacy							
Regulatory capital as percent of risk-weighted assets	17.1	15.0	15.7	14.3	16.5	14.6	15.9
Capital as percent of assets	8.0	8.4	11.0	10.4	11.4	10.2	10.6
Asset composition and quality							
Distribution of bank credit by borrower							
Central government, local government, government agencies	1.4	1.0	1.3	2.2	2.6	2.0	2.1
Funds	0.6	0.4	1.2	1.1	0.4	0.5	0.1
State-owned companies	1.0	1.0	1.9	1.9	2.0	2.5	2.7
Private companies, entrepreneurs	60.6	59.2	56.4	56.1	56.8	55.9	54.8
Banks	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Financial Institutions	0.9	0.8	0.3	0.5	0.3	0.3	0.4
Citizens	34.5	35.8	36.6	34.7	36.1	36.4	37.1
Credit cards	0.9	1.3	1.7	1.8	1.8	1.8	2.2
Other	0.0	0.4	0.6	1.8	0.0	0.6	0.6
Distribution of bank credit by sectoral economic activity							
Agriculture, hunting, fishing	1.0	0.6	0.3	0.5	0.3	0.4	0.4
Mining and energy	1.0	1.6	2.2	2.3	2.2	2.4	2.5
Civil engineering	9.0	7.2	7.8	7.8	8.2	8.8	8.1
Trade	26.1	22.6	22.8	21.3	21.9	22.7	22.9
Services, tourism	8.6	7.7	7.5	9.4	7.9	7.8	7.4
Transport, warehousing, communications	3.6	3.1	2.6	2.5	3.0	3.0	3.0
Finance	2.8	2.5	2.4	2.5	1.8	2.0	1.7
Real estate trading	3.6	4.2	4.4	3.8	3.6	2.9	3.0
Administration, other public services	2.9	2.0	2.6	2.4	2.6	2.9	3.1
Consumer loans	35.1	36.4	38.3	38.2	37.9	38.2	39.3
Other	6.3	12.1	9.1	9.3	10.7	8.8	9.0
Asset quality							
Non-performing loans (NPL), in percent of gross loans	3.2	7.2	13.5	14.9	16.8	17.6	21.0
Provisions, in percent of NPL	73.6	55.6	46.3	45.7	44.9	44.9	30.7
Provisions, in percent of total loans	2.3	4.0	6.3	6.8	7.5	7.9	6.4
NPL net of provisions, in percent of capital	7.9	32.0	52.5	62.5	63.4	74.0	102.8
Earnings and profitability							
Gross profits, in percent of average assets (ROAA)	0.8	-0.6	-0.6	-3.4	-3.2	-4.2	-2.7
Gross profits, in percent of average equity capital (ROAE)	10.5	-6.6	-6.9	-34.4	-31.6	40.9	-27.0
Net profits, in percent of average assets (ROAA)	0.7	-0.6	-0.7	-3.5	-3.2	-4.2	-2.8
Net profits, in percent of average capital (ROAE)	6.2	-6.9	-7.8	-34.4	-31.6	-41.1	-27.3
Net interest margin 1/	3.0	3.8	4.9	1.1	2.4	3.7	4.9
Gross income, in percent of average assets	7.0	5.1	5.3	5.2	5.3	5.6	5.4
Net interest income, in percent of gross income	55.4	67.7	74.2	69.5	71.9	71.9	71.6
Non-interest income, in percent of gross income	44.6	32.3	25.8	30.5	28.1	28.1	28.4
Net fee income, in percent of net interest income	57.1	43.3	27.2	28.6	29.4	30.3	30.3
Trading income, in percent of gross income	12.9	3.0	5.7	10.6	7.0	6.3	6.7
Aggregate overhead expenses, in percent of gross income	57.3	61.4	62.3	62.3	64.0	62.0	64.0
Liquidity							
Liquid assets, in percent of total assets	18.1	11.2	15.3	13.5	16.6	17.1	19.1
Liquid assets, in percent of short-term liabilities	32.0	20.9	25.8	22.8	28.3	28.9	32.9
Deposits, in percent of assets	70.3	60.1	60.3	60.6	60.6	61.3	60.8
Loans, in percent of deposits	107.4	140.5	131.4	133.3	129.1	126.9	122.9
Sensitivity to market risk							
Original maturity of assets (in percent of total)							
Less than 3 months	31.1	24.7	30.4	28.9	31.1	31.3	34.4
3 months to 1 year	20.4	23.6	20.5	22.8	19.5	20.1	17.2
1 to 5 years	34.0	35.0	33.9	34.0	34.7	33.8	33.6
Over 5 years	14.6	16.8	15.3	14.3	14.7	14.8	14.8
Original maturity of liabilities (in percent of total)							
Less than 3 months	35.0	32.2	34.7	39.7	37.0	38.7	38.5
3 months to 1 year	27.3	27.2	32.4	27.3	30.2	27.7	27.1
1 to 5 years	28.7	31.7	23.5	22.9	23.9	24.5	24.4
Over 5 years	9.1	8.8	9.4	10.0	9.0	9.1	10.0

Source: Central Bank of Montenegro.

1/ Net interest income in percent of interest bearing assets

Table 6. Montenegro: Consolidated General Government Fiscal Operations, 2009-2016 1/

(in percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016
		Prel.	Projections					
Total revenues and grants	42.4	42.2	42.3	42.3	42.2	42.1	42.1	42.0
Total revenues	42.0	42.1	42.2	42.2	42.1	42.1	42.0	41.9
Current revenues	41.7	41.8	41.9	41.9	41.8	41.8	41.7	41.6
Taxes	26.7	25.0	25.6	25.6	25.5	25.5	25.5	25.4
Personal income tax	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Corporate income tax	1.8	0.7	1.1	1.1	1.1	1.1	1.1	1.1
Taxes on turnover of real estate right	0.7	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Value added tax	12.4	12.0	12.2	12.2	12.2	12.2	12.2	12.2
Excises	4.3	4.4	4.7	4.7	4.7	4.7	4.7	4.7
Taxes on international trade	1.6	1.7	1.7	1.7	1.7	1.7	1.6	1.6
Local government taxes	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Other taxes	0.3	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	8.8	11.4	10.9	10.9	10.9	10.9	10.9	10.9
Nontax revenues	6.2	5.4	5.5	5.4	5.4	5.4	5.3	5.3
Duties	1.0	0.9	1.0	0.9	0.9	0.9	0.9	0.8
Fees	3.5	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Other revenues	1.7	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Capital revenues	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Grants	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditures and net lending	47.7	46.0	45.7	44.8	44.2	43.9	43.6	43.2
Total expenditures	48.9	46.0	45.7	44.9	44.3	44.0	43.7	43.3
Current expenditures	21.3	21.2	21.7	21.4	21.4	21.5	21.6	21.7
Gross salaries	10.8	11.7	11.5	11.5	11.5	11.5	11.6	11.6
Other personal income	0.9	0.8	1.0	1.0	1.0	1.0	1.0	1.0
Goods and services	5.4	5.8	5.8	5.8	5.8	5.8	5.8	5.8
Interest payments	0.9	1.0	1.6	1.7	1.9	2.2	2.4	2.4
Rent	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Subsidies to enterprises	1.7	1.3	1.3	0.8	0.6	0.4	0.3	0.3
Other outflows	1.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2
Social security transfers	13.9	14.0	14.0	13.9	13.7	13.5	13.2	12.9
Other transfers	4.9	4.8	4.4	4.0	3.6	3.4	3.2	3.1
Capital expenditures	8.4	5.4	5.2	5.2	5.2	5.2	5.2	5.2
Reserves	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Net lending	-1.2	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
					0.0	0.0	0.0	0.0
Overall Balance	-5.3	-3.9	-3.4	-2.5	-2.0	-1.8	-1.6	-1.3
Financing	6.0	5.8	3.4	2.5	2.0	1.8	1.6	1.3
Domestic financing	-2.5	-0.4	-1.5	-1.6	-0.6	0.3	0.4	-0.4
Banking system	-2.5	2.0	1.7	2.2	0.8	0.8	0.8	0.0
Nonbank	0.1	-2.4	-3.2	-3.7	-1.4	-0.5	-0.4	-0.4
of which : Budget arrears (- net repayment)	-0.5	-0.4	-0.5	-0.5	0.0	0.0	0.0	0.0
Foreign financing	4.1	5.3	4.1	3.4	2.0	0.8	0.6	1.1
Privatization receipts	4.4	0.8	0.7	0.7	0.6	0.6	0.6	0.5
Discrepancy 2/	-0.7	-1.9	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Primary balance	-4.4	-2.8	-1.8	-0.8	-0.1	0.4	0.8	1.2

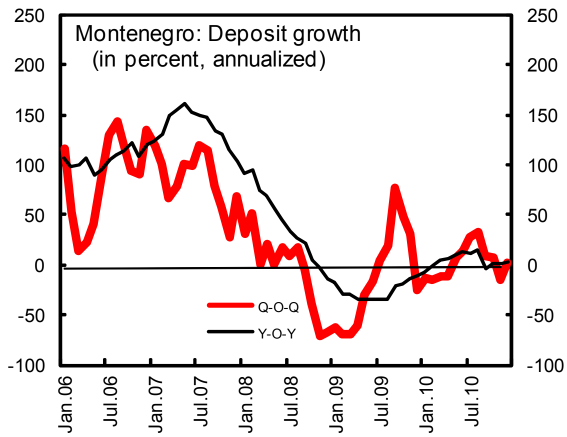
Source: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes republican budget and local governments.

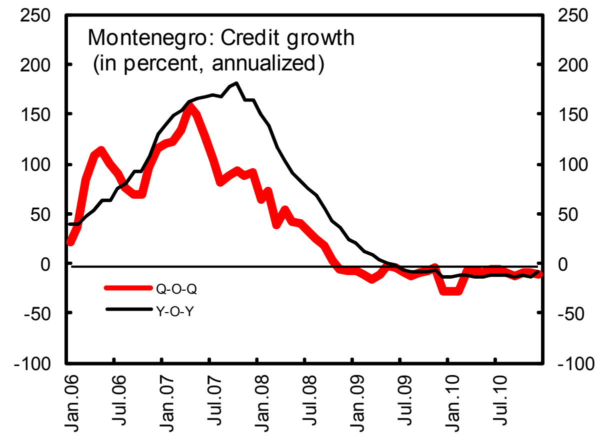
2/ Part of the discrepancy is due to new issuance of restitution bonds and court rulings, both leading to increase of government liabilities.

Figure 1. Montenegro: Financial Sector Developments, 2006-10

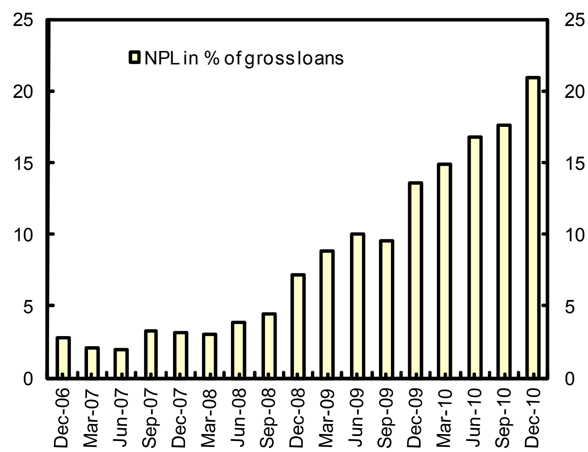
Massive deposit withdrawals have…



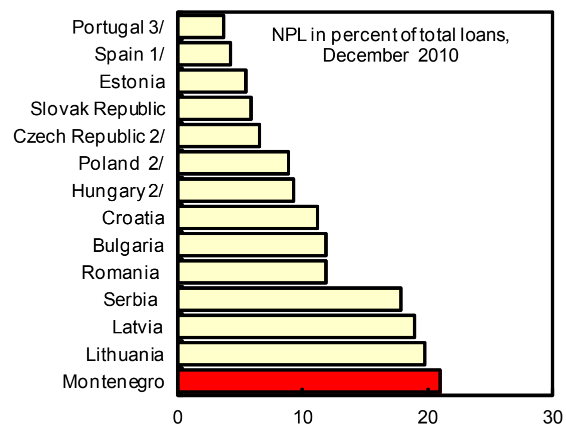
… brought credit to a halt.



With the economy weakening, NPL have been rising fast…



… and are now one of the highest.

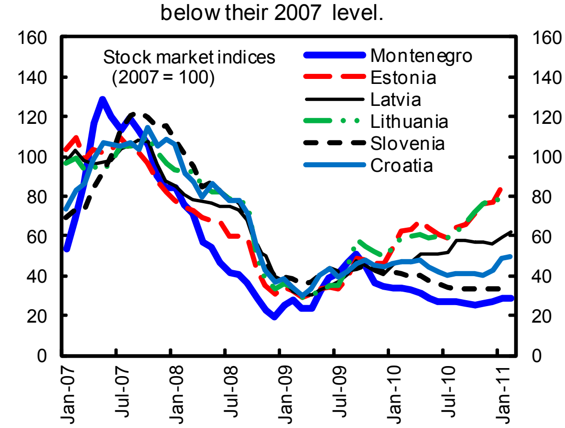


The banking system is largely foreign-owned and highly concentrated

	Number	Market share	
		Loans	Deposits
	(In percent, Dec. 2010)		
Foreign	9	89	85
o/w Large	3	58	56
Domestic	2	12	15
o/w Large	1	11	15
Total	11	100	100

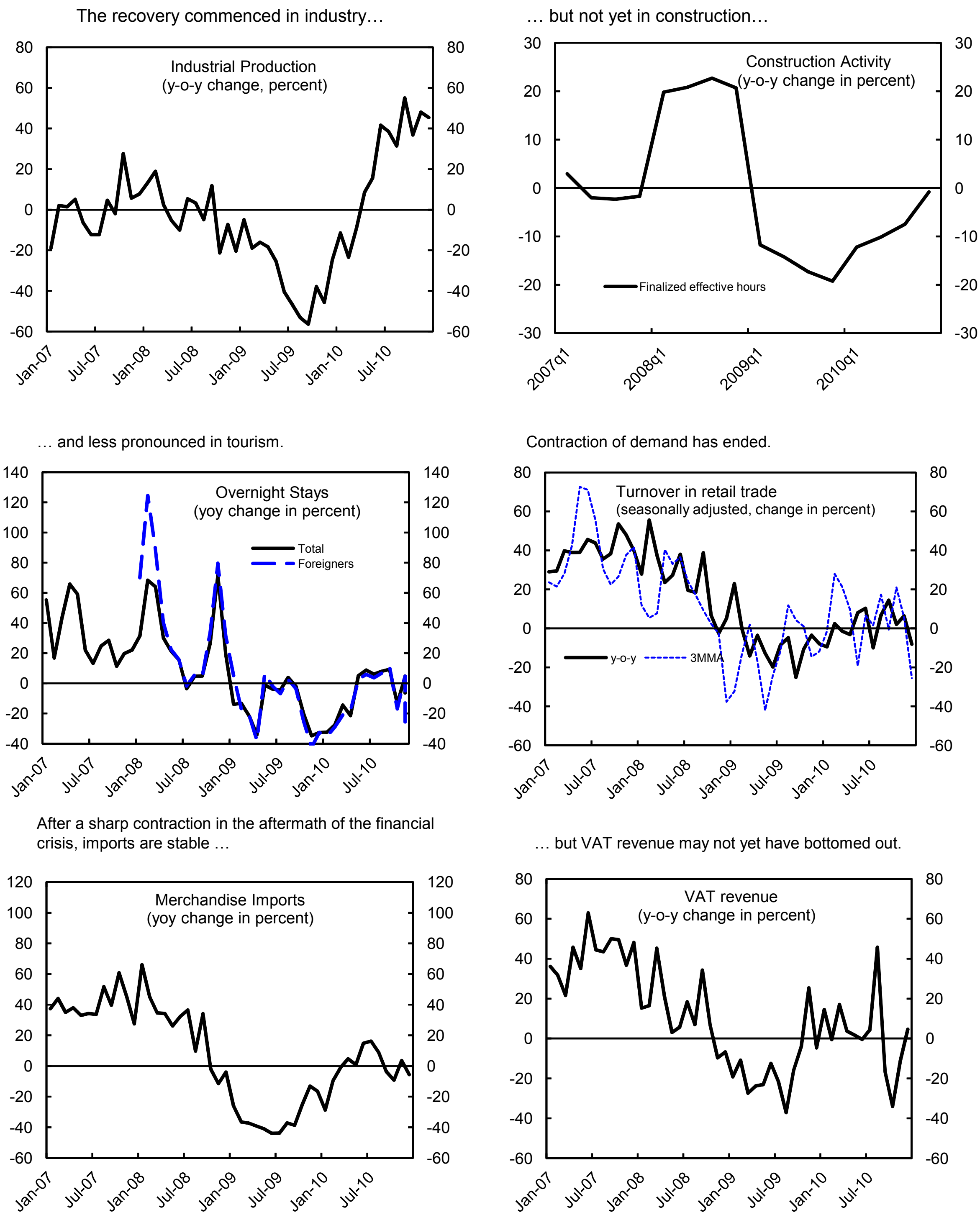
Source: Central bank of Montenegro.

Despite some recovery, equity prices remain below their 2007 level.



Sources: Central Bank of Montenegro; Global Stability Report (Oct 2008); Bloomberg; and IMF staff calculations.
1/ NPL to total loans for June 2010
2/ NPL to total loans for September 2010.
3/ NPL to total loans for November 2010.

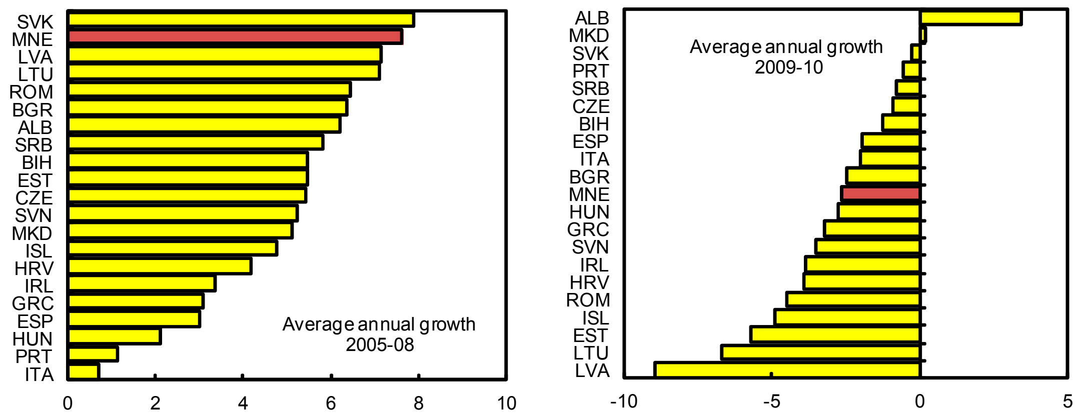
Figure 2. Montenegro: High frequency indicators suggest a recovery in 2010



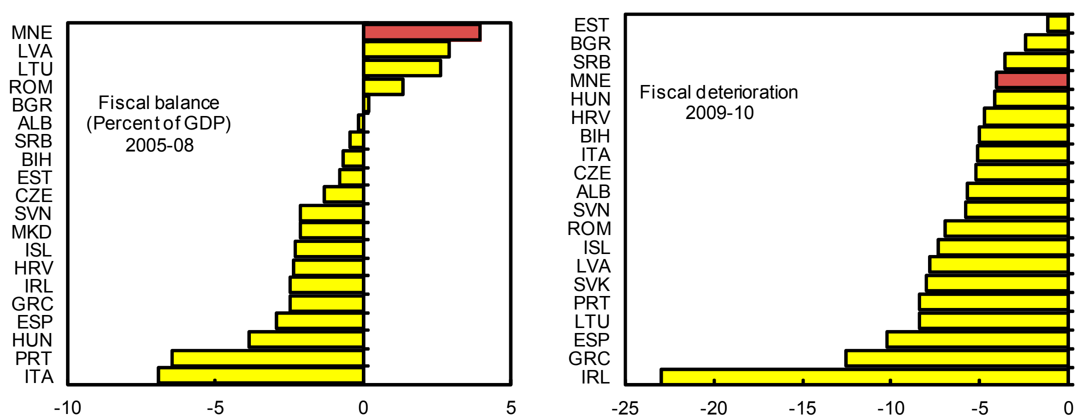
Sources: MONSTAT; Central Bank of Montenegro; Ministry of Finance; and IMF staff calculations.

Figure 3. Macroeconomic Developments in International Perspective

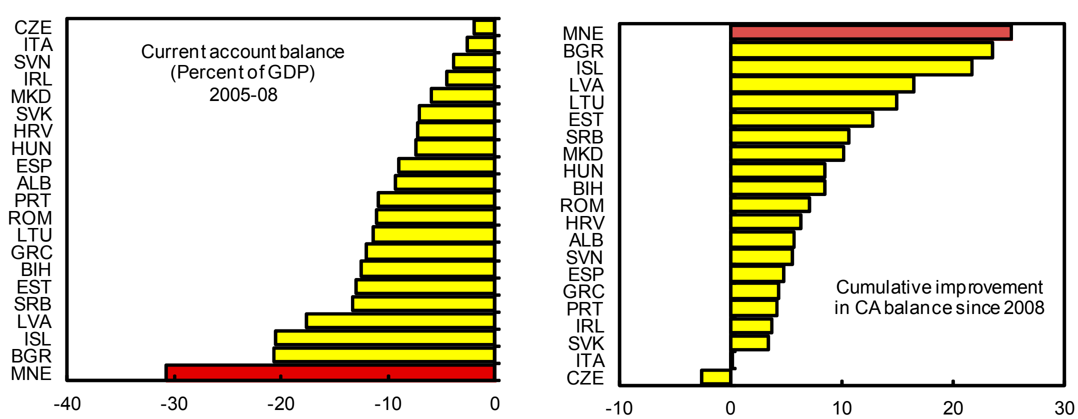
The recent recession has resulted in large turnarounds in growth...



... fiscal positions, and...



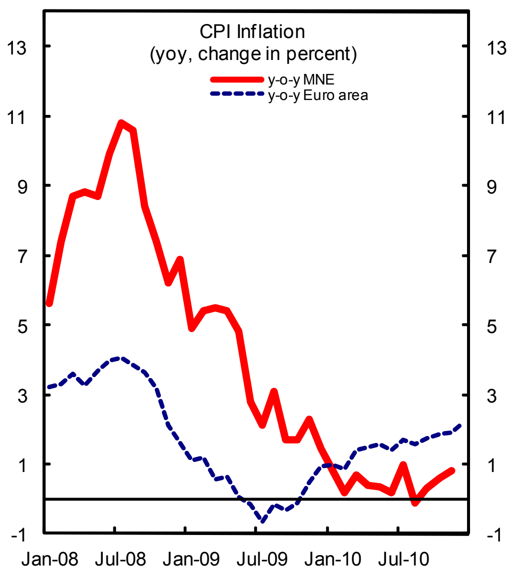
...current account balances.



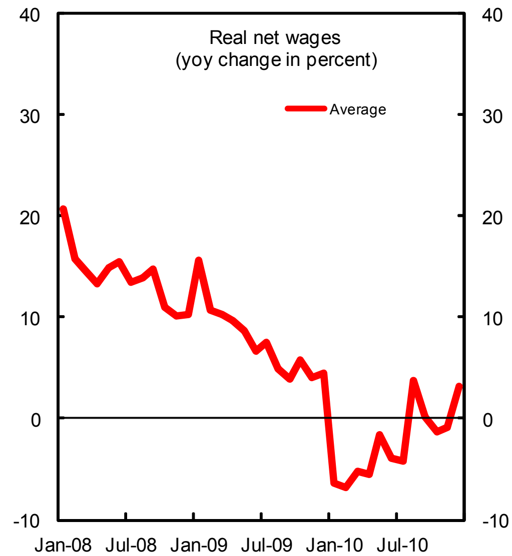
Sources: WEO; and IMF staff calculations.

Figure 4. Montenegro: Inflation pressures have been declining

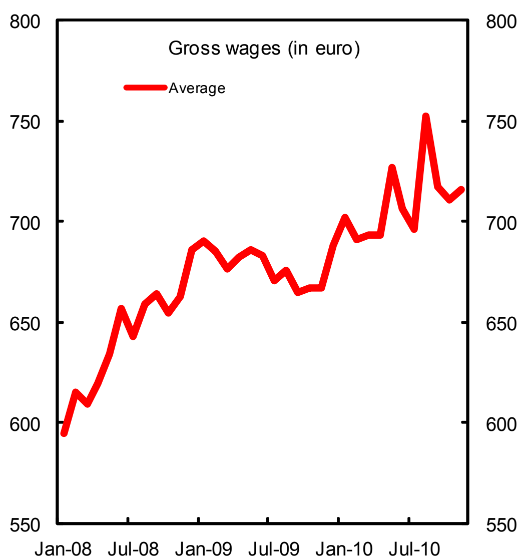
Slowing demand has been taking pressure off prices…



… and net wages…

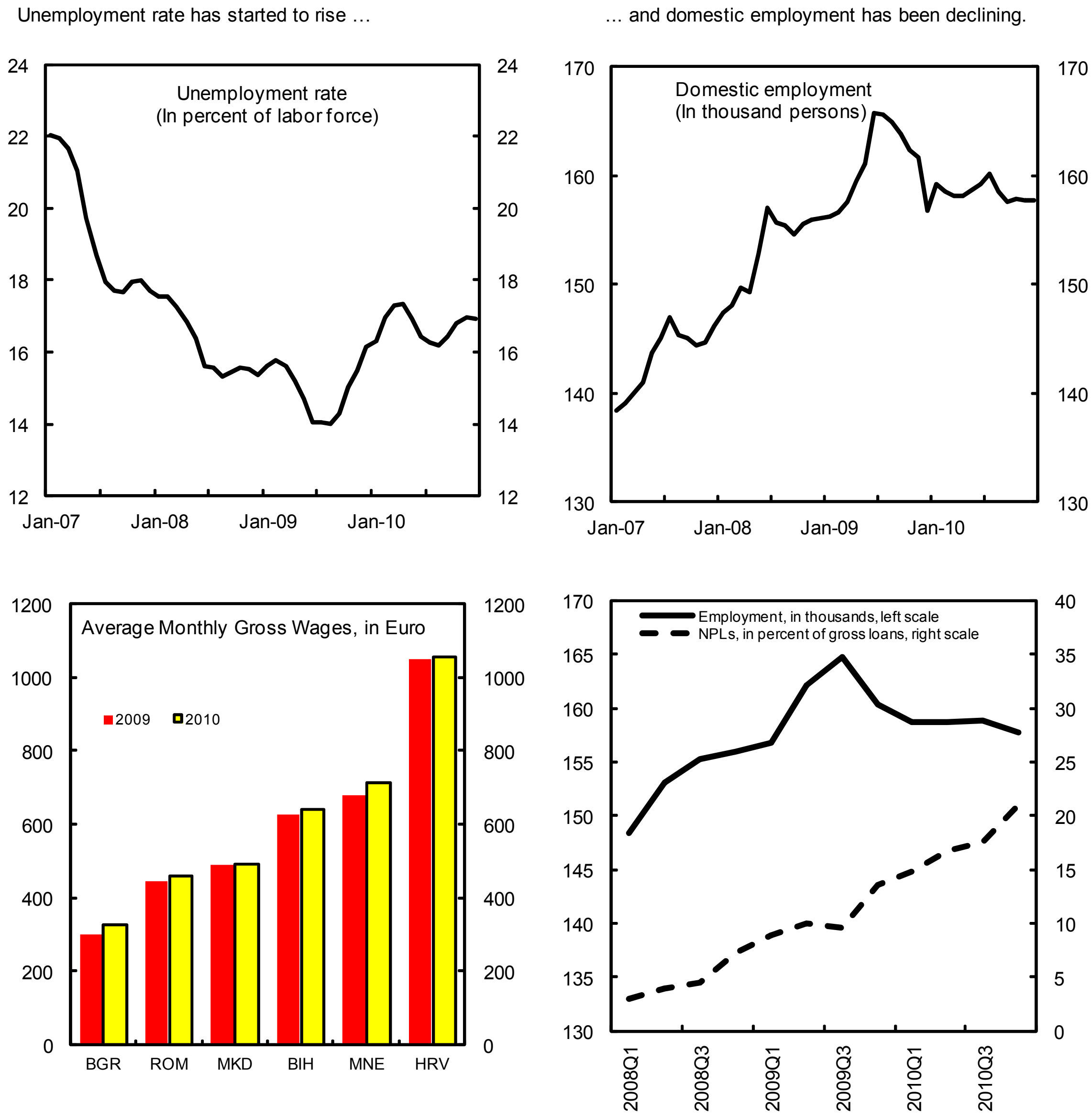


…but gross wages have risen due to contribution hikes.



Sources: MONSTAT; and IMF staff calculations.

Figure 5. Montenegro: Labor Market indicators, 2007-10 1/



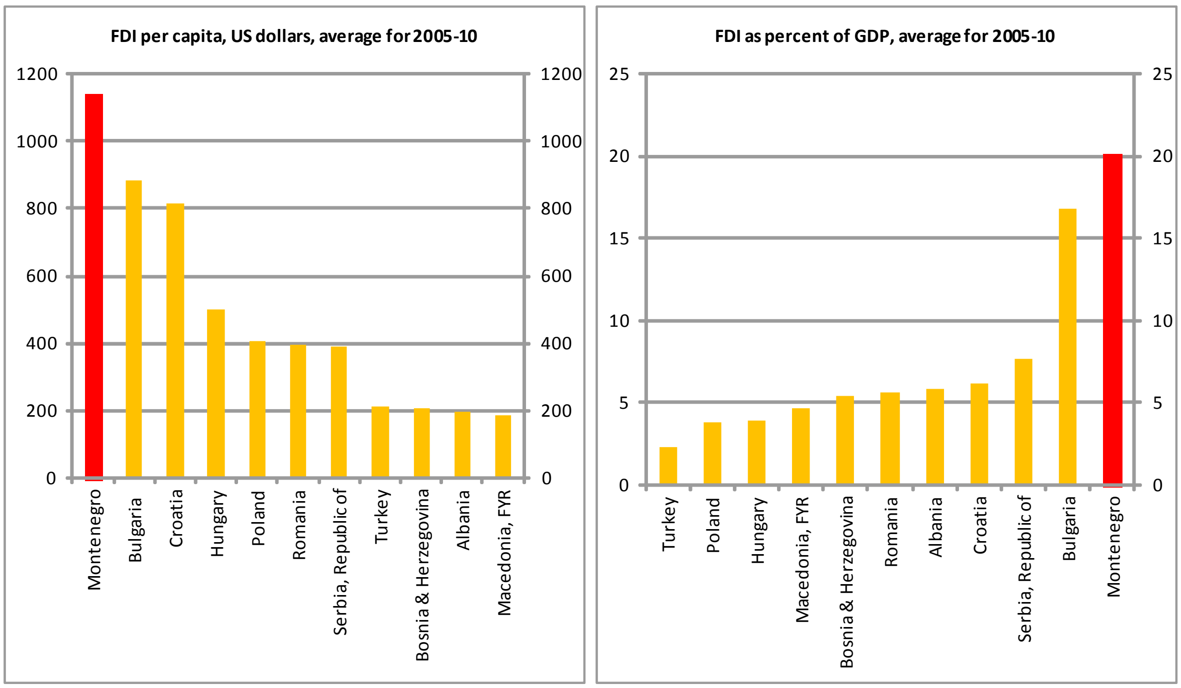
Sources: MONSTAT; and IMF staff calculations and estimates.
1/ Employment and wage data have been adjusted based on staff estimates.

ANNEX I. FOREIGN DIRECT INVESTMENT IN MONTENEGRO[1]

A. Background

Being a small economy with significant potential, Montenegro attracted very high levels of FDI in relative terms. As Figure 1 shows, for the last five years it had the highest FDI per capita as well as FDI as percent of GDP among the emerging market economies of Central and South Eastern Europe.

Figure 1. FDI in Montenegro and other countries of the region



Source: IFS

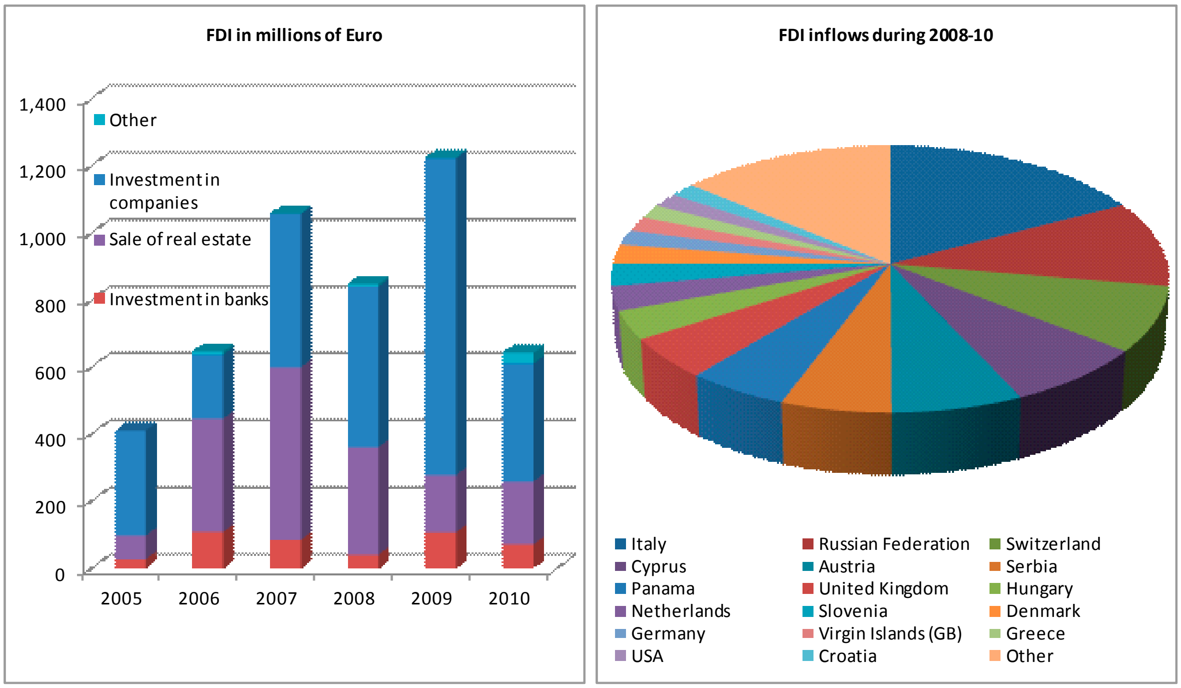
The FDI boom mostly targeted the tourism, real estate, financial and energy sectors. FDI took the form of both greenfield investments and privatization of state-owned enterprises. Regarding the latter, prominent examples are two, relatively major, investments in the aluminum smelter and the steel works. The banking sector continued to attract FDI even after the initial equity acquisitions, mostly because of recapitalization needs in the aftermath of the financial crisis.

As a result, all energy sector companies now have substantial foreign ownership, so do most of major hotels and industrial enterprises, and the banking sector is around 90 percent

[1] Prepared by Vahram Stepanyan.

foreign-owned. Regarding the origins of FDI, these were quite diversified, with Italy and Russia topping the list of the investor countries. Figure 2 below presents the FDI allocation by broad sectors of the Montenegrin economy as well as by countries of origin.

Figure 2. Distribution and origin of FDI in Montenegro



Source: CBM

B. Literature on FDI and Its Relevance to Montenegro

What explains FDI in general and FDI in Montenegro in particular? Empirical research suggests FDI is sensitive to host-country political and economic conditions such as the political situation in the country and the region, the education level of the labor force, overall market size, factor costs, quality of infrastructure, and the general business climate.[2] In particular, a number of such studies find that FDI is lower in countries with higher corporate tax rates and suggest that host-country taxation regime is likely to influence FDI decisions.[3]

Regarding the impact of FDI on economic growth, while many studies failed to provide conclusive evidence on possible links between FDI and economic growth, studies that tried to account for initial conditions in the recipient countries were more successful in showing such a linkage. Dabla-Norris et al (2010) mention, amongst others, the level of financial

[2] See, for example, Hanson (2001).

[3] See, for example, Hines (1996).

sector development, quality of institutions and macroeconomic policies, and capital endowments as factors that can help explain a country's ability to benefit from FDI externalities.

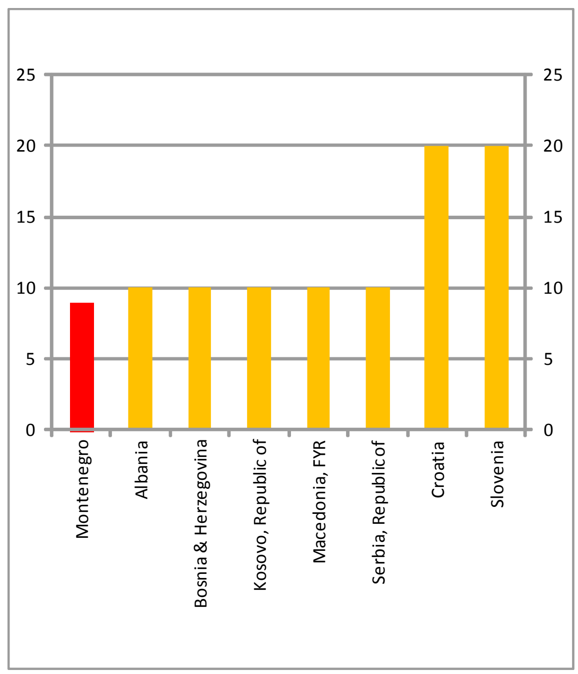
Looking at the period since 2006, when Montenegro gained its independence, one can see that most of the factors mentioned in the literature are relevant to Montenegro. During this period the country was politically stable, maintained good relations with its neighboring countries, and has recorded substantial progress on the road to European Union integration. The unilateral adoption of the euro as the legal tender has anchored investors' expectations (more than half of countries of FDI origin use euro) and, together with the liberal trade and exchange systems, most likely played an important role in FDI decisions.

Although a small economy with a small internal market, Montenegro has benefited from its geographical location and natural endowments to become a popular tourist destination and is continuing to improve its tourism competitiveness. According to the World Economic Forum's 2011 assessment, Montenegro has managed to substantially improve its travel and tourism competitiveness index and ranks 36th amongst 139 countries included in the assessment (Figure 3).[4] Montenegro has also tried to stay competitive in terms of taxation regime and currently has one of the lowest income taxation rates in the region (Figure 4).

Figure 3. 2011 competitiveness ranking in tourism

Source: World Economic Forum.

Figure 4. Corporate income tax rates as of 2010



Source: Country authorities.

[4] The overall index consists of three sub indices: regulatory framework; business environment and infrastructure; and human, cultural, and natural resources.

C. FDI Prospects in Montenegro

The prospects of the Montenegrin economy largely depend on FDI prospects. In particular, the tourism and energy sectors present clear potential for large projects such as the development of the coastal line and the transformation of Montenegro into a hub for the regional electricity exchange. However, in order to achieve a broad-based growth which will be accompanied with substantial employment generation, the economy needs also investment flowing into medium and small businesses. Hence, it is important to further improve the business environment for such enterprises and to provide possibilities for improving competitiveness.

Particular near-term priorities for Montenegro comprise reforms in labor and product markets and in market regulation. Other important areas of action include improvement of the quality of education to better align it with the labor skills required in the market and the development of transport infrastructure. Finally, well-developed and stable domestic financial markets and sound macroeconomic policies can create a general stimulus for FDI.

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Hines, J., 1996, "Tax policy and the activities of multinational corporations," NBER Working Paper No. W5589.

ANNEX II. SCOPE FOR IMPROVING THE TAX SYSTEM OF MONTENEGRO[1]

During the last decade, Montenegro has moved towards a relatively simple and transparent tax system that combines broad bases with low rates. While this generally complies with principles of 'good taxation', there is room for improvement and some aspects of the tax system warrant reconsideration. Some improvements could also contribute to fiscal consolidation in the short-term. Four key priorities are identified.

Reduce the tax wedge on labor

Despite a low proportional personal income tax rate of 9 percent, the total tax wedge on labor is high due to additional local surcharges and a high rate of social security premiums. The total tax wedge as a percentage of labor costs exceeds 40 percent. This exerts significant adverse labor-market incentives and may partly explain the very weak labor-market performance in Montenegro. For instance, the participation rate among the low-skilled is only 13 percent and the overall unemployment rate is almost 17 percent. Reducing the tax wedge, especially for low incomes, should be a key ingredient of a comprehensive reform strategy to mitigate labor market distortions. A potentially promising instrument that could be considered—and that has been successfully introduced in various other countries—is the earned income tax credit. By gradually phasing out this credit with higher incomes, the credit can be targeted to low labor incomes, while limiting the budgetary cost.

Mitigate tax arbitrage in the income tax

Two forms of arbitrage threaten income tax revenue from entrepreneurs.

- The self-employed with low turnover are taxed according to a lump-sum regime. The way this is structured creates ample incentives for underreporting and for operating in the informal sector, especially due to spikes in the tax schedule and a regressive social security burden. A straightforward improvement would be to transform the lump-sum regime into a turnover tax for those self-employed.

- Entrepreneurial income from limited liability companies is taxed at much lower rates than the income of nonincorporated businesses. This creates strong incentives for entrepreneurs to incorporate and for director-owners to label their business income as capital returns. Arbitrages can be reduced by increasing the mandatory remuneration for owner-directors of companies, which is taxed as labor income. Moreover, the tax difference should be reduced by increasing either the corporate income tax rate or the personal tax rates on capital income.

[1] Prepared by Ruud De Mooij.

Strengthen the property tax

Current property tax revenue in Montenegro is low in an international perspective. This can be partly explained by deficiencies in the system of registration and valuation of properties, and partly by policy parameters, such as low tax rates and ample exemptions. Strengthening property tax revenue by improving registration and valuation, increasing rates and abolishing tax concessions could reduce reliance on other revenue sources of local government finance, such as central government transfers, revenue sharing with central government taxes and the plethora of local fees and taxes, which are perceived as a significant burden by the business community.

Remove remaining tax incentives

Although the tax base is generally broad, Montenegro still applies some tax incentives in the personal income tax, the corporate income tax and the value-added tax, the benefits of which are unlikely to outweigh their costs. For instance, in the personal income tax on business income, there is a tax concession for the labor costs of newly hired workers that could better be abolished. In the corporate income tax, there is a three-year tax holiday for newly established firms in underdeveloped municipalities, which could better be phased out. In the VAT, more goods and services should be taxed under the normal VAT rate of 17 percent, including tourism and computer equipment.

ANNEX III. DEBT SUSTAINABILITY ANALYSIS

Table 1. Montenegro: External Debt Sustainability Framework, 2007-2016
(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing non-interest current account 7/**
Baseline: External debt	84.4	75.2	97.8	100.2	**99.0**	**97.5**	**94.1**	**89.1**	**82.5**	**73.8**	**-9.2**
Change in external debt	24.6	-9.2	22.6	2.3	-1.2	-1.5	-3.4	-5.1	-6.6	-8.7	
Identified external debt-creating flows (4+8+9)	6.9	22.3	2.8	6.3	7.0	4.2	2.1	0.2	-2.2	-4.0	
Current account deficit, excluding interest payments	37.9	47.7	25.4	20.0	17.7	15.5	12.7	9.4	6.4	3.5	
Deficit in balance of goods and services	42.3	54.5	33.3	28.7	26.7	24.5	21.7	18.9	15.8	12.4	
Exports	44.4	39.5	32.1	36.5	39.4	41.3	43.0	44.6	46.2	47.8	
Imports	86.7	94.0	65.4	65.2	66.1	65.8	64.7	63.5	62.0	60.3	
Net non-debt creating capital inflows (negative)	-20.9	-17.5	-29.9	-17.7	-15.6	-14.6	-13.7	-12.2	-11.3	-10.0	
Automatic debt dynamics 2/	-10.1	-7.9	7.2	4.0	4.8	3.3	3.1	3.0	2.7	2.5	
Contribution from nominal interest rate	1.6	2.9	4.8	5.7	6.7	6.6	6.5	6.3	5.9	5.5	
Contribution from real GDP growth	-4.7	-4.7	4.7	-1.1	-1.9	-3.3	-3.4	-3.3	-3.2	-3.0	
Contribution from price and exchange rate changes 3/	-7.0	-6.2	-2.3	-0.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	17.7	-31.5	19.8	-4.0	-8.2	-5.7	-5.5	-5.3	-4.4	-4.6	
External debt-to-exports ratio (in percent)	190.2	190.5	304.6	274.4	251.5	236.1	219.0	199.7	178.4	154.4	
Gross external financing need (in billions of US dollars) 6/	1.6	2.7	1.7	1.5	1.5	1.5	1.4	1.3	1.4	1.2	
in percent of GDP	43.1	59.2	39.8	38.1	36.8	34.3	31.2	27.6	28.1	21.6	
Scenario with key variables at their historical averages 6/					**99.0**	**96.7**	**95.2**	**94.3**	**94.6**	**95.1**	**-28.2**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	10.7	6.9	-5.7	1.1	2.0	3.5	3.7	3.7	3.8	3.8	
GDP deflator in US dollars (change in percent)	23.0	15.6	-3.1	-4.3	1.9	0.7	0.9	1.1	1.5	2.0	
Nominal external interest rate (in percent)	3.7	4.3	5.9	5.6	7.0	7.0	7.0	7.0	7.0	7.0	
Growth of exports (US dollar terms, in percent)	22.4	9.9	-25.6	10.0	12.0	9.3	8.9	8.8	9.3	9.5	
Growth of imports (US dollar terms, in percent)	49.2	34.0	-36.4	-3.5	5.3	3.8	2.9	2.8	2.9	2.9	
Current account balance, excluding interest payments	-37.9	-47.7	-25.4	-20.0	-17.7	-15.5	-12.7	-9.4	-6.4	-3.5	
Net non-debt creating capital inflows	20.9	17.5	29.9	17.7	15.6	14.6	13.7	12.2	11.3	10.0	

1/ All calculations are very preliminary estimates based on staff assumptions and subject to change as private sector external debt statistics are not officially published.

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

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

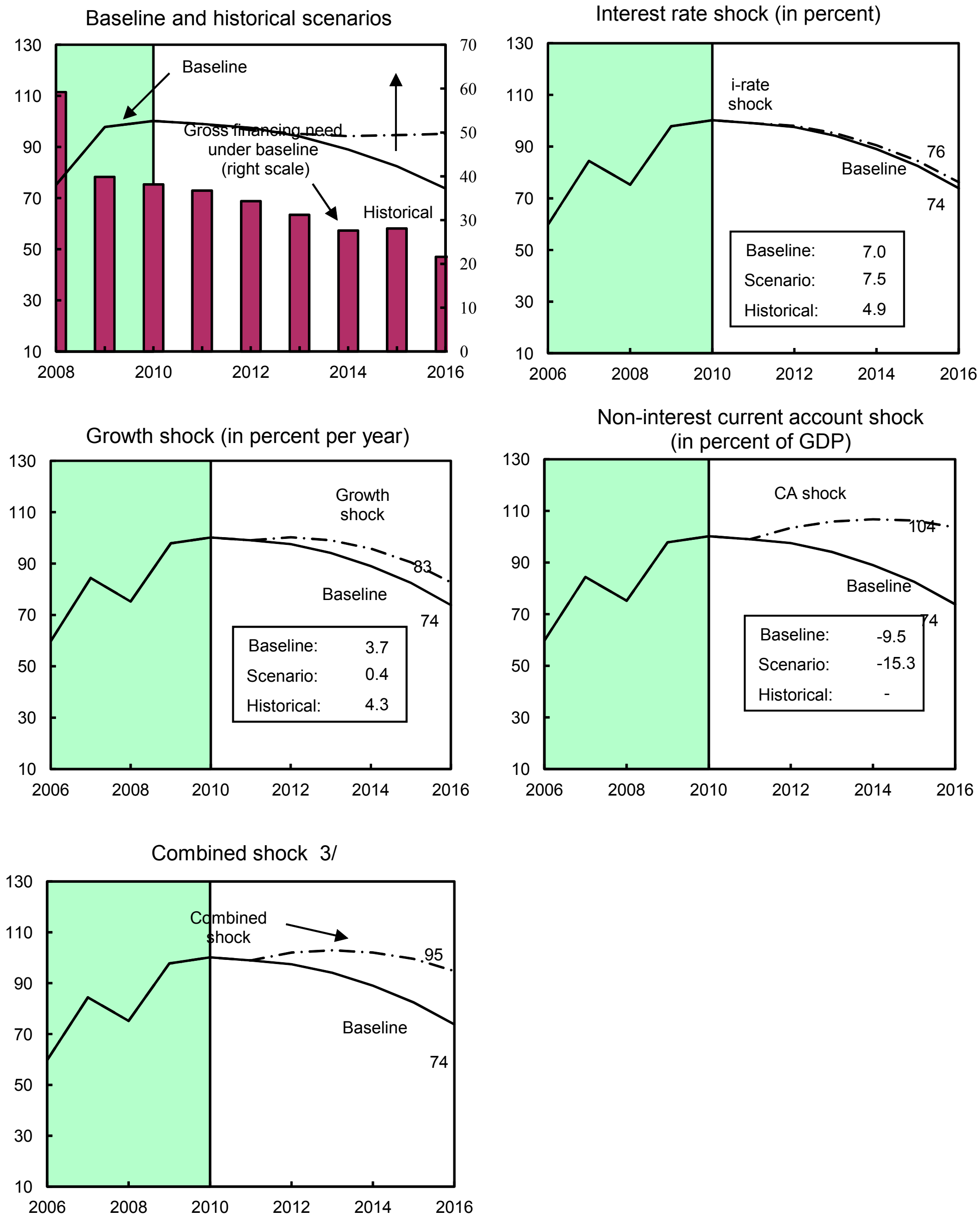
4/ For projection, line includes the impact of price and exchange rate changes.

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

6/ 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.

7/ 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/
(External debt in percent of GDP)



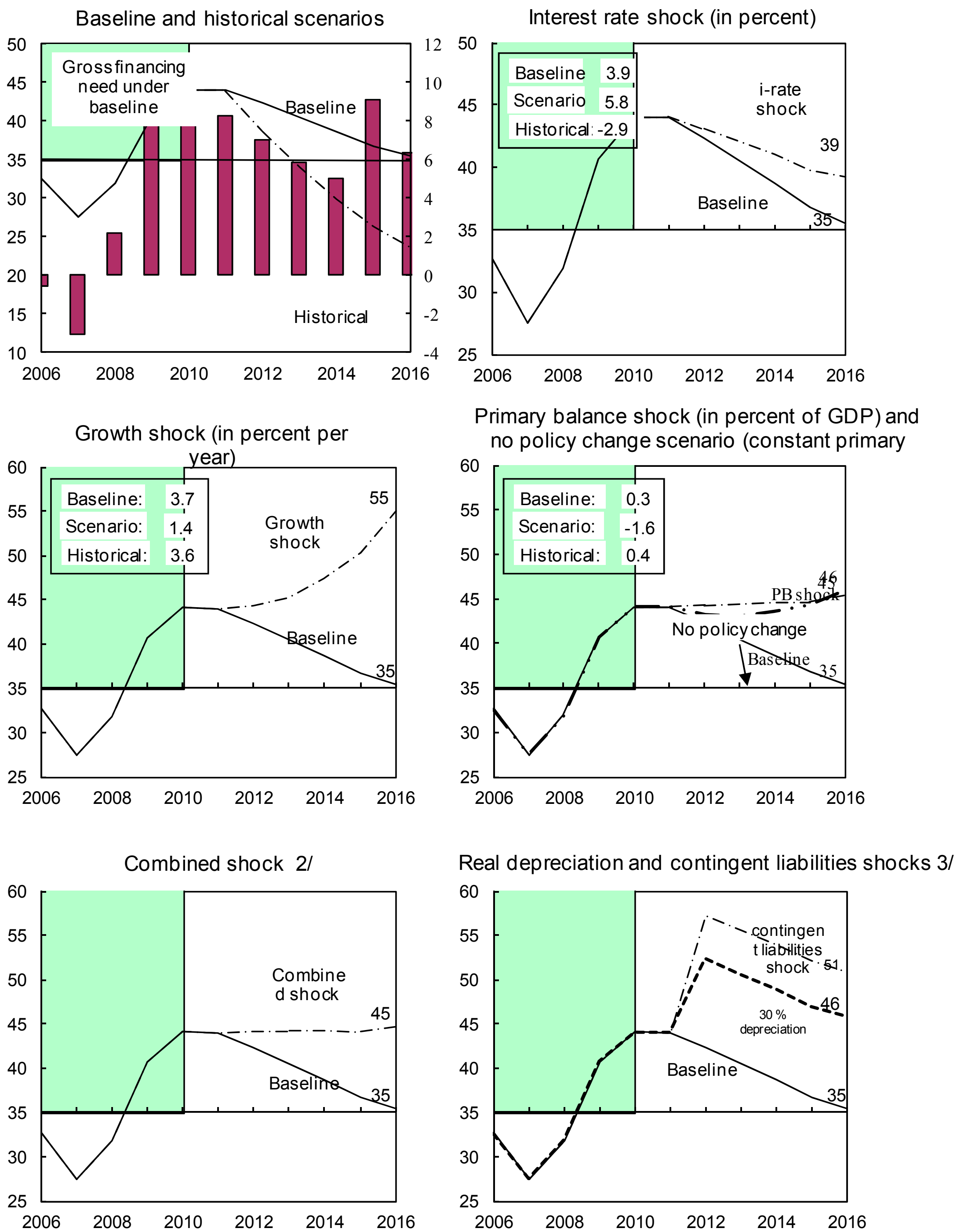
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ All calculations are very preliminary estimates based on staff assumptions and subject to change as private sector external debt statistics are not officially published.
2/ Shaded areas represent actual data. Individual 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.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

Table 2. Country: Public Sector Debt Sustainability Framework, 2007-2016
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	32.6	27.5	31.9	40.7	44.1	**44.0**	**42.3**	**40.5**	**38.7**	**36.8**	**35.4**	**-0.2**
Change in public sector debt	-6.0	-5.1	4.4	8.8	3.4	0.0	-1.7	-1.8	-1.8	-1.9	-1.3	
Identified debt-creating flows (4+7+12)	-14.3	-19.2	-3.4	1.5	2.6	1.4	0.8	-0.7	-0.9	-1.2	-1.3	
Primary deficit	-4.1	-7.8	-0.5	4.4	2.8	1.8	0.8	0.1	-0.4	-0.8	-1.2	
Revenue and grants	43.4	47.7	48.3	42.4	42.2	42.3	42.3	42.2	42.1	42.1	42.0	
Primary (noninterest) expenditure	39.3	39.9	47.8	46.8	45.0	44.1	43.1	42.3	41.7	41.3	40.8	
Automatic debt dynamics 2/	-7.5	-7.5	-1.6	1.4	0.6	0.3	-0.3	-0.1	0.1	0.2	0.4	
Contribution from interest rate/growth differential 3/	-4.9	-5.4	-2.8	2.0	0.5	0.3	-0.3	-0.1	0.1	0.2	0.4	
Of which contribution from real interest rate	-2.1	-2.6	-1.2	0.1	0.9	1.2	1.1	1.4	1.5	1.6	1.7	
Of which contribution from real GDP growth	-2.8	-2.8	-1.6	1.9	-0.4	-0.9	-1.5	-1.5	-1.4	-1.4	-1.3	
Contribution from exchange rate depreciation 4/	-2.6	-2.0	1.2	-0.6	0.1	...	...	...	...	...	...	
Other identified debt-creating flows	-2.8	-4.0	-1.2	-4.4	-0.8	-0.7	0.3	-0.6	-0.6	-0.6	-0.5	
Privatization receipts (negative)	-2.8	-4.0	-1.2	-4.4	-0.8	-0.7	-0.7	-0.6	-0.6	-0.6	-0.5	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	8.4	14.1	7.7	7.3	0.8	-1.4	-2.6	-1.1	-0.9	-0.8	0.0	
Public sector debt-to-revenue ratio 1/	75.1	57.7	65.9	96.0	104.5	104.1	100.2	96.0	91.8	87.4	84.4	
Gross financing need 6/	-0.6	-3.0	2.2	8.3	10.4	8.3	7.0	5.8	5.0	9.1	6.4	
in billions of U.S. dollars	0.0	-0.1	0.1	0.3	0.4	0.4	0.3	0.3	0.2	0.5	0.4	
Scenario with key variables at their historical averages 7/						**44.0**	**38.6**	**34.0**	**29.9**	**26.3**	**23.7**	**-2.0**
Scenario with no policy change (constant primary balance) in 2011-2016						**44.0**	**43.2**	**43.1**	**43.6**	**44.3**	**46.0**	**-0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.6	10.7	6.9	-5.7	1.1	2.0	3.5	3.7	3.7	3.8	3.8	
Average nominal interest rate on public debt (in percent) 8/	3.4	4.0	3.2	2.6	2.6	3.6	4.0	4.8	5.7	6.5	7.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.6	-8.7	-4.5	0.2	2.2	2.8	2.7	3.4	4.0	4.4	5.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	11.6	11.8	-7.5	3.7	-0.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	9.0	12.7	7.7	2.4	0.3	0.9	1.2	1.4	1.6	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	15.3	12.2	28.2	-7.7	-2.8	0.0	1.1	1.7	2.3	2.7	2.7	
Primary deficit	-4.1	-7.8	-0.5	4.4	2.8	1.8	0.8	0.1	-0.4	-0.8	-1.2	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
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: General Government Debt Sustainability: Bound Tests 1/
(Public 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2011, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

MONTENEGRO

Staff Report for the 2011 Article IV Consultation— Informational Annex

Prepared by the European Department

April 15, 2011

Contents Page

Annex I. Fund Relations[1]

(As of March 31, 2011)

I. **Membership Status**: Joined: 01/18/07; Article VIII

II. **General Resources Account**:

	SDR Million	% Quota
Quota	27.50	100.00
Fund Holdings of Currency	20.90	76.00
Reserve position in Fund	6.60	24.00

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	25.82	100.00
Holdings	26.17	101.34

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Exchange Rate Arrangement:** Montenegro does not issue its own currency, has been using the euro as legal tender since 2002, and has accepted the obligations under Article VIII.

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.

VII. **Article IV Consultation:** Montenegro is on a 12-month cycle.

VIII. **FSAP Participation and ROSCs**: A Financial Sector Assessment Program, initiated in July 2006 jointly with the World Bank, was concluded during the 2007 Article IV consultation.

[1] Updated information relating to members' positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/fin/tad/exfin1.aspx).

IX. **Technical Assistance**:

MFD/FAD	July 2005	Management of Proceeds of Privatization and Review of PFM (Montenegro)
FAD	April 2006	Assessment of state-owned enterprises under the World Bank Public Expenditure Review
STA	June 2006	Monetary and financial statistics
FAD	January 2007	Peripatetic advisor on debt management
FAD	March 2007	Fiscal risk assessment of Private Public Partnership
FAD	April 2007	Tax administration
STA	April 2007	Real sector statistics
MCM	October 2007	Emergency liquidity management
MCM	March 2008	Enforcement of securities regulation
MCM	January 2009	Crisis preparedness and management
LEG/MCM	February 2009	Exchange system
STA	Aug. 2009–July 2010	Resident advisor for real sector statistics
LEG	April 2010	Bank Resolution Framework
FAD	June 2010	Debt management
STA	Dec. 2010	Real sector statistics
FAD	February 2011	Tax policy
FAD	March 2011	Tax administration
FAD	March 2011	Medium-term budget framework

X. **Resident Representative:** None.

Annex II: Statistical Issues
(As of end-March, 2011)

A. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance. Shortcomings are most serious in national accounts and balance of payments.
National Accounts: The Statistical Office of Montenegro (MONSTAT) compiles real sector data. MONSTAT has started to adopt the *1993 System of National Accounts* as a framework for compiling national accounts estimates. However, the scope of the accounts is limited to compiling the annual production account in current and in previous year prices. The accuracy of the data sources needs to be improved and breaks in the time series eliminated by revising historic data. Business statistics are still following the material system product concepts, collecting data mainly on quantities produced. The national accounts estimates depend solely on bookkeeping data. The coverage of the informal sector is not exhaustive. On the expenditure side, there are no data on changes in inventories and the quality of investment and merchandise trade data is unsatisfactory. MONSTAT switched from general to specific trade statistics in an effort to better capture imports; however, there are indications that exports might be seriously under-recorded, resulting in a corresponding under-estimation of GDP. National accounts data are also undermined by the lack of sound techniques to account for nonobserved activities. Some work has been done on measuring informal activity in construction, retail trade, hotels and restaurants, but a more comprehensive approach needs to be developed. Statistical techniques for deriving volume measures of GDP are constrained by the lack of suitable price and volume indices. The business register is being expanded and a general census is scheduled for 2011. Preparations are advancing for the compilation of quarterly national accounts. An STA mission visited Podgorica in December 2010 to assist the MONSTAT in the compilation of QNA. The mission concluded there is still a critical need to: (i) improve the accuracy and reliability of the quarterly indicators to be used in compiling QNA; and (ii) compile volume measures of quarterly GDP at previous year's prices. More TA will be needed to achieve compilation of QNA.
Price statistics: MONSTAT compiles and disseminates monthly consumer and producer price indices, which broadly follow international standards. However, in both indices, the "carry-forward" technique for treatment of seasonal goods, new goods, and missing items are used, resulting in downward bias. New consumer price indices, monitoring more items and with a broader geographic coverage, started to be compiled in 2010 and the EU harmonized consumer price indices are scheduled to be released in 2011.

Labor market statistics: The quality of the labor and wage indicators is relatively good but there is little information on foreign employment; frequent methodological revisions impair time series analyses.
Government finance statistics: Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include data for the social security funds and local governments. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications, especially at all levels of local government and social funds. The MOF has established a unit responsible for data collection for state-owned enterprises (SOE), 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 strengthened.
Monetary statistics: Monetary and financial statistics are compiled by the Central Bank of Montenegro (CBM), broadly following the institutional coverage, classification, and valuation methodology set forth in the *Monetary and Financial Statistics Manual (2000)*. Dissemination practices meet the recommendations of the General Data Dissemination System (GDDS) with respect to the periodicity and timeliness for financial sector data. Beginning in early 2006, the CBM publishes detailed monetary statistics in its monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the CBM and the commercial banks.
Balance of payments: Balance of payments statistics are compiled by the CBM following international reporting standards. The external sector statistics have benefited from improvements undertaken by MONSTAT to improve coverage, valuation, and classification of merchandise trade statistics. Merchandise trade debits (imports) are valued at CIF, rather than FOB prices. Data on imports and exports in the BOP are based on the general trade system. There is evidence that general trade imports are seriously under recorded, prompting MONSTAT to switch from general to special trade statistics in the national accounts. There are also indications that exports are underestimated, an issue MONSTAT is currently investigating. In the meantime, there is an inconsistency between balance of payments statistics, which are based on general trade data, and national accounts, which are based on special trade data. The CBM has not developed acceptable methodology to estimate the value of insurance and freight on imports, which should be deducted from the CIF value. Weaknesses remain, due primarily to the paucity of source data and the shortage of staff to undertake the data collection and compilation processes. The CBM has made progress in improving the recording of transactions in the ITRS by refining the transactions coding system and increasing interaction with the commercial banks; however, the ITRS remains

<table>
<tr><td colspan="2">inadequate for recording a broad range of balance of payments transactions such as reinvested earnings and trade credits. Further, the ITRS records transactions on a cash basis, whereas balance of payments transactions should be recorded on an accruals basis. The CBM still needs to undertake a small number of direct surveys of enterprises to supplement the data received through the ITRS, and prepare comprehensive documentation on compilation methods and data sources. Montenegro does not yet compile International Investment Position statistics.</td></tr>
<tr><td colspan="2" align="center">B. Data Standards and Quality</td></tr>
<tr><td>Montenegro does not participate in the GDDS.</td><td>No data ROSC is available.</td></tr>
<tr><td colspan="2" align="center">C. Reporting to STA</td></tr>
<tr><td colspan="2">A page for Montenegro in International Financial Statistics (IFS) was introduced in the March 2007 issue.

Montenegro does not report government finance statistics for publication in the Government Finance Statistics Yearbook or IFS.

Montenegro does not report data for the IMF’s Coordinated Portfolio Investment Survey and the Coordinated Direct Investment Survey, respectively.

The CBM does not yet report monetary data in the format of Standardized Report Forms (SRFs). To avoid duplication of effort, the CBM will need to decide whether to adopt the European Central Bank’s framework for collecting, compiling and reporting monetary data or the STA-developed SRFs, either of which will provide monetary data that accord with international standards.</td></tr>
</table>

Montenegro: Table of Common Indicators Required for Surveillance

(As of end-March, 2011)

	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]	Mar. 2011	Apr. 2011	M	M	M
Reserve/base money	...	...	NA	NA	NA
Central bank balance sheet	Feb. 2011	Mar. 2011	M	M	M
Consolidated balance sheet of the banking system	Feb. 2011	Mar. 2011	M	M	M
Interest rates[2]	Feb. 2011	Mar. 2011	M	M	M
Consumer price index	Dec. 2010	Feb. 2011	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Dec. 2010	Feb. 2011	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3]– central government	Dec. 2010	Feb. 2011	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Dec. 2010	Feb. 2011	Q	Q	Q
External current account balance	Dec. 2010	Feb. 2011	Q	Q	Q
Exports and imports of goods	Dec. 2010	Feb. 2011	Q	Q	Q
GDP/GNP	2009	Nov. 2010	A	I	A
Gross external debt	Dec. 2010	Feb. 2011	Q	Q	Q
International Investment Position[6]	...	...	NA	NA	NA

[1] Any 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.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. General government reporting is incomplete; local government expenditure data are available only after a six-month lag.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Annex III: Relations with the World Bank Group

Montenegro has joined World Bank Group (WBG) as an independent country in January 2007. The Bank had implemented a discrete program of lending and analytical work for Montenegro for most of the period since the State Union of Serbia and Montenegro had joined the WBG in 2001, with three projects still being active at the onset of Montenegro's first *Country Partnership Strategy* (CPS) for the fiscal years 2007–10. Within this framework, the Board approved two IDA credits (US$19 million)—just prior to graduation—and five IBRD loans (US$54 million) to provide selective support to three key country priorities, viz., (i) enhancing sustainable macroeconomic growth; (ii) building institutions and strengthening the rule of law; and (iii) improving the standard of living for citizens. The committed portfolio has grown from US$34 million in 2007 to US$81 million in 2011. About 70 percent of these commitments remain to be disbursed. Investment operations are focused principally on supporting programs in the sustainable development and human development sectors.

Montenegro: World Bank Project Portfolio, March 31, 2011

Project name	Board date	Original commitment (US$ millions)	Disbursement ratio (percent)
Active project portfolio			
Environment (solid waste management)	Nov. 2003	12.5	24.3
Health system improvement	Jun. 2004	14.2	56.8
SEE energy community (APL3)	Jul. 2007	9.0	65.6
Energy efficiency	Dec. 2008	9.4	24.7
Land administration	Dec. 2008	16.2	9.9
Agriculture and institutional development	Apr. 2009	19.7	18.7

In January 2011, the Board approved the US$ 216-million CPS for FY2011–14. This CPS supports the government's overarching objective of full integration with the EU within a medium-term horizon. The strategy—reflecting Montenegro's status as an upper middle income client with well-defined development priorities—aims at (i) strengthening institutions and competitiveness in line with EU accession requirements; and (ii) improving environmental management, including reducing the costs of environmental problems. The government has requested the Bank to focus its support in areas where it had previously been engaged and/or gained applicable regional or global experience. The centerpiece of the Bank's engagement will be two financial-sector development policy loans (about US$105 million), which will support a program to strengthen the banking sector, bring regulations into line with EU norms, and encourage resumption of (healthy) credit growth. New investment lending is planned for a Higher Education/R&D project, a small investment to facilitate Montenegrin participation in a Regional Catastrophe Risk Insurance Facility, and an Industrial Waste Management and Clean-Up Project.

Cooperation with the IMF has been strong, particularly the areas of macroeconomic and financial sector policies. Bank and Fund teams have closely coordinated comments on a set of (organic) financial sector laws enacted by Parliament in mid-2010. The WBG, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input on issues such as (i) public expenditure, including pension and health reforms; (ii) business climate and competitiveness; (iii) public sector institutions and fiduciary review, and (iv) agricultural assessment; and (v) statistical capacity building and poverty monitoring. The Fund and Bank have sought each other's input in internal review processes.

Montenegro: JMAP Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, July 2010–May 2011

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV mission Technical assistance on financial sector legislation Resident advisor for real sector statistics.	February 2011 Summer-Fall 2010 Aug. 2009–July 2010	April 2011
2. Bank work program	Banking sector stability DPL Public Expenditure and Institutional Review	May 2011	July 2011 June 2011
3. Joint work program	Technical assistance on drafting banking legislation	Summer-Fall 2010	

Prepared by World Bank staff; questions may be addressed to Jan-Peter Olters.

Statement by Age Bakker, Executive Director for Montenegro and Miroslav Tomic, Advisor to Executive Director April 29, 2011

1. The authorities of Montenegro would like to thank staff for the focused report and the high quality of advice extended since the previous Article IV consultations. The report correctly puts in a perspective the causes of the crisis and the challenges the economy of Montenegro is facing in the post-crisis period. More importantly, the report indicates the necessary path of action required to utilize the enormous growth potential. There is a high degree of agreement between staff and the authorities on policy actions necessary for sustainable growth.

2. Although the economic developments in 2010 surprised on the upside—a positive real GDP growth of 1.1 percent was realized against negative projections of -1.7 percent, matched with low inflation (the end year CPI was at 0.5 percent) and a sizeable current account adjustment—the authorities are fully aware of the need to step up structural reform efforts in order to further boost the recovery and put the economy on a higher growth path in the medium term. In order to avoid severe internal devaluation that could further limit policy space, the fiscal deficit was financed by tapping into international capital markets. After the initial issue in September 2010, the recent second issue was better priced (by 62.5 basis points), signaling the market's recognition of the appropriate policy efforts. A sizeable headline fiscal adjustment was booked and is projected to continue, in line with the government's determination to return into surplus territory as soon as feasible.

3. The authorities are fully aware of the impact of borrowing on public debt, and, therefore, enacted several measures to contain public finances in a structural manner, the most important being pension reform. The pension law has extended the retirement age and puts the entitlements on a more solid footing from a fiscal sustainability perspective. Staff is right in claiming that implementation of the key pension reform parameter changes should be sooner rather than later. The enacted solution reflects, however, the maximum social compromise that could have been reached within the existing political economy constraints. In addition, to remedy high spending on wages in the public sector, the government introduced a rule where for every new hire in public administration two positions have to be closed.

4. Although there are encouraging signs of stabilization, such as deposit growth and recent small credit increase, recovery of the banking system is not taken for granted. Despite relatively tight prudential regulations, severe damage to the banking system was not avoided, exemplified through the deposit run, collapse of credit, increase in NPLs and decreasing profitability. With hindsight, an even more conservative approach to implementation of banking sector regulation would have been appropriate—a lesson learned the hard way that will shape the future supervisory and regulatory actions. The authorities' swift response to support domestic banks, accompanied by adequate reaction from the

foreign parent banks to their subsidiaries, succeeded in preserving overall confidence in the system. Although the NPLs remain high, a reduction and cleaning of balance sheets of major banks is underway. With technical support from the WB and the IMF, several important laws (including a law on commercial banks, a law on bankruptcy, and a law on the central bank) have been adopted in 2010. The Central Bank, under the new mandate, has stepped up on-site inspection and is carefully monitoring developments in the financial system.

5. The authorities recognize that setting the financial system on a solid footing is a precondition for continued macroeconomic stability. With a limited role for the 'lender-of-last-resort' function of the Central Bank, the authorities are aware of the buffers on public finance needed to maintain the necessary confidence. Although in theory there may be short-run macroeconomic benefits from a faster credit recovery, the authorities value full recovery of the financial system as a more important goal and will refrain from any action that could water down prudency in credit approval. Further improvements in the financial sector are continuously discussed with both the Fund and the WB staff, and the authorities stand ready to implement best international practice.

6. The specificities of a small and open economy help explain the large and volatile current account. Any of several big projects in the pipeline, requiring import of goods not locally produced, may further add to this but should not be seen exclusively from the negative side of the savings-investment imbalance. With the highest per capita FDI in Europe and a very diversified origin of FDI, Montenegro has relied and will continue to rely on FDI as a major source of growth.

7. In light of the macroeconomic framework, the authorities recognize the need to have a flexible labor market, not only in the tourism industry, which relies also on labor import, but also in other sectors. Staff recommendation to introduce opt-out clauses from collective bargaining agreements to allow for a more efficient restructuring is well received. Similarly, recommendations to increase labor supply through earned income tax credits are worth considering. The work on removing administrative barriers is underway, and this should, together with the labor law reforms, secure positive developments in competitiveness.

8. Political stability is expected to continue in the future. Furthermore, as firm EU and NATO integration processes are progressing, the country is expected to increase its attractiveness to foreign investors. The authorities continue to consider these processes, apart from the political perspective, as business development opportunities and will fine-tune their policies so that that full economic potential from integration processes can be realized.

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with Montenegro

On April 29, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Background

A tentative recovery is taking hold, following the global crisis that exerted heavy blows upon the economy. In 2010, a good tourism season was followed by resumed metal production, while heavy rains in the region boosted electricity production and exports. After contracting for almost two years, industry began to grow again in the second half of 2010. Nevertheless, industrial production at end-2010 was still considerably below its pre-crisis peak. Expected large-scale infrastructure foreign direct investment has so far not materialized and construction activity remains depressed. Overall 2010 GDP growth is estimated at 1.1 percent, keeping output below its 2008 level.

The needed rebalancing of the economy has begun. Inflation and wage growth decelerated sharply and the current account deficit halved to around 26 percent of GDP in 2010. While most of the improvement was due to a weather related boost in electricity exports and rebounding metals production, the nascent adjustment in costs has also improved competitiveness. The improved fundamentals have also contributed to the

[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. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

September 2010 debut Eurobond issuance of €200 million, subsequent spread tightening, and a further €180 million issuance in April 2011.

Fiscal consolidation has commenced. Reflecting mainly significant capital expenditure cuts, the 2010 fiscal deficit is estimated to have declined by 1½ percent of GDP to 3.9 percent, though, loan guarantees of 3.6 percent were extended to industrial companies. Going forward, the authorities aim at balancing the budget in 2012 and achieving a sizeable surplus thereafter in order to bolster sustainability, lower financing risk, and boost the economy's resilience to shocks.

In the banking sector, confidence has begun to return, as evidenced by increasing deposits, though they are still below their levels in the third quarter of 2007. However, non-performing loans have not yet leveled off and Financial Soundness Indicators have continued to deteriorate. Stagnant lending at the current juncture primarily reflects the dearth of creditworthy projects.

Executive Board Assessment

Executive Directors noted that, although the recovery is gaining momentum, limited policy space and incomplete reforms pose risks to the outlook. Accordingly, Directors encouraged the authorities to step up efforts to reconstitute fiscal, external, and financial buffers and to address rigidities in product and labor markets.

Directors welcomed the start of fiscal consolidation and supported the authorities' plan to balance the central government budget by 2012, and run surpluses thereafter. They considered that a durable fiscal adjustment should encompass both revenue and expenditure measures, including steps to increase the yield from property taxes and curb the public sector wage bill. An early implementation of pension reform would also strengthen the public finances, as would further efforts to avoid expenditure arrears and direct budget support to private companies.

Directors stressed the importance of restoring the soundness of the banking system to bolster the resilience of the economy and promote private sector-led growth. They welcomed recent steps to reinforce the legal and prudential frameworks and encouraged stronger supervisory practices. In particular, noting that full euroization limits the ability of the central bank to provide liquidity support to banks, Directors called for conservative capital and liquidity requirements and an early unwinding of regulatory forbearance.

Noting the importance of strengthened competitiveness for securing external stability, Directors agreed that structural reforms should remain a top policy priority. Greater flexibility in wage setting and employment protection would support job creation in the private sector, while addressing unemployment and poverty traps would boost labor participation and market attachment. Improvements in the business environment and investment climate are also part of the unfinished agenda.

Directors cautioned that long-standing weaknesses in economic statistics hamper policy design and evaluation. They encouraged the authorities to make further progress in addressing them.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Montenegro is also available.

Montenegro: Selected Economic Indicators, 2008–11
(Under current policies)

	2008	2009	2010	2011
			Est./Prel.	Proj.
Real economy				
Nominal GDP (millions of €)	3,086	2,981	3,023	3,111
Gross national saving (percent of GDP)	-10.0	-3.1	-3.6	-2.5
Gross investment (percent of GDP)	38.2	26.8	22.0	22.0
	(Annual percentage change)			
Real GDP	6.9	-5.7	1.1	2.0
Industrial production	-2.1	-32.2	15.0	...
Tourism				
Arrivals	4.8	1.6	6.0	...
Nights	6.9	-3.1	5.0	...
Consumer prices (period average) 1/	8.5	3.4	0.5	3.1
Consumer prices (end of period) 1/	7.2	1.5	0.7	3.0
GDP deflator	7.7	2.4	0.3	0.9
Average net wage (12-month) 2/	23.4	11.3	-1.8	...
Money and credit (end of period, 12-month)				
Bank credit to private sector	24.7	-15.1	-8.9	4.0
Enterprises	20.9	-15.4	-15.0	...
Households	32.0	-10.9	-7.0	...
Private sector deposits	-14.2	-4.1	6.0	6.0
	(In percent of GDP)			
General government finances (cash) 3/				
Revenue and grants	48.3	42.4	42.2	42.3
Expenditure (incl. discrepancy)	48.6	47.7	46.0	45.7
Overall balance	-0.3	-5.3	-3.9	-3.4
Primary balance	0.5	-4.4	-2.8	-1.8
Privatization receipts	1.2	4.4	0.8	0.7
General government gross debt (end of period, stock)	31.9	40.7	44.1	44.0
Balance of payments				
Current account balance, excl. grants	-50.9	-30.4	-26.2	-25.4
Foreign direct investments	17.9	30.8	17.9	15.4
External debt (end of period, stock)	…	93.3	98.9	99.3
REER (CPI-based; annual change; + indicates appreciation)	1.5	5.9	0.2	…

Sources: Ministry of Finance, Central Bank of Montenegro, Monstat, Employment Agency of Montenegro; and IMF staff estimates and projections.
1/ Cost of living index for 2008.
2/ 2008-2009 wage data have been adjusted to reflect a change in the methodology by Monstat starting January 1, 2010.
3/ Includes extra-budgetary funds and local governments, but not public enterprises.