INTERNATIONAL MONETARY FUND

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MONTENEGRO

February 2015

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MONTENEGRO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 23, 2015, following discussions that ended on November 4, 2014, 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 January 8, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 23, 2015 consideration of the staff report that concluded the Article IV consultation with Montenegro.
- 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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MONTENEGRO

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

January 8, 2015

KEY ISSUES

Context: Moderate growth is continuing; however credit and wage growth are weak. The level of nonperforming loans (NPLs) remains high and public debt has risen sharply in recent years.

Fiscal policy: Medium-term funding needs to roll over existing debt and to fund budget deficits are large. A new highway, budgeted to cost about one quarter of GDP, will cause deficits to widen and add to public debt. The draft 2015 budget shows appropriate restraint on other spending, but a long period of strong fiscal discipline will be needed to manage fiscal risks. Laying out clear long-term plans for managing the public finances would boost credibility and reduce risks to market access. Fundamental expenditure reform, especially of the pension system and the public sector wage bill, would be an essential part of such plans.

Financial sector: The banking system's liquidity appears comfortable; however, profitability is low and lending spreads are high. Regulatory provisioning is set higher than that reported under international accounting standards, but a wide range of provisioning levels across banks and weak incentives to take losses remain concerns. A more transparent and comprehensive reporting environment would be beneficial. Reforms to ensure better enforcement of contracts and collateral would help bring down structural lending risk premia.

Structural reform: Higher levels of labor participation and employment are needed to boost potential growth and safeguard the public finances. Ensuring that wages adjust in line with productivity alongside reforms to achieve better employment outcomes and boost productivity would enhance the economy's ability to respond to macroeconomic shocks, and are even more important in a country that lacks its own currency and with decreasing fiscal buffers.

Approved By
European Department

Discussions were held in Podgorica October 22–November 4, 2014. The staff team comprised Alasdair Scott (head), Thomas Dowling, Christopher Faircloth, and Zsoka Koczan (all EUR). Mr. Aasim Husain (EUR) attended some of the meetings. The team met with the authorities (central bank, ministries of finance, justice, transportation, and labor), private sector representatives (unions, employers, and banks), and international agencies (EC, EBRD, and World Bank). HQ support was provided by Dustin Smith and Patricia Mendoza (EUR).

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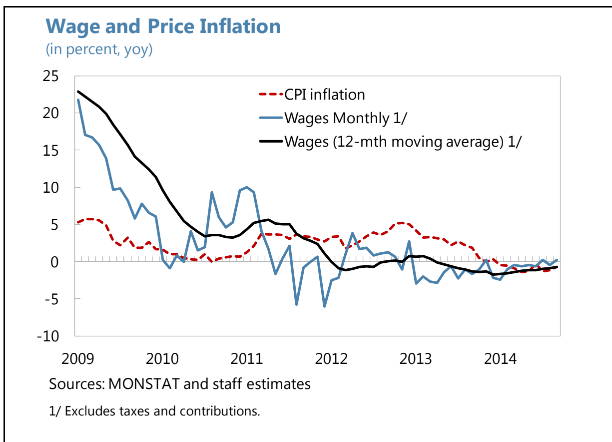
CONTEXT

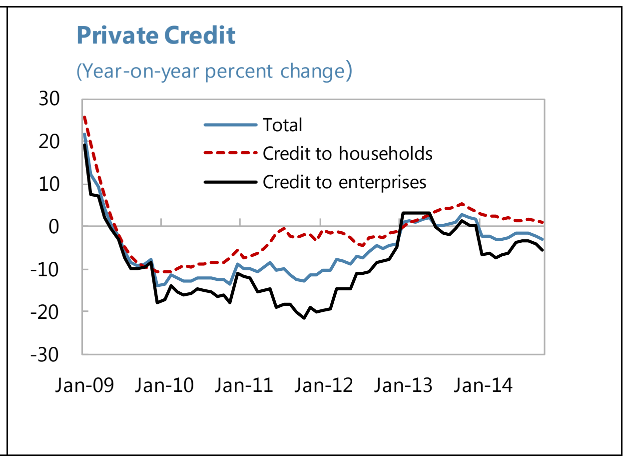
1. Montenegro's economy is highly dependent on tourism and FDI. It is suffering from relatively high public debt, unprofitable state companies, high levels of NPLs, and ongoing bank deleveraging. It faces challenges from an aging population and low employment. It is euroized and therefore lacks independent monetary policy, while flexibility is weak owing to a relatively rigid labor market. During the past two years, the government has implemented significant fiscal consolidation measures. But it has also committed to a highway investment project, of which the first phase is budgeted to cost EUR 809 million (24 percent of 2013 GDP) (Box 1).[1] In December 2010, Montenegro received official candidate status for EU accession; negotiations are ongoing.

RECENT DEVELOPMENTS

2. **Moderate growth is continuing.** After contracting by 2½ percent in 2012, real GDP rebounded by 3¼ percent last year, supported by increased hydro electricity production, growth in tourism, and the commencement of several tourism-based investment projects. Preliminary data indicates a sharp growth slowdown beginning in the second quarter of 2014. Construction activity has decelerated, associated with delayed infrastructure projects (including the highway project). Manufacturing production has contracted over the year to date, while electricity production has slowed to more normal levels (Figure 1).

3. **The nominal side of the economy is weak.** The CPI decreased steadily in 2014 through October, mainly because of low international energy and food prices and weak inflation pressures in the euro area. Average net earnings have been broadly flat since 2011 and bank credit has retrenched through the first three quarters of 2014.





[1] In what follows, "highway" denotes the first stage only, unless otherwise stated, not the complete highway (which has not yet been contracted or budgeted).

Box 1. Montenegro's Highway Project

The Bar-Boljare Highway is a project to connect Bar, Montenegro's main seaport, to the border of Serbia. The authorities see major economic and non-economic benefits arising from the project, including regional development, trade, road safety, and national security.

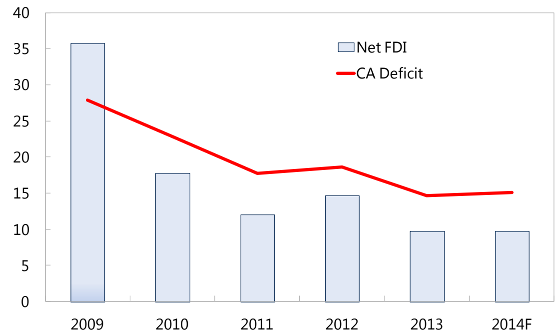
The authorities selected China Road and Bridge Cooperation (CRBC) and China ExIm Bank as the main partners for the first stage of the project, to link the capital city Podgorica with the northern municipality Kolašin. The agreement signed with CRBC stipulates a construction period of four years and 30 percent of the investment to be subcontracted to domestic companies. Construction was to start in 2014, but is now expected to begin in the spring of 2015.

ExIm Bank will provide 85 percent of the financing (EUR 688 million) as a 20 year loan, denominated in dollars, with a fixed 2 percent interest rate and a six-year grace period. The government will provide the remaining 15 percent of the project's financing, from revenue over-performance, cuts in non-highway capital spending, and/or additional borrowing. The government also intends to rely on tolls once the highway is completed.

4. Laudable fiscal adjustment was achieved in 2013, but public debt continues to increase (Figure 2). Personal income tax (PIT) and value-added tax (VAT) rate hikes, a freeze on pensions, efforts to increase tax compliance, and recovering economic activity contributed to a fiscal adjustment of nearly 3 percent of GDP in 2013, despite large repayments of guarantees to the aluminum producer KAP. This reduced the overall deficit to 3.3 percent of GDP and the primary deficit to 1.1 percent (an overall balance of 0 and a primary surplus of 2.1 percent excluding the repayment of loan guarantees). Nonetheless, public debt increased to 58 percent in 2013, double the level of five years ago. Revenues in 2014 are expected to be higher than (conservatively) budgeted; however, so are expenditures. Balances for the year as a whole will depend on expenditure restraint in the last quarter.

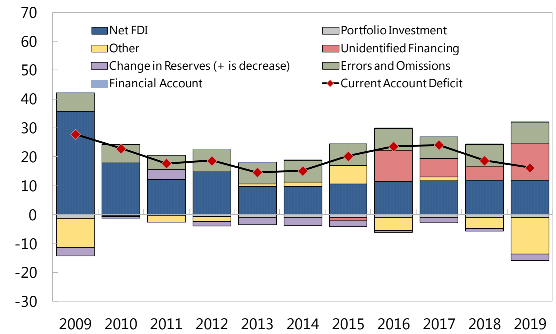
5. Underlying vulnerability in external balances remains. The economy has a narrow production base and very high import penetration—the trade imbalance was 40 percent of GDP in 2013. The current account deficit has widened in the first nine months of 2014 by 1.2 percent of GDP, mainly as a result of a worsening income balance, which deteriorated by about 1¼ percent, and transfers, which fell by ½ percent. The deterioration of the net exports of goods was more than offset by net increases on the service side. Net FDI inflows, which historically cover about 70 percent of the deficit, decreased by 7 percent in the first nine months of 2014.

Current Account Deficit and FDI Flows
(in percent of GDP)



Sources: MONSTAT and staff estimates

Financing of Current Account Deficit
(in percent of GDP)



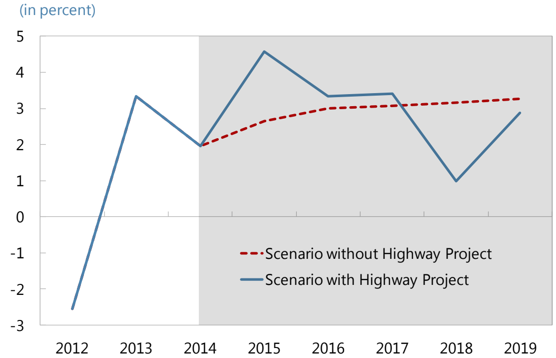
Sources: CBCG and staff estimates

6. **The effects of the weakening Russian economy on the Montenegrin economy are as yet unclear.** Russians comprise almost ¼ of total foreign tourists, yet tourist arrivals have increased by 1¼ percent through 2013:Q3.[2] However, capital inflows associated with real estate—the bulk of which historically originate from Russia—have fallen by 11 percent in the first ten months of 2014.

OUTLOOK AND RISKS

7. **Growth momentum has slowed, but is expected to pick up over the medium term.** Growth is projected to be only 2 percent in 2014, but converges to an underlying growth rate of 3¼ percent by 2019. The expenditures on the highway add more to growth in the near term.[3] Inflation pressures will likely remain negligible given low international commodity prices and subdued EU inflation. The current account is expected to widen as the base effects of strong electricity exports last year dissipate.

Real GDP Growth
(in percent)



Sources: MONSTAT and Staff projections.

8. **Montenegro faces a number of external and domestic risks** (see Risk Assessment Matrix):

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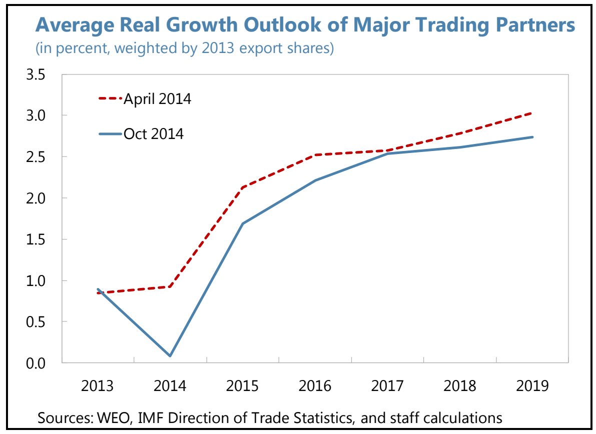
[2] Tourist numbers were down in June and July, but recovered in August, suggesting the downturn might have had more to do with poor weather.

[3] The highway is assumed to add about 2 percentage points to GDP growth in 2015, with corresponding base effects as work finishes in 2018. The increase reflects the assumed domestic value added from the extra spending on the highway, with a small contemporaneous spillover to aggregate demand. As this first stage of the project does not connect the coast to the Serbian border, and population density is low in the area of construction, significant effects on potential growth are not assumed.



- *External risks are mainly to the downside*: Montenegro is vulnerable to a downturn in external demand, especially from the euro area, Russia, and Serbia, which exacerbate existing competitiveness problems (see ¶30). Given euroization, the economy is liable to import "lowflation" from the euro area. Low oil prices could lower inflation further, while also improving external balances, lowering production costs, and boosting real incomes.[4] But they could also signal even weaker external demand that could counteract terms of trade benefits. If very persistent, they could also drive down electricity prices (on which Montenegro is highly dependent). Reliance on inward capital flows, and substantial public financing needs (even in the absence of the highway project), expose Montenegro to shifts in risk aversion and disruptions to global financial markets. Public debt will increase substantially as a result of the highway spending, and could escalate substantially in the event of negative growth shocks, and cost overruns on the highway could generate higher financing needs (see also ¶14 and Appendix I). External private debt is also large and projected to increase further, making the country vulnerable to growth and terms of trade shocks (Appendix II).

- *There are upside and downside domestic risks:* Growth could be substantially higher if some large-scale investment projects start earlier than anticipated and their spillovers to the domestic economy are greater. Conversely, delays to the highway and an undersea power connection with Italy could undermine growth. Demands for higher pensions and public sector wages have so far been resisted, but there is a risk that fiscal discipline could relax (¶14).

POLICY DISCUSSIONS

9. Major policy challenges include: (i) confronting significant risks to fiscal sustainability, (ii) addressing the ongoing problems in the banking sector, and (iii) accelerating structural reforms to boost growth potential and economic resilience.

[4] Oil imports are substantial, at around 10 percent of total imports by value. Staff estimates that a persistent 25 percent reduction in oil prices would improve the current account deficit by about 2¼ percent of GDP relative to the baseline projection. Energy accounts for 13 percent of the CPI basket.

A. Fiscal Policy: Safeguarding Debt Sustainability Amid Mounting Fiscal Pressures

10. The draft 2015 budget shows spending restraint. Compared to the 2014 budget:

- nominal (central government) non-highway capital spending is reduced by 23 percent (around EUR 24 million, which would result in a 0.8 percentage point improvement in the overall balance), with cuts focused on non-essential spending (e.g., sports centers rather than infrastructure);
- transfers for social protection fall as a share of GDP by 0.4 percentage points (0.3 percentage points from the fall in pension and disability, 0.1 percentage points from redundancy payments), though they increase in nominal levels; and there are increases in transfers to institutions, individuals, NGOs and the public sector (0.1 percentage points), and reserves (0.1 percentage points);
- no new revenue measures are introduced, although the authorities intend to continue measures against the informal economy.[5] Planned VAT changes are revenue neutral, but an additional tax bracket makes the system somewhat more complicated.[6]

Staff estimates that the expenditure measures would result in a 0.9 percent improvement in the overall balance when excluding highway spending (and assuming revenues stay constant as a share of non-highway GDP).[7,8]

11. However, the highway places a large burden on the public finances, more than undoing the improvement in the fiscal balances over the past two years. Assuming that revenue and non-highway expenditure policies in the 2015 budget are maintained through to 2019, staff projects public debt to increase to around 69 percent of GDP in 2017, and to gradually decline thereafter.[9,10] The debt profile is particularly sensitive to the timing of expenditures—if highway spending were to be more back-loaded, the peak debt ratio would not only be later but lower.

[5] Tax revenues increased by 1ppt of GDP in 2013. The effects of administrative measures intended to reduce informality, a VAT rate hike, and the post-crisis recovery are difficult to separate.

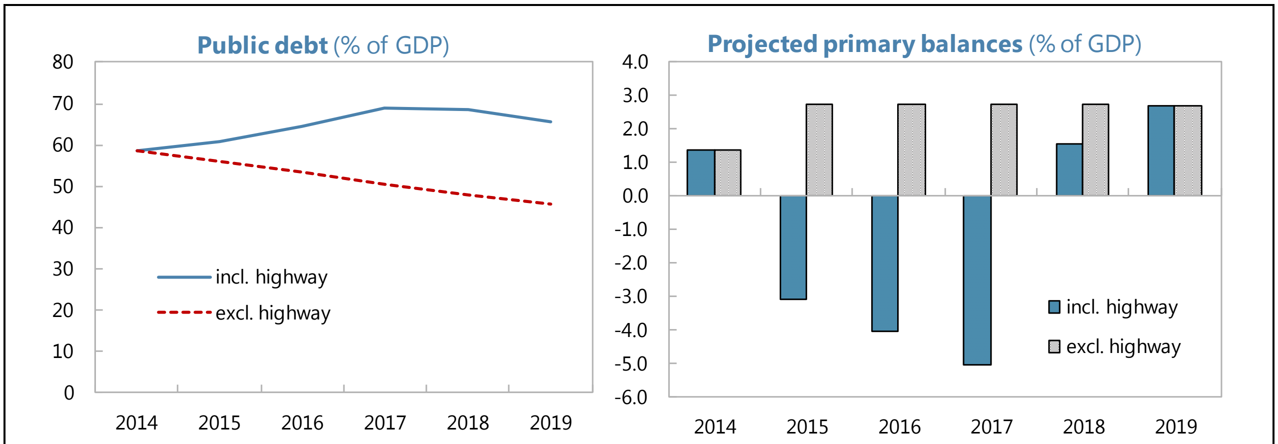
[6] The current system has a standard 19 percent rate, a discounted 7 percent rate, and a full-exemption bracket. The planned changes add two intermediate rates of 5 and 10 percent instead of the current 7 percent rate.

[7] The highway will be exempt from VAT payments, fuel excise will apply at the lower rate, there will be no excises on the import of machinery, and there is no requirement to pay PIT or contributions for foreign employees.

[8] Note that rounding means that these numbers do not add up to the contribution of 0.9.

[9] The profile of highway expenditures has not been finalized. Staff projections are based on the latest announced schedule (EUR 206 million in 2015, EUR 253 million in 2016, EUR 303 million in 2017, and EUR 47 million in 2018).

[10] In the absence of the highway, a primary surplus of 2.7 percent would have been expected from 2015; with the highway, deficits of around 3 to 5 percent are incurred through 2015–2017.



Source: Montenegrian authorities and staff calculations.

12. Medium-term funding needs are large. Substantial repayments of Eurobonds and commercial bank loans to the state are due over the next five years, peaking at 8–9 percent of GDP a year in 2015, 2016 and 2019. Demand for domestically-issued debt has been increasing, but Montenegro will remain highly dependent on external funding. With the additional burden from the highway, gross financing needs exceed 15 percent.

13. Important progress in divesting from state-owned industries has been made, but is not yet complete. Consistent with Fund advice, the authorities have finished payments arising from KAP guarantees (amounting to 0.8 and 3.2 percent of GDP in 2012 and 2013), and have sold the loss-making aluminum producer, KAP, but privatization payments have not been fully received.[11] The state is still involved in a number of smaller companies that it has tried, as yet unsuccessfully, to sell, and other guarantees amounting to almost 10 percent of GDP remain.

14. Hence, the public finances are subject to numerous risks:

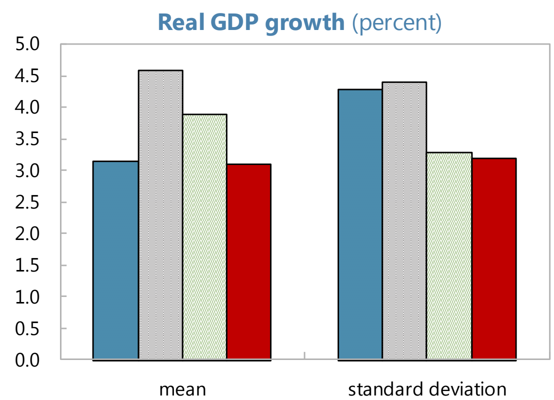
- *Growth:* Real GDP growth has historically been highly volatile, a particular concern for a unilaterally euroized economy (Box 2). The accompanying DSA shows that debt would increase to 86 percent of GDP following a one standard deviation shock to growth. The historical sample includes the boom and bust; hence, the shock is large—4.9 percentage points—and arguably not useful as a guide to likely future shocks. A 1ppt shock—as seen over the past year—would increase debt to 72 percent of GDP.

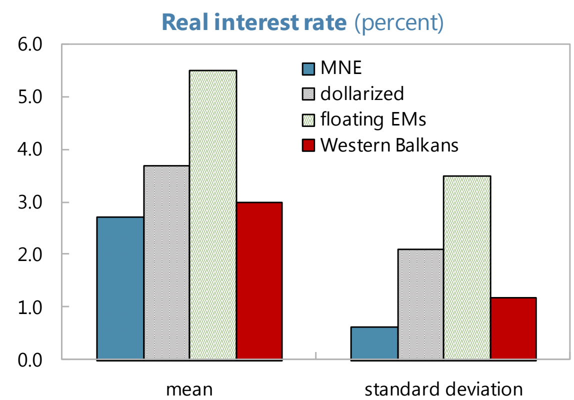
[11] Local company Uniprom signed a contract to buy KAP for EUR 28 million in June, and took over in July. However, it received a two-month extension on payment at the time, and another six-month extension in September when it paid EUR 4 million and provided a guarantee from BNP Paribas Bank for the remainder.

Box 2. Fiscal Policy in a Unilaterally Euroized Economy

Using another country's currency provides for a strong monetary anchor and reduces administrative costs associated with running an own currency. However, the arrangement puts a premium on disciplined fiscal policies and flexibility to adjust to external shocks. With this in mind, some stylized facts of economies that have unilaterally adopted another currency[1] are notable:

First, Montenegro, along with other euroized and dollarized economies, has benefited from relatively favorable interest rate-growth differentials. However, it has also experienced greater volatility of growth rates. This is of particular concern as even brief, one-off growth shocks can erode much-needed fiscal buffers and can have a lasting negative impact on debt sustainability.





Source: World Economic Outlook.
Note: Averages over 2000-2013. The real interest rate is calculated from the effective nominal interest rate on gross government debt, deflated using the GDP deflator.

Second, public revenues are more volatile in dollarized economies than in their non-dollarized peers. Regression analysis suggests that primary balances have typically not responded to debt or economic conditions in dollarized economies. As boom years were not used to build sufficient buffers, these countries often had to resort to pro-cyclical cuts, for instance in reaction to difficulties in market access. Hence, dollarized and euroized economies have faced large increases in debts since the crisis.

These economies differ greatly in many respects, so caution should be exercised when drawing inferences about policy. Nonetheless, their experiences suggest that they should aim for larger fiscal buffers than their emerging market peers. Fiscal policy should also become more responsive to the business cycle, in particular by using boom years to create policy space.

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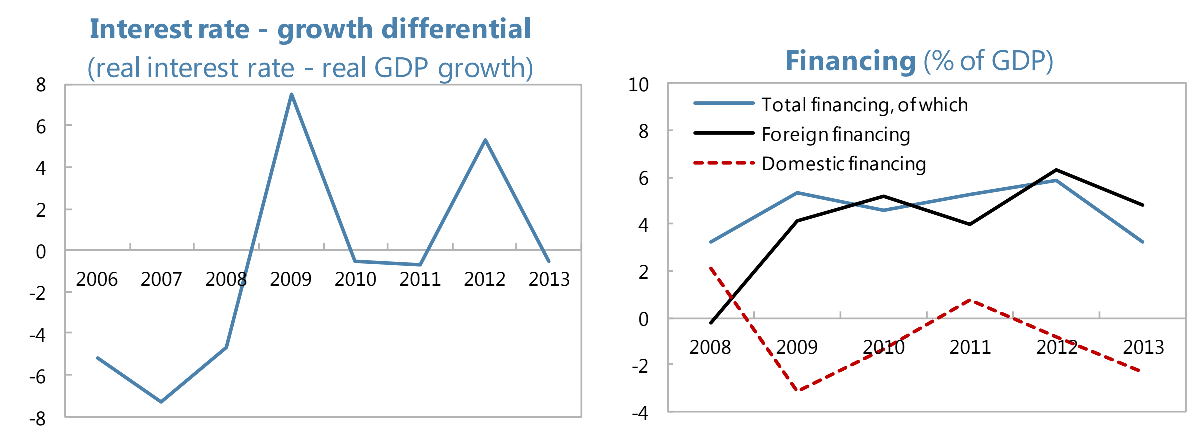
[1] The countries in the "dollarized" sample include Montenegro, Kosovo, Ecuador, El Salvador and Panama. "Floating EMs" includes Albania, Serbia, Argentina, Brazil, Chile, Colombia, Guatemala, Mexico, and Peru (for the years for which they were classified as floating or free floating). "Western Balkans" includes Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, and Serbia.

- *Financing*: The successful issuance of a Eurobond earlier in 2014 alleviated short-term pressures.[12] However, Montenegro's high reliance on foreign financing makes it vulnerable to changes in market conditions as it rolls over existing loans. Financing needs for the highway are mostly met by the ExIm loan.

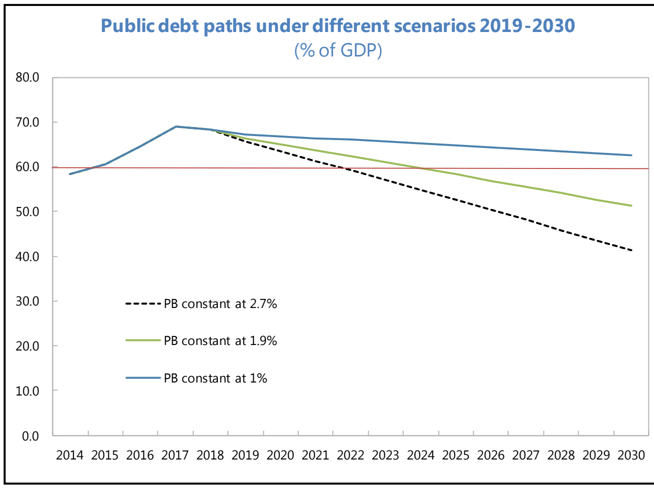
- *Political economy:* The government is coming under increased pressure to relax the freeze on pensions and increase public sector wages.

- *Highway costs:* Experiences of other highway projects show that delays are common and that cost overruns can be sizeable.[13] The dollar denomination of the ExIm loan creates exchange rate risk that will be costly to hedge.



Source: Montenegrin authorities and staff calculations.

15. The offsetting measures in the draft 2015 budget are appropriate, given still-fragile growth, but a long period of strong fiscal discipline will be needed. The measures should be at least maintained through the highway construction period, as assumed in the Staff projections. This would result in a primary surplus of 2.7 percent of GDP in 2019, after highway construction is finished (if no downside risks eventuate). Staff advises maintaining current spending discipline and revenue measures after the



[12] A EUR 280 million Eurobond was issued in May 2014, at a coupon of 5½ percent, of which EUR 195 million was used for budget financing and EUR 85 million to retire Eurobonds from 2010 and 2011. Domestic issuance of Treasury bills totals EUR 180 million so far this year. Hence, estimated financing needs of EUR 343 million in 2014 are covered. However, staff estimates financing needs to be higher in 2015, even aside from the highway.

[13] For example, the Albanian section of the Albania-Kosovo highway cost more than double its initial estimate.

highway spending ends, while restoring the non-highway capital budget, to allow for other essential infrastructure projects. This would imply a surplus of 1.9 percent of GDP, to reduce debt below 60 percent within ten years.

16. To reduce risks and improve funding conditions, the authorities should lay out long-term fiscal plans. A credible and reliable consolidation requires fundamental expenditure reform, especially of the pension system, which is persistently underfunded, and the public sector wage bill, which is high by regional standards (Figure 3). Elements of a long-term plan would include:

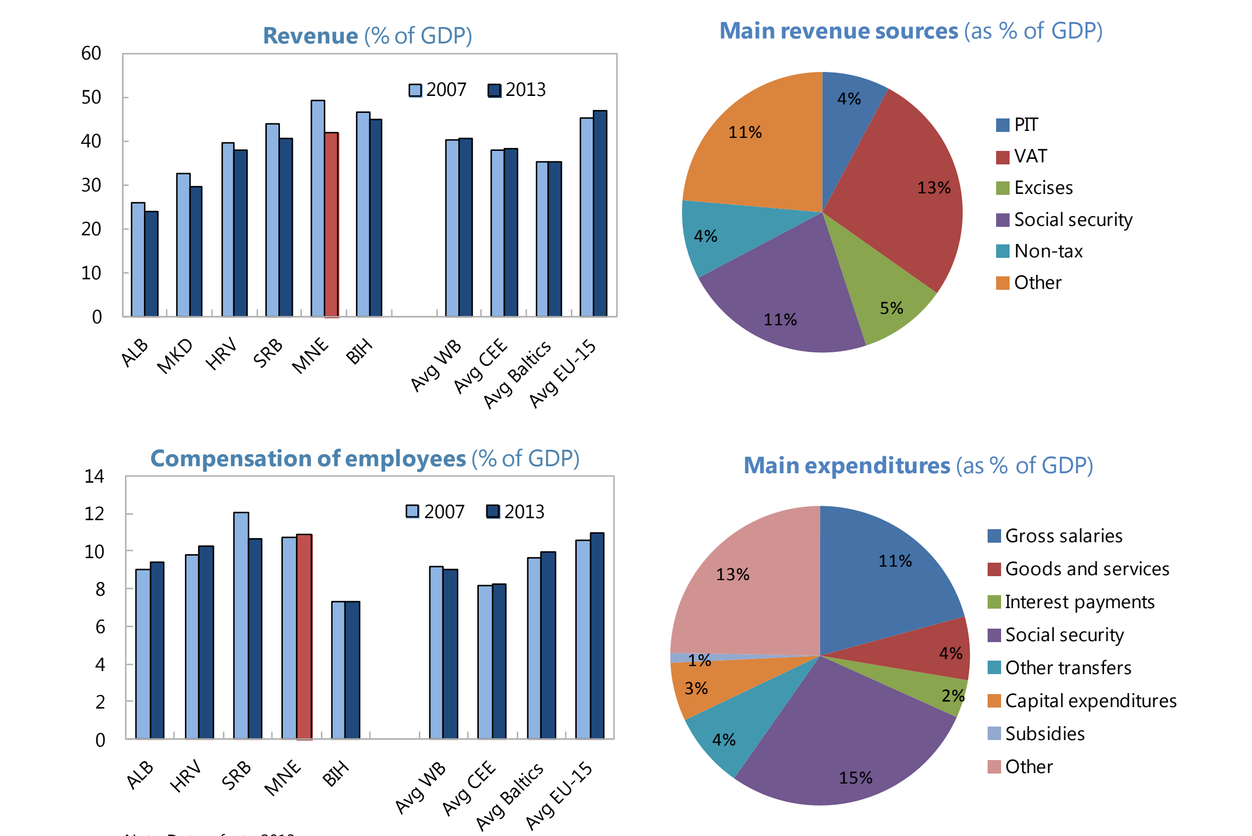
- Further pension reform, to show how pension costs can be contained over the near term.[14]
- Further cuts in the public sector wage bill (including through rationalizing employment), which would also reduce the relative reservation wage and help improve competitiveness.
- Identification of and budgeting for essential non-highway capital budget items.[15]

17. Staff does not favor substantial and permanent increases in taxes, but there is potential to raise VAT revenues in the near term. Revenues are relatively high for the region, a low PIT rate is appropriate to avoid further disincentives to formalization, and a much higher CIT rate risks deterring investment. However, there is potential to raise more revenues from VAT, for instance by eliminating exemptions, and unifying rates, which could increase compliance and yields.[16]

[14] The 2011 pension reform increases the pensionable age to 67 only by 2025 for men and 2041 for women.

[15] Key needs include infrastructure to support the sustainable development of the tourism sector and investment in the energy sector, as losses in energy distribution are significant.

[16] The current top rate of 19 percent is lower than many peers, and exemptions bring the average effective rate to 12–13 percent.



Note: Data refer to 2013.
Source: World Economic Outlook, Montenegrian authorities and staff calculations.

18. Additional measures would be needed in the near term if risks eventuate. The authorities should also lay out additional consolidation plans that would be applied in the event of unanticipated shocks to growth or refinancing and highway costs. The first recourse should be to cut or delay spending on the highway.

19. The fiscal framework should be bolstered. A fiscal rule was approved in April to embrace the Maastricht 3 percent of GDP deficit and 60 percent of GDP debt limits. Enforcement is, however, weak: there are no automatic spending caps, no deadlines for implementing fiscal measures, and the exception for "strategically important projects" undermines its credibility.[17] The authorities should also strengthen controls in the broader public sector and refrain from providing more support to enterprises, whether direct or indirect.

Authorities' views

20. The authorities acknowledged the risks to the public finances from the new highway and aim to manage them through a combination of revenue gains and expenditure restraint.

[17] If the deficit or debt exceed the 3 and 60 percent, respectively, the government has to submit a proposal of corrective measures to the parliament within 60 days, but there is no deadline by which the deficit/debt has to be below the limit again.

- The authorities pointed to conservative revenue estimates in their budgets, and further gains from on-going efforts to address informality (mainly through administrative measures, such as changing the criminal code to treat the payment of wages without corresponding payment of taxes and contributions by employers as a criminal offense, and similarly, treating the payment of wages in cash as a criminal offense).

- They pointed to the strong demand for the Eurobond issuance in May 2014 (which was heavily oversubscribed), and saw good prospects for continued market access at favorable terms.

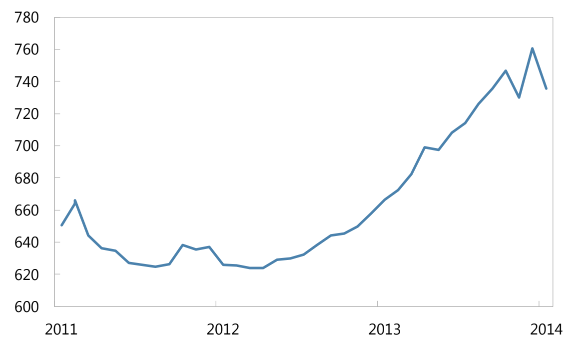
- The authorities expect large growth benefits from the highway to tourism, transport, trade and regional development, which in turn would boost social cohesion. They consider the highway loan's terms to be very attractive, despite the exchange rate risk. The authorities hope to raise toll revenues of EUR 17 million (0.4 percent of projected 2018 GDP) per year on completion of the highway in 2018, increasing to EUR 60 million in 2047, based on expectations of high traffic flows.

B. Monetary and Financial Sector Policies: Strengthening Credit Conditions

21. Financial conditions remain tight. Lending rates remain high and have increased in real terms. Interest rate spreads are around 7½ percentage points, near their historical peak, despite deposit rates falling to around 2 percent. Notwithstanding a modest increase in lending to households, overall credit contracted by 3 percent (yoy) through October.

Deposit to Lending Rate Spread

(Basis points)



Sources: Central Bank of Montenegro and Fund staff calculations.

22. The picture for banks' health is mixed (Figure 4):

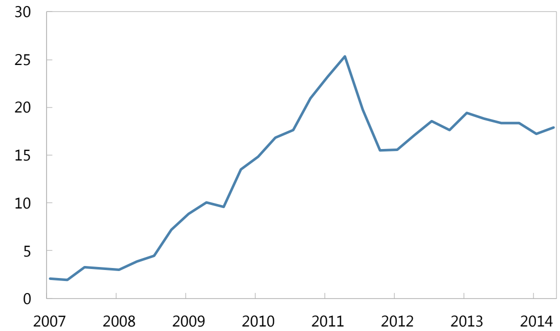
- Banks' capitalization has improved, although it is relatively low compared to those in the rest of Eastern Europe.[18]

- In terms of funding, deposits continue to grow, and liquidity appears sufficient, at 30 percent of short-term assets. On average, banks have reduced the ratio of loans to deposits since the crisis to a more sensible 100 percent, although this figure conceals wide heterogeneity across banks.

[18] Banks calculate regulatory capital based on Basel 1.

- Asset quality remains a problem. Over the course of 2011–12, some EUR 600 million in NPLs were shifted to the balance sheets of factoring companies. A change in classification at the end of 2012 further reduced reported NPLs, but the level remains high at 17 percent of total loans for the banking system as a whole. Banks with high levels of NPLs are naturally more risk averse and hesitant to lend and/or charge high effective lending rates

Nonperforming Loans
(Percent of gross loans)



Sources: CBCG and Fund staff calculations.

23. Regulatory provisions exceed the required levels under IFRS accounting standards but do not necessarily lead to losses being recognized. System-wide regulatory provisioning is 68 percent. The regulatory environment is reinforced by annual onsite reviews, coupled with stress tests. However, regulatory provision levels exhibit a wide range across banks, from 33 percent to 85 percent. Given that banks in Montenegro have very similar business models and have experienced the same lending environment, this raises questions about whether all banks follow classification rules properly (e.g., whether they have been "evergreening" loans). Further, banks report significantly lower levels of provisioning in their IFRS financial statements than under the regulatory provisioning rules, which might reflect overly optimistic collateral valuations used to offset loan impairment. Hence, banks might be understating losses implied by regulatory provisions in their income statements and avoiding writing off bad loans.

24. Greater transparency, simplicity, and oversight could bring useful benefits.

- *Reporting*: Currently, Montenegro misses potential benefits from its relatively strict regulatory provisioning environment, as the provisions are not reported publicly (only the provisions per IFRS standard are published). Quarterly Reports on banks are prepared but not published. Nor does there appear to be a published policy on collateral valuations. An enhanced reporting regime could expose problems and increase incentives to resolve bad loans. External asset quality reviews could be considered as an independent assessment of banks' financial health and a means for boosting confidence.

- *Regulatory classifications*: The regulations specify seven categories of loan performance for provisioning purposes, but data on the values of loans in the "B1" and "B2" and "C1" and "C2" subcategories are not available. Simplifying to five categories (A, B, C, D, and E) would make corroboration easier, and greater automaticity of classifications might prevent evergreening practices.

- *Oversight of factoring companies*: The supervisor lacks any oversight over factoring companies, which further reduces the transparency of the financial system as around EUR 600 million have been effectively transferred out of the oversight of regulators but remain in the system. Staff urged progress on the draft law on factoring companies, which should grant the supervisor powers of direction over the use of factoring companies and create transparent and verifiable standards for recording assets held by such vehicles.

25. The authorities are considering a number of measures:

- The authorities have tabled a law before parliament on voluntary restructuring—the "Podgorica Approach"—that aims to encourage out-of-court workouts to resolve impaired loans. The approach is potentially useful for solvent firms with temporary cash flow or liquidity problems.
- In response to what the authorities perceive as lack of competition in lending rates, new bank licenses have been approved, bringing their number to 12, and the authorities have indicated a willingness to grant more.[19]

26. Policies are needed to address credit risk. Staff analysis suggests that lending spreads reflect structural lending risk premia, which commends reform of legal processes and enforcement.

- The Montenegrin banking system does not show typical signs of lack of competition: the number of banks is high, and profitability is relatively weak. Widening spreads could reflect the wish to rebuild profitability. Going forward, lending spreads could remain high to cover lending risks arising from difficulties in reliable credit information, securing collateral, and inconsistent application of regulations (e.g., tax administration) (Box 3).[20]
- The recent introduction of dedicated public enforcement officers could facilitate the resolution of some claims, but further progress will depend on more timely court decisions, with penalties for delays, and improved administration.

27. Reserve assets appear adequate. Montenegro is euroized. Hence, traditional reserve metrics normally applied to countries with fixed exchange rate regimes—such as the coverage of a certain number of months of imports or a percentage of short-term external debt—are not very useful. As an economy without lending of last resort operations, a better metric is to look at reserves as a ratio to deposits. On these terms, Montenegro ranks fairly well against other dollarized or euroized economies, and the ratio has been broadly stable.

[19] The authorities also discussed lending rate caps as a measure to boost credit growth but have opted not to pursue such measures, which would risk reducing credit availability to newer and smaller enterprises.

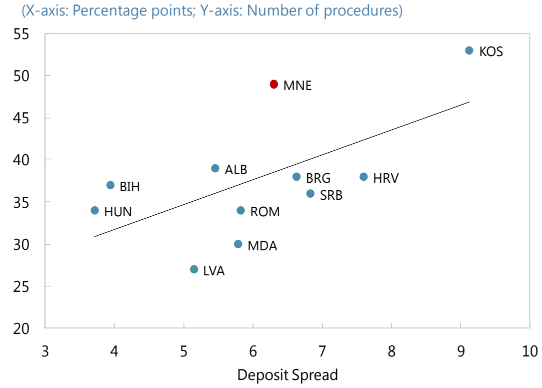
[20] Although net lending has been contracting, household lending has been expanding, which might be due in part to lower lending risk: the law allows creditors to directly garnish wages for past due debts.

Box 3. Interest Rate Spreads

High lending spreads over funding rates could be explained by large operational costs, weak profitability, and high credit risk, the last in turn reflecting structural factors such as institutions, legal frameworks, and the rule of law and its outcomes. To look at which of these could be significant for Montenegro, lending spreads in a sample of central and eastern European economies are correlated with a range of indicators.[1]

For example, nominal GDP—a proxy for economies of scale—is inversely and significantly correlated with lending spreads, suggesting that smaller economies might face inherently higher borrowing costs. (However, spreads are uncorrelated with the level of bank concentration.)

Deposit Spread and DB Procedures to Enforce Contracts
(X-axis: Percentage points; Y-axis: Number of procedures)



Contract enforcement is cited as a key risk to lending by banks in Montenegro. Likewise, the data indicate that structural factors are likely to be important for credit risk. For example, lending spreads are positively and significantly correlated with the number of procedures to enforce a contract. Similarly, higher recovery rates are associated with a significantly lower price of lending. Lending spreads are also positively correlated with the average time needed to enforce a contract and the cost of enforcing a contract, while measures of the strength of investor protection are negatively correlated, indicating that a higher level of protection would generally be associated with lower markups. However, given the small sample for which data are available, these latter correlations are not significant at conventional levels.

The results suggest that policy measures that address the time and cost of securing collateral and the predictability of legal outcomes would help lower borrowing costs. Such reforms will have long run effects in lowering the structural risk premia being paid by borrowers.

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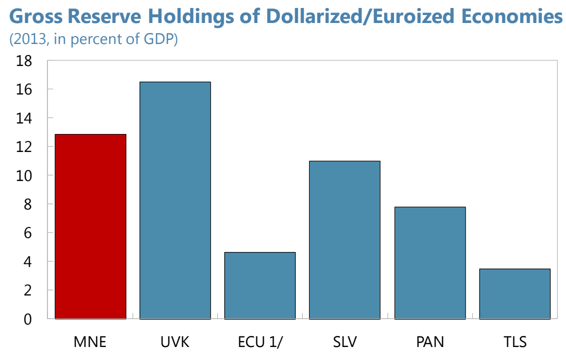
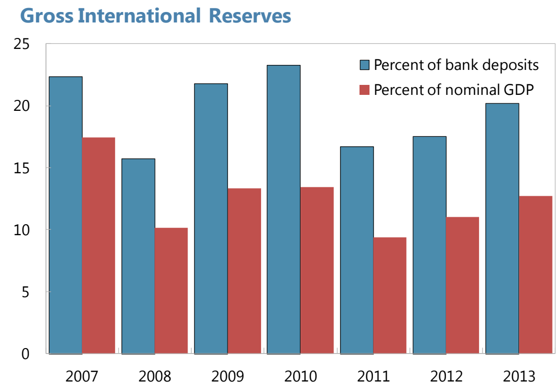
[1] The sample of countries includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Moldova, Montenegro, Romania, and Serbia. All measures are from the World Bank's Doing Business survey.



1/ Net reserves.
Sources: WEO, Staff Reports, and staff estimates.



Sources: CBCG, Haver Analytics, IFS, and staff calculations

28. The authorities have undertaken measures to increase oversight of AML/CFT issues. Banks are responsible for identifying politically exposed persons and beneficial owners. In practice, there are problems with data issues, owners of foreign firms can be difficult to trace, and banks might be reluctant to jeopardize relations with clients. The authorities are thus encouraged to closely monitor the implementation of risk management systems that identify politically exposed persons and ultimate beneficial ownership. A new law in 2014 shifted the responsibility for initiating violation procedures to the central bank. However, fines appear low, being limited by law to EUR 25,000.

Authorities' views

29. The authorities regard the large stock of NPLs and high prevailing interest rates as key policy challenges. They expressed confidence that the set of policy initiatives underway hold the potential to make progress in both these areas. In particular, the authorities indicated that:

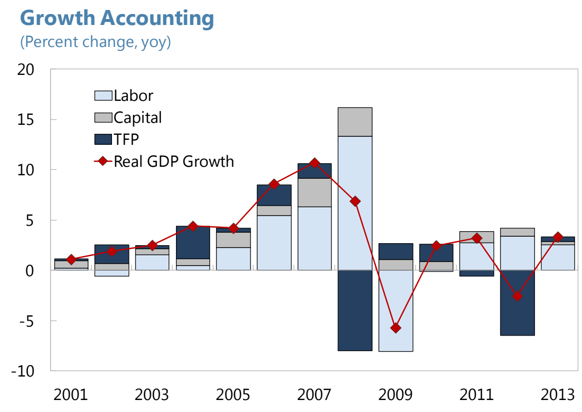
- The draft law on restructuring will help align incentives and facilitate a substantial reduction in NPL levels. The authorities also indicated that a law granting the supervisor oversight of factoring companies was imperative to enhance transparency and the smooth functioning of the financial system.
- Ensuring adequate competition in the banking sector is essential, as lending premiums reflect a broader market failure.
- The recent introduction of public enforcement officers marks an important step to strengthen contract enforcement, but it is pre-mature to assess the effectiveness of the program at this stage.
- There is scope to increase penalties banks face for breaches of AML/CFT regulations, and the authorities are currently reconsidering the laws governing the limit on bank penalties.

C. Structural Reform: Strengthening Economic Resilience and Reinvigorating Growth

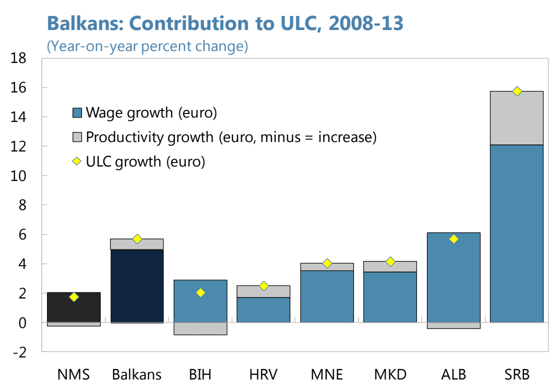
30. Potential growth and competitiveness are concerns (Box 4):

- Montenegro has historically relied on deepening capital and labor intensity to achieve high growth, while productivity growth has been relatively muted. Population, however, is expected to decline, implying that labor participation and employment will need to increase from their current low levels of 53½ and 43½ percent.

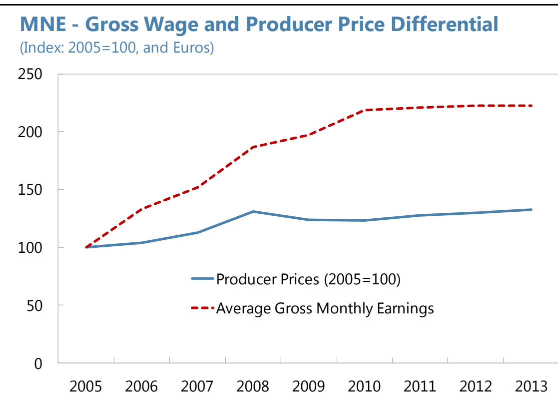
- Recent low nominal wage growth has lowered unit labor costs, but not in relation to peers. In recent years, wages have outpaced producer prices.



Sources: Montenegrin authorities and staff calculations.



Sources: WEO; Haver; and IMF staff calculations.

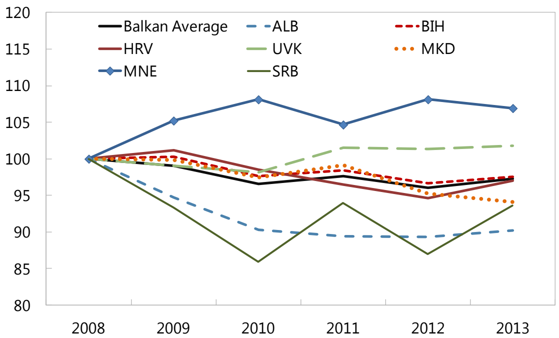


Sources: Monstat and staff estimates.

Box 4. External Competitiveness

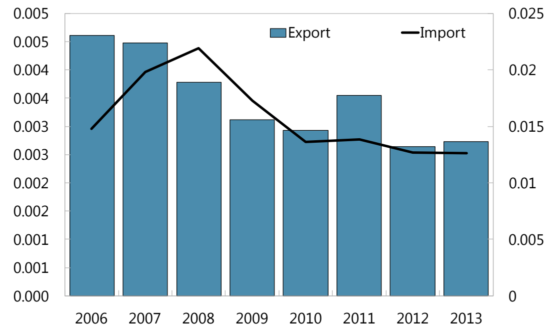
Indicators of Montenegro's competitiveness are mixed. The CPI-REER has been roughly stable relative to regional comparators, largely reflecting a modestly appreciating euro balanced by weak price pressures. Wage growth has moderated substantially, but unit labor costs remain relatively high, potentially pointing to competitiveness issues. Although Montenegro's share in world trade improved a little in 2013, the share is substantially lower than in previous years.

Real Effective Exchange Rate
(Index 2008=100)



Sources: INS and staff calculations

Montenegro: Importance in World Trade
(percent of total world trade)



Sources: DoT Database and staff calculation

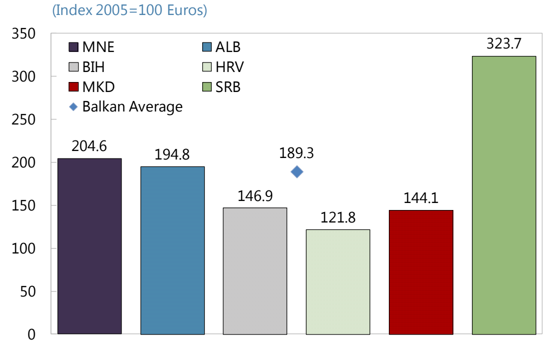
Staff analysis using the Macroeconomic Balance and External Sustainability approaches indicates the current account balance is around 9–11 percentage points below its norm, possibly pointing to weak cost competitiveness. However, data uncertainties (related to errors and omissions in the balance of payments, which amount to about 7½ percent of GDP), the short length of the time series, and the volatility associated with small countries make point estimates from a CGER-type analysis highly imprecise.[1]

Current Account Balance Gap:
Macrobalances and External Sustainability Approaches
(in percent of GDP, unless otherwise specified)

	Macroeconomic Balance Approach	External Sustainability Approach
CA Norm 1/	-7.0	NA
NFA-stabilizing CA	NA	-5.6
CA Balance	-16.2	-16.2
Gap	**9.2**	**10.7**

Source: IMF staff estimates
1/ Vitek, Francis (2014), "Exchange Rate Assessment Tools for Advanced, Emerging, and Developing Economies.'

Real Unit Labor Costs, 2013
(Index 2005=100 Euros)



Sources: WEO; Haver; and IMF staff calculations.

Staff's preferred metric is to look at relative unit labor costs, which in Montenegro are slightly above the average for the Western Balkans, which in turn is above the level of New Member States. In the absence of an independent currency, this suggests ongoing wage restraint and/or a boost to productivity will be required to restore competitiveness.

Box 4. External Competitiveness (continued)

Montenegro generally ranks well on business indicators compared with regional peers. Nonetheless, reforms to improve competitiveness remain important. For example, continued external stability will hinge on sustained tourism development and attracting diversified FDI flows. Priorities in this area include improving infrastructure, enhancing the quality of services, and reducing administrative burdens that could undermine future diversified investment opportunities.

The overall competitiveness ranking in tourism has been improving

	Overall ranking		Regulatory framework		Business environment and infrastructure		Human, cultural, and natural resources	
	2011	2013	2011	2013	2011	2013	2011	2013
Spain	8	4	22	14	10	5	6	6
Cyprus	24	29	23	22	14	21	44	46
Greece	29	32	34	39	29	33	29	30
Italy	27	26	45	50	27	29	15	14
Malta	26	24	9	15	22	14	54	49
Croatia	34	35	42	42	36	39	43	42
Slovenia	33	36	29	33	33	35	53	52
Slovakia	54	54	39	43	57	60	52	55
Bulgaria	48	50	54	58	44	45	51	53
Montenegro	**36**	**40**	**32**	**34**	**49**	**50**	**36**	**47**
Turkey	50	46	66	64	55	52	28	27
Romania	63	68	51	66	66	68	66	73
Serbia	82	89	67	74	84	81	94	109
Albania	71	77	53	63	91	90	61	63

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

[1] A significant share of the current account balance is related to imports funded by FDI, reflecting large investment needs, especially for large-scale infrastructure projects; conversely, in a small economy such as Montenegro, a surge in investment-related imports can result in large swings to the current account balance.

31. **Improving the functioning of the labor market is crucial.** The labor market does not appear efficient at allocating labor: unemployment rates are persistently high—registered unemployment is around 18½ percent (youth unemployment 32½ percent) of which 91 percent is long-term—while seasonal and low-paid employment is mostly provided by foreign workers. The system appears rigid: a multi-tiered collective bargaining process applies a standard wage across sectors. This includes public and private employment, which adds to the importance of public sector wage setting for competitiveness. Further, non-wage costs are relatively high. Although the law provides specific criteria for dismissal, in practice the burden of proof is placed on employers, and outcomes are frequently over-turned by the courts. Hence, the risk premium for employment is high. Private sector employers appear to respond by placing new workers on short-term contracts and avoiding extending employment,[21] which prevents development of human capital and inhibits productivity.

32. **The authorities have responded with a mix of structural reform initiatives and temporary government-funded hiring programs.** Substantial labor market reform was undertaken in 2011. Lay-off costs were reduced, by restricting severance packages to "in-firm" as opposed to "lifetime" years of service, thus reducing an important disincentive to hiring. Fixed-term contracts were limited to a maximum of 24 months, which effectively tightened employment

[21] Redundancy costs amount to 6½ weeks of salary after 5 years of continuous employment and increase to 13 weeks of salary after 10 years. This puts Montenegro's ranking at around 73 out of 187 countries in terms of redundancy costs (with 1 being least costly) according to World Bank indicators.

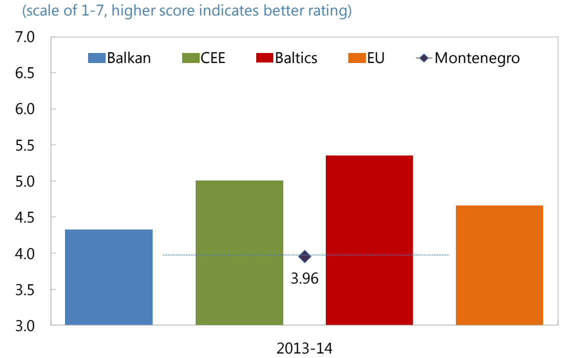
protections. Despite these changes, unemployment remains high and labor participation low. In recent years, the authorities have favored selective subsidy programs to boost employment, such as financial incentives to hire "hard-to-employ" individuals and youths and a temporary (9-month) government-sponsored internship program for recent university graduates. The effectiveness of these programs, however, is not clear: youth unemployment has only decreased modestly since the introduction of the internship program, and anecdotal information suggests that employers tend to hire only around 10 percent of participating interns.

33. Social benefits are not the primary driver of labor informality. Although there is potential scope to lower the opportunity costs of formal employment for people eligible for social assistance (e.g., by shifting to a gradual withdrawal of benefits and/or earned income tax credits), social benefits are not generally seen as a key source of labor market distortions.[22] The authorities plan to implement a "social card" system by the end of 2014, which will consolidate all benefits in a single system. Staff welcomed this initiative, which is expected to significantly increase transparency and deter fraudulent claims.

34. But the efficiency of the labor market will need to increase. Flexibility in wage bargaining should be encouraged to allow wages to evolve with productivity. Measures are likely needed to reduce informal employment incentives, such as onerous dismissal procedures. Subsidy schemes constitute "stop-gap" measures.[23] Outcome-oriented active labor market schemes, such as where financial incentives are linked in some fashion to improved labor outcomes, are therefore preferable.

35. Concentration is also a problem. Montenegro lacks domestic economies of scale, and the lack of diversification makes it vulnerable to external shocks. Infrastructure failings—such as the dependence on seasonal energy, and inefficiencies in utilities—are likely holding back development. Diversification might be held back by investment bottlenecks, notably delays in registering property and weaknesses in enforcing contracts (which are areas in which Montenegro ranks relatively poorly). The quality of the overall macroeconomic environment is also cited as problematic, which places a premium on policy discipline and reforms to improve cost competitiveness and economic flexibility.

Quality of Macroeconomic Environment by Region
(scale of 1-7, higher score indicates better rating)



Sources: WEF Competitiveness Indicators and Staff calculations.

[22] Kovtun D, et. al, Boosting Job Growth in the Western Balkans (IMF Working Paper, WP/14/16).

[23] Staff estimates the fiscal cost of the internship program at about 0.3 percent of GDP.

36. There is scope to further address structural impediments to investment. Staff encourages efforts to further: i) rationalize and ensure the consistent application of regulations; ii) facilitate property registration and streamline administrative procedures; iii) improve the efficiency of the judicial system, particularly as regards collateral enforcement, and, iv) clamp down on unregulated and informal businesses that hinder high-quality investments and fiscal revenue intake, and v) fight corruption.

Authorities' views

37. Efforts are underway to formulate a strategy to combat labor informality and increase the transparency of the social benefit system. The authorities consider that the multi-tier collective bargaining framework is well-understood and sufficiently flexible to avoid distortionary labor market outcomes. They see ongoing merit in targeted employment programs, such as the internship scheme which is a key initiative to bridge skills mismatch. A study of the underlying causes of the informal economy is underway (to be completed by July 2015) and is regarded as a pre-requisite to developing a broader policy strategy to improve labor market outcomes.

38. Initiatives to further improve the business environment are moving forward. The authorities see FDI as critical to boosting long-term growth and promoting economic diversification, particularly in tourism and energy. The government has recently introduced important business environment improvements, notably establishing a one-stop shop for construction permits, strict time limits for the issuance of approvals, and a decrease in procedures required for obtaining a permit. In addition, nearly 60 percent of recommendations endorsed in a 2013 Action Plan to improve the regulatory environment have been implemented; full implementation is expected by end-2015. Amendments to the Law on Enforcement and Security are also being considered to improve the enforcement of claims.

STAFF APPRAISAL

39. Montenegro is continuing its economic transition but confronts policy challenges associated with a rising public debt burden and the fallout of the lending boom. The economy is relatively undiversified and relies heavily on external financing. The rapid rise in public debt has increased vulnerabilities and the large stock of bad loans has likely constrained lending. The highway project should provide a short-term boost to economic activity but exacerbates debt-related vulnerabilities.

40. Growth is expected to pick up, but risks weigh on the downside. Growth is projected to increase to 4½ next year as the highway project gets underway. But Montenegro is vulnerable to a downturn in external demand, especially from the euro area and Russia, and substantial financing needs expose the country to shifts in risk aversion and disruptions to global financial markets.

41. Sustained fiscal restraint over the medium-term will be needed, with an emphasis on fundamental expenditure reform. The authorities have undertaken bold fiscal adjustment over the past two years that constitutes an important step to addressing imbalances. These efforts, along with a recovery in economic activity, helped deliver fiscal adjustment of nearly 3 percent of GDP in 2013. The authorities are to be commended for ceasing repayments of guarantees to the aluminum producer, KAP, and addressing longstanding issues at KAP that have facilitated its sale. A timely completion of the KAP transaction would be welcome. The measures in the draft 2015 budget that partly offset the impact of the highway on the deficit are welcome, as are the authorities' efforts to restrain the public sector wage bill. Going forward, laying out clear long-term plans for managing the public finances would boost credibility and reduce risks to market access. Fundamental expenditure reform, especially of the pension system and the public sector wage bill, would be an essential part of such plans. In addition, the authorities should define contingency measures to address unforeseen fiscal shocks, with the first recourse being a delay or cut in highway spending. Efforts should continue to reduce support, directly or indirectly, to risky and/or loss-making state-owned enterprises.

42. Addressing NPLs and improving credit conditions are priorities. The "Podgorica Approach" has the potential to facilitate debt workouts. This effort should be complemented by reforms to address problems with contract enforcement and securing collateral that have impeded timely NPL resolution and likely contribute to high interest rate margins. Although provisioning coverage for the banking system as a whole appears sizable on a regulatory basis, the wide variation across banks may warrant enhanced supervisory scrutiny. There is scope to improve regulatory transparency, including by publishing quarterly banking reports with information on the level of regulatory provisions and a summary of all stress test results.

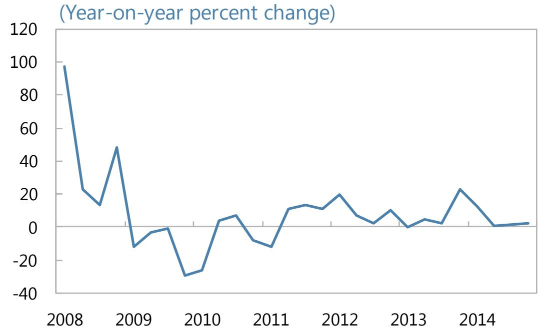
43. Structural reforms are essential to raise potential growth and improve flexibility and competitiveness. Measures to ensure that wages adjust in line with productivity developments and to reduce disincentives for employment (such as onerous dismissal procedures) would improve labor market outcomes. Sustaining recent policy momentum to strengthen the business environment and spur investment is also critical. Priorities include simplifying the regulatory environment, eliminating burdensome administrative procedures, improving the efficiency of the judicial system, and combating economic informality, including by effectively implementing the AML/CFT regime.

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

Figure 1. Montenegro: Real Sector Developments

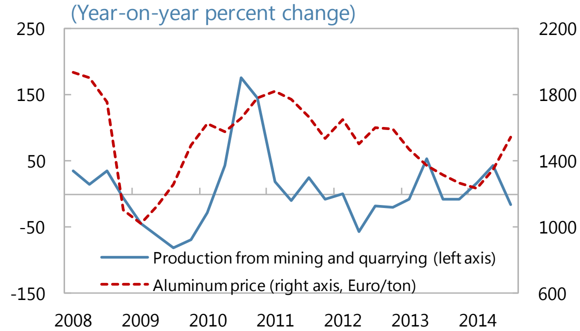
A modest increase in tourism receipts is expected but…

Travel Income
(Year-on-year percent change)



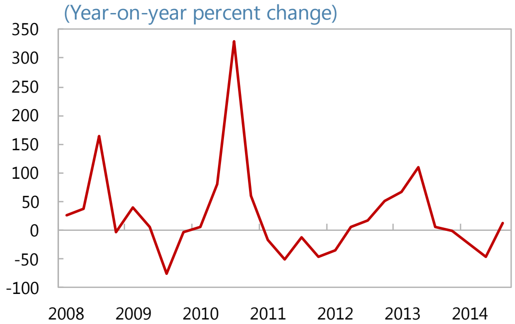
…production is faltering. The unresolved privatization of KAP has contributed to slow metals production…

Metals Production
(Year-on-year percent change)



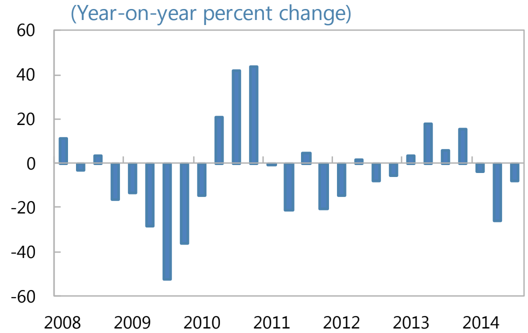
…and a return to normal rain patterns has decreased electricity output.

Electricity Production
(Year-on-year percent change)



Overall industrial indicators point to a decrease in economic activity in 2014…

Industrial Production
(Year-on-year percent change)



…despite indications of a modest pick-up in private consumption.

Retail Trade
(Year-on-year percent change)

However, growth momentum is expected to pick-up next year as delayed infrastructure projects get underway.

Construction Activity
(Year-on-year percent change)

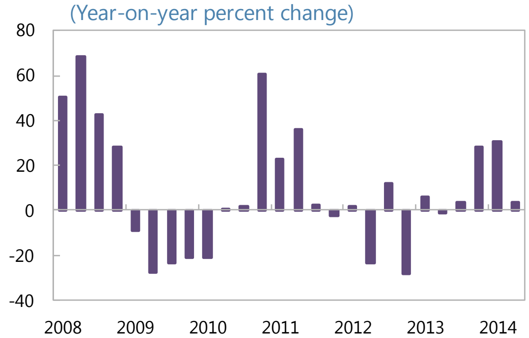


Figure 2. Montenegro: Fiscal Developments

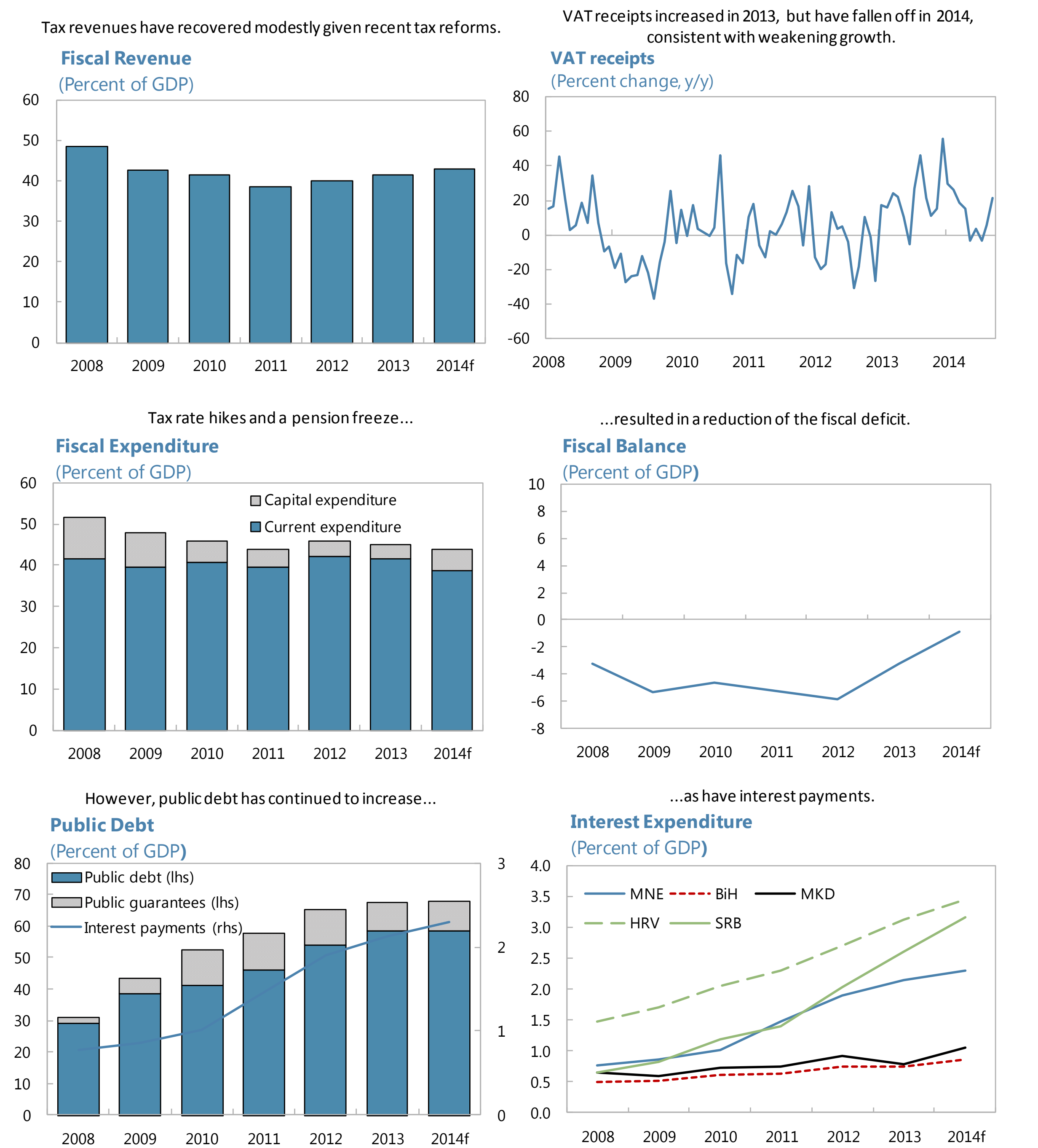


Figure 3. Montenegro: Pension Expenditures

Pension expenditures

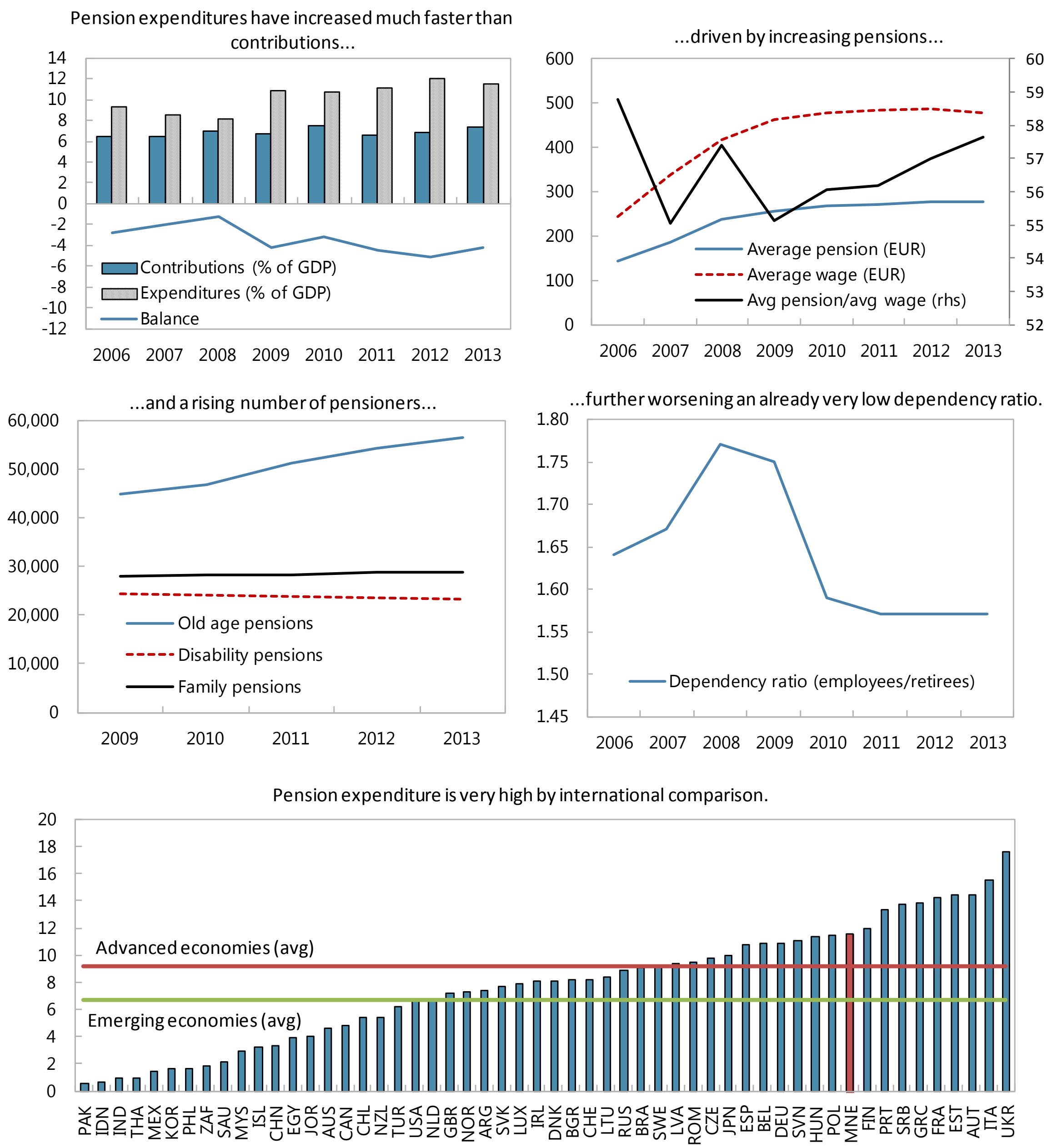
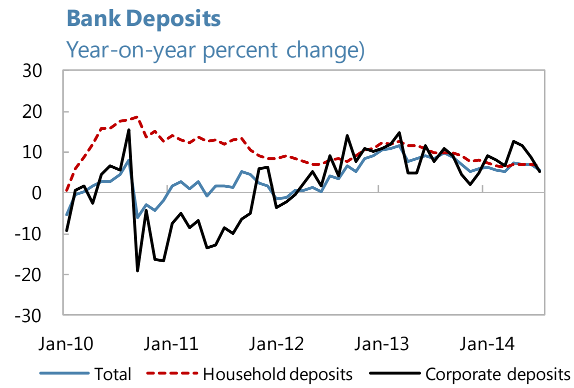
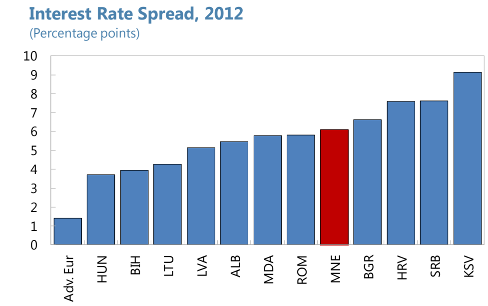


Figure 4. Montenegro: Financial Sector Developments

Deposits have recovered modestly after the recession of 2012, and deposit returns have dome down…

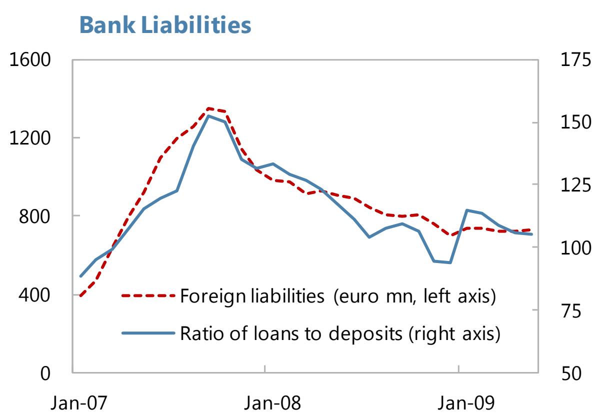


…but lending spreads and lending rates remain high.

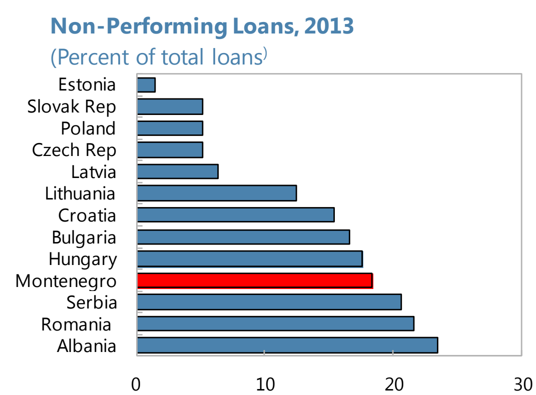


Sources: Central Bank of Montenegro, Eurostat, World Bank WDI, and Fund staff calculations.

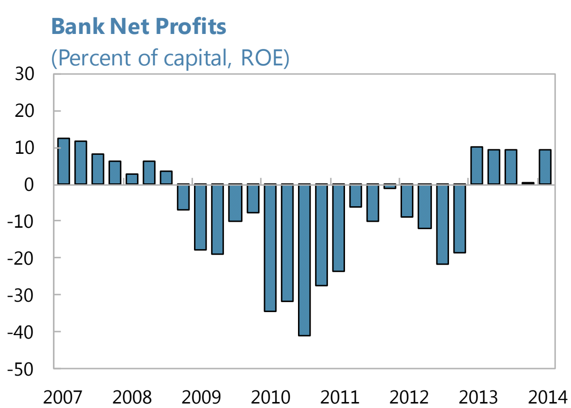
Banks' foreign liabilities have declined significantly.



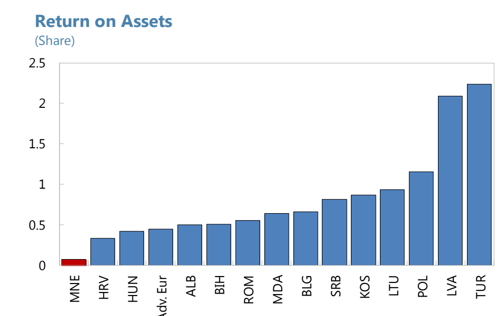
Despite a sell-off of bad loans in 2011, the stock of NPLs is sizeable.



Banks returned to profitability in 2013…



… but returns on assets are still very low.



Sources: Central Bank of Montenegro, IMF Financial Soundness Indicators and Fund staff calculations.

Figure 5. Montenegro: Risk Assessment Matrix

(Scale – high, medium, or low)

Source of Risks	Relative Likelihood[2]	Impact if Realized	Policy Response
1. **A protracted growth slowdown in advanced and emerging economies**	**High** Delays by advanced economies to address legacies of the financial crisis and persistently low inflation threaten the global recovery. This could be compounded by failures on the part of emerging market countries that have struggled with inefficient investments and incomplete structural reform.	**High** A protracted slowdown in the EU and neighboring countries could adversely impact the appetite for external and public financing (especially FDI flows and tourism infrastructure developments). Further "lowflation" could be imported from the euro area which, if protracted, would adversely impact debt dynamics, consumption, and bank profitability.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Accelerate structural reforms to increase competitiveness and reduce structural bottlenecks that impede credit to the private sector.
2. **Spillovers from a deterioration of global financial market conditions**	**High** A surge in global financial market volatility could be triggered as investors reassess risks.	**High** Montenegro is highly reliant on external financing. Gross public financing needs range from 10-20 percent of GDP during the next five years.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Put in place a credible medium-term fiscal consolidation plan that puts debt on a sustainable trajectory.
3. **Heightened geopolitical risks associated with Russia/Ukraine tensions and ongoing Middle East conflicts**	**Medium** Geopolitical events could disrupt global financial flows, trade and commodity markets, as well as lead to a sharp increase in oil prices.	**Medium** Given important tourism and real estate links, a deterioration in Russia's growth prospects could undermine FDI inflows to and growth prospects in Montenegro.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Speed up structural reforms to improve the business environment and competitiveness.
4. **Weakening of fiscal discipline**	**Low** The authorities have demonstrated a commitment to fiscal consolidation. But the planned highway is a source of concern. And pressure to raise public sector wages and pensions will remain.	**Medium** Given high and increasing public debt, a loss of fiscal discipline could raise concern over the sustainability of the fiscal position.	• Sustain fiscal consolidation; maintain public wage discipline and pension freezes, and further recent efforts to boost tax revenues. • Curtail subsidies to loss-making public enterprises.
5. **Delays and withdrawals from capital investment projects**	**Medium** Ongoing geopolitical tensions, weak administrative procedures on land development, and concerns regarding public fiscal sustainability could threaten capital investments in tourism and industry.	**Medium** Construction and activity associated with large-scale investment projects (both tourism and infrastructure based) are key drivers of growth.	• Put in place a credible strategy to safeguard fiscal sustainability and implement structural reforms to improve the business environment and strengthen mechanisms to fight corruption.

Table 1. Montenegro: Selected Economic Indicators, 2010–19

(Under current policies)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
Real economy										
Nominal GDP (millions of €)	3,104	3,234	3,149	3,327	3,387	3,588	3,759	3,944	4,045	4,228
Gross national saving (percent of GDP)	-2.6	-2.0	0.9	1.3	3.0	3.8	2.3	3.2	2.6	4.0
Gross investment (percent of GDP)	22.8	19.5	19.5	15.9	18.1	24.0	25.9	27.3	21.2	20.3
					(percent change)					
Real GDP	2.5	3.2	-2.5	3.3	2.0	4.6	3.3	3.4	1.0	2.9
Industrial production	17.5	-10.3	-7.1	10.6	...	...	...	...	...	...
Tourism										
Arrivals	4.6	8.7	4.8	3.7	...	...	...	...	...	...
Nights	5.5	10.2	4.3	2.8	...	...	...	...	...	...
Consumer prices (period average)	0.7	3.1	3.6	2.2	-0.6	1.2	1.4	1.5	1.5	1.6
Consumer prices (end of period)	0.7	2.8	5.1	0.3	0.6	0.9	1.8	1.1	1.9	1.3
GDP deflator (percent change)	1.6	0.9	-0.1	2.2	-0.1	1.3	1.4	1.5	1.6	1.6
Average net wage (12-month) 1/	3.5	1.0	0.6	-1.6	...	...	...	...	...	...
Money and credit (end of period)										
Bank credit to private sector 2/	-8.9	-13.0	-3.1	2.1	-3.6	3.2	3.8	4.3	4.5	4.5
Enterprises	-11.2	-20.3	-4.9	0.1	...	...	...	...	...	...
Households	-5.7	-3.2	-1.1	3.7	...	...	...	...	...	...
Private sector deposits	5.9	1.2	7.2	5.4	...	...	...	...	...	...
General government finances (accrual) 3/					(as percent of GDP)					
Revenue and grants	41.3	38.5	40.0	41.5	42.9	42.1	42.0	41.9	42.8	42.9
Expenditure	45.9	43.8	45.9	44.8	43.8	47.5	49.4	50.5	45.5	44.4
Overall balance	-4.6	-5.2	-5.9	-3.3	-0.9	-5.3	-7.4	-8.6	-2.7	-1.5
Primary balance	-3.6	-3.8	-4.0	-1.1	1.4	-3.1	-4.1	-5.0	1.6	2.7
Domestic financing (net)	-1.4	0.7	-0.8	-2.4	-2.2	-2.7	-2.2	-2.1	-1.9	-1.8
Privatization receipts	0.8	0.5	0.4	0.8	0.6	0.0	0.0	0.0	0.0	0.0
General government gross debt	40.9	46.0	54.0	58.2	58.5	60.7	64.5	69.0	68.4	65.6
General government debt, including loan guarantees	52.4	57.8	65.0	67.6	67.9	70.1	73.9	78.4	77.8	75.0
Balance of payments										
Current account balance	-22.9	-17.7	-18.7	-14.6	-15.1	-20.2	-23.6	-24.1	-18.7	-16.2
Foreign direct investment	17.8	12.0	14.7	9.7	9.7	10.6	11.4	11.7	11.9	11.9
External debt (end of period, stock)	115.5	117.6	126.6	128.7	132.9	137.5	144.8	152.8	157.4	157.6
Of which: Private sector 4/	86.1	84.7	85.5	85.6	88.0	87.1	87.2	87.1	88.6	88.5
REER (CPI-based; annual average change, in percent) (- indicates depreciation)	2.8	-3.2	3.3	-1.1	...	...	...	...	...	...
Memorandum:										
Aluminum price (€ per tonne)	1,644	1,822	1,542	1,348	1,340	1,417	1,447	1,467	1,480	1,494

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

1/ Reflects a change in the methodology by Monstat starting January 1, 2010.

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

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

4/ Estimates, as private debt statistics are not officially published.

Table 2. Montenegro: Savings and Investment Balances, 2010–19

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

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
Gross national savings	-2.6	-2.0	0.9	1.3	3.0	3.8	2.3	3.2	2.6	4.0
Non-government	-2.6	0.2	4.4	3.2	0.6	0.8	1.7	3.1	3.8	5.1
Government	0.0	-2.2	-3.5	-1.9	2.4	3.0	0.7	0.1	-1.2	-1.1
Gross domestic investment	22.8	19.5	19.5	15.9	18.1	24.0	25.9	27.3	21.2	20.3
Non-government	17.5	15.3	15.6	12.7	12.8	13.9	14.8	15.2	15.6	15.7
Government	5.3	4.2	3.9	3.3	5.3	10.2	11.2	12.1	5.7	4.5
Savings - investment balance	-25.4	-21.6	-18.7	-14.6	-15.1	-20.2	-23.6	-24.1	-18.7	-16.2
Non-government	-20.1	-15.2	-11.2	-9.5	-12.2	-13.0	-13.1	-12.1	-11.8	-10.6
Government	-5.3	-6.4	-7.5	-5.1	-2.9	-7.2	-10.5	-12.0	-6.8	-5.6
Current account balance 1/	-22.9	-17.7	-18.7	-14.6	-15.1	-20.2	-23.6	-24.1	-18.7	-16.2
Foreign direct investment (net)	17.8	12.0	14.7	9.7	9.7	10.6	11.4	11.7	11.9	11.9
External debt	115.5	117.6	126.6	128.7	132.9	137.5	144.8	152.8	157.4	157.6

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

1/ Balance of payments data were revised in late 2012 to correct for unrecorded tourism receipts, resulting in an average annual improvement in the current account balance of 1.7 percent of GDP in 2009-2011. This revision has not yet been incorporated in the national accounts data, which results in the large discrepancy between the current account balance and the savings-investment balance calculated from the national accounts.

Table 3. Montenegro: Summary of Accounts of the Financial System, 2010–14

(In millions of euros)

	2010	2011	2012	2013	2014
					Proj.
			I. Central Bank		
Net foreign assets	386	273	318	395	483
Assets	416	303	348	424	512
Liabilities	30	31	30	29	29
Net domestic assets	-321	-191	-227	-297	-380
Net credit to the nonfinancial public sector	-71	-18	-24	-12	-12
Of which: general government	-71	-18	-24	-12	-12
Net credit to the banking system	-277	-207	-237	-319	-272
Required reserves	-134	-129	-129	-150	-153
Giro account	-142	-77	-108	-169	-119
Claims on depository institutions	-1	-1	-1	-1	-1
Other assets net	27	35	34	34	-96
Deposits included in broad money	19	22	31	39	43
Equity	47	61	60	59	60
			II. Banking System		
Net foreign assets	-532	-348	-156	-162	-162
Assets	399	456	543	561	577
Liabilities	932	804	700	723	739
Net domestic assets	2,327	2,085	2,061	2,170	2,149
Net assets held in the central bank	276	206	236	318	271
Net credit to nonfinancial public sector	-69	37	45	115	206
Of which: general government	-70	65	45	115	206
Credit to the private sector	2,076	1,808	1,742	1,777	1,714
Other domestic assets	44	34	38	-41	-41
Liabilities	1,795	1,737	1,878	2,008	1,988
Private sector deposits	1,349	1,365	1,462	1,481	1,508
Other items, net	446	372	415	527	480
o/w capital	311	305	289	390	434
			III. Consolidated System		
Net foreign assets	-146	-75	161	233	321
Net domestic assets	2,007	1,894	1,834	1,873	1,769
Net credit to the nonfinancial public sector	-140	19	21	103	194
Of which: general government	-140	46	21	103	194
Credit to the private sector	2,076	1,808	1,742	1,777	1,714
Other net domestic assets	71	68	72	-8	-138
Liabilities	1,814	1,758	1,908	2,046	2,031
Equity capital of the central bank	47	61	60	59	60
			IV. Ratios		
Reserves ratio	20.5	15.1	16.2	21.5	18.0
Effective required reserves ratio 1/	9.9	9.5	8.8	10.1	10.1
Credit to private sector / GDP	66.9	55.9	55.3	53.4	50.6
Banks' capital / credit to private sector	15.0	16.9	16.6	21.9	25.3
CBCG reserves / bank deposits	30.9	22.2	23.8	28.6	34.0
Banks' foreign liabilities / lending	44.9	44.4	40.0	40.0	40.0

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

1/ Reserve requirements are set at 9.5% on deposits with maturity up to one year and 8.5% on deposits with maturity over one year.

Table 4. Montenegro: Balance of Payments, 2010–19

(Under current policies)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
	(Millions of euros)									
Current account balance	-710	-573	-588	-487	-513	-726	-888	-951	-756	-687
Trade balance	-1,267	-1,306	-1,389	-1,329	-1,342	-1,574	-1,718	-1,822	-1,667	-1,665
Exports	357	477	392	396	361	382	397	413	424	441
Imports	-1,624	-1,783	-1,781	-1,724	-1,702	-1,956	-2,115	-2,235	-2,091	-2,106
Services account	464	589	612	653	647	654	677	721	788	849
Receipts 1/	801	906	998	994	1,012	1,067	1,129	1,197	1,260	1,336
Expenditures	-337	-317	-385	-341	-364	-413	-452	-476	-472	-487
Income account	-22	26	54	66	56	61	15	4	-27	-27
Compensation of employees, net	150	168	174	185	189	200	209	220	225	235
Investment income, net	-172	-142	-120	-120	-133	-139	-194	-216	-252	-263
Current transfers, net	114	117	135	123	125	133	139	146	150	157
Government, net	16	6	18	22	22	24	25	26	27	28
Other sectors, net	98	112	118	101	103	109	114	120	123	129
Capital and financial account	529	302	389	314	347	571	223	474	290	-77
Foreign direct investment, net	552	389	462	324	330	382	429	462	481	503
Portfolio investment, net 2/	-12	-16	-25	-38	-39	-41	-43	-45	-46	-48
Other investment, net 1/	-11	-68	-55	26	54	227	-165	55	-148	-535
General government 2/	209	133	203	37	86	323	-49	178	-9	-390
Commercial banks	-176	-205	-192	71	0	2	3	9	14	21
Other sectors	-44	5	-67	-82	-32	-98	-119	-133	-154	-166
Errors and omissions 1/	198	157	243	250	254	269	282	296	304	317
Unidentified financing 3/	0	0	0	0	0	-36	410	247	198	533
Change in official reserves (- denotes increase)	-17	114	-45	-77	-89	-78	-28	-65	-36	-86
Memorandum items	(percent of GDP)									
Current account balance	-22.9	-17.7	-18.7	-14.6	-15.1	-20.2	-23.6	-24.1	-18.7	-16.2
Trade balance	-40.8	-40.4	-44.1	-39.9	-39.6	-43.9	-45.7	-46.2	-41.2	-39.4
Exports	11.5	14.7	12.4	11.9	10.6	10.6	10.6	10.5	10.5	10.4
Imports	-52.3	-55.1	-56.6	-51.8	-50.2	-54.5	-56.3	-56.7	-51.7	-49.8
Services account	15.0	18.2	19.4	19.6	19.1	18.2	18.0	18.3	19.5	20.1
Receipts	25.8	28.0	31.7	29.9	29.9	29.7	30.0	30.4	31.2	31.6
Payments	-10.8	-9.8	-12.2	-10.3	-10.8	-11.5	-12.0	-12.1	-11.7	-11.5
Income account	-0.7	0.8	1.7	2.0	1.6	1.7	0.4	0.1	-0.7	-0.6
Current transfers, net	3.7	3.6	4.3	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Foreign direct investment, net	17.8	12.0	14.7	9.7	9.7	10.6	11.4	11.7	11.9	11.9
Portfolio investment, net	-0.4	-0.5	-0.8	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Other investment, net	-0.4	-2.1	-1.7	0.8	1.6	6.3	-4.4	1.4	-3.7	-12.7
Errors and omissions	6.4	4.9	7.7	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Gross external debt 4/	115.5	117.6	126.6	128.7	132.9	137.5	144.8	152.8	157.4	157.6

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

1/ Balance of payments data were revised in late 2012 to correct for unrecorded tourism receipts, resulting in an average annual improvement in the current account balance of 1.7 percent of GDP in 2009-2011. The revision also lowered the estimate of other investment outflows, with a corresponding reduction in errors and omissions.

2/ Sovereign Eurobond issuance is classified under Other Investment rather than Portfolio Investment in this presentation.

3/ Financing for the highway is included under general government flows (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

4/ This includes only estimates of private external debt as private debt statistics are not officially published.

Table 5a. Montenegro: Consolidated General Government Fiscal Operations, 2010–19 1/

(In millions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
Total revenues and grants	1281.4	1246.0	1258.8	1381.8	1454.0	1511.9	1578.8	1651.2	1729.3	1814.2
Total revenues	1273.2	1237.8	1250.9	1372.1	1445.3	1503.2	1569.7	1641.8	1719.4	1803.8
Current revenues	1265.5	1232.3	1238.1	1366.0	1439.1	1496.8	1563.1	1634.8	1712.1	1796.1
Taxes	757.2	794.5	786.0	863.5	912.5	949.1	991.1	1036.6	1085.6	1138.9
Personal income tax	115.1	113.2	109.7	124.1	134.4	139.8	146.0	152.7	159.9	167.8
Corporate income tax	20.3	36.1	64.0	40.6	48.8	50.8	53.0	55.5	58.1	60.9
Taxes on turnover of real estate	16.5	15.7	14.4	18.3	18.6	19.4	20.2	21.2	22.2	23.2
Value added tax	364.2	392.2	354.7	429.2	459.3	477.7	498.8	521.7	546.4	573.2
Excises	134.3	143.4	151.8	161.4	160.4	166.8	174.2	182.2	190.8	200.1
Taxes on international trade	50.8	45.3	29.0	22.3	21.7	22.6	23.6	24.7	25.8	27.1
Local government taxes	44.6	44.5	58.2	62.4	63.6	66.1	69.0	72.2	75.6	79.3
Other taxes	11.6	4.2	4.3	5.1	5.7	5.9	6.2	6.5	6.8	7.1
Social security contributions	343.6	311.3	318.7	357.5	379.6	394.8	412.3	431.2	451.6	473.8
Nontax revenues	164.7	126.5	133.4	145.0	147.0	152.9	159.6	166.9	174.8	183.4
Capital revenues	7.7	5.5	12.8	6.0	6.1	6.4	6.7	7.0	7.3	7.7
Grants	8.2	8.2	7.9	9.7	8.7	8.7	9.1	9.5	9.9	10.4
Total expenditures and net lending	1424.3	1415.0	1444.3	1490.0	1484.5	1702.6	1856.9	1991.9	1840.2	1878.9
Total expenditures	1424.2	1415.8	1446.9	1493.4	1487.2	1703.2	1857.4	1992.4	1840.8	1879.5
Current expenditures	658.5	650.6	719.6	636.4	648.3	654.2	724.3	768.3	829.6	867.3
Gross salaries	350.2	361.6	364.2	361.2	375.9	368.1	384.4	402.1	421.1	441.7
Other personal income	24.6	20.2	13.3	14.5	15.2	14.7	15.3	16.0	16.8	17.6
Goods and services	163.1	131.6	199.1	118.4	105.1	87.7	91.6	95.8	100.3	105.7
Current maintenance	32.9	28.2	27.4	24.4	26.0	27.5	28.8	30.2	31.0	32.4
Interest payments	31.4	47.6	59.7	70.8	77.9	80.5	125.1	141.5	173.8	178.9
Rent	8.6	7.7	7.4	8.4	8.5	8.7	9.1	9.6	10.0	10.5
Subsidies to enterprises 2/	39.8	46.4	26.6	18.2	19.6	22.1	23.0	24.1	25.2	26.5
Other outflows 2/	7.9	7.3	21.9	20.6	20.2	45.0	47.0	49.1	51.4	54.0
Social security transfers	423.6	455.5	482.1	483.4	498.8	505.4	527.8	552.0	578.1	606.5
Other transfers	160.6	125.9	74.5	141.4	137.9	159.7	166.8	174.5	182.8	192.3
Capital expenditures	165.8	135.6	124.4	108.9	179.8	365.3	419.2	477.3	229.0	191.1
Repayment of guarantees	0.0	34.1	24.7	107.2	9.7	0.0	0.0	0.0	0.0	0.0
Reserves	15.8	14.1	21.5	15.9	12.7	18.5	19.4	20.2	21.2	22.2
Net lending	0.1	-0.8	-2.5	-3.4	-2.7	-0.5	-0.5	-0.6	-0.6	-0.6
Overall Balance	-142.9	-169.0	-185.5	-108.2	-30.5	-190.8	-278.1	-340.6	-110.9	-64.7
Financing 3/	142.9	167.9	185.5	108.2	30.5	190.8	278.1	340.6	110.9	64.7
Domestic financing	-42.5	23.5	-26.7	-78.4	-75.3	-96.0	-82.7	-84.3	-78.3	-78.0
Use of gov. deposits	66.9	79.3	15.2	47.7	-86.0	35.4	-8.7	-10.3	-11.9	-12.6
Net borrowing from other sources	-109.4	-55.8	-41.9	-126.1	10.7	-131.4	-74.0	-74.0	-66.4	-65.4
Foreign financing	160.3	129.4	198.3	159.8	86.0	323.1	-49.2	178.3	-8.7	-390.0
Privatization receipts	25.1	15.0	14.0	26.8	19.8	0.0	0.0	0.0	0.0	0.0
Unidentified	0.0	0.0	0.0	0.0	0.0	-36.3	409.9	246.6	197.9	532.7
Discrepancy	0.0	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Primary balance	-111.5	-121.4	-125.8	-37.4	47.4	-110.3	-153.0	-199.1	62.9	114.2
Overall balance excluding loan guarantee repayments	-142.9	-134.9	-160.8	-0.9	-20.8	-190.8	-278.1	-340.6	-110.9	-64.7

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

1/ Includes republican budget and local governments.

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

3/ Financing for the highway is included under foreign financing (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

Table 5b. Montenegro: Consolidated General Government Fiscal Operations, 2010–19 1/

(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
Total revenues and grants	41.3	38.5	40.0	41.5	42.9	42.1	42.0	41.9	42.8	42.9
Total revenues	41.0	38.3	39.7	41.2	42.7	41.9	41.8	41.6	42.5	42.7
Current revenues	40.8	38.1	39.3	41.1	42.5	41.7	41.6	41.5	42.3	42.5
Taxes	24.4	24.6	25.0	26.0	26.9	26.5	26.4	26.3	26.8	26.9
Personal income tax	3.7	3.5	3.5	3.7	4.0	3.9	3.9	3.9	4.0	4.0
Corporate income tax	0.7	1.1	2.0	1.2	1.4	1.4	1.4	1.4	1.4	1.4
Taxes on turnover of real estate	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Value added tax	11.7	12.1	11.3	12.9	13.6	13.3	13.3	13.2	13.5	13.6
Excises	4.3	4.4	4.8	4.9	4.7	4.6	4.6	4.6	4.7	4.7
Taxes on international trade	1.6	1.4	0.9	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	1.4	1.4	1.8	1.9	1.9	1.8	1.8	1.8	1.9	1.9
Other taxes	0.4	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.1	9.6	10.1	10.7	11.2	11.0	11.0	10.9	11.2	11.2
Nontax revenues	5.3	3.9	4.2	4.4	4.3	4.3	4.2	4.2	4.3	4.3
Capital revenues	0.2	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Total expenditures and net lending	45.9	43.8	45.9	44.8	43.8	47.5	49.4	50.5	45.5	44.4
Total expenditures	45.9	43.8	45.9	44.9	43.9	47.5	49.4	50.5	45.5	44.5
Current expenditures	21.2	20.1	22.9	19.1	19.1	18.2	19.3	19.5	20.5	20.5
Gross salaries	11.3	11.2	11.6	10.9	11.1	10.3	10.2	10.2	10.4	10.4
Other personal income	0.8	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Goods and services	5.3	4.1	6.3	3.6	3.1	2.4	2.4	2.4	2.5	2.5
Current maintenance	1.1	0.9	0.9	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Interest payments	1.0	1.5	1.9	2.1	2.3	2.2	3.3	3.6	4.3	4.2
Rent	0.3	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises 2/	1.3	1.4	0.8	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Other outflows 2/	0.3	0.2	0.7	0.6	0.6	1.3	1.2	1.2	1.3	1.3
Social security transfers	13.6	14.1	15.3	14.5	14.7	14.1	14.0	14.0	14.3	14.3
Other transfers	5.2	3.9	2.4	4.3	4.1	4.4	4.4	4.4	4.5	4.5
Capital expenditures	5.3	4.2	3.9	3.3	5.3	10.2	11.2	12.1	5.7	4.5
Repayment of guarantees	0.0	1.1	0.8	3.2	0.3	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.4	0.7	0.5	0.4	0.5	0.5	0.5	0.5	0.5
Net lending	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Overall Balance	-4.6	-5.2	-5.9	-3.3	-0.9	-5.3	-7.4	-8.6	-2.7	-1.5
Financing 3/	4.6	5.2	5.9	3.3	0.9	5.3	7.4	8.6	2.7	1.5
Domestic financing	-1.4	0.7	-0.8	-2.4	-2.2	-2.7	-2.2	-2.1	-1.9	-1.8
Use of gov. deposits	2.2	2.5	0.5	1.4	-2.5	1.0	-0.2	-0.3	-0.3	-0.3
Net borrowing from other sources	-3.5	-1.7	-1.3	-3.8	0.3	-3.7	-2.0	-1.9	-1.6	-1.5
Foreign financing	5.2	4.0	6.3	4.8	2.5	9.0	-1.3	4.5	-0.2	-9.2
Privatization receipts	0.8	0.5	0.4	0.8	0.6	0.0	0.0	0.0	0.0	0.0
Unidentified	0.0	0.0	0.0	0.0	0.0	-1.0	10.9	6.3	4.9	12.6
Discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Primary balance	-3.6	-3.8	-4.0	-1.1	1.4	-3.1	-4.1	-5.0	1.6	2.7
Overall balance excluding loan guarantee repayments	-4.6	-4.2	-5.1	0.0	-0.6	-5.3	-7.4	-8.6	-2.7	-1.5
Public debt (gross)	40.9	46.0	54.0	58.2	58.5	60.7	64.5	69.0	68.4	65.6
Public debt, including guarantees	52.4	57.8	65.0	67.6	67.9	70.1	73.9	78.4	77.8	75.0

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

1/ Includes republican budget and local governments.

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

3/ Financing for the highway is included under foreign financing (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

Table 5c. Montenegro: Consolidated General Government 1/

(In millions of euros, GFSM2001)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
1. Revenue	**1273.7**	**1240.5**	**1246.0**	**1375.8**	**1447.9**	**1505.5**	**1572.1**	**1644.2**	**1722.0**	**1806.5**
Taxes	757.2	794.5	786.0	863.5	912.5	949.1	991.1	1036.6	1085.6	1138.9
Personal income tax	115.1	113.2	109.7	124.1	134.4	139.8	146.0	152.7	159.9	167.8
Corporate income tax	20.3	36.1	64.0	40.6	48.8	50.8	53.0	55.5	58.1	60.9
Property taxes	16.5	15.7	14.4	18.3	18.6	19.4	20.2	21.2	22.2	23.2
Value added tax	364.2	392.2	354.7	429.2	459.3	477.7	498.8	521.7	546.4	573.2
Excises	134.3	143.4	151.8	161.4	160.4	166.8	174.2	182.2	190.8	200.1
Taxes on international trade	50.8	45.3	29.0	22.3	21.7	22.6	23.6	24.7	25.8	27.1
Local government taxes	44.6	44.5	58.2	62.4	63.6	66.1	69.0	72.2	75.6	79.3
Other taxes	11.6	4.2	4.3	5.1	5.7	5.9	6.2	6.5	6.8	7.1
Social security contributions	343.6	311.3	318.7	357.5	379.6	394.8	412.3	431.2	451.6	473.8
Nontax revenues	164.7	126.5	133.4	145.0	147.0	152.9	159.6	166.9	174.8	183.4
Grants	8.2	8.2	7.9	9.7	8.7	8.7	9.1	9.5	9.9	10.4
2. Expense	**1258.4**	**1280.2**	**1322.5**	**1384.4**	**1307.3**	**1337.9**	**1438.3**	**1515.1**	**1611.8**	**1688.4**
Gross salaries and other personal income	374.8	381.8	377.5	375.7	391.1	382.8	399.7	418.1	437.8	459.3
Use of goods and services	195.9	159.8	226.5	142.8	131.0	115.2	120.4	126.0	131.3	138.1
Interest payments	31.4	47.6	59.7	70.8	77.9	80.5	125.1	141.5	173.8	178.9
Subsidies to enterprises	39.8	46.4	26.6	18.2	19.6	22.1	23.0	24.1	25.2	26.5
Other current outflows	16.5	15.0	29.3	29.0	28.6	53.7	56.1	58.7	61.4	64.5
Social security transfers	423.6	455.5	482.1	483.4	498.8	505.4	527.8	552.0	578.1	606.5
Other transfers	160.6	125.9	74.5	141.4	137.9	159.7	166.8	174.5	182.8	192.3
Repayment of guarantees	0.0	34.1	24.7	107.2	9.7	0.0	0.0	0.0	0.0	0.0
Reserves	15.8	14.1	21.5	15.9	12.7	18.5	19.4	20.2	21.2	22.2
3. Gross operating balance (= 1 - 2)	**15.3**	**-39.7**	**-76.5**	**-8.7**	**140.5**	**167.6**	**133.9**	**129.2**	**110.2**	**118.1**
4. Net acquisition of nonfinancial assets	**158.1**	**130.1**	**111.6**	**102.9**	**173.7**	**358.9**	**412.5**	**470.4**	**221.7**	**183.5**
Capital revenue	-7.7	-5.5	-12.8	-6.0	-6.1	-6.4	-6.7	-7.0	-7.3	-7.7
Capital expenditure	165.8	135.6	124.4	108.9	179.8	365.3	419.2	477.3	229.0	191.1
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-142.8**	**-169.8**	**-188.1**	**-111.6**	**-33.2**	**-191.3**	**-278.6**	**-341.2**	**-111.5**	**-65.4**
6. Net acquisition of financial assets	**-91.9**	**-95.1**	**-31.7**	**-77.9**	**63.5**	**-35.9**	**8.2**	**9.7**	**11.3**	**12.0**
Domestic	-91.9	-95.1	-31.7	-77.9	63.5	-35.9	8.2	9.7	11.3	12.0
Currency and deposits	*-66.9*	*-79.3*	*-15.2*	*-47.7*	*86.0*	*-35.4*	*8.7*	*10.3*	*11.9*	*12.6*
Loans	*0.1*	*-0.8*	*-2.5*	*-3.4*	*-2.7*	*-0.5*	*-0.5*	*-0.6*	*-0.6*	*-0.6*
Equity and investment fund shares	*-25.1*	*-15.0*	*-14.0*	*-26.8*	*-19.8*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
7. Net incurrence of liabilities	**50.9**	**73.6**	**156.3**	**33.7**	**96.7**	**191.7**	**-123.1**	**104.4**	**-75.0**	**-455.3**
Domestic	-109.4	-55.8	-41.9	-126.1	10.7	-131.4	-74.0	-74.0	-66.4	-65.4
Foreign	160.3	129.4	198.3	159.8	86.0	323.1	-49.2	178.3	-8.7	-390.0
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**-1.1**	**0.0**	**0.0**	**0.0**	**36.3**	**-409.9**	**-246.6**	**-197.9**	**-532.7**
Memorandum items:										
Primary balance	-111.4	-122.2	-128.4	-40.8	44.7	-110.8	-153.5	-199.7	62.3	113.5
Nominal GDP	3104	3234	3149	3327	3387	3588	3759	3944	4045	4228

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

1/ Includes republican budget and local governments.

5d. Montenegro: Consolidated General Government Fiscal Operations, 2010–19 1/
(In percent of GDP, GFSM2001)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Projections					
1. Revenue	**41.0**	**38.4**	**39.6**	**41.4**	**42.7**	**42.0**	**41.8**	**41.7**	**42.6**	**42.7**
Taxes	24.4	24.6	25.0	26.0	26.9	26.5	26.4	26.3	26.8	26.9
Personal income tax	3.7	3.5	3.5	3.7	4.0	3.9	3.9	3.9	4.0	4.0
Corporate income tax	0.7	1.1	2.0	1.2	1.4	1.4	1.4	1.4	1.4	1.4
Property taxes	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Value added tax	11.7	12.1	11.3	12.9	13.6	13.3	13.3	13.2	13.5	13.6
Excises	4.3	4.4	4.8	4.9	4.7	4.6	4.6	4.6	4.7	4.7
Taxes on international trade	1.6	1.4	0.9	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	1.4	1.4	1.8	1.9	1.9	1.8	1.8	1.8	1.9	1.9
Other taxes	0.4	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.1	9.6	10.1	10.7	11.2	11.0	11.0	10.9	11.2	11.2
Nontax revenues	5.3	3.9	4.2	4.4	4.3	4.3	4.2	4.2	4.3	4.3
Grants	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
2. Expense	**40.5**	**39.6**	**42.0**	**41.6**	**38.6**	**37.3**	**38.3**	**38.4**	**39.8**	**39.9**
Gross salaries and other personal income	12.1	11.8	12.0	11.3	11.5	10.7	10.6	10.6	10.8	10.9
Use of goods and services	6.3	4.9	7.2	4.3	3.9	3.2	3.2	3.2	3.2	3.3
Interest payments	1.0	1.5	1.9	2.1	2.3	2.2	3.3	3.6	4.3	4.2
Subsidies to enterprises	1.3	1.4	0.8	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Other current outflows	0.5	0.5	0.9	0.9	0.8	1.5	1.5	1.5	1.5	1.5
Social security transfers	13.6	14.1	15.3	14.5	14.7	14.1	14.0	14.0	14.3	14.3
Other transfers	5.2	3.9	2.4	4.3	4.1	4.4	4.4	4.4	4.5	4.5
Repayment of guarantees	0.0	1.1	0.8	3.2	0.3	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.4	0.7	0.5	0.4	0.5	0.5	0.5	0.5	0.5
3. Gross operating balance (= 1 - 2)	**0.5**	**-1.2**	**-2.4**	**-0.3**	**4.1**	**4.7**	**3.6**	**3.3**	**2.7**	**2.8**
4. Net acquisition of nonfinancial assets	**5.1**	**4.0**	**3.5**	**3.1**	**5.1**	**10.0**	**11.0**	**11.9**	**5.5**	**4.3**
Capital revenue	-0.2	-0.2	-0.4	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Capital expenditure	5.3	4.2	3.9	3.3	5.3	10.2	11.2	12.1	5.7	4.5
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-4.6**	**-5.2**	**-6.0**	**-3.4**	**-1.0**	**-5.3**	**-7.4**	**-8.7**	**-2.8**	**-1.5**
6. Net acquisition of financial assets	**-3.0**	**-2.9**	**-1.0**	**-2.3**	**1.9**	**-1.0**	**0.2**	**0.2**	**0.3**	**0.3**
Domestic	-3.0	-2.9	-1.0	-2.3	1.9	-1.0	0.2	0.2	0.3	0.3
Currency and deposits	*-2.2*	*-2.5*	*-0.5*	*-1.4*	*2.5*	*-1.0*	*0.2*	*0.3*	*0.3*	*0.3*
Loans	*0.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Equity and investment fund shares	*-0.8*	*-0.5*	*-0.4*	*-0.8*	*-0.6*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
7. Net incurrence of liabilities	**1.6**	**2.3**	**5.0**	**1.0**	**2.9**	**5.3**	**-3.3**	**2.6**	**-1.9**	**-10.8**
Domestic	-3.5	-1.7	-1.3	-3.8	0.3	-3.7	-2.0	-1.9	-1.6	-1.5
Foreign	5.2	4.0	6.3	4.8	2.5	9.0	-1.3	4.5	-0.2	-9.2
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.0**	**-10.9**	**-6.3**	**-4.9**	**-12.6**
Memorandum items:										
Primary balance	-3.6	-3.8	-4.1	-1.2	1.3	-3.1	-4.1	-5.1	1.5	2.7

Source: Ministry of Finance; and Fund staff estimates and projections.
1/ Includes republican budget and local governments.

Table 6. Montenegro: Financial Soundness Indicators of the Banking Sector, 2009–14

	2009	2010	2011	2012	2013				2014		
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Capital adequacy											
Regulatory capital as percent of risk-weighted assets	15.7	15.9	16.5	14.7	14.4	15.5	15.0	14.4	15.1	15.8	16.2
Capital as percent of assets	11.0	10.6	10.9	10.3	13.7	13.9	13.9	13.4	14.2	14.3	14.2
Asset composition and quality											
Distribution of bank credit by borrower											
Central government, local government, government agencies	1.3	2.1	4.9	4.8	4.5	5.2	6.9	6.7	6.4	6.1	5.5
Funds	1.2	0.1	0.5	0.2	0.0	0.0	0.0	0.0	0.1	0.1	0.2
State-owned companies	1.9	2.7	2.8	3.1	2.4	2.3	2.1	2.1	2.1	2.2	1.7
Private companies, entrepreneurs	56.4	54.8	47.7	47.6	36.8	36.7	34.4	35.7	35.7	36.3	33.5
Banks	0.0	0.0	0.0	0.0	18.6	16.9	18.9	15.8	15.5	15.5	19.5
Financial Institutions	0.3	0.4	0.5	0.1	0.2	0.2	0.2	0.2	0.3	0.2	0.3
Citizens	36.6	37.1	40.5	41.3	33.3	34.3	33.4	35.6	35.9	36.5	35.6
Credit cards	1.7	2.2	2.1	2.1	1.6	1.6	1.4	1.4	1.4	1.3	1.2
Other	0.6	0.6	0.9	0.8	2.6	2.9	2.8	2.6	2.7	1.8	2.6
Distribution of bank credit by sectoral economic activity											
Agriculture, hunting, fishing	0.3	0.4	1.2	1.6	1.4	1.4	1.3	1.5	1.5	1.8	1.8
Mining and energy	2.2	2.5	1.8	1.9	1.9	2.2	2.2	2.0	1.7	1.5	1.4
Civil engineering	7.8	8.1	6.7	6.6	8.9	8.6	8.5	4.9	5.4	5.2	5.3
Trade	22.8	22.9	20.7	19.7	17.3	17.6	15.9	19.0	19.8	20.2	19.7
Services, tourism	7.5	7.4	6.1	6.8	5.5	3.7	3.7	4.0	4.4	4.5	4.1
Transport, warehousing, communications	2.6	3.0	3.1	3.0	3.8	3.6	3.3	3.6	3.0	3.0	2.9
Finance	2.4	1.7	2.7	2.2	2.5	3.0	5.1	2.1	1.0	0.8	0.8
Real estate trading	4.4	3.0	2.3	2.3	1.1	1.1	1.3	1.5	1.2	1.1	1.1
Administration, other public services	2.6	3.1	4.3	4.2	8.8	9.2	9.6	12.0	11.7	11.2	11.0
Consumer loans	38.3	39.3	42.6	43.4	43.5	43.8	43.6	44.5	45.2	45.6	47.1
Other	9.1	9.0	8.4	8.4	5.5	5.7	5.5	5.0	5.1	5.1	4.9
Asset quality											
Non-performing loans (NPL), in percent of gross loans	13.5	21.0	15.5	17.6	19.4	18.8	18.4	18.4	17.2	17.9	17.3
Provisions, in percent of NPL	46.3	30.7	32.8	40.2	42.1	40.7	39.7	44.7	46.3	44.5	43.8
Provisions, in percent of total loans	6.3	6.4	5.1	7.1	8.2	7.7	7.3	8.2	8.0	8.0	7.6
NPL net of provisions, in percent of capital	52.5	102.8	66.9	68.0	71.7	68.6	66.9	62.4	53.5	56.0	54.5
Earnings and profitability											
Gross profits, in percent of average assets (ROAA)	-0.6	-2.7	-0.1	-2.0	1.5	1.4	1.3	0.1	0.3	0.5	0.7
Gross profits, in percent of average equity capital (ROAE)	-6.9	-27.0	-0.6	-18.1	10.6	9.7	9.5	0.9	2.4	3.5	4.9
Net profits, in percent of average assets (ROAA)	-0.7	-2.8	-0.1	-2.0	1.4	1.3	1.3	0.1	1.3	1.0	0.9
Net profits, in percent of average capital (ROAE)	-7.8	-27.3	-1.1	-18.3	10.0	9.2	9.2	0.5	9.3	6.8	6.2
Net interest margin 1/	4.9	4.9	4.8	5.0	1.0	2.1	3.2	4.2	1.1	2.2	3.4
Gross income, in percent of average assets	5.3	5.4	5.2	5.2	5.2	5.3	5.2	5.2	5.2	5.2	5.3
Net interest income, in percent of gross income	74.2	71.6	70.5	73.1	69.5	71.0	70.3	68.2	72.0	71.2	70.7
Non-interest income, in percent of gross income	25.8	28.4	29.5	26.9	30.5	29.0	29.7	31.8	28.0	26.0	26.5
Net fee income, in percent of net interest income	27.2	30.3	28.6	24.2	27.8	26.9	31.1	32.5	30.7	30.4	31.1
Trading income, in percent of gross income	5.7	6.7	9.4	9.2	11.1	9.9	7.8	9.7	5.9	4.4	4.5
Aggregate overhead expenses, in percent of gross income	62.3	64.0	70.7	77.7	69.1	67.6	67.9	69.1	68.5	68.7	67.4
Liquidity											
Liquid assets, in percent of total assets	15.3	19.1	19.9	24.0	13.2	14.5	21.2	20.0	18.0	18.8	23.2
Liquid assets, in percent of short-term liabilities	25.8	32.9	32.8	40.1	21.3	23.5	34.1	32.2	29.0	29.6	36.1
Deposits, in percent of assets	60.3	60.8	64.7	70.5	69.9	69.7	71.5	71.6	71.6	72.1	73.5
Loans, in percent of deposits	131.4	122.9	107.6	94.0	114.8	113.4	108.8	105.8	105.5	102.4	99.9
Sensitivity to market risk											
Off-balance sheet operations, in percent of assets	439.5	429.5	464.0	370.5	359.8	335.9	318.8	319.7	312.2	308.2	301.3
Original maturity of assets (in percent of total)											
Less than 3 months	30.4	34.4	21.5	32.1	30.0	39.2	38.8	38.7	35.8	39.3	39.4
3 months to 1 year	20.5	17.2	28.2	23.4	23.3	17.3	18.7	16.6	19.8	17.0	19.0
1 to 5 years	33.9	33.6	35.4	31.5	31.0	30.6	30.0	31.6	31.9	31.4	29.8
Over 5 years	15.3	14.8	14.9	13.0	12.7	12.9	12.6	13.1	12.5	12.4	11.9
Original maturity of liabilities (in percent of total)											
Less than 3 months	34.7	38.5	21.9	31.3	40.9	40.0	41.2	40.4	39.0	42.9	42.5
3 months to 1 year	32.4	27.1	47.1	27.9	31.3	31.7	31.4	31.7	33.8	31.6	32.8
1 to 5 years	23.5	24.4	23.4	23.8	23.6	22.9	22.2	22.9	22.4	21.7	19.6
Over 5 years	9.4	10.0	7.7	4.3	4.2	5.4	5.3	5.0	4.8	3.9	5.1

Source: Central Bank of Montenegro.

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

Appendix I. Montenegro: Public Debt Sustainability Analysis

Despite last year's sizeable fiscal adjustment, public sector debt has increased and is projected to rise further to 69 percent of GDP in the baseline. The projected debt trajectory is highly susceptible to various shocks, especially a negative real GDP growth shock. Gross financing needs are high, a particular concern as Montenegro is highly dependent on external financing.

Baseline and Realism of Projections

- **Macroeconomic assumptions**. Growth momentum is projected to slow in 2014 on account of base effects, as well as delays in several large infrastructure projects. Growth picks up gradually through the projection period—in the absence of the highway project, it would reach 3.3 percent. The expenditures on the highway are assumed to add EUR 206 million, EUR 253 million, EUR 303 million, and EUR 47 million to the nominal level of GDP in the years 2015–2018, less import content (assumed to be 70 percent), with an additional contemporaneous multiplier on aggregate demand of 5 percent, resulting in additional growth of 1.9, 0.3, 0.3, -2.2, and -0.4 in the years 2015–19. Inflation pressures are expected to remain negligible given low international agricultural prices and subdued EU inflation.

- **Fiscal adjustment.** A sizeable fiscal adjustment was achieved last year on account of a pension freeze and PIT and VAT rate hikes. In staff's baseline projections, the primary balance worsens significantly in 2015–17 on account of highway expenditures. This assumes that non-highway non-interest expenditures remain at their 2015 budget levels as a share of non-highway GDP in 2016-2019 as well, implying continued pension restraint and significant cuts in other capital spending.

- **Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high as debt approaches the 70 percent of GDP benchmark under the baseline and exceeds it under several shock scenarios. Gross financing needs are also well above the 15 percent benchmark, even under the baseline. Public debt held by non-residents also constitutes a vulnerability. Growth shocks have a very large impact on the debt profile.

- **Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) in 2005–2013 suggest on average an upward bias in staff's past projections. The median forecast error for the primary balance suggests that staff projections have been too pessimistic on average. While the projected CAPB adjustment is small, the key risks are high dependence on external financing and vulnerability to macro shocks.

Shocks and Stress Tests

Stress tests indicate that in particular growth shocks, but also fiscal shocks and cost overruns and delays related to the highway project, would have a major impact on fiscal sustainability.

Montenegro-specific stress tests

- **Highway shock.** In this scenario, the construction of the highway is assumed to cost 20 percent more (in 2018). Debt increases to 70 percent of GDP, while financing requirements far exceed those under the baseline in 2018.

Standard stress tests

- **Growth shock.** Under this scenario, real output growth rates are lowered during 2015 and 2016 by one standard deviation (4.9 ppt), also affecting inflation and interest rates. The public debt ratio increases to 86 percent by 2018, while the gross financing needs ratio in 2016 increases 9 percentage points relative to the baseline. (Even half a standard deviation shock pushes debt to 77 percent of GDP).

- **Interest rate shock.** This scenario examines the implications of an increase in interest rates on new debt by 200 basis points (relative to the baseline) in 2015–19. The deterioration in the ratios for debt and gross financing needs are back loaded as old debt gradually matures. However, by 2019, the impact on financing needs is significant.

- **Combined macro shock.** This scenario comprises a recession in 2015 and 2016, a 200 basis point increase in interest rates, and a sharp rise in expenditures. It pushes the debt to GDP ratio up to 89 percent of GDP, and has a very large impact on gross financing needs.

- **Financial contingent liability shock.** The noninterest expenditure shock is equivalent to 10 percent of the size of the banking sector and is combined with a shock to GDP and interest rates. The shock results in a sharp increase in the debt ratio to 85 percent of GDP. Meanwhile, gross financing needs would rise to over 28 percent of GDP in 2015, and stay higher over the medium term.

- **Primary balance shock.** This scenario assumes a revenue shock and a rise in interest rates leading to a 2 ppt of GDP deterioration in the primary balance in 2015 and 2016. The combined shocks lead to deterioration in the debt ratio and gross financing needs, but the impact is more muted than in other scenarios under consideration.

- **Real exchange rate shock.** The scenario assumes a 13 percent devaluation in the real exchange rate in 2015. As the ExIm loan is dollar denominated, debt increases to 70 percent, though the impact depends critically on the extent of exchange rate pass-through to inflation.

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

(In percent of GDP, unless otherwise indicated)

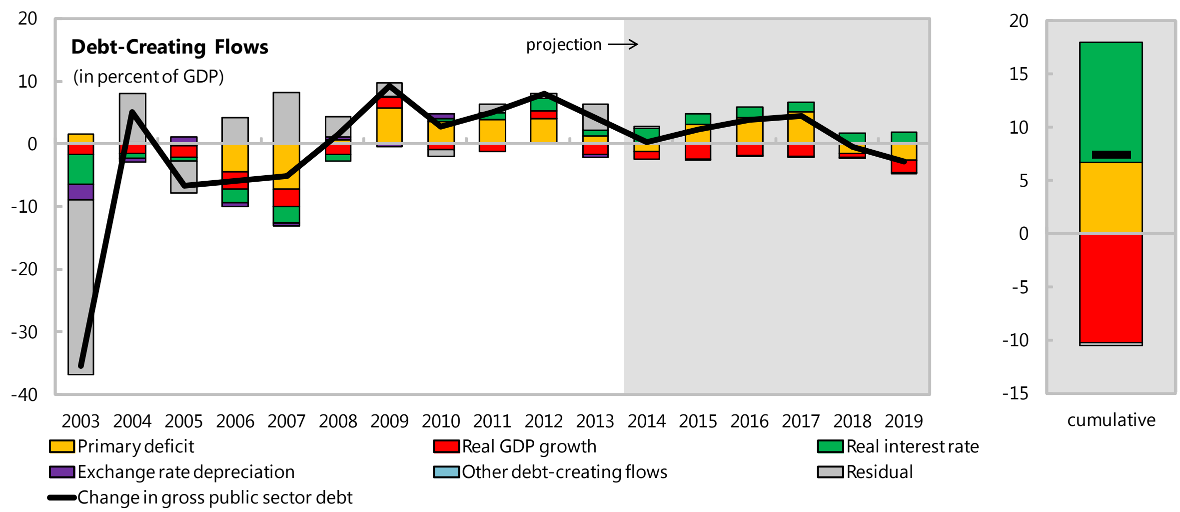
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	37.6	54.0	58.2	58.5	60.7	64.5	69.0	68.4	65.6
Public gross financing needs	11.5	11.5	12.6	10.5	20.2	21.8	18.1	9.7	15.1
Real GDP growth (in percent)	4.1	-2.5	3.3	2.0	4.6	3.3	3.4	1.0	2.9
Inflation (GDP deflator, in percent)	5.9	-0.1	2.2	-0.1	1.3	1.4	1.5	1.6	1.6
Nominal GDP growth (in percent)	10.4	-2.6	5.7	1.8	5.9	4.8	4.9	2.6	4.5
Effective interest rate (in percent) [4/]	3.2	4.0	4.2	4.2	4.5	4.4	4.2	4.2	4.5

As of August 30, 2013		
Sovereign Spreads		
EMBIG (bp) 3/		n.a.
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	B+	B+
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing
Change in gross public sector debt	-3.3	8.0	4.2	0.3	2.2	3.8	4.5	-0.6	-2.8	7.4	primary
Identified debt-creating flows	-2.5	7.3	0.0	0.0	2.3	3.9	4.6	-0.4	-2.7	7.7	balance [9/]
Primary deficit	0.4	4.1	1.2	-1.3	3.1	4.1	5.1	-1.5	-2.7	6.7	0.0
Primary (noninterest) revenue and gra	42.0	40.0	41.5	42.9	42.1	42.0	41.9	42.8	42.9	254.6	
Primary (noninterest) expenditure	42.3	44.1	42.8	41.6	45.2	46.1	46.9	41.2	40.2	261.3	
Automatic debt dynamics [5/]	-2.8	3.2	-1.2	1.3	-0.8	-0.2	-0.5	1.1	0.0	1.0	
Interest rate/growth differential [6/]	-2.6	3.1	-0.8	1.3	-0.8	-0.2	-0.5	1.1	0.0	1.0	
Of which: real interest rate	-1.2	1.9	0.9	2.5	1.7	1.7	1.6	1.8	1.9	11.2	
Of which: real GDP growth	-1.4	1.2	-1.7	-1.1	-2.5	-1.9	-2.1	-0.7	-1.9	-10.2	
Exchange rate depreciation [7/]	-0.3	0.0	-0.5	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-0.8	0.7	4.2	0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

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

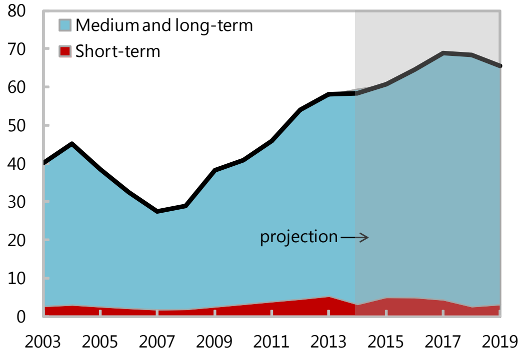
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Montenegro: Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

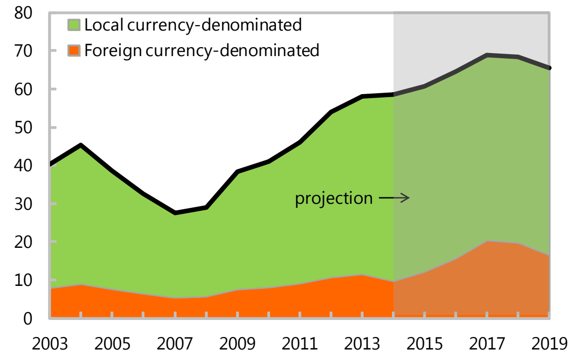
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

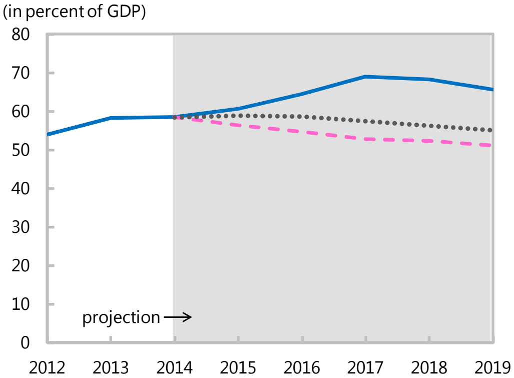


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

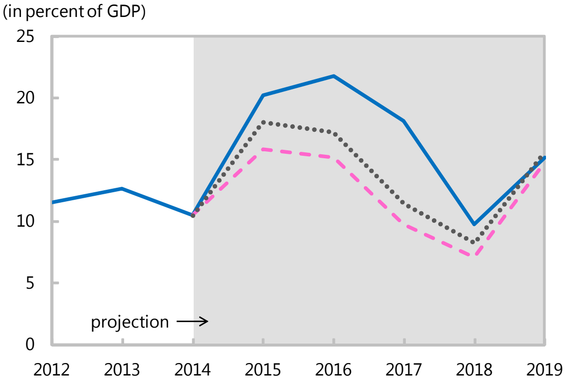
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	4.6	3.3	3.4	1.0	2.9
Inflation	-0.1	1.3	1.4	1.5	1.6	1.6
Primary Balance	1.3	-3.1	-4.1	-5.1	1.5	2.7
Effective interest rate	4.2	4.5	4.4	4.2	4.2	4.5
Constant Primary Balance Scenario						
Real GDP growth	2.0	4.6	3.3	3.4	1.0	2.9
Inflation	-0.1	1.3	1.4	1.5	1.6	1.6
Primary Balance	1.3	1.3	1.3	1.3	1.3	1.3
Effective interest rate	4.2	4.5	4.5	4.2	4.3	4.7

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	3.6	3.6	3.6	3.6	3.6
Inflation	-0.1	1.3	1.4	1.5	1.6	1.6
Primary Balance	1.3	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	4.2	4.5	3.3	2.2	1.8	1.9

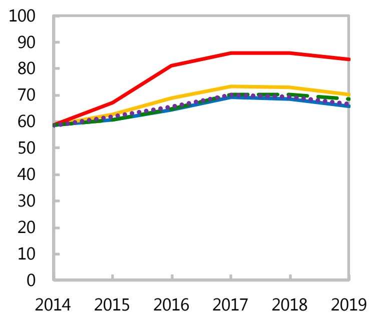
Source: IMF staff.

Montenegro: DSA – Stress Tests

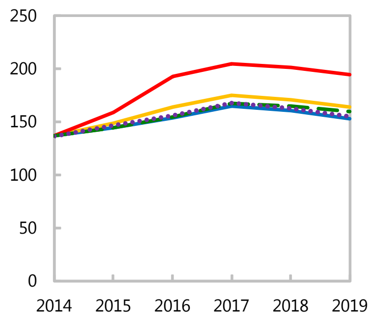
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

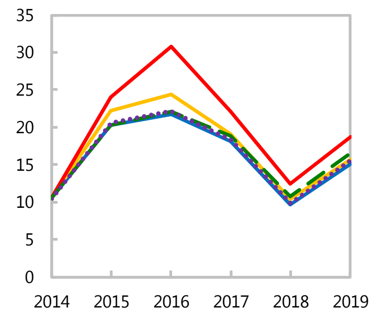
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



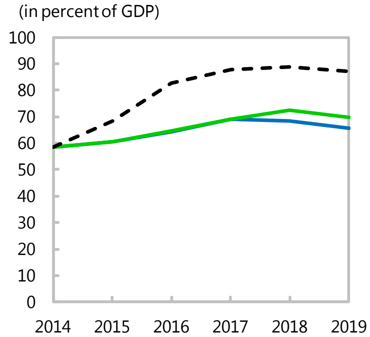
Public Gross Financing Needs
(in percent of GDP)



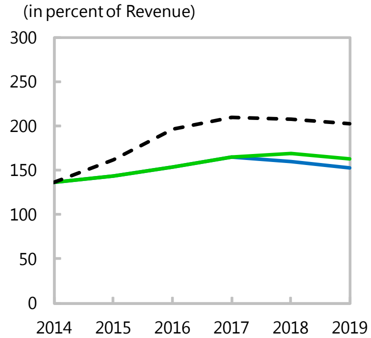
Additional Stress Tests

Baseline
Highway shock
Combined Macro-Fiscal Shock

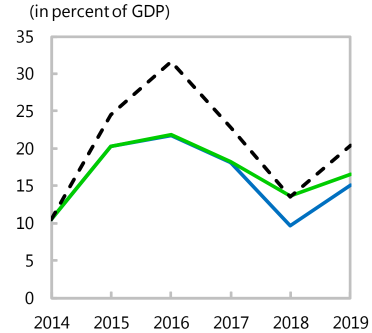
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	4.6	3.3	3.4	1.0	2.9
Inflation	-0.1	1.3	1.4	1.5	1.6	1.6
Primary balance	1.3	-5.1	-6.1	-5.1	1.5	2.7
Effective interest rate	4.2	4.5	4.6	4.5	4.4	4.7
Real Interest Rate Shock						
Real GDP growth	2.0	4.6	3.3	3.4	1.0	2.9
Inflation	-0.1	1.3	1.4	1.5	1.6	1.6
Primary balance	1.3	-3.1	-4.1	-5.1	1.5	2.7
Effective interest rate	4.2	4.5	5.0	5.2	5.5	6.0
Combined Shock						
Real GDP growth	2.0	-0.3	-1.5	3.4	1.0	2.9
Inflation	-0.1	0.1	0.2	1.5	1.6	1.6
Primary balance	1.3	-5.9	-10.0	-5.1	1.5	2.7
Effective interest rate	4.2	4.6	5.0	5.3	5.6	6.0

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	-0.3	-1.5	3.4	1.0	2.9
Inflation	-0.1	0.1	0.2	1.5	1.6	1.6
Primary balance	1.3	-5.9	-10.0	-5.1	1.5	2.7
Effective interest rate	4.2	4.5	4.6	4.8	4.7	5.0
Real Exchange Rate Shock						
Real GDP growth	2.0	4.6	3.3	3.4	1.0	2.9
Inflation	-0.1	1.7	1.4	1.5	1.6	1.6
Primary balance	1.3	-3.1	-4.1	-5.1	1.5	2.7
Effective interest rate	4.2	4.6	4.4	4.2	4.2	4.5

Source: IMF staff.

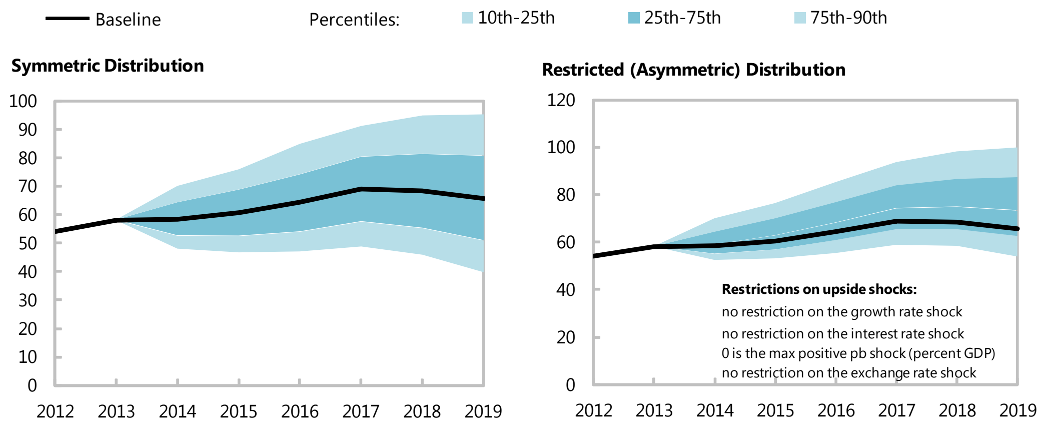
Montenegro: DSA – Risk Assessment

Heat Map

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

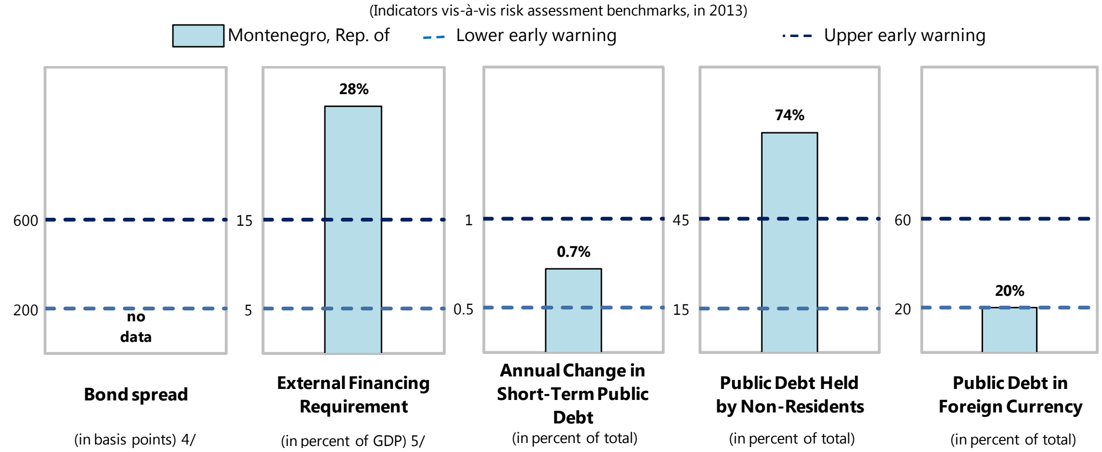
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

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

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

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

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

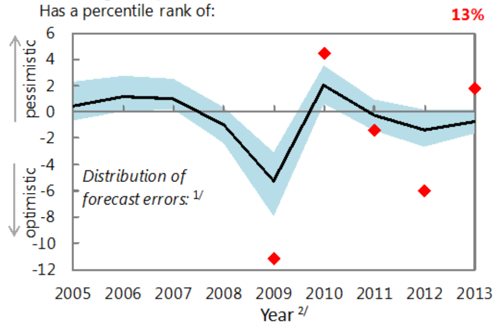
4/ Long-term bond spread over German bonds, an average over the last 3 months, 01-Jun-13 through 30-Aug-13.

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

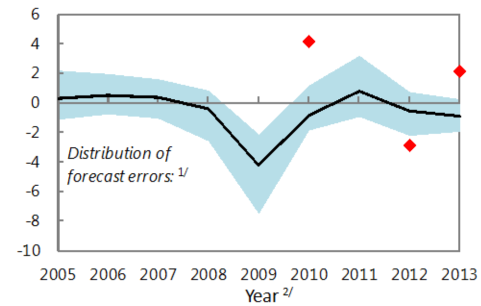
Montenegro: DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

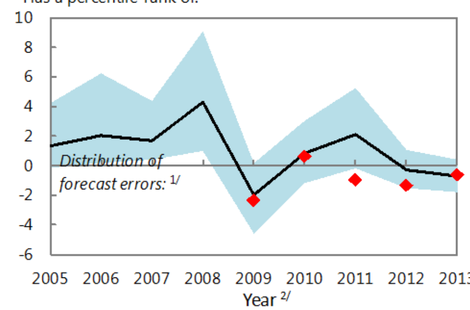
Real GDP Growth
(in percent, actual-projection)
Montenegro, Rep. of median forecast error, 2005-2013: -1.39
Has a percentile rank of: 13%



Primary Balance
(in percent of GDP, actual-projection)
Montenegro, Rep. of median forecast error, 2005-2013: 2.14
Has a percentile rank of: 92%

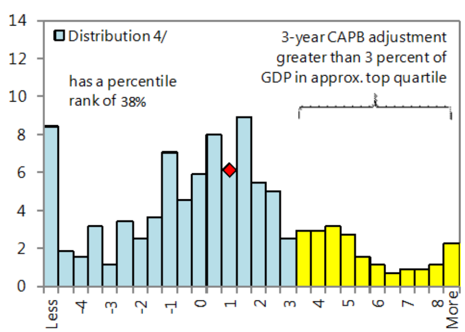


Inflation (Deflator)
(in percent, actual-projection)
Montenegro, Rep. of median forecast error, 2005-2013: -0.95
Has a percentile rank of: 6%

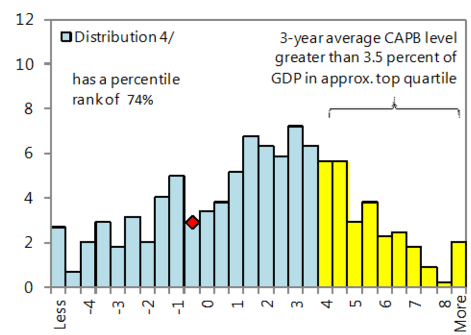


Assessing the Realism of Projected Fiscal Adjustment

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

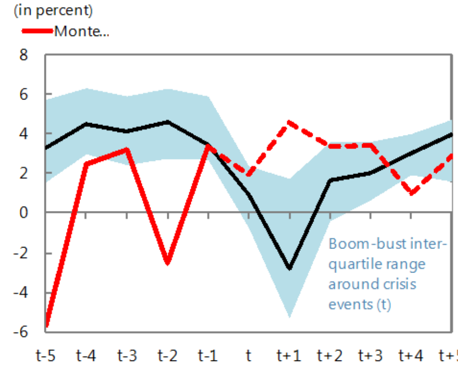


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Montenegro, Rep. of has had a positive output gap for 3 consecutive years, 2011-2013. For Montenegro, Rep. of, t corresponds to 2014; for the distribution, t corresponds to the first year of the crisis.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Appendix II. Montenegro: External Debt Sustainability Analysis

External debt has increased by nearly 60 percentage points of GDP since 2007 to an estimated 133 percent of GDP in 2014. This was driven in part by the sharp increase in public debt, which more than doubled over this period and comprises about 45 percent of total external debt. Under the baseline, external debt is projected to increase to 157½ percent of GDP. The projected debt trajectory is highly susceptible to various shocks, particularly a depreciation of the euro. Montenegro's heavy dependence on external financing reinforces the importance of fiscal and structural reforms to safeguard market access.

Shocks and Stress Tests

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

Standard stress tests

- **Growth shock.** Under this scenario, the baseline real GDP growth profile is permanently reduced by a one-half standard deviation calculated over the recent 10-year period (2.5 percent) effective in 2015. This corresponds to an average growth rate of 0.6 percent of GDP over 2015–19, compared with baseline average growth of 3 percent. Under this scenario, the external debt ratio increases to 172 percent of GDP in 2019.

- **Interest rate shock.** This scenario examines the implications of an increase in nominal external interest rates on new debt (relative to the baseline) by a one-half standard deviation in 2015–2019. Stable average external interest rates historically imply only a modest average increase in interest rates of 27 basis points in this scenario and, consequently, a relatively small increase in the external debt profile to 160 percent of GDP by 2019.

- **Non-Interest Current Account shock**. This scenario permanently increases the non-interest current account by one-half standard deviation in 2015–2019. Given historically-high current account deficits, this amounts to an increase of 6¼ percentage points. In the absence of offsetting debt creating flows, external debt increases to 189 percent of GDP by 2019.

- **Combined macro shock.** This scenario comprises a permanent ¼ standard deviation shock applied to the real interest rate, the growth rate, and the current account deficit effective 2015–19. The combined shock pushes the external debt ratio to 182 percent of GDP and increases gross financing needs by 26½ percent of GDP cumulatively over the shock period.

- **Real exchange rate shock.** The scenario assumes a one-time 30 percent devaluation in the real exchange rate in 2015 applied to the stock of external debt. Second round impacts (in terms of potential increases in competitiveness and improved trade balances) are not taken into account. Given the large stock of external debt, the shock increases the external debt-to-GDP ratio by 62½ percent of GDP in 2015. Gross financing needs are correspondingly higher, by about 17½ percent of GDP on average over 2015–19 relative to the baseline.

Table 1. Montenegro: External Debt Sustainability Framework, 2009–19

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	93.5	115.5	117.6	126.6	128.7			**132.9**	**137.5**	**144.8**	**152.8**	**157.4**	**157.6**	**-13.0**
2 Change in external debt	2.7	22.0	2.1	9.0	2.1			4.2	4.6	7.4	8.0	4.6	0.3	
3 Identified external debt-creating flows (4+8+9)	-4.7	1.4	1.0	7.2	-1.9			2.9	3.9	7.8	7.7	5.3	0.0	
4 Current account deficit, excluding interest payments	25.0	19.6	13.9	15.0	11.2			11.5	16.8	18.9	19.2	12.9	10.5	
5 Deficit in balance of goods and services	30.9	25.9	22.2	24.7	20.3			20.5	25.6	27.7	27.9	21.7	19.3	
6 Exports	34.5	37.3	42.7	44.1	41.8			40.5	40.4	40.6	40.8	41.7	42.0	
7 Imports	65.4	63.2	64.9	68.8	62.1			61.0	66.0	68.3	68.7	63.4	61.3	
8 Net non-debt creating capital inflows (negative)	-35.8	-17.8	-12.0	-14.7	-9.7			-9.7	-10.6	-11.4	-11.7	-11.9	-11.9	
9 Automatic debt dynamics 1/	6.1	-0.4	-0.8	6.8	-3.4			1.1	-2.3	0.3	0.3	4.3	1.4	
10 Contribution from nominal interest rate	2.9	3.3	3.8	3.6	3.4			3.6	3.5	4.7	5.0	5.7	5.7	
11 Contribution from real GDP growth	5.4	-2.2	-3.6	3.1	-4.0			-2.5	-5.7	-4.4	-4.7	-1.5	-4.3	
12 Contribution from price and exchange rate changes 2/	-2.2	-1.5	-1.1	0.1	-2.8			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	7.5	20.6	1.1	1.8	3.9			1.3	0.8	-0.5	0.2	-0.8	0.3	
External debt-to-exports ratio (in percent)	271.2	309.7	275.1	286.9	307.9			327.9	340.6	356.7	374.4	377.8	375.0	
Gross external financing need (in billions of Euro) 4/	1.3	1.1	0.9	0.9	0.9			1.1	1.4	1.6	1.6	1.3	1.6	
in percent of GDP	42.9	35.3	28.0	29.9	26.9	10-Year	10-Year	31.9	40.3	43.3	39.3	32.7	38.5	
Scenario with key variables at their historical averages 5/								**132.9**	**138.5**	**142.9**	**147.9**	**151.9**	**156.6**	**-20.2**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	-5.7	2.5	3.2	-2.5	3.3	3.6	4.9	2.0	4.6	3.3	3.4	1.0	2.9	
GDP deflator in US dollars (change in percent)	2.4	1.6	0.9	-0.1	2.2	4.7	4.1	-0.1	1.3	1.4	1.5	1.6	1.6	
Nominal external interest rate (in percent)	3.1	3.7	3.4	3.0	2.8	3.4	0.6	2.9	2.8	3.6	3.6	3.8	3.8	
Growth of exports (Euro terms, in percent)	-16.2	12.6	19.4	0.5	0.1	13.1	19.6	-1.3	5.5	5.4	5.5	4.7	5.5	
Growth of imports (Euro terms, in percent)	-32.3	0.6	7.1	3.2	-4.7	13.7	23.4	0.0	14.6	8.4	5.6	-5.4	1.2	
Current account balance, excluding interest payments	-25.0	-19.6	-13.9	-15.0	-11.2	-22.4	12.6	-11.5	-16.8	-18.9	-19.2	-12.9	-10.5	
Net non-debt creating capital inflows	35.8	17.8	12.0	14.7	9.7	13.0	11.4	9.7	10.6	11.4	11.7	11.9	11.9	

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

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

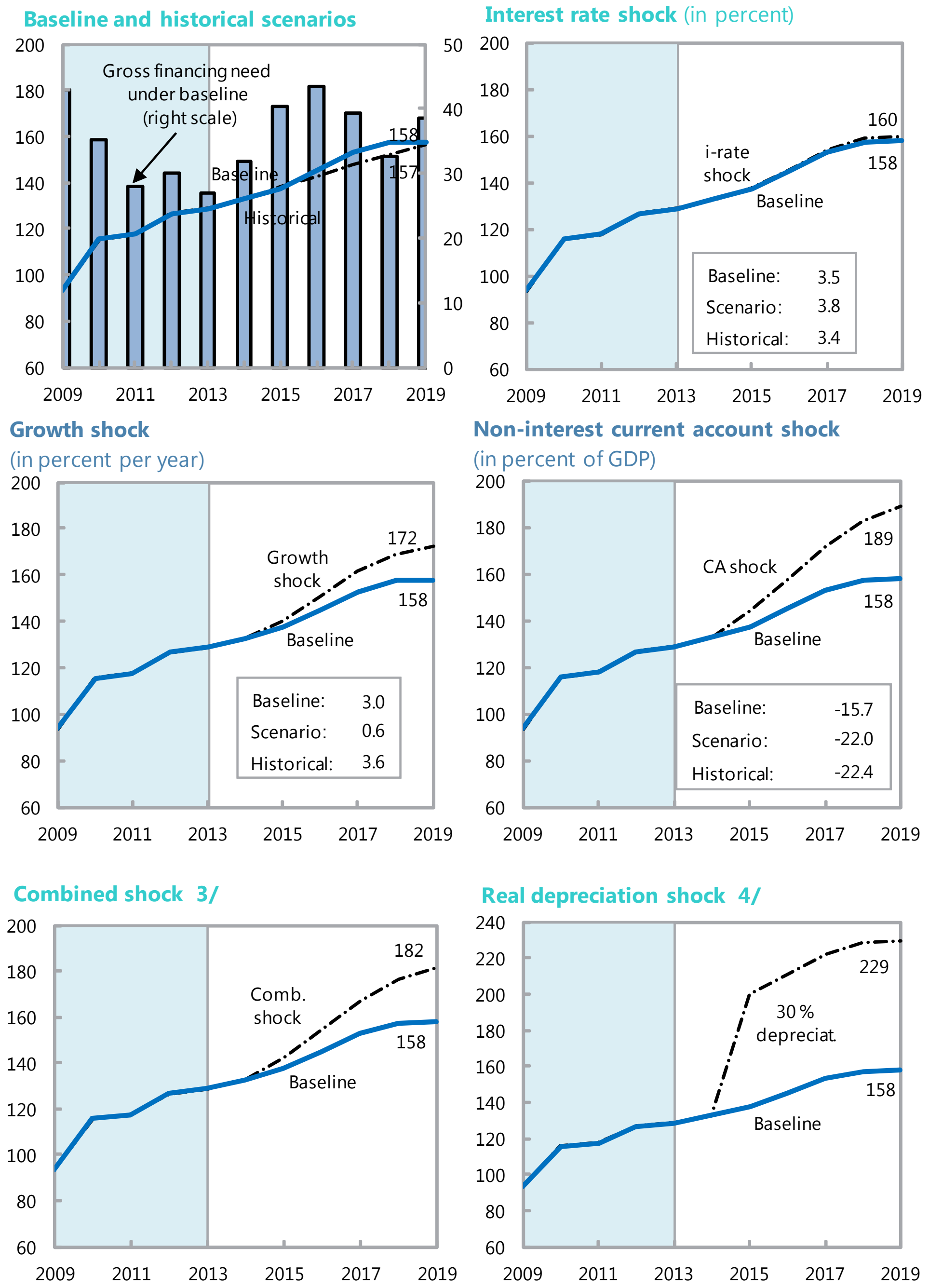
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Figure 1. Montenegro: External Debt Sustainability: Bound Tests [1/,2/]



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2015.

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 8, 2015

Prepared By

The European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of October 31, 2014)

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

General Resources Account:	**SDR Million**	**% Quota**
Quota	27.50	100.00
Fund Holdings of Currency	20.90	76.00
Reserve Position	6.60	24.00

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	25.82	100.00
Holdings	26.34	102.02

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not Applicable.

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

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

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

Latest Article IV Consultation: Concluded on July 22, 2013 (IMF Country Report No. 13/271).

FSAP Participation: A Financial Sector Assessment Program was initiated in July 2006, jointly with the World Bank, and concluded during the 2007 Article IV consultation. The Executive Board discussed the Financial System Stability Assessment in January 2008 (IMF Country Report No. 08/50).

Technical Assistance in the Past 12 Months:

Department	Timing	Purpose
STA	Sep-14	National Accounts Statistics
MCM	Jul-14	Financial Stability Analysis, including Stress Testing, Early Warning System
STA	Jun-14	Consumer Prices/Producer Price
FAD	Jun-14	Public Financial Management
STA	Jun-14	National Accounts Statistics
MCM	May-14	Reserve Management
STA	Jan-14	Consumer Prices/Producer Price
STA	Jan-14	National Accounts Statistics

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

Resident Representative: None.

WORLD BANK GROUP RELATIONS

1. **Montenegro joined the World Bank Group (WBG) as an independent country in January 2007.** The Bank had implemented a program of lending and analytical work for Montenegro for most of the period since the State Union of Serbia and Montenegro joined the WBG in 2001. Six projects are currently active, with 1½ years before the end of the Montenegro's second Country Partnership Strategy (CPS) for the fiscal years 2011–15. The CPS was prepared at a time when the country was striving to recover from a sharp economic contraction associated with the 2008 global and Eurozone crisis. In the wake of the crisis, the initially-envisaged total IBRD lending of US$215.7 million was increased by nearly US$100 million. The lending program was complemented by a mix of analytic and technical support aligned with the CPS pillars.

2. **The Board approved the CPS in January 2011 and the CPS Progress Report in May 2014** extending the CPS by one year through FY15 as both CPS pillars—(i) strengthening institutions and aligning them with European Union (EU) requirements in areas critical for longer-term competitiveness in global markets; and (ii) improving environmental management—remain highly relevant, and the additional year facilitates the delivery of the planned lending program. Also, with uncertainties in the fiscal framework and public investment program, an additional year was deemed helpful in gaining greater clarity on the likely medium-term macro-fiscal framework that would underpin a new Country Partnership Framework (CPF) and influence planned lending volumes and instruments.

Montenegro: World Bank Project Portfolio, November 2014

Project Name	Date, Board App	Net Comm Amt ($m)	Total Percent Disb.	Percent Disb. Ratio FY15 (as of Oct. 2014)
Higher Education and Research for Innovation and Competitiveness	01/24/2012	15.98	36.8	21.3
Energy Efficiency	12/09/2008	16.20	57.4	4.1
Montenegro Institutional Development and Agriculture Strengthening	04/21/2009	15.70	66.7	19.3
Montenegro Institutional Development and Agriculture Strengthening (GEF)	04/21/2009	4.00	58.1	21.8
Land Administration and Management	12/09/2008	16.20	71.3	19.6
Industrial Waste Management and Cleanup	09/19/2014	68.90	0.2	0.0
		136.98	**29.0**	**17.2**

3. **Within the CPS FY11–FY15, the IBRD Board approved five IBRD loans to provide selective support to two key CPS priorities.** The CPS originally envisaged a series of two financial sector development policy operations (DPOs). In light of post-crisis needs, the second DPO was converted into a larger financial sector policy-based guarantee (PBG) that supported a comprehensive program of measures designed to strengthen the banking sector, address its vulnerabilities, and bolster its resilience to possible future shocks. This support also led to advisory work on nonperforming loans (NPL) resolution. Additional countercyclical stimulus was considered through a Public Expenditure DPO, but did not materialize in FY13–14 given the remaining

weaknesses in the medium-term fiscal framework. New investment lending was approved for a Higher Education/R&D project (US$16 million), Energy Efficiency Additional Financing (US$6.8 million) and an Industrial Waste Management and Clean-Up Project (US$69 million). The committed portfolio has doubled since to US$137 million in 2014. About 71 percent of these commitments remain to be disbursed.

4. **Pipeline projects include** (i) a Revenue Administration and Modernization Project building on the recent tax administration assessment that aims to increase the effectiveness and efficiency of tax administration as well as reduce the cost of compliance for the taxpayer; (ii) a Fiscal and Debt Management technical assistance operation that aims to support strengthening the institutional capacity of fiscal resources and public debt management; (iii) a Trade and Competitiveness project that aims to provide support to the business environment, enterprise development and skills and labor market development interventions; (iv) a second Health Improvement project that aims to provide a support for financing reforms and governance for quality in the health sector.

5. **Cooperation with the IMF has been good, particularly in the areas of macroeconomic and financial sector policies.** Bank and Fund teams coordinated closely during the preparation of the Financial Sector DPL and Policy-Based Guarantee in 2011 and 2012 and the TA on NPL resolution. The World Bank Group, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input to the IMF on issues such as (i) public expenditure, including pension and health reforms; (ii) business climate and competitiveness, including labor market reform and the resolution of nonperforming loans; (iii) public sector institutions and fiduciary reviews, (iv) agricultural assessments; and (v) statistical capacity building and poverty monitoring. The Fund and Bank staff have sought each other's input in internal review processes.

Montenegro: Joint Management Action Plan - Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, January—December 2015

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	Fall 2015	January 2016
2. Bank work program	Systematic Country Diagnostics	February 2015	March 2015
	TA on pension model PROST	January-April 2015	May 2015
	Revenue Administration Project	February 2015	April 2015
	Fiscal and Debt Management	January 2015	May 2013
3. Joint work program	None	None	

Prepared by World Bank staff. Questions may be addressed to Sanja Madzarevic-Sujster, country economist (smadzarevic@worldbank.org), and Gallina A. Vincelette, lead economist Western Balkans (gvincelette@worldbank.org).

STATISTICAL ISSUES

MONTENEGRO—STATISTICAL ISSUES APPENDIX

As of December 2014

I. Assessment of Data Adequacy for Surveillance

General: Data provision has some shortcomings, but is broadly adequate for surveillance. The most affected areas are labor market indicators, and government finance statistics.

National Accounts: The Statistical Office of Montenegro (MONSTAT) compiles annual production and expenditure accounts in current and previous year's prices. The production GDP estimates are reconciled with the expenditure GDP estimates through the supply and use framework (i.e. reconciling supply and use). The quality of the annual GDP is good.

Montenegro started disseminating quarterly GDP by production using an indirect method in 2012, but the methodology has room for improvement. The estimates are compiled at an aggregated level (mostly NACE section level). The accuracy of the short term statistics needs to be improved, mostly for agriculture, and construction. The latest national accounts TA mission in September 2014 continued working on developing quarterly GDP. estimates by expenditure approach. Experimental estimates have been compiled; the official dissemination will be in March 2015.

Price Statistics: MONSTAT compiles and disseminates a monthly consumer price index that broadly follows international standards. MONSTAT continues to implement improvements to the producer price index. Improvements include developing a total output PPI; expanding index coverage to include services and construction; and updating index calculation methods. MONSTAT began compiling and disseminating the EU harmonized consumer price indices, beginning in 2011. An export price index has been published since 2009, and an industrial import price index since 2011. There is need to improve the industrial production index.

Labor market statistics: MONSTAT reports labor and wage statistics based on data from the labor force survey (LFS) and administrative sources. The unemployment rate from the LFS is computed according to the ILO definition. The quality of wage indicators is relatively good, but information on foreign employment remains limited. The presence of a large informal sector impedes the accurate assessment of the unemployment rate. Frequent methodological revisions also impair time series analyses.

Government Finance Statistics: Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and, since early 2006, includes data on local governments and social security funds. The latter was merged with the treasury account in 2010. The charter of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications. The MOF has established a unit responsible for data collection for state-owned enterprises, but a satisfactory compilation of the public sector fiscal balance requires significant further effort. Data on enterprises owned by municipalities are rarely available. Data on the stock of local government arrears need to be significantly strengthened and disseminated. Data on stocks of financial assets and liabilities are incomplete.

The latest GFS TA mission in March 2013 recommended updating the table on the institutional structure of the public sector to facilitate consistency among producers of official statistics. It was also recommended to establish a migration plan to phase in the *GFSM 2001* framework and to start publishing quarterly budgetary central government data in the *IFS*.

Monetary and Financial Statistics: Monetary and financial statistics are compiled by the Central Bank of Montenegro (CBM), broadly following the institutional coverage, classification, and evaluation methodology set forth in the Monetary and Financial Statistics Manual (2000). However, the monetary data are not reported in IMF recommended Standardized Report Form format. 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 has published detailed monetary statistics in its monthly Statistical Bulletin, which includes tables on monetary statistics, balance sheets and surveys for the CBM and commercial banks. At the beginning of 2013, the CBM adopted new financial reporting requirements for banks in line with IAS 39; as a result, monetary data for 2013 are not comparable with data from previous years. Montenegro does not report Financial Soundness Indicators to the IMF.
External sector statistics: Balance of payments statistics are compiled by the CBM and follow international reporting standards. External sector statistics have benefited from improvements undertaken by MONSTAT to improve coverage, valuation, and classification of merchandise trade statistics. Data on imports and exports in the BOP are compiled according to the special trade system. The CBM adjusts export and import data from MONSTAT from CIF to FOB basis. The biggest challenge to the BoP statistics is the coverage of transactions through the informal economy. As with many euroized economies, difficulty in estimating currency and deposits and large errors and omissions continue to be an issue in the balance of payment statistics. Although current account statistics have been revised recently, errors and omissions are still large and with a persistent positive sign, largely due to an underestimation of the export of tourism services. The CBM has made progress in improving the recording of transactions via the ITRS by refining the transactions coding system and increasing interaction with commercial banks. However, the ITRS remains 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. The CBM has expressed its interest in reporting BoP statistics under the presentation of the sixth edition of the *Balance of Payments and International Investment Position Statistics Manual (BPM6).* The CBM has received TA on International Investment Position (IIP) statistics, but does not yet disseminate these data. More recently, the CBM has conveyed to STA continuous difficulties with compiling and disseminating IIP statistics. The latest BoP TA mission in January 2013 concluded with the following action items: (i) the compilation and regular dissemination of the IIP and external debt statistics; (ii) the revision of the compilation of the flows in currency and deposits assets by other sectors; and (iii) the improvement of the currently estimation procedure for the item Compensation of Employees (credit).

II. Data Standards and Quality	
Participant in the Fund's General Data Dissemination System (GDDS) since December 2011. The latest update of metadata and GDDS plans for improvement were in 2012.	No data ROSC available.

Table of Common Indicators Required for Surveillance

(As of end-Dec 2014)

[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

	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]	Oct-2014	21-Nov-2014	M	M	M
Reserve/Base Money	Oct-2014	21-Nov-2014	M	M	M
Central Bank Balance Sheet	Oct-2014	21-Nov-2014	M	M	M
Consolidated Balance Sheet of the Banking System	Oct-2014	21-Nov-2014	M	M	M
Interest Rates[2]	Oct-2014	21-Nov-2014	M	M	M
Consumer Price Index	Oct-2014	21-Nov-2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sept-2014	21-Oct-2014	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Sept-2014	21-Oct-2014	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept-2014	24-Oct-2014	Q	Q	Q
External Current Account Balance	Q3-2014	21-Nov-2014	Q	Q	Q
Exports and Imports of Goods and Services	Q3-2014	21-Nov-2014	Q	Q	Q
GDP/GNP	Q2-2013	24-Sept-2014	Q	Q	Q
Gross External Debt	--	--	NA	NA	NA
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 nonbank financing.

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

[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); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 15/31
FOR IMMEDIATE RELEASE
February 4, 2015

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

IMF Executive Board Concludes 2014 Article IV Consultation with Montenegro

On January 23, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Economic momentum slowed in 2014, but growth is expected to accelerate in 2015, aided by expenditures on the highway project. Nonetheless, Montenegro is vulnerable to a downturn in external demand, and substantial financing needs expose the country to shifts in risk aversion and disruptions to global financial markets.

The authorities have undertaken bold fiscal adjustment over the past years, reflecting a combination of tax hikes, pension freezes, and efforts to increase tax compliance. Measures in the draft 2015 budget that partly offset the extra spending on the highway are welcome, but a sustained period of fiscal discipline will be needed nonetheless. Laying out clear and credible long-term plans for managing the public finances, including savings on pensions and the public sector wage bill, would boost credibility and reduce risks to market access. In addition, the authorities should define contingency measures to address unforeseen fiscal shocks, with the first recourse being a delay or cut in highway spending.

Addressing non performing loans and improving credit conditions are priorities. The “Podgorica Approach” has the potential to facilitate debt workouts; this effort should be complemented by reforms to address problems with contract enforcement and securing collateral. Although provisioning coverage for the banking system as a whole appears sizable on a regulatory basis, the wide variation across banks may warrant enhanced supervisory scrutiny. There is scope to improve transparency, including by publishing quarterly banking reports with information on the level of regulatory provisions and all stress test results.

Structural reforms are essential to raise potential growth and improve flexibility and competitiveness. Bolstering the economy’s ability to respond to macroeconomic shocks is especially important in a country lacking its own currency and with decreasing fiscal buffers. Measures to ensure that wages adjust in line with productivity developments and to reduce

[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.

disincentives for employment would improve labor market outcomes. Sustaining recent policy momentum to strengthen the business environment and spur investment is also critical to broaden the economic base.

Executive Board Assessment[2]

The directors noted that moderate growth continues, but the outlook remains challenging, and risks weigh on the downside, including from external spillovers. Against this backdrop, Directors underscored the need for continued fiscal discipline, further efforts to strengthen the banking sector, and comprehensive structural reforms to address macroeconomic vulnerabilities and spur growth.

Directors commended the authorities' efforts to address fiscal imbalances in recent years. While recognizing the potential impact on economic growth, they noted that the Bar-Boljare highway project places a large burden on public finances and exacerbates debt and financing risks. Directors underscored that the underlying fiscal restraint embedded in the 2015 budget needs to be sustained to contain fiscal risks and ensure debt sustainability. In this context, they encouraged the authorities to lay out a clear long-term consolidation strategy, including further measures to reform the pension system and reduce the public-sector wage bill. Directors stressed that contingent fiscal measures should be identified to address unanticipated shocks. They welcomed ongoing efforts to reduce support to state-owned entities, and called for the timely completion of the sale of the aluminum producer KAP.

Directors observed that banking system health indicators are mixed. Capitalization has improved and liquidity appears sufficient, but profitability has been weak and the large stock of non-performing loans burdens balance sheets and impedes lending. They agreed that improving credit conditions is a top priority, and welcomed the draft law on voluntary financial restructuring. Reforms to bolster contract and collateral enforcement are also needed. Directors agreed that the wide variation of provisioning coverage across banks warrants a strong supervisory scrutiny over banks' classification and collateral valuation practices. They saw merit in taking steps to enhance regulatory transparency and reporting.

Directors underscored the importance of reforms to boost competitiveness and economic flexibility. They emphasized that improving labor market outcomes is necessary to boost growth potential and help contain long-term fiscal pressures. Lasting improvements require measures to ensure wages adjust in line with productivity and to reduce informal employment incentives. Directors also encouraged the authorities to sustain progress in improving the business and investment environments so as to promote economic diversification and boost long-term growth.

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[2] 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.

Montenegro: Selected Economic Indicators

	2010	2011	2012	2013	2014 Proj.	2015 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	2.5	3.2	-2.5	3.3	2.0	4.6
Nominal GDP (in millions of euro)	3,104	3,234	3,149	3,327	3,387	3,588
Industrial production	17.5	-10.3	-7.1	10.6	--	--
Tourism (Overnight stays)	5.5	10.2	4.3	2.8	--	--
Unemployment rate (in percent) 1/	19.7	19.7	19.7	19.5	--	--
Consumer prices (average)	0.7	3.1	3.6	2.2	-0.6	1.2
Consumer prices (end of period)	0.7	2.8	5.1	0.3	0.6	0.9
General government finances (percent of GDP) 2/						
Revenue and grants	41.3	38.5	40.0	41.5	42.9	42.1
Expenditure	45.9	43.8	45.9	44.8	43.8	47.5
Fiscal balance	-4.6	-5.2	-5.9	-3.3	-0.9	-5.3
Primary fiscal balance	-3.6	-3.8	-4.0	-1.1	1.4	-3.1
General government gross debt	40.9	46.0	54.0	58.2	58.5	60.7
Monetary sector (end-period, percent change)						
Bank credit to private sector	-8.9	-13.0	-3.1	2.1	-3.6	3.2
Enterprises	-11.2	-20.3	-4.9	0.1	--	--
Households	-5.7	-3.2	-1.1	3.7	--	--
Private sector deposits	5.9	1.2	7.2	5.4	--	--
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-22.9	-17.7	-18.7	-14.6	-15.1	-20.2
Exports of goods and services	37.3	42.7	44.1	41.8	40.5	40.4
Imports of goods and services	-63.2	-64.9	-68.8	-62.1	-61.0	-66.0
Foreign direct investment	17.8	12.0	14.7	9.7	9.7	10.6
External debt 3/	115.5	117.6	126.6	128.7	132.9	137.5
REER (CPI-based; average change, in percent; + indicates appreciation)	2.8	-3.2	3.3	-1.1	--	--

Sources: Montenegro authorities; and IMF staff estimates and projections

1/ Labor Force Survey (LFS) data.
2/ Includes extra-budgetary funds and local governments, but not public enterprises.
3/ Staff estimates, as private debt statistics are not officially published.

**Statement by Menno Snel, Executive Director for Montenegro
and Andrijana Cudina, Advisor to Executive Director
January 23, 2015**

The Montenegrin authorities thank staff for the very constructive dialogue during their mission in Montenegro. They appreciate staff's comprehensive analysis and broadly agree with their assessments and policy recommendations. Discussions have helped the authorities to frame the policy measures needed to boost growth and resilience of the economy, and safeguard the fiscal sustainability going forward.

Economic developments and outlook

The Montenegrin economy continues to grow against a challenging background. Real GDP rebounded by 3¼ percent in 2013, but has weakened in 2014 and looks likely to be close to 2½ percent for the year. The slowdown is attributable to the weakened external demand and the floods in the region. However, positive developments have been registered in tourism, construction, forestry and the retail trade. Although employment is on the rise, the unemployment rate is persistently high. Inflation has fallen sharply but remains in positive territory. Credit growth has still not recovered. The external position remains vulnerable, although the ongoing political uncertainties in the region so far have had only limited effects on the foreign direct investments and tourism performance.

The medium-term growth is expected to converge to about 3 percent backed by a number of ambitious, large-scale investment projects, including the start of the first stage of the Bar-Boljare highway (costing a quarter of the national product), as well as projects in the energy sector and tourism. The authorities expect positive spillover effects from these projects to the rest of the economy. The highway is especially critical in this regard, not only in economic terms, but also for safety reasons, regional development and broader integration. However, there are clear risks to the outlook, given the country's high dependence on foreign capital inflows and substantial refinancing needs, and it's vulnerability to downturns in external demand.

Fiscal policy

The fiscal consolidation continued with laudable adjustments in the last two years, narrowing the overall deficit from -5.9 in 2012 to -0.9 percent of GDP in 2014. Important steps including higher taxes, a freeze on pensions, and measures to fight the grey economy contributed to such significant consolidation. Nonetheless, the public debt is on the rise reaching 58 percent of GDP in 2014.

The authorities agree with staff that, given the cost of the highway, strong fiscal discipline will be needed to preserve the sustainability of public finances. The recently adopted budget for 2015 envisages appropriate measures which are expected to result in further improvement in the budget balance (excluding the highway spending). Apart from better revenue collection, the focus is on rationalization of the current expenditures, while the capital expenditures will be limited to essential infrastructural projects. The wage and pension bill as well as social transfers will be contained. Although staff expressed concerns about non-renewing of the pension freeze in 2015, the expenditure adjustment to the pensions is likely to be on the downside since they will follow the cost of living and the average wages in the economy which are both on a declining path.

As for the fiscal rule, the authorities agree with staff that there is room for further strengthening of the framework. They have also made progress in divesting from state-owned companies. A positive example is the long-lasting issue of the aluminum plant (KAP) which was successfully sold to a new owner. However, full payment is still pending due to a prolonged court procedure. Privatization of the shipyards is also expected to start soon.

Public debt sustainability

Staff's public debt sustainability analysis (DSA) indicates serious vulnerability of the Montenegrin public finances in different scenarios. In the authorities' view, the underlying drivers of the debt trajectory presented in the Staff Report are not fully capturing the spillover effects from the infrastructural projects on growth and inflation, which will likely mitigate the debt dynamics. Also, caution is warranted when interpreting the results of the shock-to-growth scenario, given the high volatility of domestic growth in the past.

As staff points out, the medium-term financing needs are considerable. In the authorities' view, the financial burden to the budget from the repayment of the highway loan may be somewhat overstated. The terms under which the loan for the first stage was signed with the Chinese partners are rather favorable. The annual installments of about EUR 50-60 million (taking into account the revenues from tolling, the net fiscal burden would amount to about EUR 25 million annually) are manageable. If the construction is finished as planned by 2019 the budget would have two years of receiving tolls before the first installment is due. Regarding the exchange rate risks, the authorities are prepared to consider a swap arrangement.

In the event of shocks to public finance and unanticipated highway cost over-runs, the authorities are prepared to lay out a contingent consolidation plan. Cutting or delaying spending on the highway in the middle of the construction process would be counterproductive in their view. Instead, they would focus on tackling the current budget expenditures and boosting revenues, possibly through stronger taxation of goods like alcohol, tobacco and oil derivatives.

Monetary policy and financial system

The Montenegrin banking sector is sound and liquid, as indicated by the liquidity and solvency ratios. However, the banks are operating in a challenging environment which is reflected in their tight lending policy, weak credit activity and low profitability. Despite recent improvements, the level of non-performing loans is still high at around 17 percent.

The authorities are taking comprehensive measures to address these challenges. The new regulatory framework on voluntary financial restructuring (*Podgorica Approach*) will be an important step to elevate the debt burden for solvent but illiquid companies and gradually facilitate the reduction in NPLs. From a financial sector perspective, closer monitoring of factoring companies would also have positive effects, given their important role in this process.

The high level of lending interest rates is another major concern, as it hampers the resolution of NPLs and holds back new lending. Given the complexity of the underlying factors that contribute to such financing conditions, efforts are being made to reduce market inefficiencies stemming from the lack of competition and limited business opportunities. Despite the limitations of a small market, addressing structural credit risks will be the key to revive lending activity. Strengthening the institutions and legal framework as well as the rule of law, especially contract enforcement, is the priority in this regard.

Competitiveness and structural reforms

The authorities recognize that structural reforms remain essential to raise potential growth and improve the flexibility and competitiveness of the economy. Their priority areas are the labor market, the pension system and the business environment. Labor market reforms are crucial given the high unemployment and low participation rate. Several reform initiatives have been implemented to increase the labor market flexibility by reducing dismissal costs and simplifying hiring. A temporary government-funded program for graduates is also in place with the aim to help integrating the young into the labor market. Efforts are made to better match the educational system and the labor market needs. Streamlining of the social benefits through the introduction of "*social cards*" will increase the transparency of the system and reduce the disincentives to work. With regard to the pension system, the ongoing reforms aim to reduce the deficit of the Pension Fund to a sustainable level, through better collection of contributions and stricter retirement rules.

The Montenegrin business environment stands relatively well in a regional context. The latest improvement, from the 42nd to the 36th position on the World Bank's *Doing business 2015* list, is mostly due to the improvements in obtaining construction permits, which is critical for the upcoming tourism projects. However, the procedures for starting a business, enforcing contracts, registering property, and tax collection remain very challenging. In addition to focusing on these priorities, the authorities also focus on attracting FDI, which is essential to promote economic diversification. Along with efforts to simplify the investment procedures, they are considering new incentives for foreign investors.