January 2008
IMF Country Report No. 08/48

Republic of Montenegro: 2007 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Republic of 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 2007 Article IV consultation with Republic of Montenegro, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 4, 2007, with the officials of Republic of Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 14, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of January 16, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 16, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Republic of Montenegro.

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

Selected Issues Paper
Financial System Stability Assessment

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

Staff Report for 2007 Article IV Consultation

Prepared by the European Department
(In consultation with other departments)

Approved by Juha Kähkönen and Michael Hadjimichael

December 14, 2007

Executive Summary

The IMF's most recent member has high economic potential. The economy is taking off, with strong investor interest in tourism. Driven by strong FDI and accelerating credit, GDP growth is projected to exceed 7 percent in 2007 and remain strong in 2008, unemployment has fallen sharply, and public debt and inflation remain low.

But strong growth is masking rising vulnerabilities. The economy is showing clear signs of overheating; the current account deficit at 37 percent of GDP has reached levels that demand vigilance; bank credit has accelerated with an aggressive push for market share, straining the ability of banks to adequately assess loan quality; inflationary pressures are on the rise despite euroization; wages have accelerated as the labor market tightens; and real estate and equity prices have soared.

Policy options are limited. Euro adoption precludes an exchange rate adjustment, but rapidly rising private debt raises the possibility of solvency problems related to real estate and asset market exposures, especially if declining competitiveness stunts Montenegro's tourism potential. With few other available policy levers, the procyclical 2008 budget is a concern. Staff stressed the need for a strong fiscal stance, and strengthened banking supervisory powers. The signing of the pre-accession agreement with the EU provides an opportunity to boost structural reforms to remove restrictive labor practices, ease energy bottlenecks, and improve the business climate.

The authorities are more sanguine about the risks. They view the widening imbalances as private sector driven, and point to large nation building needs that limit the scope for fiscal policy to contain demand pressures. The Central Bank is taking measures to strengthen supervision and dampen credit growth, but noted that its powers are limited given delays in passing key banking legislation through parliament.

Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and the Fund staff have not, as yet, undertaken a thorough analysis of Montenegro's exchange system.

Contents Page

Main Sources of Economic Statistics for the Republic of Montenegro

Data in the Staff Report reflects information received by October 31, 2007. In most cases, more recent data can be obtained directly from the following sources:

Statistical Office of the Republic of Montenegro	http://www.monstat.cg.yu
Central Bank of Montenegro	http://www.cb-mn.org
Ministry of Finance of the Republic of Montenegro	http://www.vlada.cg.yu/minfin
Montenegro Stock Exchange	http://www.montenegroberza.com
New Securities Exchange	http://www.nex.cg.yu
Institute for Strategic Studies and Prognoses	http://www.isspm.org
International Financial Statistics	

List of Acronyms

CBM	Central Bank of Montenegro (*Centralna Banka Crne Gore, CBCG)*
EPCG	Electric Power Company of Montenegro (*Elektroprivreda Crne Gore*)
ISSPM	Institute for Strategic Studies and Prognoses, Montenegro
KAP	Aluminum Factory in Podgorica *(Kombinat Aluminijuma u Podgorici*)
MONSTAT	Statistical Office of the Republic of Montenegro
MTFP	Ministry of Tourism and Environmental Protection
WTTC	World Tourism and Travel Council

I. Too Much of a Good Thing?

Montenegro: Main Indicators, 2007	
Population (in thousands)	625.2
Per capita GDP (in US$)	5,112
Unemployment rate	11.8
Inflation (average)	3.5
Fiscal revenue/GDP	50.7
Fiscal balance/GDP	5.4
Government Debt/GDP	40.5
Trade (GNFS)/GDP	136.8
FDI/GDP	24.4
CA deficit/GDP	37.0

Sources: Authorities; and Fund staff estimates.

1. **Independence and huge tourism potential has generated strong investor interest in Montenegro**. The last five years have seen price stability restored through the adoption of the euro as sole legal tender; notable progress in fiscal consolidation; restructuring of the banking sector; progress in privatization; and a favorable resolution of the state liabilities of the former union that left Montenegro with low debt (Figure 1). The authorities' vision is to create a business friendly, open economy with low taxes and minimal state interference.

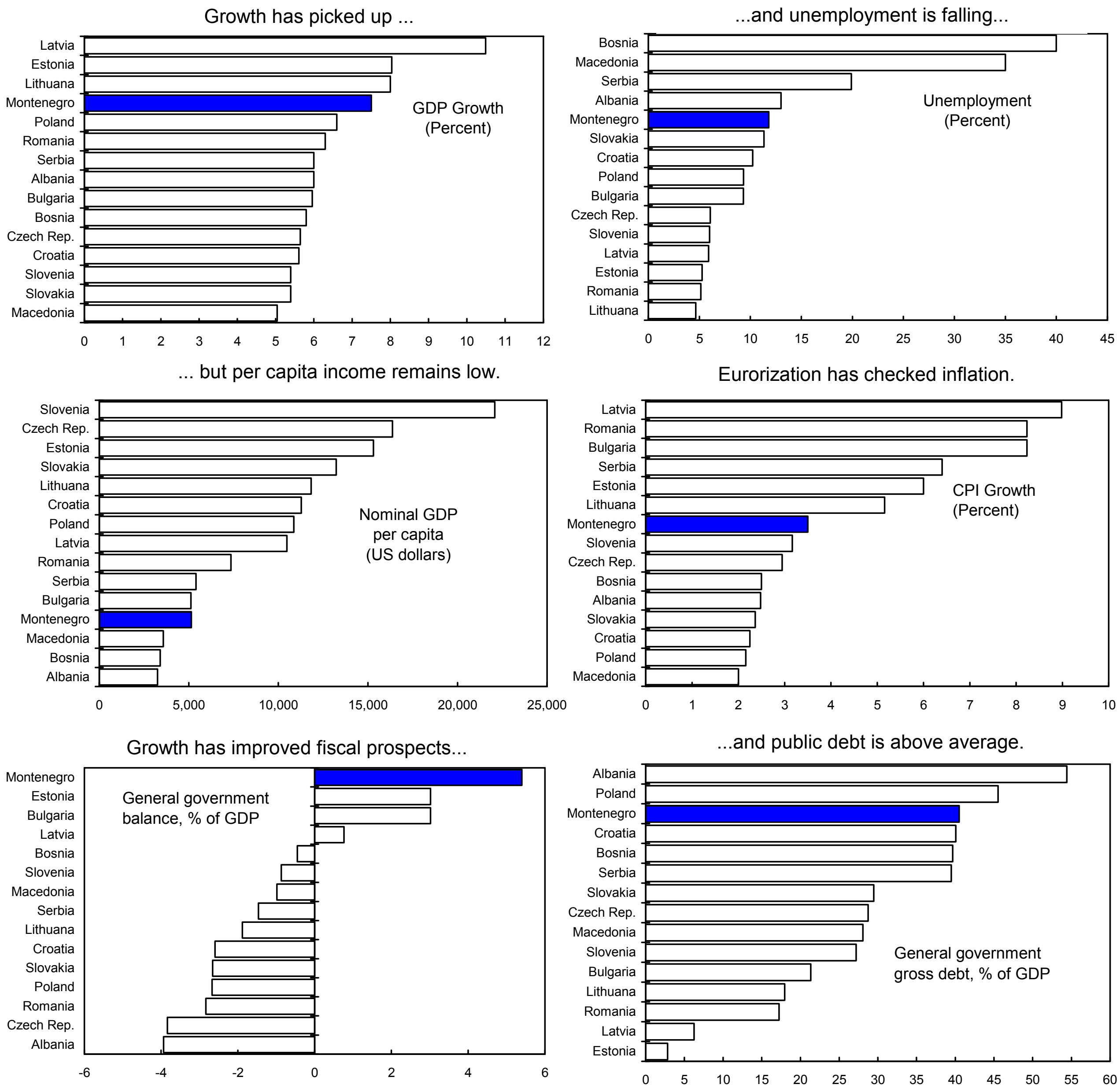
2. **But strong growth, and the exuberance it has generated, has brought its own problems.** Foreign direct investment has snowballed, targeting mainly real estate and the tourism sector. Furthermore, aggressive competition for market share has led to an explosion of bank lending. In response, asset prices have been rising sharply, with the stock index shooting up, and real estate prices rapidly reaching those in wealthier neighboring countries. The resulting wealth effect has fueled pent-up consumer demand, widening external imbalances.

3. **Euroization limits policy options to manage the boom.** Strong import-related revenue growth has generated fiscal surpluses, but the authorities have been reluctant to let the fiscal stabilizers work. Income taxes have been cut sharply, and the 2008 budget is expansionary. With monetary policy discretion curtailed by use of the euro, the Central Bank has moved to tighten prudential regulations, but lacks effective enforcement powers. Structural bottlenecks have also been quick to emerge. Restrictive labor regulations, a decapitalized electricity sector, and a difficult business environment threaten to put a brake on growth if unaddressed. The unofficial economy is large at an estimated 30 percent of GDP.

II. Background

4. **The economic expansion is proceeding at full strength.** Real growth is expected to be 7½ percent in 2007, up from 6½ percent in 2006. The tourism sector is picking up, with large inflows of FDI generating strong construction activity. However, the manufacturing sector is stalling, partly due to disruption in electricity supply. Domestic credit has progressively replaced FDI as the main driver of demand.

Figure 1. Montenegro: A Good Start to Independence, 2007



Sources: WEO and Fund staff calculations.

5. **Signs of overheating are becoming more pervasive…**

- The labor market has tightened. Unemployment has fallen sharply from 20 percent in 2005 to 12 percent in September 2007 and inflows of temporary workers doubled during the tourist season 2007 compared to the previous year.

Credit expansion has overtaken FDI in size as demand stimulus
(In percent of GDP)

	2005	2006	2007
FDI	21	24	24
Credit expansion	5	24	58

Source: IMF staff calculations.

- **Wages have grown rapidly.** Gross wages increased at an annual rate of 22 percent in November, driven by tourism and construction. Public sector wage policy has been lax, with a 30 percent wage increase in the last quarter of 2007.

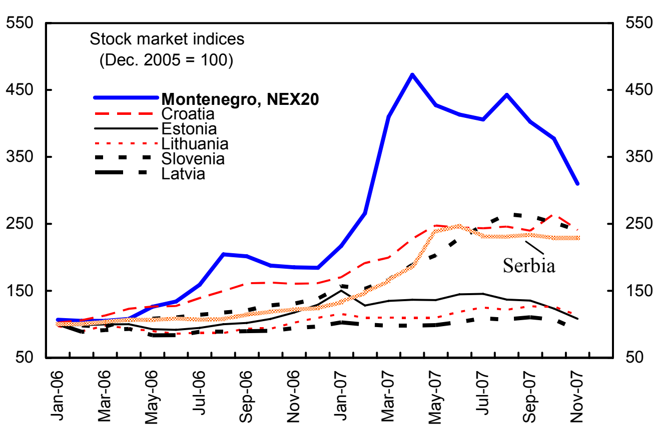
Gross Wage Increases in Selected Sectors
(Annual percentage change)

	2006 1/	XI-2007
Economy wide	15.5	22.2
Growth sectors		
Construction	30.1	41.6
Tourism	18.1	23.1
Financial intermediation	17.0	46.6
Other sectors		
Electricity	26.3	4.0
Industry	16.9	12.3
Public administration	16.8	15.1
Health care	11.8	36.5
Education	7.3	32.1

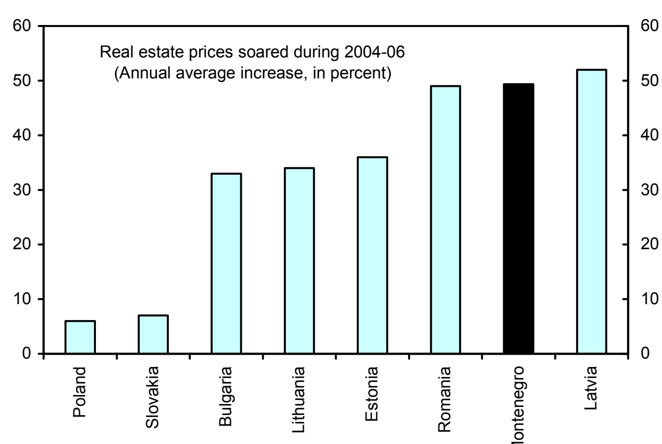
Source: Statistical Office of Montenegro.
1/ Annual average based on old official methodology.

- **Inflationary pressures have increased despite euroization.** Retail prices shot up during the summer, partly related to the region-wide drought and hikes in electricity and telecom tariffs, and the end-year inflation rate is expected to reach 5 percent, compared with under 3 percent in 2006.

- **Real estate and stock market prices have soared.** Partial data suggest that land values have already reached levels comparable to those in richer neighboring countries. Meanwhile, notwithstanding a significant correction, stock prices have tripled since end-2005 and market capitalization was 172 percent of GDP at end-November 2007.



Source: Bloomberg.



Sources: ECB and Global Property Report.

6. **…and vulnerabilities have been building up:**

- **External imbalances have widened.** The brunt of the strong demand pressures has been borne by the current account deficit, and Montenegro's competitive edge is eroding fast.

- **Credit growth has accelerated.** Exceptionally rapid credit growth could mask nonperforming loan (NPL) problems, test the capacity of the young banking system to prudently assess and manage credit risks, and weaken private sector balance sheets.

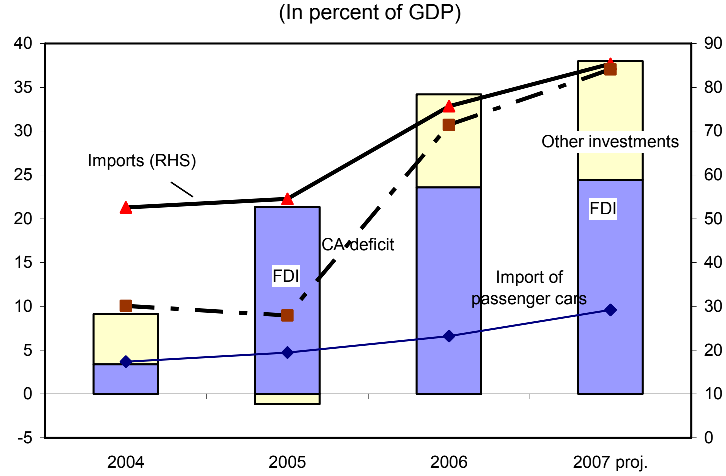
- **Fiscal risks have increased.** Large restitution claims amounting to well over 10 percent of GDP threaten to reverse the impact of the Paris Club debt write-offs at end-2006. Boom-related fiscal surpluses and large privatization receipts have raised the appetite for spending.

- **The asset price boom raises the specter of a correction.** The FSAP raised concerns regarding low disclosure requirements, infrequent reporting, and financial safeguards. A correction of stock market and real estate prices, partly fueled by the rapid credit expansion and possibly amplified by the shallowness of the market, could generate strong balance sheet effects.

The widening current account deficit is increasingly debt financed.

7. **The financing of the current account deficit is shifting.** The current account is estimated to widen to 37 percent of GDP in 2007, from 31 percent in 2006 (Figure 2). Large current account deficits are not uncommon in small states experiencing booms, and the euro peg shelters the economy from currency crises. From a savings-investment perspective, the widening of the deficit initially reflected high investment (spurred by FDI) and very low savings (associated with FDI-driven wealth effects from real estate sales). However, tourism investments have not yet been fully reflected in earnings (Box 1), eroding competitiveness limits diversification of the export base, and increasingly imports are being fueled by pent-up consumer demand. Private external debt is estimated to rise from 19 percent of GDP at end-2006, to 30 percent at end-2007.

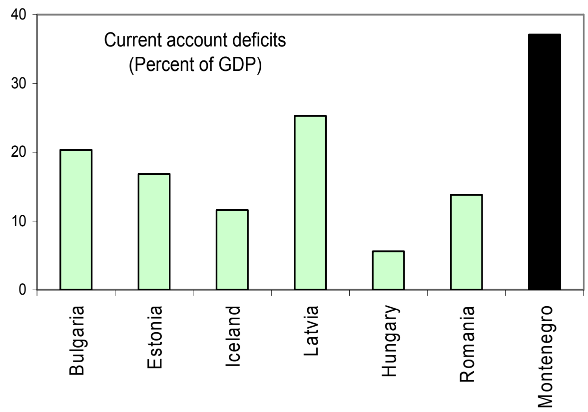
External Balance and Its Financing
(In percent of GDP)



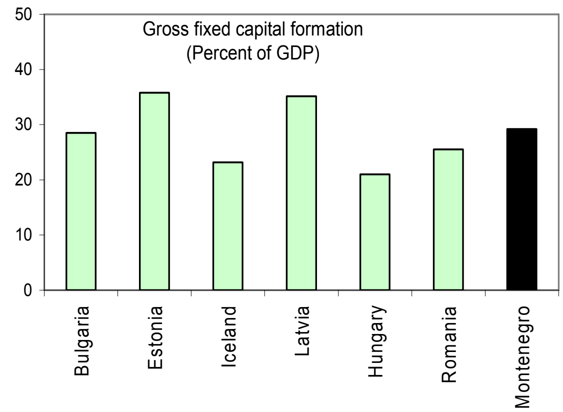
Source: Authorities; and Fund staff estimates and projections.

Figure 2. Montenegro: Developments in the External Sector, 2007

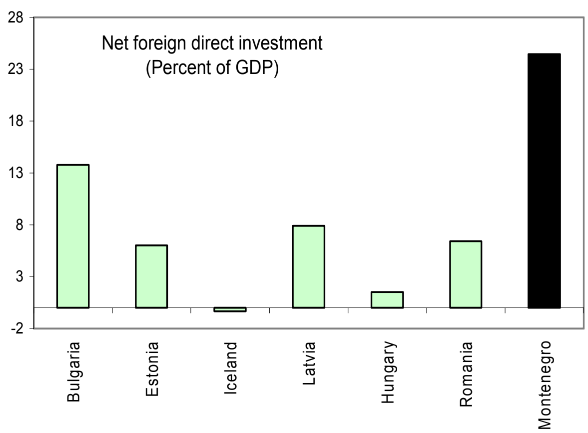
The high current account deficit…



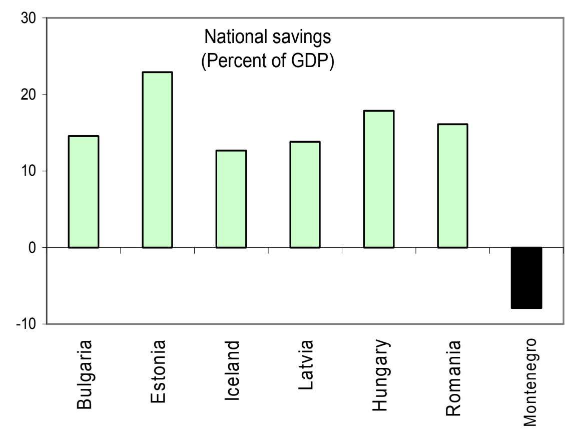
…reflects high investment,…



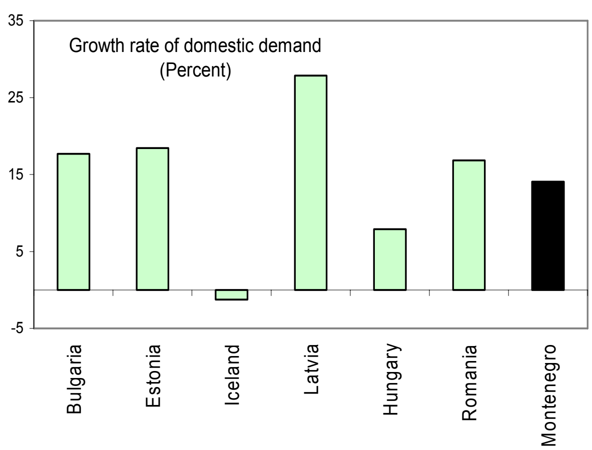
…spurred by exceptionally high FDI, ...



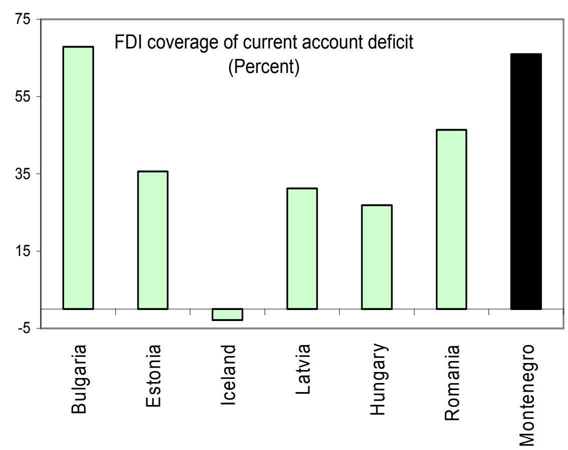
…depressed savings due to wealth effects.



..as well as continued demand growth fueled by credit expansion.



The FDI coverage of deficit is high but falling.



Sources: Montenegrin authorities, WEO, and Fund staff estimates.

Box 1: Montenegro: A Tourism Enclave? [1/]

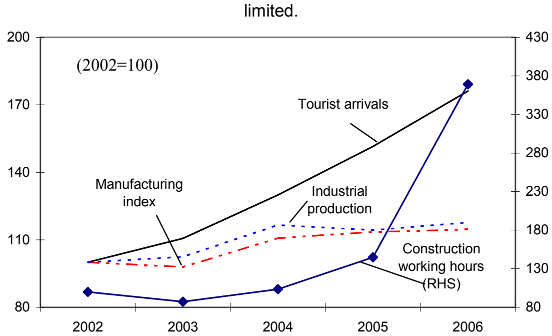
Tourism has fast become the main pillar of Montenegro's economy. The contribution of travel and tourism economy in overall GDP rose from 15 percent in 2004 to 21 percent in just three years. According to World Travel and Tourism Council (2007), Montenegro is a leading emerging tourist destination.

Despite rapid growth, the tourism sector is becoming an enclave in Montenegro. Hotels catering to international visitors rely on imported inputs, including a significant portion of labor. As a result, the tourism sector is characterized by high leakage. Meanwhile, developments in non-tourism related industries have been sluggish, and productivity has not shown any notable improvement, indicating weak linkage of tourism with the rest of the economy.

Available data on tourism suggest some inconsistencies between tourism goals and policies. Montenegro is targeting high-end customers. However, these tend to stay in resort hotels, resulting in high leakage-low retention of tourism earnings.

To achieve its target of tripling the travel and tourism sector by 2017, Montenegro must not only focus on increasing the number of beds and extending the season, but also improving infrastructure, especially roads, electricity and water supply.

Impact of tourism on the rest of the economy appears limited.



Sources: MTEP and WTTC, 2007.

Travel &Tourism estimates and targets	2007	2017	% change
T&T Industry employment ('000) (L)	14.9	26.2	76%
No. of beds ('000) (K)	35.8	86.0	141%
T&T Industry GDP (mil euro) (Y)	212.0	664.0	213%

To achieve this target, labor will need to rise by 76%, capital by 141%, and the efficiency of labor by 35% 1/.

1/ Based on estimates using CRS production function with capital and labor as inputs.
Source: MTEP and WTTC, 2007

[1/] The role of tourism for Montenegro's development is examined in an accompanying Selected Issues Paper.

Credit growth has soared

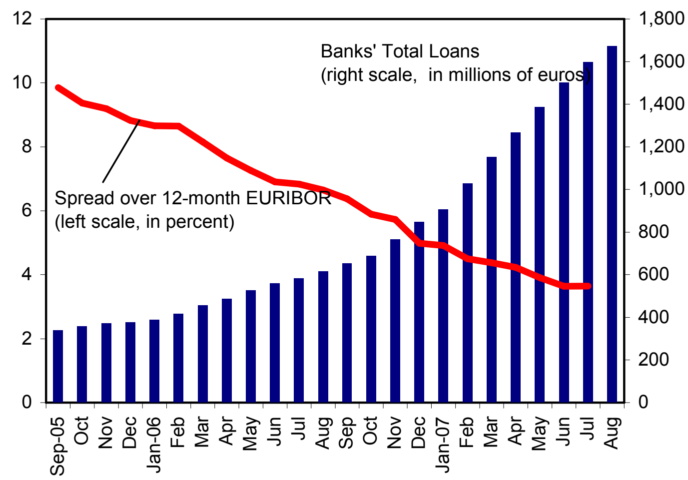
8. **Monetary developments have been dominated by large capital inflows and aggressive bank competition.** Unlike in many other countries in the region, credit expansion was initially financed from domestic sources, especially the proceeds of asset sales (real estate) to nonresidents. Recently, however, foreign credit lines and banks' own funds have had an increasingly large contribution to credit expansion. Declining interest rates due to intensifying competition and expectations of improving economic prospects have also stimulated demand for credit. Aggressive competition among banks for market share has fueled credit supply, with two banks managing to multiply their loan portfolio by tenfold within a year, one partly financed by a shift in public sector deposits to the bank. At 190 percent (y-o-y in September 2007), credit has been expanded notably faster than suggested by historical convergence dynamics (Box 2). Higher effective reserve requirements and stricter prudential requirements have only dented credit expansion at best.

Counterparts of Credit Growth
(Change in percent of GDP)

	2004	2005	2006	2007[1/]
Private sector credit	5.4	5.2	24.3	59.1
o/w a. Deposit liabilities	2.5	10.2	24.2	39.5
b. Net foreign liabilities	1.9	-3.4	3.7	14.3
c. Own funds	0.1	0.9	2.1	3.9
d. Claims on CBCG	0.2	3.4	6.7	3.3
Memo item:				
Net monetary stimulus (b+c-d)	1.8	-5.9	-0.9	14.9

Sources: Authorities and Fund staff estimates.
[1/] January-September, annualized.

Spread of Average Interest Rates on Loans to Private Companies over 12-month EURIBOR

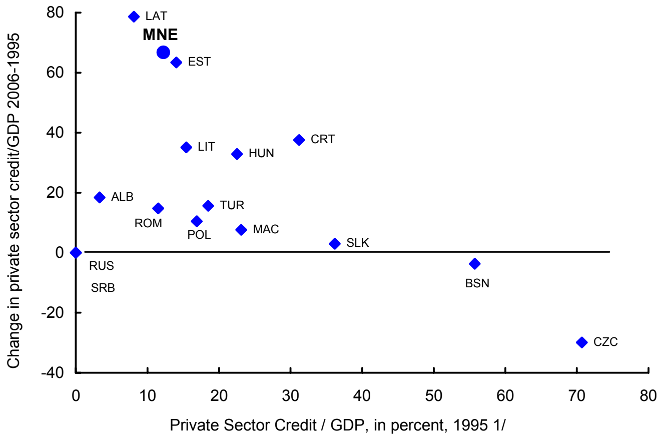


Source: Central Bank of Montenegro.

Box 2. Rapid Credit Growth [1/]

The credit-to-GDP ratio has risen rapidly during the past three years. At 79 percent, the ratio has already reached a level comparable to that in the Baltic countries but the pace of increase has been much faster.

The financial sector has been rapidly deepening...



Source: IMF, International Financial Statistics.
1/ MNE 2003-07, and SRB 1998-2007.

.....and credit/GDP is now at the top among transition economies.

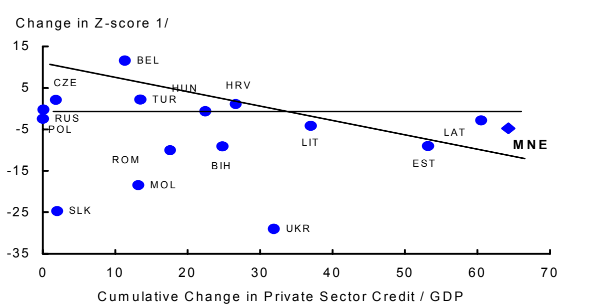
Credit to Private Sector/GDP in Selected Credit Boom Episodes [1/]

Country	Start of Boom	End of Boom	Duration	Credit at Start	Credit at End
Crisis Countries					
Argentina	1990	1995	6	9.2	19.7
Brazil	1993	1995	3	13.3	47.0
Mexico	1987	1994	8	12.3	38.7
Philippines	1988	1998	11	16.1	48.0
Turkey	1995	2000	6	18.5	23.7
Uruguay	1992	2002	11	25.2	65.9
Non-crisis countries					
Greece	1995	ongoing	12	31.9	88.7
Indonesia	1984	1993	10	14.2	44.3
Ireland	1995	ongoing	12	61.1	182.6
Portugal	1987	ongoing	20	61.4	157.0
Spain	1998	ongoing	9	84.1	164.4
Booms in selected CEE countries					
Hungary	1994	ongoing	13	26.4	55.9
Latvia	1997	ongoing	10	9.7	86.8
Lithuania	1998	ongoing	9	11.0	43.2
Macedonia	1999	ongoing	8	20.9	29.7
Ukraine	1997	ongoing	10	2.4	47.3
Montenegro	**2005**	**ongoing**	**2**	**18.2**	**79.0**

Sources: IFS and IMF staff calculations.
1/ Adapted and updated from Hilbers et al. (2005)

Is credit growing too rapidly? Out-of-sample estimation, drawing on historical convergence dynamics, suggests that credit-to-GDP exceeds its equilibrium level for the current stage of development, and the banking sector's distance to default, measured by the Z-score, has declined slightly.

Distance to default in CEE countries, 2001-07



Sources: IFS, MCM database on FSIs; and IMF staff calculations.
1/ The Z-score computes the number of standard deviations the return to capital must fall for equity to be depleted. It is measured by Z=(k + m)/s, where k is equity capital as percent of assets, m is average return as percent on assets, and s is the standard deviation of the return on assets. A lower score is associated with a higher probability of insolvency risk.

Private Sector Credit / GDP in Selected Transition Economies

Country	Actual	Predicted [1/]	Deviation	Change [2/]	Predicted [3/]	Excess
Estonia	77.4	80.8	-3.4	12.9	7.3	5.5
Latvia	86.8	75.3	11.4	13.6	6.9	6.6
Romania	26.3	49.6	-23.3	4.0	4.8	-0.8
Montenegro [4/]	62.4	46.1	16.3	15.4	5.2	10.1

Source: IFS, WEO. Based on Schadler et al. (2005); IMF staff calculations.
1/ Based on VECM of credit/GDP, log of GDP per capita at PPP and real interest rate
2/ Actual average change in credit/GDP in 2003-06
3/ Average predicted short-run change in 2003-06
4/ 2005-07 data, adjusted for the underground economy and the wealth effect from assets sales.

[1/] Financial convergence in Montenegro is examined in an accompanying Selected Issues Paper.

Fiscal policies have recently slipped

9. **The boom has contributed to fiscal surpluses (Figure 3), but the authorities have been reluctant to allow the fiscal stabilizers to work fully.** The general government balance improved to 7 percent of GDP in the first three quarters of 2007, compared with 2½ percent of GDP in 2006. Revenues surged due to VAT on imports, and expenditures were kept under control. However, the cut in the PIT tax to 15 percent in the beginning of the year (with a further cut to 9 percent planned by 2010) added to demand pressures, and weakened the impact of the automatic stabilizers.

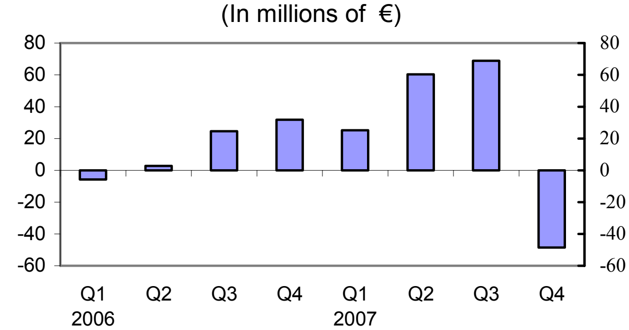
Consolidated General Government Fiscal Position, 2005-07:QI-III

	2005	2006 Prel.	2007: QI-QIII Prel. 1/
	(In percent of GDP)		
Republican budget			
Total revenues and grants	24.1	28.1	25.6
Total expenditures and net lending	25.2	24.7	17.7
Overall balance	-1.1	3.5	7.9
Primary balance	0.0	4.6	8.8
Social Funds - Overall balance			
Pension	-0.6	-0.1	-0.3
Health	0.1	-0.3	-0.1
Employment	-0.1	-0.4	-0.1
Development Fund	...	-0.9	...
Restitution Fund	...	0.3	...
Local governments - Overall balance	0.1	0.2	-0.5
Consolidated			
Overall balance	-1.8	2.4	6.9
Primary balance	-0.6	3.6	7.7

Source: Montenegrin authorities; and Fund staff estimates and projections.
1/ In percent of annual GDP.

10. **The revised 2007 budget, adopted in October, would reduce the surplus to 4½ percent of GDP.** The rectification raises spending substantially on both goods and services and capital investment. In addition, a general public sector wage increase of 30 percent has been announced, which will be implemented in steps starting from October 1, 2007. However, staff estimate that capacity constraints are likely to contain expenditures and improve overall fiscal performance to 5½ percent of GDP (Table 3).

Fiscal balance with revised 2007 budget
(In millions of €)

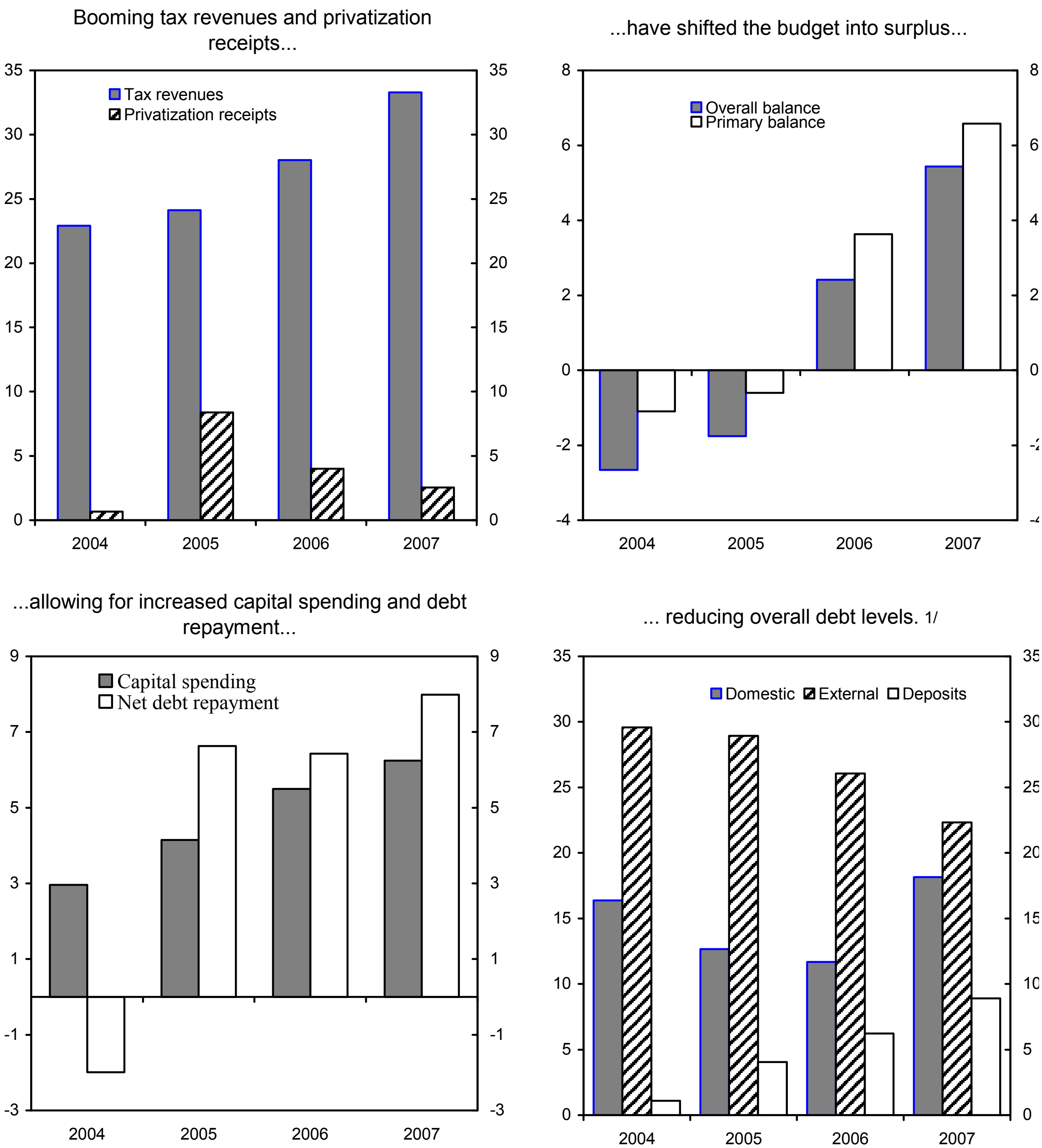


Source: Montenegrin authorities and staff estimates.

11. **The level of public debt is set to increase.** Public debt is projected to increase to 40 percent of GDP in 2007 mainly due to large restitution claims and additional compensation for foreign currency deposits seized during the Milosevic regime (Appendix I).

12. **Performance could be further undermined by weak controls in the wider public sector, despite improvements in central budget implementation.** The 2008 organic budget law will, for the first time, include the social funds, which will fall under the spending authorization of the central government. However, spending by municipal governments is unconstrained due to substantial privatization revenues; and the state-owned enterprise sector is loss making after taking into account the quasi-fiscal operations of the electricity company, amounting to an estimated 2 percent of GDP in 2006.

Figure 3. Montenegro: Consolidated Fiscal Developments, 2004–07
(Percent of GDP)

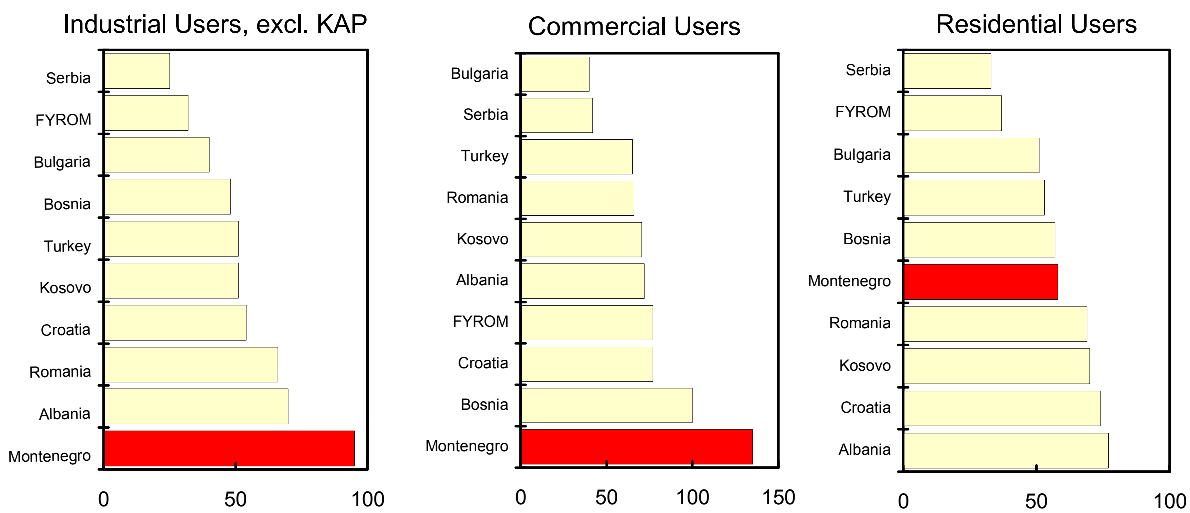


Sources: Montenegrin authorities and Fund staff estimates.
1/ Includes Paris Club debt reductions and assumption of restititution liabilities.

Structural barriers to growth are pervasive:

13. **Electricity shortages pose a serious threat to growth.** Electricity demand is growing fast while production is hampered by dilapidated production and distribution facilities, and chronic operating losses in the state-owned electricity company (EPCG) that have precluded investment in the sector. The situation is complicated by a distorted tariff structure that overcharges commercial consumers (to offset implicit subsidies worth 2 percent of GDP to the private aluminum complex (KAP), governed by a long-term contract). Household charges are not particularly low by regional standards, but are well below costs, contributing to EPCG losses. The increase of electricity tariffs in July 2007 has not been sufficient to bring EPCG to profit.

Electricity tariffs are high in Montenegro, especially for commercial users
(Electricity tariffs in euro per MWh, in 2006)



Source: USAID.

14. **Restrictive labor legislation, too, is a drag on the local economy**. Excessive employment protection, a fairly high tax wedge, and low wage flexibility are major deterrents to labor market participation, especially in the formal economy, and encourage the employment of temporary foreign workers, especially in tourism and construction.

15. **The business climate remains weak**. The reduction of corporate taxation, the speeding up of licensing and the adoption of a *laissez fare* attitude have bolstered the attractiveness of Montenegro as a business location. However, interference by municipalities remains pervasive, incomplete zoning regulations raise the effective cost of investment, and public administration is weak.

III. Policy Discussions

16. **Against this background, the discussions focused on policies to manage the upswing and prevent a hard landing, complete the transition to a market economy, and reduce vulnerabilities.**

- **The potential growth outlook is strong, but staff expressed concerns about the impact of overheating and eroding competitiveness on external sustainability.** Staff and the authorities concurred that near-term prospects are positive, with strong tourism potential, but differed on the assessment of risks.

- **The CBM shared staff concerns regarding the extremely fast credit growth**. There was agreement that the enforcement powers of the CBM need to be strengthened, and prudential supervision tightened further.

- **There was less agreement on the use of fiscal policy to counter the boom.** Staff emphasized the importance of a countercyclical fiscal stance, but the authorities pointed to high nation-building needs. Staff stressed the importance of a comprehensive medium-term expenditure framework to create space for public investments.[1]

- **Discussions on policies to promote growth were mixed.** There was agreement on the need to strengthen labor and business legislation to increase the flexibility of the economy and reduce grey market activity, but less agreement on energy policies and privatization.

- **The authorities were more sanguine about the need for measures to offset vulnerabilities**. Nevertheless, progress has been made on limiting restitution compensation, which is the main source of contingent fiscal liabilities, and strengthening financial markets

[1] The fiscal framework is discussed in an accompanying Selected Issues Paper.

A. Medium-Term Framework

17. **Growth potential is high, but with risks**. The good prospects for tourism, as demonstrated by WTTC projections and phenomenally high FDI, provide a firm basis for strong growth over the medium term. However, current macroeconomic policies are adding to overheating pressures and increasing downside risks and, together with the slowing of reforms, are denting growth potential and impeding economic diversification by eroding competitiveness.

Medium-term Macroeconomic Framework, 2005-15

	2005	2006	2007	2008	2009	2012	2015
	Prel.	Est.			Proj.		
Growth rates							
GDP (real)	4.0	6.5	7.5	7.2	5.5	4.7	4.5
Inflation (ave)	3.4	2.1	3.5	4.7	4.1	3.0	3.0
Exports (euro)	12.6	25.6	25.6	21.6	9.9	9.1	7.7
In percent of GDP							
Fixed investments	16.0	29.4	29.2	27.7	25.7	20.2	19.7
Domestic savings	-1.8	-7.1	-10.7	-8.4	-7.1	-3.2	5.7
Fiscal balance	-1.8	2.4	5.4	2.3	1.3	-2.1	-2.8
Privatization receipts	8.4	4.0	2.6	2.1	2.1	1.4	0.0
Gross public debt (end of period, stock)	41.6	37.7	40.5	38.6	35.9	29.3	29.9
Current account (before grants)	-8.9	-30.7	-37.0	-33.0	-29.5	-21.3	-12.4

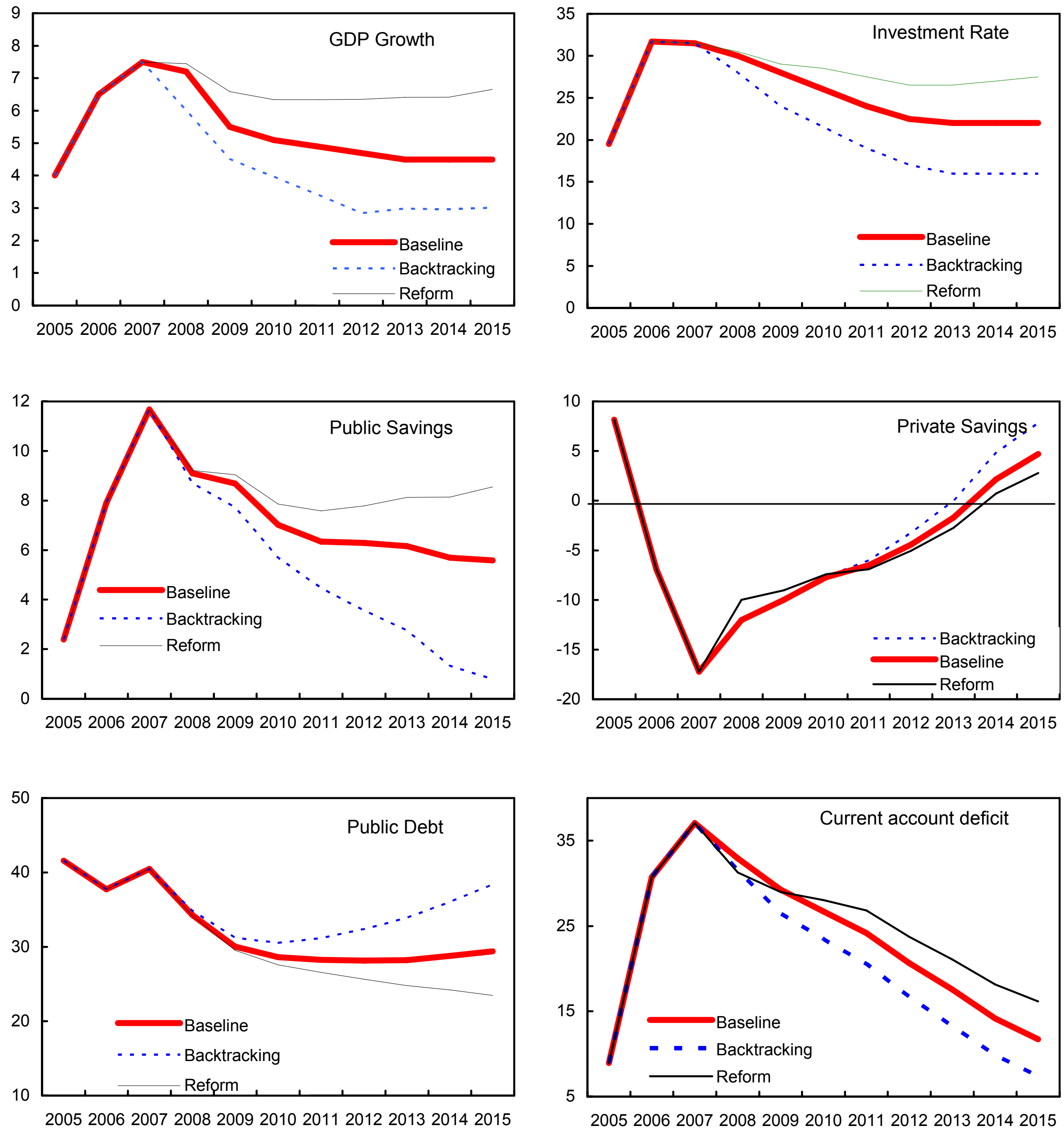
Sources: Ministry of Finance; and Fund staff estimates and projections.

18. **Short-term growth prospects remain positive, despite overheating**. Staff projections are close to those of the authorities with growth of about 7 percent in 2008, as tourism picks up, and demand continues to be buoyed by strong FDI and credit growth (although less than in 2007). Both expected inflation to inch up in the face of wage pressures. The current account deficit is projected to narrow to 33 percent of GDP in 2008, due to a pick-up in tourism earnings, and less strong demand due to weakening wealth effects and policies to rein on credit growth.

19. **The boom is expected to slow over the medium term (Figure 4).** Medium-term growth prospects are where the authorities and staff differ. The staff see competitiveness erosion and the slow pace of structural reforms moderating potentially higher growth rates from strong tourism expansion (Box 3) to levels lower than expected for the current stage of transition. Both agree that the current account would narrow as the demand shock peters out, as credit markets are quickly saturated given the already high credit-to-GDP ratio (Box 2), and narrowing investment opportunities lead to the unwinding of FDI inflows. But staff stressed that labor costs have been rising very rapidly compared with the experience of other transition countries; and that wage moderation and reforms facilitating broader-based growth were indispensable for a soft landing.[1] The current account would become increasingly debt financed, with private external indebtedness doubling from 30 percent of GDP at end 2007 to 59 percent by 2012 (Appendix II).

[1] The macroeconomic adjustment to the large FDI inflows is discussed in more detail in the accompanying Selected Issues Paper.

Figure 4. Montenegro: Macroeconomic Framework, 2005-15
(Percent of GDP)



Sources: Montenegrin authorities; and Fund staff estimates and projections.
The slow reform scenario is driven by lower FDI, weaker private investment, and smaller gains in labor force participation and unemployment reduction.

Box 3. Montenegro's Competitiveness and External Sustainability

Montenegro's high current account deficit largely reflects transitory demand pressures, as confirmed by macroeconomic balance analysis, which implies a correction as the demand shocks unwind. Competitiveness indicators do not provide clear evidence of overvaluation but rapidly rising labor costs point to the need for productivity enhancing structural reforms to preserve competitiveness.

I. Price and cost competitiveness

Competitiveness indicators give mixed signals. The RPI-based REER shows little movement compared to other countries in the region, but the statistics are distorted by price repression. The average net wage is currently at middle range compared to other neighboring countries; however, it has been rising rapidly, and the wage-based REER suggests erosion of competitiveness. The internal terms of trade rose in 2004 but have stabilized since.

II. Tourism prospects: do costs matter?

Surveys have shown that tourism is not particularly sensitive to local costs, especially the type of enclave tourism resorts being established in Montenegro, which depend heavily on imported inputs and labor. Tourism receipts more than doubled from 2003 to 2006. According to the World Travel and Tourism Council, Montenegro ranks 3rd in speed of growth of tourism in 2007. This suggests that the importance of competitiveness is more to foster broad-based growth, and ensure that the local economy benefits from tourism-related activities.

Assessment of business climate

2007 CPI 1/ by Transparency Intl.		2008 Doing Business by IFC		2007-08 GCI by 2/ World Economic Forum	
Countries	rank	Countries	rank	Countries	rank
Slovenia	27	Slovakia	32	Estonia	27
Malta	33	Namibia	43	Czech Rep.	33
Dubai/UAE	34	Bulgaria	46	Slovenia	39
Botswana	38	Botswana	51	Slovak Rep.	41
Cyprus	39	Slovenia	55	Latvia	41
Slovakia	49	Turkey	57	Poland	51
Greece	56	Belize	59	Turkey	53
Namibia	57	Trinidad & Tobago	67	Croatia	57
Turkey	64	**Montenegro**	**81**	Greece	65
Bulgaria	64	Vietnam	91	Ukraine	72
Croatia	64	Croatia	97	Romania	74
Trinidad & Tobago	79	Greece	100	Botswana	76
Montenegro	**84**	Dubai/UAE	...	**Montenegro**	**82**
Belize	99	Malta	...	Serbia	91
Vietnam	123	Cyprus	...	Macedonia	94

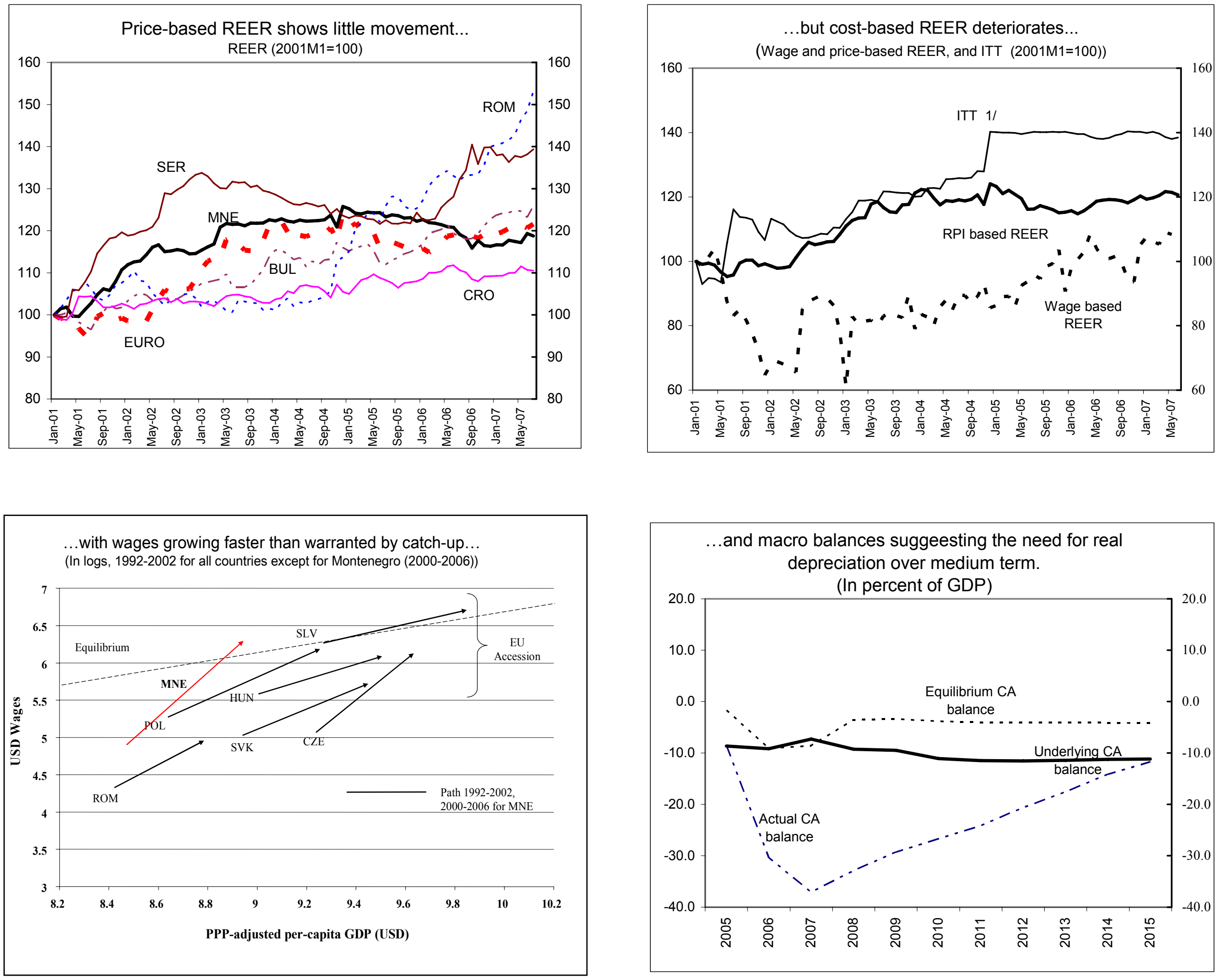
Source: Transparency International, World Bank, World Economic Forum
1/ Corruption Perception Index
2/ Global Competitiveness Index

III. Macro-balance approach

The macroeconomic balance approach suggests that the large current account deficit will decline as FDI moderates, which is not unusual for transition economies. The underlying balance, which adjusts for transitory factors, is roughly equal to its equilibrium level but a gap is expected to emerge reflecting eroding cost competitiveness due to rapid wage increases and slow productivity growth. The equilibrium current account balance is based on economic fundamentals such as fiscal balance, old-age dependency ratio, population growth, relative income, and ratio of NFA to GDP.

IV. Institutional indicators

Various indicators of the business climate rank Montenegro consistently at the middle of the group. Montenegro ranked 84 out of 179 in the Transparency International's Corruption Perception Index, and 81 out of 177 in World Bank's Doing Business Index. The 2007 Freedom House report shows deterioration, in large part due to the lack of transparency in privatization.



1/ Ratio price of nontradeables to tradebles using RPI.
Source: Central Bank of Montenegro, WEO and staff estimates and projections.

20. **Staff cautioned that a harsher landing is clearly possible**. Disillusion with current policies or diminished expectations could trigger a more abrupt private sector adjustment choking off private investment and discouraging FDI. Euroization rules out a currency crisis, but reliance on wage correction would be painful, especially if rigidities in labor markets are not addressed. The authorities acknowledged that overheating could result in a "hard landing," but remained relatively sanguine about the risks of a disorderly adjustment and expected that after the adoption of the constitution the reform effort would regain momentum. Staff emphasized the downside risks including excessive restitution claims, potential volatility of the large FDI inflows, wage increases in excess of productivity growth, and an abrupt weakening of private sector balance sheets due to a shift in expectations. Public debt is not a source of vulnerability as confirmed by sustainability analysis (Appendix I).

Box 4. FSAP Recommendations and Follow-up

The Central Bank of Montenegro is in the process of implementing an action plan to follow-up the FSAP, as described in the FSSA. The main findings of the FSAP were:

- Rapid credit growth has strained banks' capacity to underwrite loans prudently, and eroded capital adequacy and profitability.

- Banking supervision is robust, but the legal framework needs to be strengthened through adoption of the banking law, and enhanced enforcement powers.

- The buoyant stock market is poorly supervised and may pose a reputational risk.

While the CBM has moved quickly to restructure supervisory practices and address specific vulnerabilities by tightening capital requirements, approval of the banking law has dragged.

Central Bank of Montenegro: Action Plan 1/

Measure in Action Plan	Status of Implementation
Change the organizational structure of CBM: Increased specialization Integration of on-site and off-site supervision Development of portfolio management	Adopted by the CBM council in March 2007
Thematic controls of banking sector: Credit risk Liquidity risk FX risk Operational risks	Included in Work Plan for 2007, currently underway
Supervisory Development Plan for 2007–10	To be finalized by end-2007
Consolidated Supervision	Started for a number of banks.
Banking Law and Central Bank Law	Pending parliamentary discussion
Measures to address bank-specific vulnerability	Several banks were required to strengthen their capital.
Credit Registry: Broaden access to information by banks Include additional information in line with Basel II Charge a fee to access information	Data exchange with banks has yet to start. Expected to be fully operative by end-2007

1/ As of October 31, 2007.

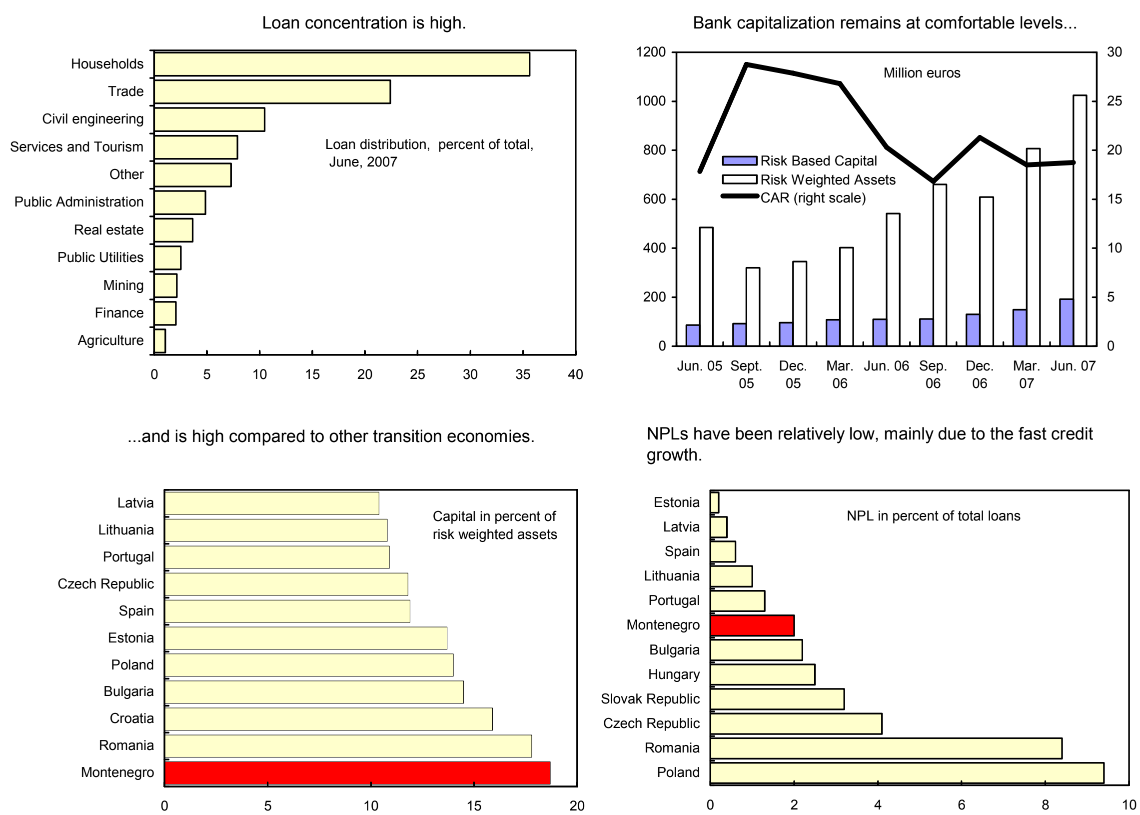
B. Safeguarding Financial Sector Stability

21. **The central bank has moved to tighten credit, but lacks sufficient enforcement powers.** The absence of a lender of last resort arrangement in Montenegro suggests the need for higher liquidity ratios. The authorities noted that they recently had raised effective reserve requirements to 14 percent (on average), which is high by international standards. They had also instructed some banks to strengthen their capital, and the average capital adequacy ratio at 18.7 percent appears to be at a comfortable level. CBM representatives noted that the turmoil in international financial markets had not been felt in Montenegro. The CBM has been following up on FSAP recommendations (Box 4), has been monitoring banks very closely, and has prepared regulations refining (effectively tightening) loan classification rules, but lacks effective enforcement powers. Staff agreed that the banking system is reasonably well supervised but noted that its resilience has not been tested in a downturn and

the rapid credit growth has been taking its toll on banks' financial indicators, especially regarding liquidity (Table 5).

22. **Staff noted that euroization still leaves some limited room for maneuver in controlling credit growth.** Staff noted that expanding the base of calculation of reserve requirements to include all non-capital liabilities would discourage banks' recourse to foreign financing and reduce moral hazard. Moreover, relatively high concentration of risks, and the inexperience of some banks, argued for above average solvency rates. The CBM argued that the pending refinements in loan classification obviated at this stage the need for higher minimum solvency ratios. Direct credit controls were also discussed but rejected by the CBM on efficiency and enforceability grounds.

23. **There was agreement on a number of structural measures to check credit growth and strengthen the financial system.** These included acceleration of the approval of the laws on the central bank and banks to provide, among other things, CBM supervisors with effective enforcement powers and immunity in the discharge of their duties; and to facilitate strengthened supervision, a tightening of loan-to-income and loan-to-value ratios, and the development of early warning systems for systemic macro risks, particularly for bank exposure to the stock market and real estate sector. Improved access to the Credit Registry would also enhance risk management practices at banks.



Sources: Central Bank of Montenegro, and Global Stability Report, IMF.

24. **Exuberance on the stock market is a concern.** The authorities have requested Fund technical assistance to help strengthen governance.

C. Fiscal Framework: Balancing Growth and Stability

Medium-term fiscal framework.

25. **Staff and authorities agreed that implementation of two key elements of the medium-term fiscal framework would bolster policy credibility:**

- **Fiscal policy should be anchored on a medium-term target.** The target to reduce gross debt to below 30 percent of GDP by 2012 can be achieved with, on average, a small primary surplus over the medium-term (Appendix I).

- **Downsizing of the public sector.** The authorities plan to reduce current spending to make room for further tax cuts, and higher public investments. They have yet, however, to formulate concrete public sector reforms that would lend credibility to these plans. Staff recommended the development of a medium-term fiscal framework to reconcile spending needs.

Fiscal policy in 2007–08: leaning against the wind

26. **Staff argued for a countercyclical fiscal stance.** Notwithstanding their medium-term objective of downsizing the public sector, the authorities' immediate plans were predicated by nation building expenditure and prior commitments to reduce tax rates. As a result, the revised budget for 2007 and preliminary 2008 budget would add additional fiscal stimuli to the domestic economy. Reductions of social contribution rates, large public wage increases, and increases in spending are estimated to add 3½ percent of GDP to demand in 2008. Staff recommended a re-assessment of the policy package to aim for an unchanged primary balance. But apart from scaling back a proposed abolition of municipal surtaxes and doubling the real estate turn-over tax, the authorities felt bound by political considerations and already announced policy changes.

Structural balance (in percent of GDP)

	2006	2007	2008
	Prel.	Proj.	
Overall balance	2.4	5.4	2.3
Primary balance	3.6	6.6	3.3
Revenues	44.9	50.7	48.9
Expenditures	42.7	45.2	46.6
Cyclical adjustment	5.5	7.4	7.7
Primary balance (structural)	-1.9	-0.4	-4.0
Fiscal impulse	0.4	-1.5	3.6

Sources: Montenegrin authorities; and Fund staff estimates and projections.

27. **Staff suggested that strong fiscal performance should be used to implement difficult but essential public sector reforms.** Staff noted that tax reductions and wage increases will be difficult to claw back when the economy slows, and fiscal space will be needed when large infrastructure projects are ready to be executed. Staff proposed the following:

- **Public administration reforms should accompany the announced wage increases.** Montenegro is not alone in the region in facing the challenge of keeping qualified staff in the public sector as private sector wages increase. The answer is a reform of pay scales and streamlining of the public sector to allow pay to better match skills. The public expenditure review conducted by the World Bank provides useful recommendations for public sector reform.

- **Reassessing tax reforms.** With tax rates already low by international standards, further reform should be undertaken with care and aim at strengthening the revenue base, and preventing distortions by eliminating exemptions and preferences.

- **Increased control of the broader public sector.** Staff recommended that the government more actively exercise its ownership rights in public enterprises and strengthen control of local government spending decisions. In addition, staff proposed to transfer public sector deposits to the central bank to avoid fueling bank credit.

28. **The authorities concurred with the importance of enhancing the monitoring and reduction of fiscal risks.** The government is currently considering the possibility of financing large infrastructure projects through Private-Public Partnerships (PPP), in particular, regional highways. Staff pointed out that while PPPs could be an attractive means of financing they could also generate substantial fiscal risks; and stressed the need to introduce a sound legal and institutional framework, as suggested in earlier technical assistance. The government is contemplating prepayment of restitution claims, and while the discount could be sizeable, staff strongly advised against this due to the potentially sizeable negative impact on domestic demand and risk of unequal treatment of claimants.

D. Boosting Structural Reforms

29. **The authorities stressed their commitment to structural reform but indicated that forging the necessary consensus is not easy**. They noted that they had made considerable progress in privatization and establishing the legal basis for a business friendly environment.

30. **Staff emphasized the importance of energy reforms to prevent shortages.** Staff stressed that adjustment of electricity tariffs toward market levels was critical for reducing quasi-fiscal losses of about 2½ percent of GDP, and attracting much needed private investment into the sector. The authorities were less convinced of the importance of tariff reform and privatization. However, World Bank staff consulted were concerned that the electricity company had neither the resources nor the know-how to undertake the large investments needed. In addition, the tariff increase of July 2007 was barely sufficient to cover operating costs and regulators explained that it included no allowance for return on capital. More positively, the authorities have completed the financial unbundling of EPCG's

operations into generation, transmission and distribution and were expecting to open up the market in early 2008.

31. **The authorities were in the process of a comprehensive reform of labor legislation.** They explained that the new draft law incorporated key provisions from international conventions. Staff stressed the need for flexibility in collective bargaining (especially allowing separate agreements for individual sectors and opt out clauses), facilitating job mobility, and reducing non-wage costs, which were among the highest in the region.

32. **The authorities confirmed their commitment to improving the business environment.** Staff acknowledged that significant progress had been achieved in improving the business environment but stressed the need for further progress, especially in improving predictability and limiting discretion, setting timely limits in processing applications, upgrading the judiciary, and completing zoning regulations at the municipal level. Staff emphasized the importance of strengthening corporate governance, especially regarding the timely release of financial statements for listed companies, and noted that failure to do so could risk the reputation of the young stock exchange.

33. **The authorities were committed to combating money laundering and the financing of terrorism.** They explained that the framework for AML/CFT was being upgraded and a new law would be submitted to parliament in early 2008.

34. **Economic policy was hampered by deficiencies in macroeconomic statistics.** The weakest area was the real sector, where the implementation of statistical standards has barely kept pace with the increasing data demand. The authorities noted that progress was being made in developing data sources, implementing international standards in statistics methodology, and developing expertise.

IV. Staff Appraisal

35. **Much is going well.** The economy is booming. Euro adoption has delivered low inflation and anchored expectation, and the discovery of Montenegro as an international tourist destination has drawn massive FDI inflows.

36. **But strong growth is hiding growing vulnerabilities.** The economy is overheating. Rapid credit growth is overstretching banks, and has contributed to ballooning asset prices.

37. **Eroding competitiveness is a concern**. Euro adoption precludes an exchange rate adjustment, but rapidly rising private debt raises the possibility of solvency problems related to asset markets, especially if competitiveness problems stunt Montenegro's tourism potential.

38. **Policy levers are few, but need to be used.** The authorities need to make more active use of those policy instruments available to address demand pressures, reduce vulnerabilities, and ensure a soft landing.

39. **Management of the boom falls on fiscal policy.** However, the preliminary 2008 budget would be expansionary unless revised. The 30 percent public sector wage increase and tax cuts would provide an unhelpful boost to an already overheated economy.

40. **Tax cuts have been procyclical and potentially destabilizing**. Corporate tax cuts, combined with absence of capital gains taxation, only provide investors with a windfall in a country with the enormous potential of Montenegro. Strong import-driven VAT growth should not be seen as providing scope for further tax cuts, as these revenues will eventually fall as import growth slows. The authorities should review ongoing tax reforms to strengthen the tax base and fiscal stabilizers.

41. **Fiscal risks need to be contained.** Paris Club debt reductions have lowered public debt, but the central government should resist assuming large restitution liabilities. Recent efforts to tighten criteria and ensure that property is returned to owners rather than compensated through government bonds are welcome. The authorities also need to guard against the assumption of guarantees and contingent liabilities, including PPPs, to solve their large infrastructure needs.

42. **Better budgetary control is crucial.** Control over local government should be strengthened, and state enterprise quasi-fiscal operations brought on budget.

43. **Absent monetary policy, the main focus of credit policy should be to strengthen banking sector supervision.** Passage of the banking law is the single most important measure to allow for enhanced supervisory practices to be enforced. Attention needs to be given to the monitoring of systemic risks, including real estate prices, and private external debt. Urgent attention is needed to limit risks associated with the highly capitalized stock market.

44. **Completing the transition to market economy should be kept at the top of the policy agenda.** Progress has been made, but energy and labor reforms, two areas critical for ensuring sustained growth, have been patchy at best. Privatization momentum, especially in the electricity sector, needs to be reinvigorated, and more weight given to market-based policies. Labor flexibility is crucial to ensure competitiveness given euroization. The authorities' plans to reform the labor legislation are welcome, but need to address restrictive practices and ensure sufficient weight is given to both private sector and social partners in the planned consultative process.

45. **The authorities need to address the poor state of the statistics**. Important deficiencies and gaps in the national accounts, fiscal, price, and balance of payments

statistics undermine informed policy decisions. Reorganization of the statistical agency is essential if further technical assistance is to be effective.

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

Table 1. Montenegro: Selected Economic Indicators, 2003–09

	2003	2004	2005	2006	2007	2008	2009
			Prel.	Est.	Proj.		
Real economy							
Nominal GDP (millions of €) 1/	1,392	1,651	1,785	1,979	2,204	2,453	2,711
Gross national saving (percent of GDP)	7.8	8.9	7.3	-1.0	-7.8	-5.0	-3.4
Gross investment (percent of GDP)	15.1	16.2	16.0	29.4	29.2	27.7	25.7
Unemployment rate (in percent)	22.9	22.3	19.7	13.5	11.8 a/	...	...
	(Annual percentage change)						
Real GDP	2.4	4.2	4.0	6.5	7.5	7.2	5.5
Industrial production	2.4	13.8	-1.9	1.0	...	...	...
Tourism							
Arrivals	10.7	17.4	16.6	16.3	19.0 b/	...	...
Nights	7.8	14.7	14.3	13.9	22.4 b/	...	...
Retail prices (period average)	7.5	3.1	3.4	2.1	3.5	4.7	4.1
Retail prices (end of period)	6.2	4.2	1.8	2.0	5.0	4.5	4.0
GDP deflator	...	...	4.0	4.1	3.6	3.8	4.7
Average net wage (12-month)	22.3	12.3	9.1	15.3	...		
Money and credit (end of period, 12-month)							
Bank credit to private sector	...	43.2	33.2	138.9	191.3 a/	...	...
Enterprises	...	40.6	30.2	112.2	198.4	...	...
Households	...	49.4	39.7	193.0	180.7	...	...
Bank deposits - private sector	...	23.0	84.2	119.5	129.4 a/	...	...
	(In percent of GDP; unless otherwise noted)						
General government finances (cash) 2/							
Revenue and grants	41.8	37.8	37.4	44.9	50.7	48.9	47.7
Expenditure (incl. discrepancy)	46.6	40.5	39.1	42.5	45.2	46.6	46.4
Overall balance	-4.8	-2.7	-1.8	2.4	5.4	2.3	1.3
Primary balance	-3.7	-1.1	-0.6	3.6	6.6	3.3	2.2
Privatization receipts	2.4	0.7	8.4	4.0	2.6	2.1	2.1
Central government deposits (end-of-period)	1.6	1.1	4.1	6.2	8.9	10.7	12.7
Net debt (end-of-period) 3/	50.3	44.8	37.5	31.5	31.6	27.9	23.1
General government gross debt (end of period, stock)	51.8	45.9	41.6	37.7	40.5	38.6	35.9
External debt	33.2	29.6	28.9	26.1	22.3	21.4	20.0
Domestic debt	18.7	16.4	12.7	11.7	18.1	17.2	15.9
Balance of payments							
Current account balance, excl. grants	-11.1	-10.1	-8.9	-30.7	-37.0	-33.0	-29.5
Foreign direct investments	2.8	3.4	21.4	23.6	24.4	21.3	18.7
External debt (end of period, stock)	41.2	40.4	44.6	44.9	52.8	59.4	63.3
Of which: Private sector	8.0	10.9	15.7	18.8	30.4	38.0	43.3
REER (wage-based; annual average change, in percent)							
(- indicates depreciation)	4.4	6.6	7.9	7.4	3.6 c/	...	...
Memorandum:							
Aluminum price (€ per tonne)	1,267	1,382	1,526	2,049	1,963	1,747	1,595

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

1/ There is a break in the GDP series in 2005.

2/ Includes extra-budgetary funds and, from 2006, local governments, but not public enterprises.

3/ Gross debt minus deposits; projected path dependent on privatization receipts and restitution compensations. Gross debt includes also extra-budgetary funds; these are not included in official debt statistics.

a/ As of September 2007.

b/ As of August 2007.

c/ As of June 2007.

Table 2. Montenegro: Macroeconomic Framework, 2005-12

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
				Est.	Prel.			Proj.		
						(Percent change)				
Real GDP	2.4	4.2	4.0	6.5	7.5	7.2	5.5	5.1	4.9	4.7
Retail prices (end-period)	6.2	4.2	1.8	2.0	5.0	4.5	4.0	3.5	3.0	3.0
						(In percent of GDP; unless otherwise indicated)				
Gross domestic savings	-2.7	-0.1	-1.8	-7.1	-10.7	-8.4	-7.1	-6.1	-5.2	-3.2
Non-government	-0.3	0.1	-4.1	-14.8	-22.2	-17.3	-15.4	-12.8	-11.2	-9.2
Government	-2.4	-0.1	2.2	7.7	11.6	8.9	8.3	6.7	6.0	5.9
Net factor receipts and transfers from abroad	10.5	9.0	9.2	6.1	2.8	3.5	3.6	3.0	2.5	2.2
Non-government	9.3	8.6	9.0	5.9	2.7	3.2	3.3	2.7	2.1	1.8
Government	1.1	0.4	0.2	0.2	0.1	0.3	0.4	0.4	0.4	0.4
Gross national savings	7.8	8.9	7.3	-1.0	-7.8	-5.0	-3.4	-3.1	-2.7	-1.1
Non-government	9.1	8.6	5.0	-8.9	-19.5	-14.1	-12.2	-10.2	-9.0	-7.4
Government	-1.3	0.3	2.4	7.9	11.7	9.1	8.7	7.1	6.4	6.3
Gross domestic investment	15.1	16.2	16.0	29.4	29.2	27.7	25.7	23.7	21.7	20.2
Non-government	11.6	13.2	11.8	23.9	23.0	20.8	18.3	15.8	13.5	11.8
Government	3.5	3.0	4.1	5.5	6.2	6.9	7.4	7.9	8.2	8.4
Non-government national savings minus investment	-2.6	-4.6	-6.9	-32.8	-42.5	-34.9	-30.5	-25.9	-22.6	-19.2
Savings - investment balance	-7.3	-7.2	-8.6	-30.4	-37.0	-32.7	-29.1	-26.8	-24.4	-21.3
Non-government	-2.6	-4.6	-6.9	-32.8	-42.5	-34.9	-30.5	-25.9	-22.6	-19.2
Government	-4.8	-2.7	-1.8	2.4	5.4	2.3	1.3	-0.9	-1.8	-2.1
Foreign savings	7.3	7.2	8.6	30.4	37.0	32.7	29.1	26.8	24.4	21.3
Foreign savings, excluding official grants	11.1	10.1	8.9	30.7	37.0	33.0	29.5	27.2	24.8	21.3
Memorandum items:										
Net export of goods and services	-17.8	-16.2	-17.8	-36.5	-39.9	-36.1	-32.8	-29.8	-26.9	-23.4
Current account balance (before grants)	-11.1	-10.1	-8.9	-30.7	-37.0	-33.0	-29.5	-27.2	-24.8	-21.3
Nominal GDP (millions of €)	1,392	1,651	1,785	1,979	2,204	2,453	2,711	2,968	3,222	3,495

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

Table 3. Montenegro: Consolidated General Government Fiscal Operations, 2004-09 1/
(in percent of GDP)

	2004	2005	2006	2007	2008	2009
		Est.			Proj.	
Total revenues and grants	37.8	37.4	44.9	50.7	48.9	47.7
Total revenues	37.4	37.2	44.7	50.6	48.6	47.3
Current revenues	37.2	37.0	44.2	49.9	48.5	47.2
Taxes	22.9	24.1	28.0	33.3	32.8	32.2
Personal income tax	4.8	4.6	4.7	4.3	4.2	3.4
Corporate income tax	1.0	1.2	0.6	1.8	1.8	1.8
Taxes on property	0.2	0.3	1.3	2.0	1.9	2.1
Value added tax	9.6	10.8	13.8	16.9	16.8	16.8
Excises	3.7	3.7	3.7	4.1	4.1	4.1
Taxes on international trade	2.2	2.3	2.9	3.1	3.0	3.0
Local government taxes	1.2	1.1	0.9	0.9	0.8	0.8
Other republic taxes	0.1	0.2	0.2	0.3	0.3	0.3
Social security contributions	9.9	9.4	10.1	10.1	9.3	8.6
Nontax revenues	4.4	3.5	6.2	6.5	6.4	6.4
Capital revenues	0.2	0.3	0.5	0.7	0.1	0.1
Grants	0.4	0.2	0.2	0.1	0.3	0.4
Total expenditures and net lending	40.3	38.8	42.7	45.2	46.6	46.4
Total expenditures	39.5	38.2	42.2	44.9	46.5	46.3
Current expenditures	20.2	18.3	20.3	21.8	22.6	22.0
Gross salaries	11.4	10.6	10.4	10.5	11.4	11.1
Other personal income	1.4	1.1	1.4	1.4	1.4	1.4
Goods and services	4.4	4.3	6.6	7.5	7.6	7.5
Interest payments	1.6	1.2	1.2	1.1	1.0	0.9
Rent	0.1	0.3	0.2	0.3	0.3	0.3
Subsidies	0.8	0.6	0.3	0.6	0.6	0.5
Other outflows	0.6	0.3	0.2	0.4	0.4	0.4
Social security transfers	13.8	13.2	11.9	12.1	12.1	12.0
Other transfers	1.5	1.6	3.7	4.1	4.2	4.2
Capital expenditure	3.0	4.1	5.5	6.2	6.9	7.4
Reserves	1.0	1.0	0.8	0.7	0.7	0.7
Net lending	0.8	0.7	0.4	0.3	0.1	0.1
Discrepancy (+ expenditure)	0.2	0.3	-0.1	0.0	0.0	0.0
Overall balance	-2.7	-1.8	2.4	5.4	2.3	1.3
Financing	2.7	1.8	-2.4	-5.4	-2.3	-1.3
Domestic financing	0.1	-7.7	-7.0	-6.4	-5.0	-3.8
Banking system	0.0	-2.9	-3.7	-4.2	-3.2	-3.0
Nonbank	0.8	-2.4	-1.0	-0.8	-0.9	-0.9
T-bills	1.0	-1.6	-0.2	-0.1	0.0	0.0
Frozen foreign currency deposits (FFCD)	-0.3	-0.8	-0.6	-0.5	-0.5	-0.4
Restitution	0.0	0.0	-0.2	-0.2	-0.4	-0.5
Domestic arrears	-0.6	-2.0	-1.9	-1.3	-0.9	-0.4
Foreign financing	1.9	1.0	0.5	-1.6	0.6	0.4
Borrowing	2.0	1.3	1.3	1.3	1.3	1.0
Repayment	-0.1	-0.3	-0.7	-2.9	-0.7	-0.7
Privatization receipts	0.7	8.4	4.0	2.6	2.1	2.1
Memorandum items:						
Overall balance (incl. FFCD and restitution)	-2.9	-2.5	1.7	4.7	1.3	0.5
Primary balance	-1.1	-0.6	3.6	6.6	3.3	2.2
Wage costs (net salaries and other personal income)	9.0	8.2	8.3	8.4	9.2	9.2
Gross Domestic Product (millions of euro)	1,651	1,785	1,979	2,204	2,453	2,711

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

1/ Includes republican budget and extra-budgetary funds; and, from 2006, local governments.

Table 4. Montenegro: Summary of Accounts of the Financial System, 2003–September 2007
(In millions of euros)

	2003	2004	2005	2006	Mar-07	Jun-07	Sep-07
			I. Central Bank				
Net foreign assets	50.4	60.1	172.9	310.3	343.5	431.2	517.3
Net domestic assets	-49.7	-59.9	-171.6	-307.7	-340.3	-427.4	-512.5
Net credit to the nonfinancial public sector	2.4	2.2	-39.2	-57.0	-89.0	-137.4	-191.4
Net credit to the banking system	-30.4	-39.9	-99.2	-233.3	-232.4	-266.1	-291.7
Other assets net	-21.7	-22.1	-33.2	-17.4	-18.8	-23.8	-29.4
Central bank fully backed liabilities	0.7	0.2	1.3	2.6	3.2	3.9	4.7
			II. Banking system				
Net foreign assets	13.4	-18.7	42.2	-30.8	-97.4	-174.1	-279.7
Net domestic assets	231.7	319.4	454.7	1,048.7	1,314.9	1,689.4	2,051.3
Net assets held in the central bank	36.1	40.2	100.3	233.1	232.4	267.2	287.2
Net credit to nonfinancial public sector	23.8	28.5	26.0	23.7	13.6	-16.3	7.6
Credit to the private sector	170.4	244.1	325.6	779.6	1,057.7	1,412.9	1,722.0
Other domestic assets	1.4	6.7	2.8	12.2	11.2	25.6	34.5
Liabilities to the private sector	245.1	300.8	496.9	1,017.9	1,217.6	1,515.3	1,769.8
Deposits	176.6	217.3	400.2	878.3	1,038.3	1,292.5	1,521.4
Other	68.5	83.5	96.7	139.6	179.3	222.8	248.4
			III. Consolidated System				
Net foreign assets	63.8	41.4	215.2	279.5	246.2	257.2	237.5
Net domestic assets	181.9	259.6	283.0	741.0	974.6	1,262.0	1,538.8
Net credit to the nonfinancial public sector	26.2	30.7	-13.3	-33.3	-75.4	-153.7	-183.8
Credit to the private sector	170.4	244.1	325.6	779.6	1,057.7	1,412.9	1,722.0
Other net domestic assets	-14.6	-15.2	-29.3	-5.3	-7.7	2.8	0.7
Liabilities to the private sector	245.8	301.0	498.2	1,020.5	1,220.8	1,519.2	1,774.5

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

Table 5. Montenegro: Financial Soundness Indicators of the Banking Sector, 2004–June 2007

	2004	2005		2006			2007	
	Dec.	Jun.	Dec.	Jun.	Sep.	Dec.	Mar.	Jun.
Capital adequacy								
Regulatory capital as percent of risk-weighted assets	31.3	28.3	27.8	20.3	16.8	21.3	18.5	18.7
Capital as percent of assets	20.4	17.8	15.3	14.3	12.0	10.4	10.4	9.5
Asset composition and quality				(In percent of total credit)				
Distribution of bank credit by borrower								
Central government, local government, government agencies	...	4.5	7.0	5.8	5.2	4.2	3.2	2.4
Funds	...	5.9	3.1	2.3	3.4	2.1	1.8	1.4
State-owned companies	...	4.4	5.2	4.9	2.8	2.7	2.6	1.4
Private companies, entrepreneurs	...	58.2	56.5	53.5	51.5	52.7	54.4	56.6
Banks	...	0.0	0.0	0.2	0.0	0.1	1.3	1.0
Financial Institutions	...	0.6	0.0	0.7	0.6	0.7	0.3	0.5
Citizens	...	25.7	27.5	31.1	35.2	36.3	35.1	35.3
Credit Cards	...	0.5	0.3	0.3	0.3	0.4	0.5	0.7
Other	...	0.3	0.3	1.3	1.0	0.9	0.7	0.8
				(In percent of total credit)				
Distribution of bank credit by sectoral economic activity								
Agriculture, Hunting, Fishing	1.7	1.3	1.9	1.1	1.3	1.0	1.5	1.1
Mining and Energy	2.2	3.0	2.7	2.9	1.3	1.7	2.4	2.4
Civil engineering	5.1	5.0	5.0	5.6	8.0	7.3	9.6	10.5
Trade	41.5	28.7	34.4	36.4	29.0	31.3	23.3	22.4
Services, tourism	6.0	9.5	7.7	4.8	8.3	7.8	7.8	7.9
Transport, Warehousing, Communications	2.1	2.9	4.4	1.5	2.6	1.5	2.4	2.5
Finance	3.4	0.8	3.0	2.2	2.9	1.1	2.3	2.1
Real estate trading	0.3	0.4	2.9	2.4	0.9	0.8	3.5	3.6
Administration, other public services	4.6	8.1	5.3	5.2	3.5	4.5	6.9	4.9
Consumer loans	26.2	24.9	26.3	31.0	35.3	36.6	35.4	35.6
Other	6.8	15.5	6.6	6.8	7.0	6.6	5.0	7.0
Asset quality								
Non-performing loans (NPL), in percent of gross loans	5.2	7.0	5.3	7.0	3.6	2.9	2.0	2.0
Provisions, in percent of NPL	77.3	54.5	67.4	67.4	73.3	78.8	99.0	104.1
Provisions, in percent of total loans	4.0	3.8	3.6	2.7	2.6	2.2	2.0	2.0
NPL net of provisions, in percent of capital	3.6	11.3	6.1	5.9	4.7	3.5	0.1	-0.6
Earnings and profitability								
Gross profits, in percent of average assets (ROAA)	-0.3	2.5	0.8	0.6	1.1	1.1	1.5	1.4
Gross profits, in percent of average equity capital (ROAE)	-1.4	13.8	5.3	4.6	6.8	6.8	12.5	11.6
Net interest margin 1/	6.9	3.4	5.4	2.6	3.1	3.5	4.0	1.8
Gross income, in percent of average assets	12.3	10.3	11.1	9.5	9.2	8.9	7.6	3.9
Net interest income, in percent of gross income	49.8	41.6	48.3	50.8	50.0	50.6	53.5	53.6
Non-interest income, in percent of gross income	50.2	58.4	51.7	49.2	50.0	49.4	46.5	46.4
Net fee income, in percent of net interest income	84.3	66.7	75.8	71.1	77.4	75.6	63.0	62.0
Trading income, in percent of gross income	8.3	30.6	15.0	13.1	11.3	11.1	12.8	13.3
Aggregate overhead expenses, in percent of gross income	69.3	57.2	70.0	75.2	70.4	71.9	61.1	56.1
Liquidity								
Liquid assets, in percent of total assets	24.2	28.7	38.4	28.8	34.8	35.8	29.1	25.4
Liquid assets, in percent of short-term liabilities	41.0	47.3	58.7	43.0	58.0	63.0	48.7	43.0
Deposits, in percent of assets	61.5	65.6	70.1	73.0	73.4	75.2	75.0	74.5
Loans, in percent of deposits	103.0	95.8	77.1	88.1	80.7	78.8	88.6	95.0
Sensitivity to market risk								
Original maturity of assets (in percent of total)								
Less than 3 months	...	48.9	56.8	49.3	46.2	45.3	37.3	34.3
3 months to 1 year	...	25.4	17.4	22.4	23.8	18.1	18.9	19.9
1 to 5 years	...	22.9	22.0	21.3	21.9	25.6	34.1	31.5
Over 5 years	...	2.8	3.8	7.0	8.1	11.0	9.8	14.4
Original maturity of liabilities (in percent of total)								
Less than 3 months	...	52.2	60.4	54.4	43.9	46.4	39.9	41.8
3 months to 1 year	...	24.3	16.0	24.4	25.0	22.5	27.7	24.6
1 to 5 years	...	22.3	19.1	16.8	22.1	24.6	25.0	25.4
Over 5 years	...	1.3	2.9	4.5	9.0	6.5	7.4	8.3

Source: Central Bank of Montenegro

1/ Net interest income in percent of interest bearing assets

Table 6. Montenegro: Balance of Payments, 2004–12 1/
(In millions of euros)

	2004 Est.	2005 Est.	2006 Est.	2007 Proj. 2/	2008	2009	2010	2011	2012
Current account balance (incl. grants)	-120	-154	-601	-816	-802	-790	-795	-785	-743
Trade balance	-416	-514	-938	-1,303	-1,487	-1,556	-1,613	-1,663	-1,712
Exports f.o.b.	452	461	559	577	617	664	708	754	805
Of which: Aluminum	184	186	215	235	241	224	214	203	207
Imports c.i.f.	-869	-974	-1,498	-1,880	-2,104	-2,220	-2,321	-2,416	-2,517
Services Balance (non-factor services, net)	148	196	216	425	600	667	727	797	893
Receipts	250	330	434	670	899	1,002	1,112	1,237	1,368
Of which: Tourism	172	222	288	518	735	837	945	1,061	1,178
Expenditure	-101	-134	-217	-245	-299	-335	-385	-441	-474
Net factor income	-40	-44	-26	-47	-61	-67	-73	-80	-86
Unrequited transfers, net	188	208	147	108	145	166	164	161	162
Current account balance (excl. grants)	-166	-160	-608	-816	-808	-801	-807	-798	-743
Capital and Financial account balance	68	366	645	843	796	763	749	727	689
Financial account	68	366	659	843	796	763	749	727	689
Foreign direct investment, net	56	381	467	539	523	508	453	414	367
Portfolio investment , net	6	5	-4	6	12	15	19	25	26
Other investments	95	-20	210	298	262	241	277	288	295
Errors and omissions	61	-99	93	46	0	0	0	0	0
Overall balance	10	113	137	72	106	128	106	87	76
Financing	-10	-113	-137	-72	-106	-128	-106	-87	-76
Net foreign assets (increase, -)	-10	-113	-137	-72	-106	-128	-106	-87	-76
Arrears (reduction, -)	0	0	0	0	0	0	0	0	0
Memorandum items:									
				In percent of GDP					
Current account balance	-7.2	-8.6	-30.4	-37.0	-32.7	-29.1	-26.8	-24.4	-21.3
Excluding official grants	-10.1	-8.9	-30.7	-37.0	-33.0	-29.5	-27.2	-24.8	-21.3
Trade balance	-25.2	-28.8	-47.4	-59.1	-60.6	-57.4	-54.3	-51.6	-49.0
Service balance	9.0	11.0	10.9	19.3	24.5	24.6	24.5	24.7	25.6
				12-month growth rates (value)					
Export	67.1	1.9	21.4	3.2	6.9	7.6	6.7	6.4	6.8
Import	37.9	12.2	53.7	25.5	11.9	5.5	4.6	4.1	4.2
Tourism revenues	26.4	29.4	29.8	79.7	41.9	13.9	13.0	12.2	11.1

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

1/ BOP compilation methods have been changed in 2006, including the recording system for trade data and treatment of income transfer of foreign workers. Therefore direct comparison with 2005 may not be feasible.

Table 7. Montenegro: Indicators of External and Financial Vulnerability
(In percent of GDP; unless otherwise indicated)

	2004	2005	2006 Est.	2007 Proj.
Financial indicators				
General government debt	45.9	41.6	37.7	40.5
Deposit money (percent change, 12-month basis) 1/	-71.4	532.4	106.5	129.6
Private sector credit (percent change, 12-month basis) 1/	43.3	33.4	139.4	174.5
91 day T-bill yield 1/	10.4	5.8	1.2	0.7
External indicators				
Exports (percent change, 12-month basis)	67.1	1.9	21.4	3.2
Imports (percent change, 12-month basis)	37.9	12.2	53.7	25.5
Current account balance	-7.2	-8.6	-30.4	-37.0
Capital and financial account balance	4.1	20.5	32.6	38.2
Of which: Foreign direct investment	3.4	21.4	23.6	24.4
Gross official reserves (in euros)	60.1	172.9	310.3	432.3
Central Bank short-term foreign liabilities (in US$)	0.0	0.0	0.0	0.0
Official reserves in months of imports GS	0.8	2.1	2.7	3.4
Total external debt	40.4	44.6	44.9	52.8
Of which: General government	29.6	28.9	26.1	22.3
Exchange rate (US$ per euro, period average) 2/	1.2	1.2	1.3	1.4
REER appreciation (-) (RPI based, 12 month basis) 2/	3.5	-2.8	-5.3	-4.9
Financial market indicators				
Stock market index	115.1	463.1	918.9	2351.1
Spread of benchmark bonds (basis points, end of period)	…	…	…	…

Sources: Central Bank of Montenegro, Ministry of Finance; and Fund staff estimates and projections.

1/ End-September 2007.

2/ End-July 2007.

Appendix I: Montenegro—General Government Debt Sustainability Analysis

1. The monitoring of general government debt has improved significantly, with the debt management department of the Ministry of Finance taking a leading role in clarifying and making public the debt situation.

2. This debt sustainability analysis includes gross public debt that is recognized by the authorities and covers the general government.[1] Estimates of the liabilities from the restitution process are included. Parliament has limited the overall liabilities stemming from restitution to a maximum of 10 percent of GDP through amendments to the restitution law. For 2007, ca. €150 million is added to government liabilities. Debt of municipal governments has been revised upwards on account of recognition of domestic payment arrears (ca. €20 million). The discussions between Serbia and Montenegro on the division of external debt are not yet final, and under the current scenario, debt equivalent to €20 million is added in 2007 on account of assumed debt from the former State Union.[2] The government has also decided to compensate confiscated foreign savings of Montenegrin citizens in banks outside Montenegro[3] and, possibly, for losses incurred in the pyramid-schemes (additional €18 and €10 million are included in the current scenario). There is still uncertainty regarding debt of public enterprises from before the reconstitution of the Union between Serbia and Montenegro that ultimately could become a liability of the government. Montenegro has also decided to pre-pay World Bank debt. In September, a payment of €19 million was made, and the current scenario assumes that an additional early re-payment of €38 million will be effected before the end of 2007.

3. Under the baseline scenario, Montenegro's debt-to-GDP ratio would decline to below 30 percent of GDP in 2012 (Table 1). The primary balance is projected to improve with the current upswing in the economy. However, a weakening of the automatic stabilizers through tax rate reductions and expansion of the public sector will slow the pace of debt reduction. Nominal interest rates, while low due to the high share of relatively cheap domestic and foreign debt, are projected to reach 3½ percent on account of the government taking on a higher proportion of debt on non-IDA terms, and robust real economic growth will strengthen the automatic debt dynamics. Privatization revenues are expected to decrease following the windfall in 2005–08.

4. The standard stress tests were performed using the methodology adopted in July 2005 (Information Note on Modifications to the Fund's Debt sustainability Assessment Framework for market access Countries-http://www-imf.org/external/np/pp/eng/205/070105.htm), but with

---

[1] The central government, social funds (pension, health and employment) and local governments. Debt of state-owned enterprises is included only as so far it is explicitly recognized as a liability of the government. Official debt figures do not include extra-budgetary funds.

[2] Debt expected to be assumed by the Republic of Montenegro is toward Kuwait, Libya, Czech Republic, and Slovakia.

[3] This goes beyond the previous compensation that applied only to foreign savings confiscated by banks in Montenegro, and, in principle, the Montenegro government will have a claim on the countries in which these banks reside.

modifications due to data constraints. Relevant economic information for Montenegro prior to 2002 does not exist, and estimates for 2002–06 are used for historical averages and standard deviations.

5. The standard stress tests result in a slower reduction of debt in the medium-term, but not a reversal (Figure 1), and the debt path is robust to most adverse scenarios. Montenegro, however, is facing large risks due to external concentration in trade and uncertainties in real debt levels; and euroization limits the economy's flexibility to respond to a shock. To test the limits of the debt dynamics the standard shocks applied to real interest rate, growth rate and primary balance was doubled, and 20 percent of GDP was added to the debt stock in 2008, reflecting possible hidden debt or addition of new liabilities (Figure 2). In this scenario, debt sustainability is particularly sensitive to growth and fiscal shocks, while less sensitive to interest and exchange rate shocks (due to the relatively low interest rates on existing debt stock and a small share of debt denominated in non-euro currencies). Thus, the relatively high sensitivity to changes in growth and fiscal policy reinforces the importance of continued structural reforms and a prudent fiscal stance.

Table A1. Montenegro: General Government Debt Sustainability Framework, 2003-2012
(Percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	51.8	45.9	41.6	37.7	40.5	38.6	35.9	32.8	30.0	29.3	-2.2
Of which: foreign-currency denominated	5.2	4.6	4.2	3.8	4.0	3.9	3.6	3.3	3.0	2.9	
Change in public sector debt	-37.6	-5.9	-4.4	-3.8	2.7	-1.9	-2.7	-3.1	-2.8	-0.7	
Identified debt-creating flows (4+7+12)	-35.1	-0.5	-9.4	-9.7	-2.0	-6.3	-5.8	-2.5	-1.0	-0.7	
Primary deficit	3.7	1.1	0.6	-3.6	-6.6	-3.3	-2.2	0.1	1.1	1.4	
Revenue and grants	41.8	37.8	37.4	44.9	50.7	48.9	47.7	45.4	44.5	44.3	
Primary (noninterest) expenditure	45.6	38.9	38.0	41.3	44.1	45.6	45.5	45.5	45.6	45.7	
Automatic debt dynamics 2/	-4.7	-0.9	-1.6	-3.4	-2.7	-2.8	-2.4	-2.0	-1.5	-1.4	
Contribution from interest rate/growth differential 3/	-3.1	-0.3	-2.3	-2.9	-2.7	-2.8	-2.4	-2.0	-1.5	-1.4	
Of which: contribution from real interest rate	-1.0	1.8	-0.6	-0.4	-0.2	-0.2	-0.5	-0.3	-0.1	-0.1	
Of which: contribution from real GDP growth	-2.0	-2.1	-1.7	-2.4	-2.5	-2.6	-1.9	-1.7	-1.5	-1.3	
Contribution from exchange rate depreciation 4/	-1.6	-0.6	0.7	-0.5	...	...	...	...	...	...	
Other identified debt-creating flows	-34.1	-0.7	-8.4	-2.7	7.3	-0.2	-1.2	-0.6	-0.6	-0.8	
Privatization receipts (negative)	-2.4	-0.7	-8.4	-4.0	-2.6	-2.1	-2.1	-1.5	-1.4	-1.4	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	2.6	9.8	1.9	0.9	0.9	0.8	0.5	
Other (Paris Club rescheduling 2003 and 2006)	-31.7	0.0	0.0	-1.3	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-2.5	-5.4	5.0	5.8	4.7	4.5	3.1	-0.6	-1.8	0.1	
Public sector debt-to-revenue ratio 1/	123.8	121.5	111.2	84.0	79.9	79.0	75.2	72.2	67.3	66.2	
Gross financing need 6/	4.8	2.6	1.4	-3.1	-8.3	-3.0	-2.0	0.2	1.1	1.4	
In billions of U.S. dollars	74.8	52.4	32.2	-77.9	-246.6	-99.8	-75.4	9.0	50.5	69.6	
Scenario with key variables at their historical averages 7/					40.5	43.9	44.8	42.4	38.8	37.1	-2.3
Scenario with no policy change (constant primary balance) in 2007-2012					40.5	43.9	40.3	32.8	24.7	18.7	0.8
Key macroeconomic and fiscal assumptions underlying baseline				0.0							
Real GDP growth (in percent)	2.4	4.2	4.0	6.5	7.5	7.2	5.5	5.1	4.9	4.7	
Average nominal interest rate on public debt (in percent) 8/	1.3	3.6	2.7	3.2	3.4	3.5	3.5	3.5	3.5	3.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	3.6	-1.2	-0.8	-0.2	-0.4	-1.3	-0.7	0.0	-0.1	
Nominal appreciation (increase in US dollar value of local currency, in percent)	20.7	9.1	-11.6	11.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.4	0.0	4.0	4.1	3.6	3.8	4.7	4.2	3.5	3.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	25.6	1.3	1.5	15.8	14.7	10.9	5.2	5.2	5.1	4.9	
Primary deficit	3.7	1.1	0.6	-3.6	-6.6	-3.3	-2.2	0.1	1.1	1.4	

1/ Gross debt, including central government, social funds and local governments

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

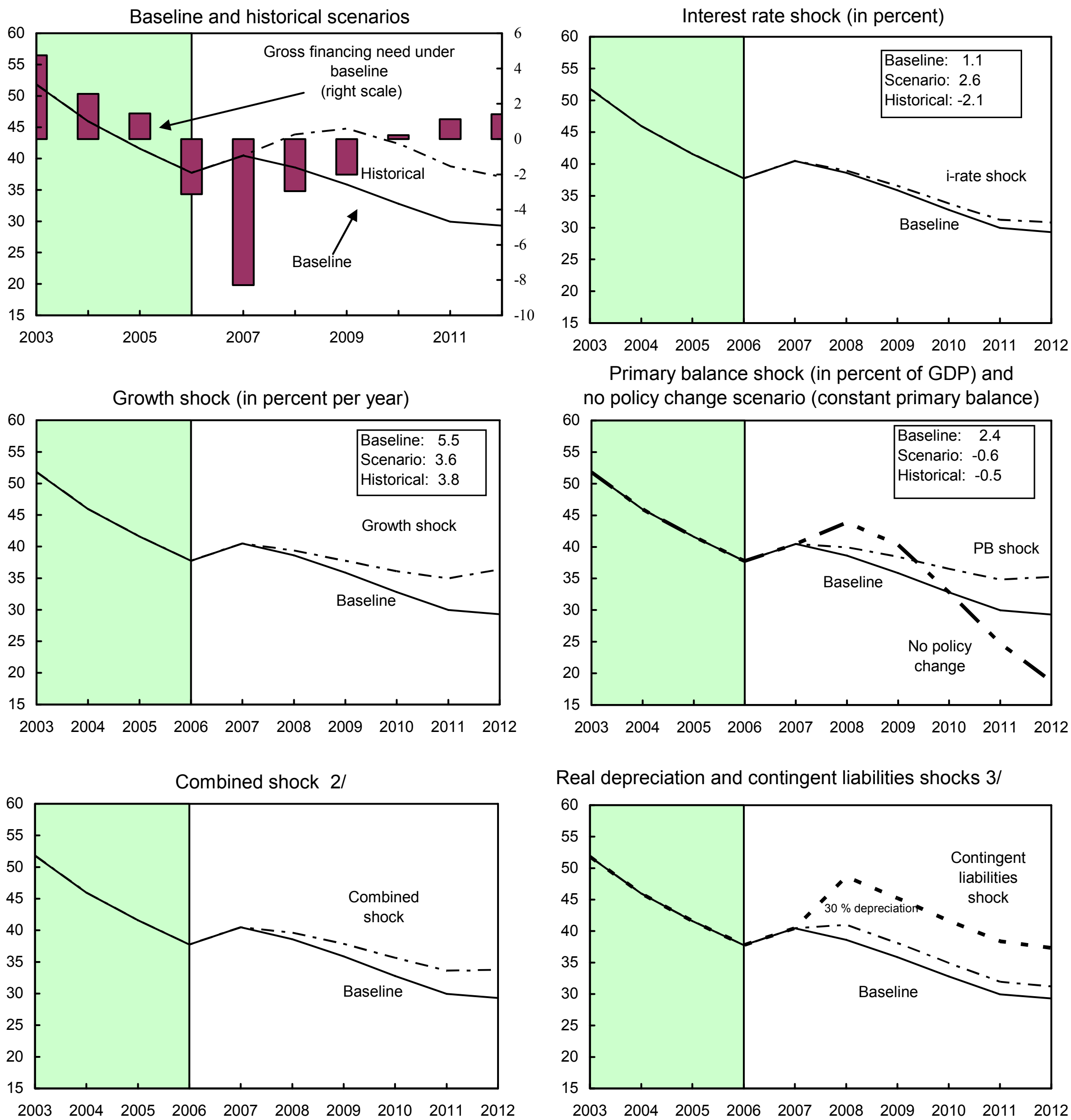
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Figure A1. Montenegro: General Government Debt Sustainability: Bound Tests 1/
(Public debt, percent of GDP)



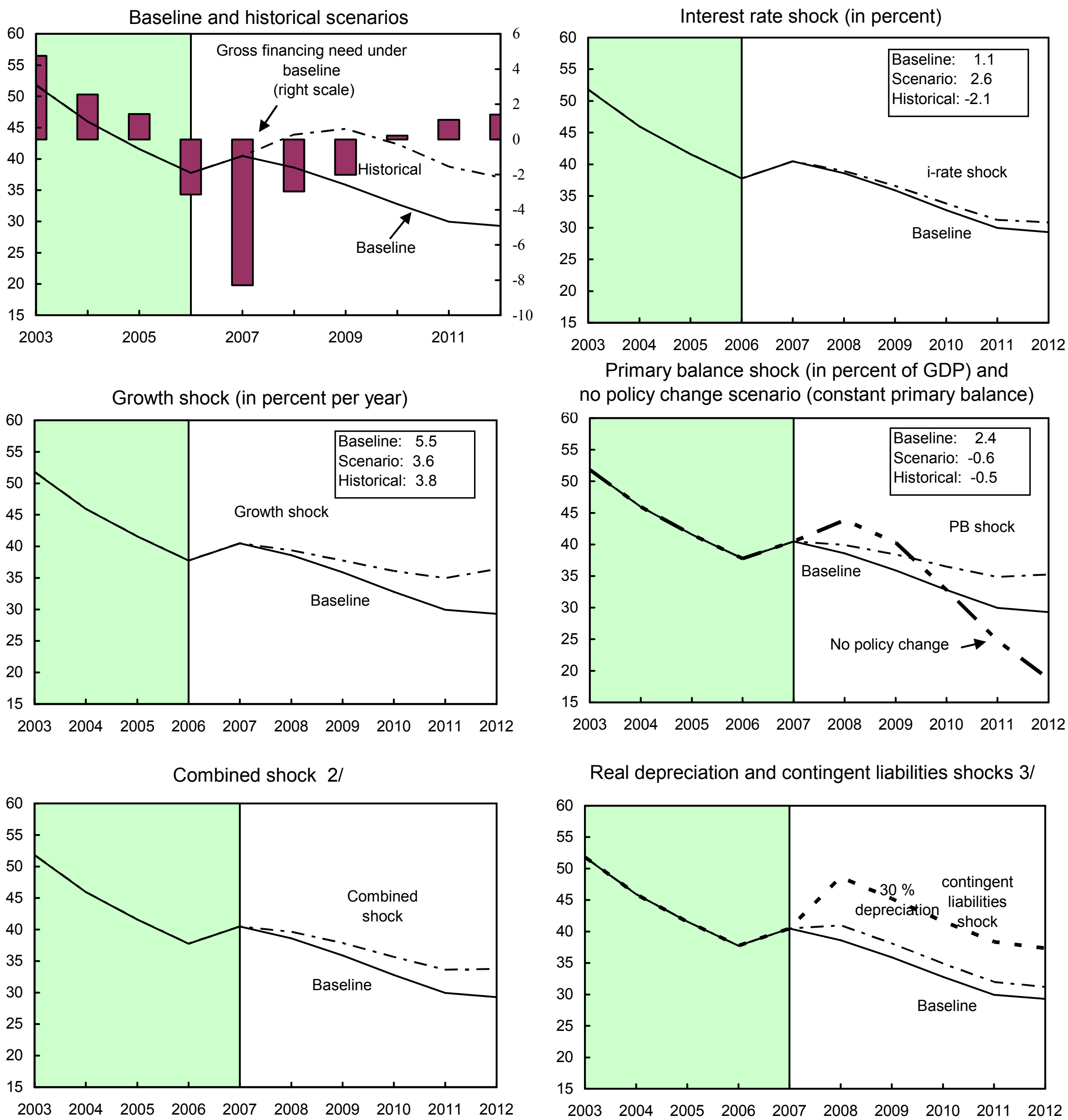
Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure A2. Montenegro: General Government Debt Sustainability: Bound Tests 1/
(Public debt, percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/2 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 20 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix II. Montenegro—External Debt Sustainability

1. Montenegro's external public debt is low. Since the debt restructuring by Paris Club and bilateral donors in 2003, which almost halved external public debt to around 33 percent of GDP, the public external debt has continued to decline. Montenegro also benefited from another debt write-off by Paris Club creditors in 2006, which contributed to total external public debt falling to about 26 percent of GDP.

2. The data on private external debt is weak; however, staff and the authorities' estimates indicate that external private debt has been increasing rapidly since 2006 which warrants cautious monitoring. Based on available data so far, private external debt is expected to jump from 19 percent of GDP in 2006 to 30 percent in 2007. Commercial bank debt accounted for just under half of the increase, with financial institutions taking advantage of improved access to international capital markets and foreign bank branches in Montenegro borrowing from headquarters abroad. The remainder of the increase may partly reflect hidden FDI, with the debt later converted to equity. The mission has stressed the need to maintain record of private debt stock.

3. The macroeconomic framework projects real growth to slow down gradually, while the current account situation improves with a fall in FDI related imports, and strong tourism earnings. Under the baseline scenario, the debt-to-GDP ratio increases from about 53 percent in 2007 to 59 percent in 2008 and continues to grow to reach 74 percent by 2012. During this period, the external *public* debt declines from 22 percent to 16 percent. Meanwhile, the private sector is expected to replace the role of FDI and pushing up the *private* external debt to 38 percent by 2008 and continue upwards to reach 58 percent by 2012. An alternative scenario with key variables at their historical average shows an *improvement* in external debt because of exceptionally high FDI. Scenarios with higher interest and a worsening current account indicate less favorable debt path, especially for the latter shock. A large real depreciation would boost exports, and lead to a significant improvement in the debt position.

Table A1. Montenegro: External Debt Sustainability Framework, 2004-2012
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing
Baseline: External debt	40.4	44.6	44.9	**52.8**	**59.4**	**63.3**	**66.9**	**70.2**	**74.1**	**-15.5**
Change in external debt	-0.7	4.2	0.3	7.9	6.7	3.9	3.6	3.3	3.9	
Identified external debt-creating flows (4+8+9)	-1.2	-20.3	-14.4	7.0	5.8	5.3	7.1	7.1	7.0	
Current account deficit, excluding interest payments	5.3	9.1	27.3	35.1	31.5	28.0	25.7	23.3	19.2	
Deficit in balance of goods and services	15.1	18.7	34.7	39.2	36.1	32.7	29.7	26.8	23.3	
Exports	39.4	46.5	47.7	55.7	61.7	61.3	61.1	61.5	61.9	
Imports	54.5	65.2	82.3	94.9	97.7	94.0	90.8	88.3	85.2	
Net non-debt creating capital inflows (negative)	-3.2	-31.2	-34.8	-26.6	-23.4	-20.8	-16.7	-14.2	-11.2	
Automatic debt dynamics 1/	-3.4	1.9	-6.9	-1.6	-2.2	-1.9	-1.9	-2.0	-1.0	
Contribution from nominal interest rate	1.6	0.0	1.6	1.3	1.2	1.1	1.0	1.0	2.0	
Contribution from real GDP growth	-1.5	-1.7	-2.3	-2.9	-3.4	-2.9	-2.9	-3.0	-3.0	
Contribution from price and exchange rate changes 2/	-3.4	3.5	-6.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.5	24.5	14.7	0.9	0.9	-1.5	-3.5	-3.8	-3.0	
External debt-to-exports ratio (in percent)	102.6	95.8	94.2	94.8	96.4	103.3	109.5	114.1	119.7	
Gross external financing need (in billions of US dollars) 4/	0.2	0.3	0.7	1.0	1.1	1.0	1.1	1.1	1.0	
in percent of GDP	9.5	11.9	25.0	32.4	31.4	27.8	25.7	23.3	20.1	
Scenario with key variables at their historical averages 5/				**52.8**	**40.5**	**28.2**	**15.5**	**3.8**	**0.0**	**-22.4**
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (in percent)	4.2	4.0	6.5	7.5	7.2	5.5	5.1	4.9	4.7	
GDP deflator in US dollars (change in percent)	9.1	-8.1	16.0	7.5	4.2	5.3	5.0	4.4	4.6	
Nominal external interest rate (in percent)	4.4	0.0	4.4	3.4	2.5	2.0	1.8	1.6	3.1	
Growth of exports (US dollar terms, in percent)	67.1	12.9	26.6	35.0	23.7	10.4	10.0	10.4	10.1	
Growth of imports (US dollar terms, in percent)	50.3	14.5	55.9	33.2	15.0	6.8	6.6	6.5	5.7	
Current account balance, excluding interest payments	-5.3	-9.1	-27.3	-35.1	-31.5	-28.0	-25.7	-23.3	-19.2	
Net non-debt creating capital inflows	3.2	31.2	34.8	26.6	23.4	20.8	16.7	14.2	11.2	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, γ = ρεαλ ΓΔΠ γροωτη ρατε, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

ANNEX I. MONTENEGRO: FUND RELATIONS[1]

(As of October 31, 2007)

Article IV Consultation. The discussions were initiated during April 18–May 4, 2007, at which time the possibility of a precautionary Stand-by was discussed. The authorities determined that an arrangement was not needed at this time, and the Article IV consultation discussions were finalized during October 4–17, 2007. The team comprised of Messrs. Justice (head), Alvesson, Gagales (all EUR), Ms. Kim (PDR), Mr. Capuano (MCM), Mr. Norregaard (FAD), Ms. Mantcheva (STA), Mr. Lalonde (LEG), and Mr. Hirschhofer (resident representative). Mr. Christofides and Ms. Cerovic from the Executive Directors's office participated in the discussions. Mr. Driessen (MCM) joined the mission on April 19–20 to present the conclusions of the FSAP. The mission met with Prime Minister Sturanovic, Deputy Prime Minister Lasovic, Finance Minister Luksic, Economy Minister Gvozdenovic, Labor Minister Radanovic, Tourism and Environment Minister Nenezic, Governor Krgovic of the Central Bank of Montenegro, Minister of Transport Lompar, and other senior officials. A press conference was held at the mission's end.

Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and the mission raised the need for a comprehensive examination of Montenegro's exchange system.

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

II. General Resources Account:	SDR Million	% Quota
Quota	27.50	100.00
Fund Holdings of Currency	20.90	76.00
Reserve position in Fund	6.60	24.00

III. SDR Department:	SDR Million	% Allocation
Holdings	0.07	N/A

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

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

VI. Exchange Rate Arrangement: Exchange arrangement with no separate legal tender. The euro is the legal tender. Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and awaits a comprehensive examination of the exchange system.

VII. Article IV Consultation: Montenegro is proposed to be put on a 12 month cycle. This is the first Article IV consultation.

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

IX. Technical Assistance:

MFD/FAD	July 2005	Management of Proceeds of Privatization and Review of PFM (Montenegro)
FAD	April 2006	Assessment of state-owned enterprises under the World Bank Public Expenditure Review
STA	June 2006	Monetary and financial statistics
FAD	January 2007	Peripatetic advisor on debt management
FAD	March 2007	Fiscal risk assessment of Private Public Partnership
FAD	April 2007	Tax administration
STA	April 2007	Real sector statistics
MCM	October 2007	Emergency liquidity management

X. Resident Representative: Mr. Harald Hirschhofer, resident representative to Serbia, was designated resident representative in January 2007. A satellite office has been established in the Central Bank of Montenegro.

ANNEX II. MONTENEGRO: RELATIONS WITH THE WORLD BANK GROUP

Montenegro's Development Goals

1. Montenegro declared independence in mid-2006, joining the World Bank and IMF about half a year later in January 2007. Even under the umbrella of the State Union of Serbia and Montenegro, the Bank had effectively established a functional relationship with Montenegro.

2. World Bank support complements Montenegro's developments goals, especially its objectives spelt out in the Stabilization and Association process (SAp) with the European Union (EU).[1] Montenegro is in the process of developing and/or updating its development and sectoral strategies and integrating those into the overarching national integration program. These are to update Montenegro's medium-term development strategy, as contained in the 2004 Development and Poverty Reduction Strategy (DPRS)[2] and the Economic Reform Agenda.

3. Following independence, and against the background of accelerating growth rates, largely fueled by a very significant inflow of foreign-direct investments, Montenegro has made substantial progress in advancing its development goals. Euroization has contributed to anchoring macroeconomic stability as a central pillar of economic policymaking, complemented by programs to advance privatization, liberalization, and structural reforms—with the aim of ensuring fiscal consolidation and promoting stronger private sector-led growth. The prolonged debate on the Constitution, the lack of institutional capacity, and the reorientation of policy priorities has delayed the implementation structural reforms in several areas and led to some relaxation of fiscal policies during late 2007. Having completed the immediate state-building tasks and the SAp, the government should overcome quickly the delays in implementing the structural reform agenda.

World Bank Group Strategy

4. A Joint World Bank-IFC Country Partnership Strategy (CPS) for Montenegro, covering FY07–10 and endorsed by the Bank's Board on June 12, 2007, will support the government's key priorities, viz., to (i) enhance sustainable economic growth, through increasing economic freedoms and strengthening the role of the private sector; (ii) build

---

[1] The Stabilization and Association Agreement (SAA) with the EU was signed on October 15, 2007, joining Albania, Croatia, and Macedonia as the fourth Southeastern European country to have successfully concluded the SAp.

[2] The Document was presented to the Board as self-standing part of the joint Serbia and Montenegro Poverty Reduction Strategy.

institutions and the rule of law; and (iii) improve the standard of living of citizens, through efficient education, health and social protection systems.

5. Coordination with the IMF has been strong, with cooperation having focused on macroeconomic issues and sectoral ones with a potentially strong macroeconomic impact—more important still after the government's decision not to request a Fund-supported program and in light of the increased risks to macroeconomic stability. The Bank, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input on issues such as (i) labor market reforms; (ii) energy sector reforms; (iii) public expenditure, pension and health reforms, with a view to streamlining service delivery, and (iv) an appropriate framework to regulate concession arrangements and potential public/private partnerships, with a view to encouraging investment in a way that would ensure that the government does not accumulate significant contingent liabilities.

6. Total outstanding debt of Montenegro towards the various part of the Bank was about US$401.5 million on November 7, 2007 (US$56.9 million for IDA and US$344.6 for IBRD), at the current exchange rate about €290 million. In September 2007, the government prepaid €20 million, with further prepayments foreseen during the fourth quarter of 2007. With these payments, Montenegro has considerably reduced per-capita exposure ratios, which had previously been among the highest for any Bank borrower.

World Bank Activities

7. The 2007 CPS envisages a total lending envelope of US$70–90 million. Following the successful completion, in 2006, of the *Second Structural Adjustment Credit (SAC 2*), the government decided not to request a follow-up development policy credit, largely because of Montenegro's strengthened fiscal position. Investments aim at fostering private-sector activities and streamlining social services, while maintaining a quality environmental infrastructure that is required for sustainable growth in tourism (a key industry).

Montenegro: World Bank Lending Envelope, FY07-FY10

Lending envelope FY07-FY10	89
Fiscal year 2007	19
Energy[1]	9
Sustainable tourism[1]	10
Fiscal year 2008	15
Sustainable tourism	5
Land admininistration	10
Fiscal year 2009	25
Energy efficiency	10
Rural and regional development	15
Fiscal year 2010	30
Improved social services	10
Transport infrastrucure[2]	20

[1] On IDA terms; IBRD terms otherwise.
[2] In high-case lending scenario.

Source: World Bank, 2007, *Country Partnership Strategy for the Republic of Montenegro*, Report No. 39800-ME.

8. Streamlining social services is a particular challenge given the relatively large cost of social services as a proportion of GDP, even when compared to neighboring countries with similar income levels. The *Montenegro Education Reform Project* aims at strengthening the capacity of the education system to make continuous improvements, especially in the quality of teaching and learning in schools and in the efficient use of budgetary resources. There is a high degree of government ownership and no problems in project implementation.

9. The *Healthcare System Improvement Project* seeks to put in place first steps toward a reformed healthcare system to increase the capacity for policy, planning, and regulation, stabilize healthcare financing, and improve primary healthcare service delivery. The implementation is proceeding well, and government ownership is strong. The Health Ministry has succeeded in securing CIDA grant funds to co-finance the project.

10. The *Energy Community of South East Europe-APL3 Montenegro Project* is awaiting effectiveness. Procurement activities for the projects have started. The General Procurement Notice is prepared and about to be published, while EPCG is finalizing the technical specifications for the projects and is planning to issue tender documents of some of these projects by end-December 2007. In addition, Bank teams have discussed an *Energy Efficiency Project*, planned for FY09, to support financing related projects in the public sector, especially in the education and health sectors. The Bank team has agreed with government representatives on next steps for further assessment of prospects and scope of energy efficiency investments in public sector buildings.

11. The *Montenegro Sustainable Tourism Development Project* is to help Montenegro to better design and implement an integrated coastal zone management approach. With this, coastal degradation is to be reduced and environmentally sound tourism development fostered by supporting activities aimed at (i) enhancing spatial development, the use of natural resources, regulatory policy, institutional capacity and governance of the coastal zone, and (ii) initiating priority investments to improve environmental conditions and foster development of high-quality tourism. These objectives will be achieved through (i) improvements in land-use planning and protection to guard against uncontrolled construction and development; and (ii) investments for the Continental and Southern part of the Regional Water Supply Scheme with the capacity to provide water from Lake Skadar/Shkodër to the municipalities of Bar and Ulcinj/Ulqin and the tourist areas of Valdanos and Velika Plaža. This phase of the MSTDP will only finance the investments from Lake Skadar/Shkodër to Bar.

12. The *Montenegro Environmentally Sensitive Tourist Areas Project* is to create ecological and commercially sustainable solid waste collection and disposal services in Montenegro coastal municipalities, needed to maintain a clean, environmentally attractive coastal area. This is to be achieved through the (i) development of the sector's institutional, policy and regulatory framework; (ii) rehabilitation of municipal disposal sites to function as properly designed regional sanitary landfills; (iii) closing existing disposal sites in an environmentally acceptable manner; (iv) provision of modern collection equipment; (v) initiating a pilot recycling campaign; and (vi) strengthening multi-municipal joint companies (MJC) that will be created to operate the two regional solid waste disposal systems.

13. Current Bank involvement is restricted to policy dialogue and an application to the *Public-Private Infrastructure Advisory Facility* trust fund, which is currently awaiting approval. The government wishes to improve competitiveness and has major development

plans for two main road corridors (Bar to the Serbian Border, and Adriatic – Ionian Corridor). The government has commissioned a study to investigate the feasibility, and implementation schedule, of constructing motorways on both these axis, and political pressure is high and increasing. The estimated costs are significant, exceeding current GDP and, consequently, available resources. The government has therefore sought the support of PPIAF and the Bank to investigate this option.

14. Over the last year, the performance of projects in Montenegro has increased considerably. As of October 5, 2007, the portfolio consisted of six projects under implementation, with a total commitment of US$43 million, of which US$17 million have been disbursed during the FY 2007. The disbursement rate, for the same period, has been 33 percent. Performance rating is *Satisfactory* (S) for 2 projects (education and sustainable tourism development), *Moderately Satisfactory* (MS) for 2 (health and pension), and *Unsatisfactory* for one (MESTAP); one project has not been rated yet (energy). The average age of the portfolio is 2.2 years. Two new projects—in sustainable tourism and energy sector development over a total amount of US$19 million—have been approved during the third quarter of 2007. With respect to non-lending operations, a public expenditure and institutional review (PEIR) is planned for the FY08.

15. In support of the implementation of the project portfolio, the Bank is also administering 2 Trust Funds financed by single and/or multi donors. Two projects financed by Global Environmental Facility (GEF), the *Tara and Lim River Basins Watershed Management Project* and the *Lake Skadar/Shkodër Integrated Ecosystem Management Project*, both under preparation, should help boost tourism in the poorer northern part of the country and around Lake Skadar/Shkodër.

16. The Bank's assistance has been supported by a standard package of analytical and advisory activities. A *CPAR* and a *CFAA* were delivered in 2002, followed by a *PEIR* and a *Poverty Assessment* in 2003. A *Montenegro Economic Memorandum* was completed in 2005 and focused on macroeconomic issues (particularly public expenditure), labor market reform, the business climate and also synthesized findings of supporting studies of energy. A *PEIR update* and *Debt Sustainability Analysis* were recently completed, while a *Poverty Assessment Update* and an *FSAP* and *ROSC* are ongoing.

17. **FIAS** assisted the self-assessment of administrative procedures for doing business which identified several major areas of concern: complex procedures for registration of enterprises, along with the lack of funds as well as shortcomings in the legal framework for competition and management of public and private enterprises.

18. **MIGA**, with EAR support, is implementing a capacity building project in support of the new Montenegrin Investment Promotion Agency. MIGA's TA activities are feeding into a new, regional FDI outreach and marketing initiative for the Western Balkans launched in summer 2004 (the European Investor Outreach Program for the Western Balkans).

19. **IFC** has also provided \$5.2 million through Opportunity Bank Montenegro to expand micro- and small-business enterprise loan portfolio. In addition, IFC has provided support through its Southeast European Enterprise Development (SEED) facility, later transformed into Private Enterprise Partnership of Southeast Europe (PEPSE) and assisted in introduction of Financial Leasing Law through its *Leasing Project*.

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

ANNEX III. MONTENEGRO: STATISTICAL ISSUES

1. While data are broadly adequate for surveillance, weaknesses hamper economic analysis and policy making. Following the creation of the State Union between Serbia and Montenegro in 2003, statistical institutions were split and Montenegro, being the smaller partner and with a capital located far from Yugoslav institutions, lacked sufficient resources and qualified personnel, and lost institutional memory and know-how. The quality and timeliness of reporting vary across sectors. For monetary and balance of payments statistics, international reporting standards have been adopted, while the adaptation of national account data has been slower. Reporting of fiscal data has recently improved but coverage is limited. A page for Montenegro in *International Financial Statistics* (IFS) was introduced with the March 2007 issue.

2. The authorities have created a statistical council to coordinate efforts to improve data quality and requested technical assistance from foreign partners. In response, the Fund has provided a series of technical assistance missions to improve the quality of macroeconomic statistics and support policy formulation, often jointly with TA provided to Serbia. Over the period 2001–04, STA conducted six missions to the State Union, including a mission on monetary and financial statistics, separate balance of payments statistics missions to Serbia and to Montenegro, and a multi-topic mission covering national accounts statistics. The status of the statistical base, as reflected in these missions, can be summarized as follows: (i) there is a critical need to improve the quality of existing macroeconomic statistics by developing comprehensive data sources and improving statistical methodologies; (ii) informal activities are inadequately recorded in the national accounts, especially in the expanding service sector; and (iii) the principles for compiling monetary statistics are broadly consistent with MFSM 2000. A 2006 monetary statistics mission and a 2007 real sector statistics mission were undertaken to assist the authorities in improving the quality of the compiled data.

A. Real Sector

3. Real sector data are compiled by the Statistical Office of Montenegro (MONSTAT). MONSTAT has started to adopt the *1993 System of National Accounts* as a framework for compiling national accounts estimates. However, the scope of the accounts is limited to compiling annual production account in current prices, and only aggregate GDP in previous year prices. The accuracy of the data sources needs to be improved. The business statistics are still following the material system product concepts, collecting data mainly on quantities produced. The national accounts estimates depend solely on bookkeeping data. There is no business register to be used for statistical surveying, although work has started with Statistics Sweden. On the expenditure side, there are no data on changes in inventories, and the quality of investment and merchandise trade data is unsatisfactory. The exhaustiveness of the national accounts data is seriously undermined by the lack of sound techniques to incorporate unobserved activities. Some work has been done on ad-hoc basis, but the estimates produced

are not included in the regular compilation practice. The techniques for deriving volume measures of GDP are constrained by the lack of suitable price and volume indices.

4. MONSTAT compiles and disseminates retail price indices (RPI), and cost of living indices, and producer price indices. A proper consumer price index is planned to be introduced in 2008. In all price indices, the "carry-forward" technique for treatment of seasonal goods, new goods, and missing items are not following international standards. The quality of the labor and wage indicators is good.

B. Balance of Payments

5. Balance of payments statistics are compiled by MONSTAT (trade statistics) and the Central Bank of Montenegro (other current account elements, capital and financial accounts). Significant improvement is needed in data compilation, in particular in external trade, where MONSTAT uses the special trade system for imports but general trade system for exports. This inconsistency may have resulted in the overestimation of imports. In addition, the classification used by MONSTAT is the Harmonized System (HS), but data are disseminated according to the Nomenclature générale des Activités économiques dans les Communautés Européennes (NACE), on highly aggregated groups, and with a significant time lag. Some components are likely under-recorded, since a significant proportion of foreign exchange transactions occur through informal channels.

6. Data on private external debt are weak. While the Central Bank of Montenegro (CBM) has continuously maintained a record of flows of private external debt in recent years, there is no data on stock of external debt. The authorities' program includes strengthening the monitoring of private external debt by CBM and MONSTAT.

7. A June/July 2004 mission to the CBM assisted with adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)* and provided recommendations to improve international trade and external debt statistics, as well as Montenegro's international transactions reporting system (ITRS). The authorities have implemented many of the recommendations of the 2004 mission. Following the authorities' request for further assistance, a mission visited Montenegro in September – October 2007. Although it noted substantial progress, inadequate data sources continue to constrain progress in improving balance of payments data.

C. Government Finance

8. Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include data for the social security funds and local governments. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications, especially, at the level of local governments and social funds. The MOF has recently created a unit responsible for data collection for state-owned enterprises (SOE), but a satisfactory

compilation of the public sector fiscal balance requires significant further efforts. Data on stock of local government arrears need to be strengthened.

D. Monetary Accounts

9. Monetary and financial statistics are compiled by the CBM, broadly following the institutional coverage, classification, and valuation methodology set forth in the *Monetary and Financial Statistics Manual*, 2000. Dissemination practices meet GDDS recommendations with respect to the periodicity and timeliness for financial sector data. Beginning in early 2006, the CBM publishes detailed monetary statistics in its monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the CBM and the commercial banks.

10. Significant progress notwithstanding, there is need for further improvement. The 2006 monetary and financial statistics mission made recommendations to the CBM on methodological issues concerning: (i) the exclusion of two banks in bankruptcy from financial reporting (the mission proposed that if these institutions are excluded from the coverage of the monetary survey, a separate table on their monetary accounts could be included in the CBM's Statistical Bulletin); and (ii) treatment of interest accrued but not yet due (which is maintained in aggregate on separate accounts rather than incorporated in the outstanding amount of the financial asset or liability).

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

MONTENEGRO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF NOVEMBER 15, 2007

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
International reserve assets and reserve liabilities of the monetary authorities[1]	Oct.2007	Nov.2007	M	M	M
Reserve/base money	Oct.2007	Nov.2007	M	M	M
Central bank balance sheet	Oct.2007	Nov.2007	M	M	M
Consolidated balance sheet of the banking system	Oct.2007	Nov.2007	M	M	M
Interest rates[2]	Aug.2007	Oct.2007	M	M	M
Cost of living index	Sep.2007	Oct.2007	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Sep.2007	Oct.2007	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3] – central government	Sep.2007	Oct.2007	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Sep.2007	Oct.2007	Q	Q	Q
External current account balance	Jun.2007	Sep.2007	Q	Q	Q
Exports and imports of goods and services	Jun.2007	Sep.2007	Q	Q	Q
GDP/GNP	2005	Apr.2007	A	I	A
Gross external debt	Jun.2007	Sep.2007	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

[3] Foreign, domestic bank, and domestic non-bank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. General government reporting is incomplete; local government expenditure data are available only after a six-month lag.

[5] Including currency and maturity composition.

[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Statement by the Staff Representative on Republic of Montenegro
January 16, 2008

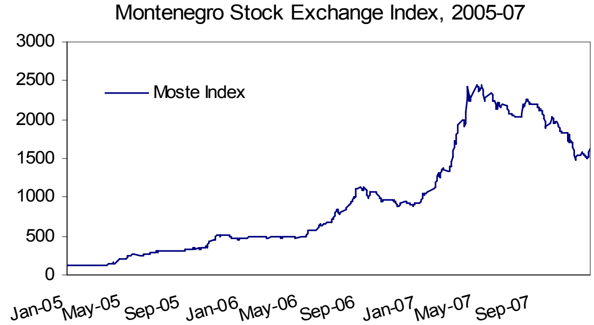
1. This statement provides an update on recent economic developments based on information received after the preparation of the staff report. The new information reinforces the message of the staff appraisal for an urgent need to rein in expansionary fiscal plans for 2008.

2. **Inflationary pressures continue to build.** Twelve-month retail price inflation is estimated to have risen to 6 percent in November, compared with the staff report projection of 5 percent for 2007.

3. **The stock market correction has continued.** The stock index dropped 35 percent by end-year compared to the May 2007 peak.

4. **The recently adopted 2008 budget would result in some additional fiscal stimulus in 2008.** The approved budget would lower the consolidated fiscal balance by 1 ½ percent of GDP compared with the staff report. This partly reflects higher capital spending of about 2 percent of GDP. Past experience suggests that spending may be limited by capacity constraints. Preliminary data suggest a stronger budgetary outturn in 2007 by about 1 percent of GDP, due to strong revenues.

Montenegro Stock Exchange Index, 2005-07



Source: Montenegro Stock Exchange

Montenegro: Consolidated fiscal operations 1/
(In percent of GDP)

	2006	2007		2008	
	Prel.	Staff report	Est. 2/	Staff report	Budget
Revenues	44.9	50.7	51.6	48.9	50.7
Expenditures	42.7	45.2	45.1	46.6	50.0
Balance	2.3	5.4	6.5	2.3	0.7
Primary balance	3.5	6.6	7.6	3.3	1.5

1/ Including local governments.
2/ Staff estimate based on central government outcome.

5. **The central bank has recently introduced a policy package to contain the credit expansion.** The package (i) extends the 19 percent reserve requirement to all public sectors deposits and all deposits with 90–180 days maturity; (ii) broadens the reserve requirement base (albeit at a reduced rate of 2 percent) to deposits with maturity between 180 days and two years; (iii) raises the minimum capital adequacy ratio from 8 to 10 percent for banks with credit growth faster than 60 percent, and to 12 percent for those with credit growth in excess of 100 percent; and (iv) caps annual credit growth to 30, 40 and 60 percent respectively for banks with outstanding loans above 200 million, between 100 and 200 million, and below 100 million euros. While the credit ceilings should help rein in credit growth temporarily, they may distort lending. They are also unlikely to be effective in the medium term as with the open capital account borrowing activity is likely to shift off-shore.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 08/6
FOR IMMEDIATE RELEASE
January 22, 2008

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

IMF Executive Board Concludes 2007 Article IV Consultation with Montenegro

On January 16, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Background

Independence and significant tourism potential have generated impressive investor interest in Montenegro and started a recovery with growth expected to reach 7½ percent in 2007. But strong growth, and the exuberance it has generated, has brought its own problems. There are signs of overheating, with inflation and wages picking up, and the current account deficit soaring. Vulnerabilities are also building up with rapid credit growth weakening private sector balance sheets, an expansive fiscal stance, and an asset price boom.

The current account deficit is expected to widen further in 2007 to 37 percent of GDP driven by high investment (spurred by foreign direct investment, which has hovered around 24 percent of GDP in the past few years) and low savings associated with wealth effects and galloping credit expansion. The share of foreign credits in the financing of the current account deficit has risen. Rising labor costs have been eroding competitiveness.

Rapid credit growth is testing the capacity of the young banking system to prudently assess and manage credit risks. Capital injections have kept the capital adequacy ratio at 18.7 percent of risk weighted assets, which is high by international standards. Banking regulation and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

supervision is relatively strong, but very fast credit expansion tests the capacity of the banks and has been taking its toll on banks' financial indicators.

Fiscal policy is adding to demand pressures. Strong revenue performance has boosted the fiscal surplus, but tax cuts have weakened the impact of automatic stabilizers. A general public sector wage increase of 30 percent, which is implemented in steps starting from October 2007, has added to demand pressures providing an unhelpful fiscal stimulus.

Executive Board Assessment

Executive Directors welcomed the bright prospects for the Montenegrin economy, and praised the authorities for their sound macroeconomic management and bold structural reforms over the past few years. These efforts have helped Montenegro attract substantial foreign direct investment. At the same time, the increased confidence related to independence and the fast growth of tourism and real estate-related investments is generating strong demand pressures, and raising vulnerabilities.

Directors considered that the economy may now be operating above capacity, with inflation picking up and large wage increases weakening competitiveness. Rapid credit growth is overstretching banks' risk assessment capabilities, and has contributed to ballooning asset prices. The quickly increasing level of private debt could lead to solvency problems, especially if eroding competitiveness dampens the potential for the further development of tourism.

Against this background, Directors observed that the key policy challenge will be to prevent overheating and ensure that the current boom unwinds smoothly. Given the limits on using monetary policy with the adoption of the euro, fiscal policy will need to play a prominent role in this regard. Directors recommended a combination of measures aimed at withdrawing fiscal stimulus, reining in credit growth, and bolstering structural reforms to boost competitiveness and improve the economy's resilience to shocks.

While recognizing the need to allocate resources to strengthen infrastructure and the institutional foundations of a new state, Directors counseled that, at a minimum, fiscal policy should avoid adding to private sector demand pressures at the current juncture. The temporary surge in tax revenues should not be seen as providing scope for tax cuts and higher current spending. Directors underscored the need to contain fiscal risks from large restitution claims and the assumption of contingent liabilities, including from private-public partnerships. They recommended the development of a strong medium-term fiscal framework.

Directors commended the Central Bank of Montenegro for recent steps to stem the very rapid growth of credit, including the broadening of reserve requirements and tightening of prudential regulations. They encouraged early passage of the Banking Law to provide for stronger supervisory powers for the banking sector regulatory authorities. Directors welcomed the authorities' commitment to combat money laundering and the financing of terrorism, and their intention to upgrade the current AML/CFT framework.

Directors encouraged the authorities to persist in implementing key structural reforms. They welcomed the authorities' efforts to reform labor legislation to improve economic flexibility and facilitate job mobility. At the same time, wage discipline should be strengthened, and a better link established between job performance and compensation. Directors called for further efforts to improve the business environment, especially by limiting the scope for discretion on the part of officials and regulators, completing zoning regulations, and strengthening corporate governance. They noted the importance of reforms in the energy sector, in particular to ensure adequate electricity supplies for the growing economy. They looked forward to the opening up of the electricity sector to private investment and the phasing out of subsidies.

Directors noted that economic statistics need to be improved considerably in order to lay a sound basis for economic analysis. They encouraged the authorities to strengthen the organization of the statistical agency.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Montenegro: Selected Economic Indicators, 2003–07

	2003	2004	2005	2006 Est.	2007 Proj.
Real economy	(Percent change; unless otherwise noted)				
Nominal GDP (millions of €)	1,392	1,651	1,785	1,979	2,204
Unemployment rate (in percent)	22.9	22.3	19.7	13.5	11.8 [a/]
Real GDP	2.4	4.2	4.0	6.5	7.5
Tourism					
Arrivals	10.7	17.4	16.6	16.3	19.0 [b/]
Nights	7.8	14.7	14.3	13.9	22.4 [c/]
Retail prices (period average)	7.5	3.1	3.4	2.1	3.5
Money and credit (end of period, 12-month)	(Percent change)				
Bank credit to private sector	…	43.2	33.2	138.9	191.3 [a/]
Enterprises	…	40.6	30.2	112.2	198.4
Households	…	49.4	39.7	193.0	180.7
Bank deposits – private sector	…	23.0	84.2	119.5	129.4 [a/]
General government finances (cash)	(In percent of GDP)				
Revenue and grants	41.8	37.8	37.4	44.9	50.7
Expenditure (including discrepancy)	46.6	40.5	39.1	42.5	45.2
Overall balance	-4.8	-2.7	-1.8	2.4	5.4
Primary balance	-3.7	-1.1	-0.6	3.6	6.6
Gross debt	51.8	45.9	41.6	37.7	40.5
Balance of payments	(In percent of GDP)				
Current account balance, excluding grants	-11.1	-10.1	-8.9	-30.7	-37.0
Foreign direct investments	2.8	3.4	21.4	23.6	24.4
Exchange rate regime	The euro is the legal tender				
Exchange rate, U.S. $/€ (period average)	1.13	1.24	1.25	1.26	…
REER (wage-based; annual average change, in percent; - indicates depreciation)	4.4	6.6	7.9	7.4	3.6 [c/]

Sources: Montenegrin authorities; and Fund staff estimates and projections.

a/ As of September 2007.
b/ As of August 2007.
c/ As of June 2007.

Statement by Age Bakker, Executive Director for Republic of Montenegro
and Svetlana Cerovic, Advisor to Executive Director
January 16, 2008

The Montenegrin authorities greatly appreciate this opportunity to benefit from the Article IV consultation discussions in the Board, two days before the first anniversary of Montenegro's membership of the Fund. The authorities highly appreciate the staff's analysis and contribution to the domestic economic debate, and the resulting comprehensive set of papers. They attach great value to the close relationship with the Fund in meeting the challenges ahead.

Recent developments

Modest economic growth in the beginning of the decade has accelerated since mid 2006 when Montenegro proclaimed its independence. Ambitious structural reforms, prudent fiscal policy and a substantial capital inflow helped the country to shift from the phase of establishing stability to the phase of accelerated growth. In the last two years real output increased by 16 percent, mainly driven by capital inflows and a construction boom. In fact, Montenegro is one of the fastest growing tourist destinations in the world. Inflation was subdued in 2006, but picked up in 2007, reflecting drought and an increase in food prices, further liberalization of electricity and telecommunication prices and an increase in global oil prices. Employment has been on an upward trend, with the unemployment rate approaching single digit. Fiscal deficits turned into surpluses, public debt declined, and structural and state-building reforms were launched. Furthermore, the financial sector displayed a remarkably dynamic development.

Montenegro's success has been recognized by international institutions. Becoming a member of the IMF and World Bank in early 2007 had a positive impact on the sovereign credit ratings. Committed to trade liberalization, Montenegro became a member of the Central European Free Trade Agreement (CEFTA), and is now in the process of acceding to the World Trade Organization (WTO). Following an intensive political process, the new Constitution was adopted in October 2007, the same month in which the Stabilization and Association Agreement with the EU was signed, a milestone in the EU integration process.

Nevertheless, the authorities acknowledge that much remains to be done and there are many risks up the road. The current account deficit is large, the private sector is still weak and the business climate needs to be enhanced. The challenge for fiscal policy is to strike the right balance between counter-cyclical measures to contain strong demand pressures, and the need to strengthen institutions and infrastructure in support of nation building.

Fiscal Policy

Growing economic activity accompanied by improved collection of fiscal revenue and rationalization of public expenditure, led to an overall budget surplus in 2006, for the first time in a long period. The favorable trends continued in 2007. The revenue windfall from the economy being confronted with unprecedented FDI inflows resulted in a significantly higher than budgeted surplus. As explained by staff in the Selected Issues papers, tightened fiscal policy in the last two years created fiscal space by withdrawing stimulus, and there was not much more that could have been done to sterilize the shocks. The authorities, as well as the private sector consider high indirect labor costs to be one of the obstacles for business development, employment growth and reducing the gray economy. Thus, the authorities have been gradually cutting tax and social contribution rates. The approach has been giving positive results over the last four years as the economy has been accelerating and overall collection of tax revenues has increased.

One of the issues highlighted in the staff report and extensively discussed during the mission is the approach of the fiscal authorities to public wage increases and investment expenditure. Public sector wages in Montenegro are based on a minimum wage. The public sector wage policy in the period 2002-2007 was very restrictive, and kept wages below subsistence level. At the same time, robust economic growth and an increase in productivity, led to a substantial increase in wages in the private sector, widening the gap between public and private sector wages. The comfortable fiscal position enabled a gradual increase of public wages in 2007 and in the beginning of 2008. The authorities see these measures as instrumental to at least partly restoring purchasing power of public sector employees and to achieve some catching up with the private sector. They argue that the need for a highly qualified public administration, as a pillar for the EU integration process, asks for a revised wage policy in order to strengthen administrative capacities. After the increase planned for 2008, the authorities intend to conduct a restrictive wage policy in 2009 and 2010.

During the 1990s the investment in infrastructure in Montenegro was neglected. The recent dynamism of the economy and future growth prospects reinforce the importance of an appropriate public investment policy. To this end, the authorities view increasing public investment as imperative for achieving sustained growth. Accordingly, capital expenditures more than doubled in 2007.

Marked improvements in revenue collection and a stronger than expected budgetary performance were used for the regular servicing of all liabilities towards domestic and international financial institutions. In addition, the authorities made a prepayment of the debt to the World Bank, which, with other prepayments, decreased the public debt to GDP ratio to 32.4 percent at the end of 2007.

The Government of Montenegro has recently approved an Economic and Fiscal Program (EFP) for 2007-2010. The EFP envisages the balancing of the consolidated public spending (overall surplus around 1 percent of GDP). The Program is frontloaded in 2008 on account of the catching-up process, nation building and the public wage structure pressures, but it is envisaged to be restrictive in 2009 and 2010. Capital expenditures will rise steadily to about 9 percent of GDP by 2010, while current spending will decline from 41 percent of GDP in

2007 to 37 percent by 2010. The authorities' mid-term fiscal revenue projection is conservative (as confirmed by the achievement of a higher than budgeted surplus in 2007), and they are committed to accumulating additional surpluses in case of revenue windfalls and to refraining from higher spending.

Financial Sector

The Montenegrin authorities broadly agree with the Financial System Stability Assessment, and they have already implemented several recommendations.

The financial sector has grown rapidly and its health has improved significantly in recent years. In only six years since the Central Bank of Montenegro (CBM) was established, the banking sector was completely transformed from being underdeveloped, ruined and state-owned, to a reputable system with high credibility. With dominant foreign players, the banking sector has seen a strong increase of the deposit base.

Like in many other countries in the region, a rapid credit expansion has been observed over the past years, which in recent months has been supported by foreign borrowing. Although the credit growth originates from a very low initial base, the authorities are fully aware of the macroeconomic and financial stability risks associated with such rapid growth. They have undertaken a set of measures in that respect recently. The CBM has passed a new Decision on the classification of bank assets and loan loss provisions that became effective as of October 2007. The implementation of this decision will allow a better quality of credit risk assessment based on international standards and improve the insurance of depositors in the banking system. In addition, the CBM imposed the following measures effective as of the beginning of 2008: an increase in the solvency ratio (to 10 percent and 12 percent for banks with credit growth faster than 60 percent and 100 percent respectively), ceilings on credit growth, and broadening of the reserve requirement base while decreasing the reserve requirement rate on long-term deposits. Besides, the Credit Registry that will enable banks and micro-credit financial institutions to gain insight into indebtedness of legal entities and private individuals, shall be operable as of January 15, 2008.

The authorities also agree with staff that passing key banking legislation through Parliament is crucial for further strengthening risk-based supervision. The Draft law on banks, prepared in accordance with international standards, was adopted by the Government in November 2007. The law is expected to be discussed in the Parliament early this year, under an accelerated procedure.

The Insurance Supervisory Agency, as an independent institution that will be in charge of supervision and control of insurance companies, was formally established in December 2007, and will start to perform its activities prescribed by law in January 2008. In line with the strategic interest of Montenegro of joining the EU, as well as becoming a member of the WTO, the Agency has successfully contacted various donors for the provision of assistance and technical support.

External Sector and Structural Reforms

Montenegro has been experiencing a significant inflow of various foreign direct investments in recent years, including privatization, green field investments, and in 2007 through real estate purchases. According to the preliminary data for 2007, FDI inflow amounted to a record-high level ranking Montenegro on the top among transition countries with regard to the share of net FDI in GDP (22%). However, similar to other small, open, service-oriented countries, Montenegro faces a large current account deficit. The existing level of the current account deficit does not represent a problem for the time being, since it is mostly covered by FDI inflows and other investments and it is self-correcting. Yet, the authorities concur with staff that the large current account deficit and increasing spending needs warrant attention and require sound policies to support its reduction.

Having said this, the authorities are aware that preserving competitiveness, while stimulating capital inflows and accelerating the privatization process, is necessary to contain external vulnerabilities. They remain committed to improving the business environment and supporting the development of small and medium enterprises. Envisaged measures, among others, include further facilitation of business start-ups, simplification of licensing procedures, introduction of on-line registration and regular updates of the Central Register. Furthermore, the Draft labor law, which incorporates EU directives and International Labor Organization (ILO) conventions, and provides more flexibility in the labor market, was adopted by the Government. The law will be discussed in Parliament in the first half of 2008.

Montenegro currently imports around a third of its electricity and the authorities attach great importance to comprehensive energy sector reforms. They adopted the Energy Development Strategy striving to considerably increase investments in the sector. The Action Plan for the implementation of the Strategy will be completed in the first quarter of 2008. Moreover, a tender for research and preparation of feasibility studies for the construction of small hydropower plants was launched in November 2007. In cooperation with the World Bank they will continue activities to improve efficiency in the energy sector.

Finally, on behalf of the authorities, we would like to thank staff and management for their highly-valued policy advice. The authorities look forward to continue their very fruitful relations with the Fund.