March 2009
IMF Country Report No. 09/88

Republic of Montenegro: 2008 Article IV Consultation—Staff Report; 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 2008 Article IV consultation with Republic of Montenegro, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 16, 2008, 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 February 5, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 23, 2009 discussion of the staff report that concluded the Article IV consultation.

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

Staff Report for the 2008 Article IV Consultation

Prepared by the European Department

(In consultation with other departments)

Approved by Anne Marie Gulde-Wolf and Alan MacArthur

February 5, 2009

Executive Summary

- Staff team: Messrs. Kanda (head), Gagales, and Yamada (all EUR), visited Podgorica during December 3–16, 2008.
- Staff met with the Prime Minister, the Minister of Finance, the Governor of the central bank, the Minister of Tourism, the Minister of Transportation, the Deputy Minister of Labor, and senior officials in these institutions. In addition staff met with parliamentarians, labor unions, academics, and the private sector, and held a press conference at the end of the mission.
- The authorities agreed to the publication of the staff report last year, and will likely consent to the publication of this year's report.
- Montenegro does not issue a currency of its own, but has been using the euro as legal tender since 2002. A joint LEG/MCM mission is scheduled to undertake a review of Montenegro's exchange system in early February 2009.

Contents Page

Main Sources of Economic Statistics for Montenegro

Data in the Staff Report reflects information received by January 15, 2009. 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	

I. Staff Appraisal and Summary

1. **Montenegro is highly exposed to the rapidly dimming global outlook**. Global financial turmoil and recession will likely have a substantial adverse impact on confidence, credit growth, tourism, and FDI inflows in the near term. Thus, a sharp deceleration in growth is expected in the near term. Moreover, over the medium term only a modest rebound in growth is expected, as FDI and credit growth are unlikely to return to the extremely high levels observed in recent years. Cooling demand will also have a substantial adverse impact on fiscal revenues, and the fiscal position is coming under pressure.

2. **Financial sector vulnerabilities are substantial**. Banks' Non Performing Loan (NPL) ratios have been rising despite booming credit growth, and there is a substantial exposure to the rapidly cooling construction sector. Banking system exposure to a sudden stop or even reversal in foreign financing inflows from parent banks is also high. Public confidence remains fragile, and a blanket deposit guarantee introduced in October 2008—as nervousness about the impact of global financial turmoil on the largely foreign-owned banking system intensified—slowed but did not stop deposit withdrawals. However, all parent banks have supported their subsidiaries with additional funding thus far, thus partly offsetting the drain on deposits.

3. **Moreover, fiscal plans are likely to undermine fiscal stability, and should be reconsidered.** As a result of a pro-cyclical fiscal policy in recent boom years, a substantial structural deficit has already emerged in 2008. Plans for cuts in tax and contribution rates and increases in capital and social expenditure will substantially increase the structural deficit in 2009 and beyond, leading to rapidly rising public debt. Moreover, there are substantial contingent liabilities linked to the blanket guarantee of bank deposits, potential recapitalization of banks, the lossmaking aluminum company, and longer term aging pressures. And the fiscal stimulus is unlikely to be very effective, given the large share of imports, narrow production base, and tight credit conditions.

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

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

6. **Fiscal policy should be guided by a net debt anchor, and supported by a medium term expenditure framework to help entrench countercyclical policy**. The objective should be to reduce net debt to 20 percent of GDP by 2013, which would require a cancellation of the tax and contribution cuts and capital expenditure increase, plus modest

restraint on current expenditure. A well designed medium term expenditure framework would create scope for the free operation of automatic stabilizers while supporting consolidation efforts. In order to be credible, the expenditure envelope should be underpinned by the development of a coherent planning framework backed by tangible measures and expenditure reforms.

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

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

9. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle.**

II. Context

10. **Montenegro has made significant progress in overhauling its economy**. The last five years have seen inflation performance improved through the adoption of the euro as sole legal tender; banking sector restructuring; significant privatization; strengthened market infrastructure; and progress in fiscal consolidation. The authorities' objective is to create a business friendly, open economy with low taxes and minimal state interference, and to integrate the country in Atlantic-European structures. After joining NATO's PfP program in 2006, accession to the EU is at the top of the political agenda: the Stabilization and Association Agreement (SAA) was signed in 2007, and an application for EU membership was submitted in December 2008.

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

12. **As a result, the economy has boomed (Tables 1–2)**. GDP growth accelerated from 4.2 percent in 2005 to 10.7 percent in 2007, led by construction and consumption. Employment and wages have grown strongly, while registered unemployment has halved from 20 percent in 2005 to 10.7 percent in 2008.

Main Economic Indicators, 2005–08
(Percent)

	2005	2006	2007	2008
GDP growth rate (percent)	4.2	8.6	10.7	7.5
Unemployment rate (percent)	19.7	14.5	12.1	10.7
Growth in number of employed (percent)	0.6	4.5	3.7	6.1 1/
Inflation (cost of living, percent)	2.4	2.3	7.6	7.7 2/
Wage growth (percent)	7.8	15.5	14.2	24.7 1/

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

1/ As of August, 2008
2/ As of October, 2008

13. **However, financial sector stability and the fiscal position are coming under pressure as the global outlook dims, and a large external deficit has emerged**. Banks' credit risk management does not appear to have kept pace with booming credit, and asset quality is declining rapidly. Moreover, banks are vulnerable to shocks to foreign financing from their parents as global financial turmoil continues. Also, a substantial structural fiscal deficit raises the prospect of a rapid deterioration in the fiscal position as the demand boom unwinds. And the current account deficit increased to over 30 percent of GDP in 2008 as booming FDI and credit stimulated strong demand for imports.

14. **Much of recent Fund advice has been implemented**. The central bank has implemented most of the recent FSAP recommendations, and also reined in credit growth. Privatization efforts continue, and in the electricity sector tariffs have been raised while cross subsidization has been reduced. A new labor law goes some way towards meeting Fund-Bank recommendations. However, it has proven difficult to implement countercyclical fiscal policy during the boom.

15. **But despite reform progress, red tape and political strains persist.** Excessive regulation, particularly at municipality level, remains significant, constraining the business environment. The grey economy is reportedly very large. And while the services and construction sectors appear buoyant, the manufacturing base is narrow and has been declining in 2008. There have also been strong differences in opinion on the reform agenda within the ruling coalition, with the minority coalition partner exhibiting lower enthusiasm for reforms, and raising concerns about corruption in the privatization process. Early elections are expected by end-March.

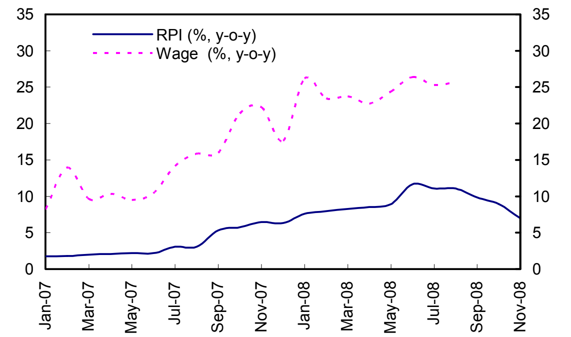
16. **Given the concerns about fiscal and financial sector soundness and the worsening outlook, the mission focused on policies to help achieve a soft landing**. Thus, discussions focused on measures to strengthen banking system stability; crisis response preparedness; fiscal consolidation and measures to help entrench countercyclical policy; and competitiveness.

III. Outlook: Weaker Growth with Substantial Downside Risks

17. **Recent data point to elevated wage and price pressures, but a deceleration in activity in 2008.**

- Wages grew 25 percent in August 2008 (y/y) well in excess of productivity growth and partly reflecting a 30 percent hike in public sector wages in early 2008. Inflation also rose sharply in the first half of 2008, reflecting domestic demand pressures, administrative price increases, and the general global increase in food and energy prices in early 2008, but has since eased.

Retail price and wage inflation



Source: Statistical Office of Montenegro.

- Private sector credit growth dropped to 23 percent in 2008, well below the record high 176 percent for 2007, reflecting prudential tightening measures in early 2008, lower risk appetite by foreign and domestic banks, and a significant decline in deposits as global financial turmoil tested public confidence (Figure 1).

- And FDI inflows are weakening as investment opportunities narrow. For Q1–Q3 2008, FDI inflows were €668 million, 10½ percent below the inflows for the same period of 2007. Construction activity has also weakened considerably in the latter part of 2008. And while comprehensive data on real estate prices are not available, anecdotal evidence suggests that prices in tourist areas have fallen sharply in the past few months.

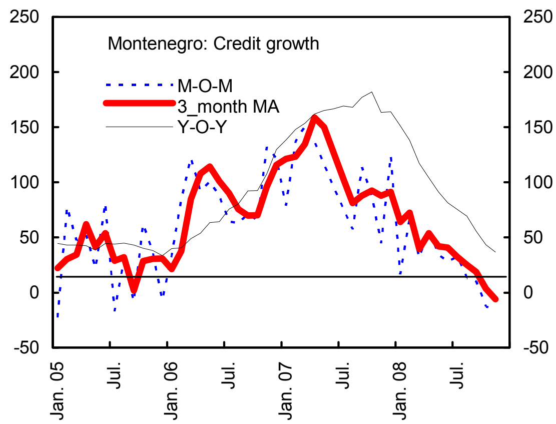
- As in other countries in the region, equity prices have dropped sharply in thin trading as worries about the impact of global financial turmoil mount.

- However, the trade deficit continued to widen, as import growth remained strong while exports were dampened, in part, by the impact of low aluminum prices on the aluminum company responsible for about 15 percent of exports.

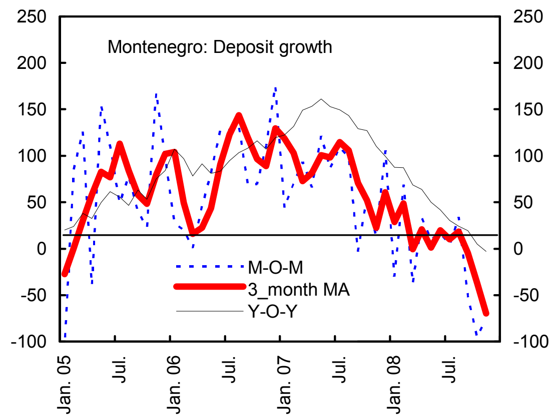
Thus, GDP growth is projected to have declined to 7½ percent in 2008, while annual average inflation is projected to have risen to around 8¾ percent. Also, the current account deficit is expected to have increased to over 31 percent of GDP.

Figure 1. Montenegro: Financial Sector Developments, 2005-08

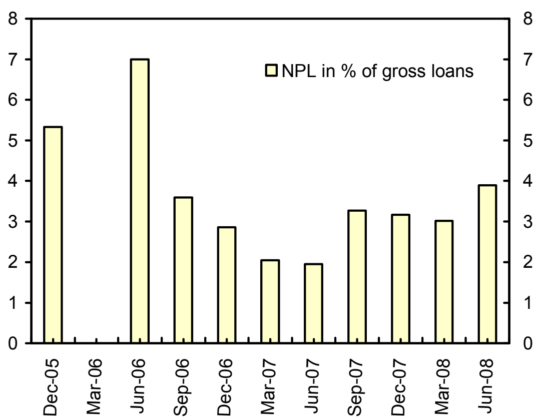
There has been a notable deceleration of credit…



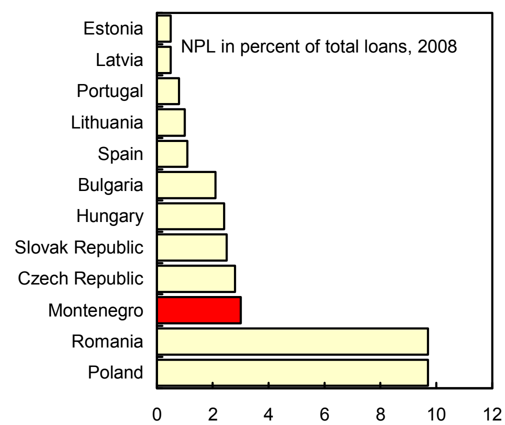
…and deposit growth.



Despite rapid credit expansion, NPL ratios are rising …



… and are not low.

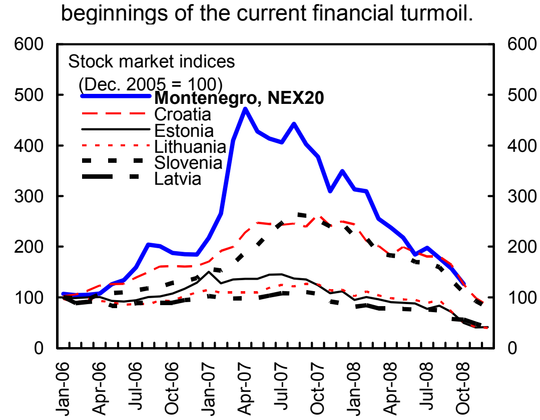


The banking system is largely foreign-owned
and highly concentrated

	Number	Market share	
		Loans	Deposits
	(In percent, June 2008)		
Foreign	9	82	78
o/w Large	3	63	57
Domestic	2	18	22
o/w Large	1	18	22
Total	11	100	100

Source: Central bank of Montenegro.

Equity prices have been declining rapidly since the beginnings of the current financial turmoil.



Sources: Central Bank of Montenegro; Global Stability Report (Oct 2008); Bloomberg; and IMF staff calculations.

18. **Staff project a sharp deceleration in growth in the near term.** GDP growth is likely to decline to about 2 percent in 2009–2010 as the demand boom fades. Credit growth is likely to slow to low single digits at best in 2009, given banks' reduced appetite for risk, further prudential tightening, and the difficulty of accessing foreign financing in the current global environment. And global recession is also likely to adversely affect tourism and FDI. In addition, the aluminum company has already announced a halving of its output in 2009, and it could shut down completely without public assistance.

Medium-Term Macroeconomic Framework, 2006–13 1/

	2006	2007	2008	2009	2010	2011	2012	2013
					Projection			
Growth rates (in percent)								
GDP (real)	8.6	10.7	7.5	2.0	2.0	4.0	4.5	4.5
Inflation (ave)	2.1	3.5	9.1	3.6	2.6	3.2	3.4	3.2
Exports (euro)	34.2	25.7	6.1	-2.1	9.8	12.1	11.6	11.9
In percent of GDP								
Fixed investments	25.4	28.0	27.0	22.0	21.0	22.0	22.0	22.0
Domestic savings	-0.7	-0.5	-2.6	1.7	7.7	12.7	12.7	13.7
Fiscal balance	2.1	6.4	1.5	-6.2	-7.9	-7.7	-7.1	-6.7
Structural balance	1.4	-0.8	-3.3	-8.9	-9.1	-8.3	-7.6	-6.7
Privatization receipts	3.7	3.8	0.4	1.0	0.7	0.5	0.4	0.2
Gross public debt (end of period, stock	34.8	27.5	32.4	36.0	41.6	46.1	49.3	52.3
Current account (before grants)	-24.1	-29.3	-31.3	-22.0	-15.0	-11.0	-11.0	-10.0
Export of goods&Services	49.4	47.5	43.0	40.1	42.1	44.1	45.5	47.3
Import of goods and services	79.1	79.5	76.2	64.0	59.0	56.9	58.3	59.2
External debt	43.7	65.5	77.2	80.7	85.5	86.8	86.0	84.8

Sources: Ministry of Finance; and IMF staff estimates and projections.
1/ Fiscal projection reflects the authorities' plan.

19. **And only a modest rebound is likely as global recession ends**. While FDI is likely to remain strong over the medium term, the recent exceptionally high levels—which saw FDI rise to as much as 21¾ percent of GDP in 2006—are unlikely to be repeated. Similarly, credit growth is also unlikely to return to the unsustainably high levels observed in recent years. Thus GDP growth is expected to increase to around 4½ percent over the medium term. With demand pressures abating the current account deficit is projected to decline to 10 percent of GDP, while inflation is projected to fall to around 3¼ percent, over the medium term.

20. **The authorities were more optimistic about the outlook, however**. They pointed to the country's tourism potential and possible large FDI projects as drivers of growth. However, over the course of the mission a steady flow of negative news on the global economy and outlook caused some movement—particularly in the central bank—towards staff's position.

21. **Domestic and external risks to the outlook are substantial and tilted to the downside.** Financial sector, fiscal, and external vulnerabilities are substantial, and rapidly declining growth in Europe could have a more adverse impact on growth than currently envisaged.

- Despite high credit growth, the NPL ratio has been rising, signaling a very rapid buildup of bad loans (Tables 3–4). Problem assets (classified B-E) doubled in one year to 236 percent of banking system capital and reserves as of September 2008. Private sector credit is now well above the typical level for countries at Montenegro's stage of development, and banks are heavily exposed to the rapidly cooling construction sector.

- While the credit boom was initially funded by deposits, foreign financing from parent banks has increased rapidly recently. As a result, the vulnerability of the banking system to a sudden stop or even reversal in financing from parent banks is substantial (Figure 2).

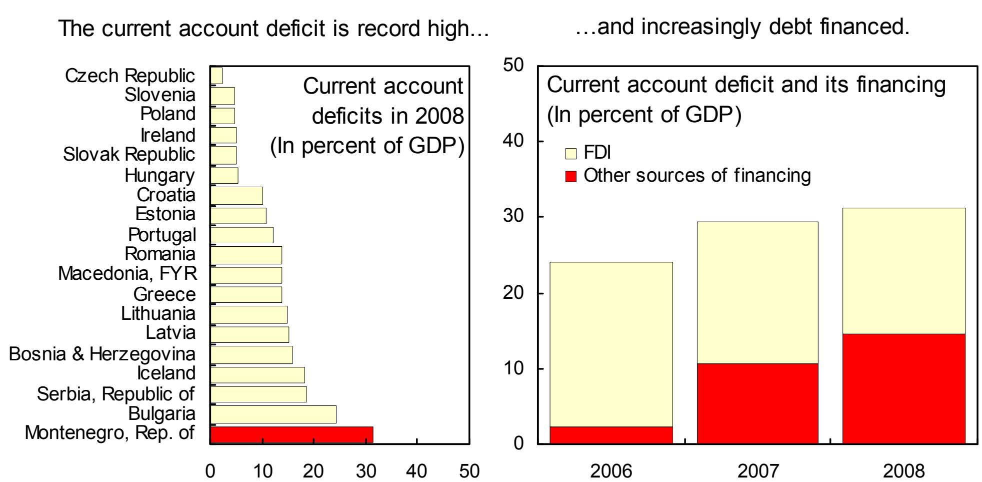
Counterparts of credit growth
(Change in percent of GDP)

	2003	2004	2005	2006	2007	2008 [1/]
Private sector credit	6.5	5.3	5.1	22.4	49.7	15.8
o/w a. Deposit liabilities	3.0	2.4	10.1	22.2	31.2	-8.1
b. Net foreign liabilities	2.4	1.9	-3.4	3.4	15.2	17.0
c. Own funds	0.1	0.1	0.9	1.9	3.1	1.8
d. Claims on Central bank	0.3	0.2	3.3	6.2	3.9	-2.4

Sources: Authorities; and IMF staff estimates.
[1/] Preliminary figures.

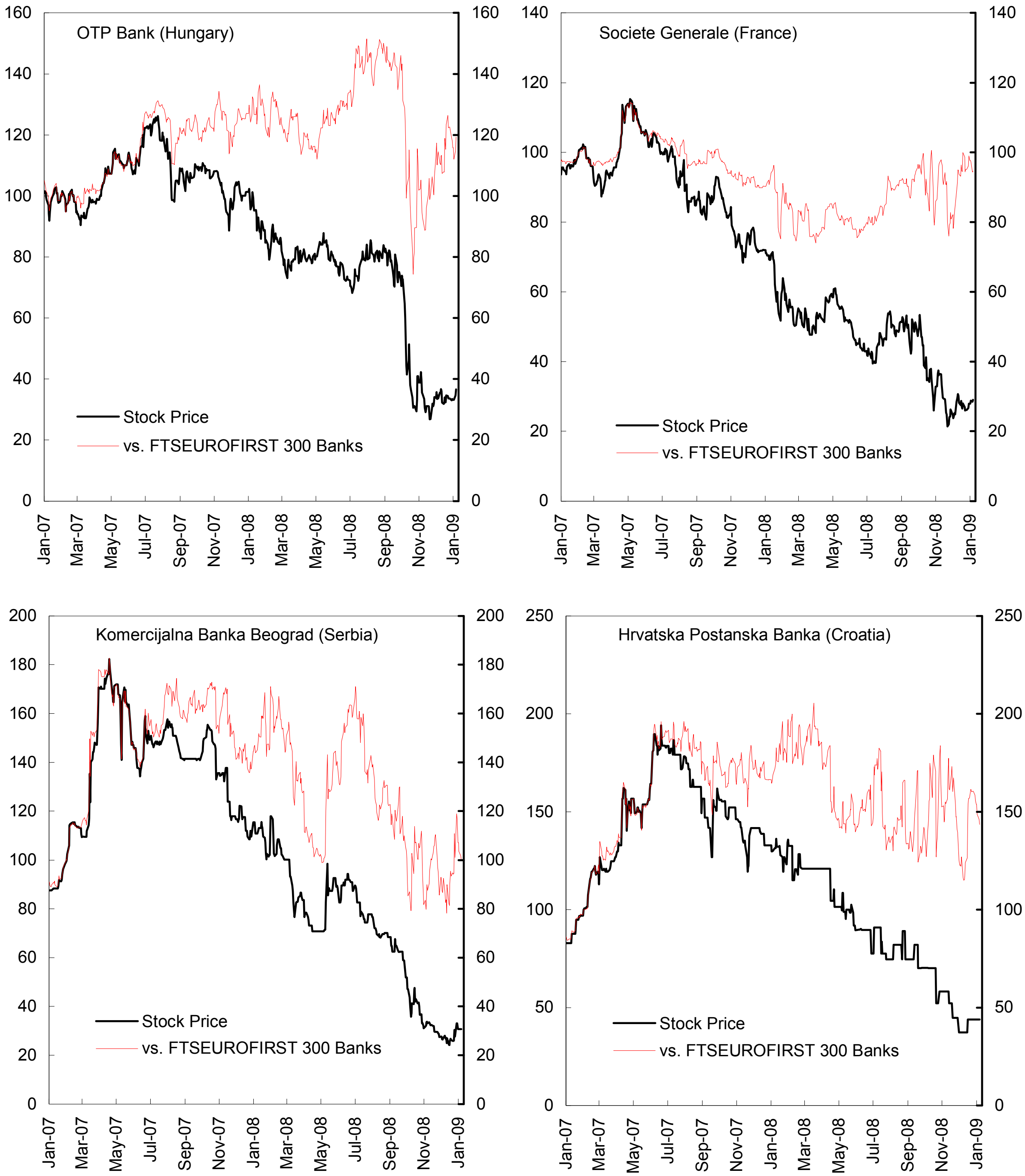
- Reflecting these financial sector risks, the authorities have recently had to extend support to Prva Banka, the second largest bank, and its loan portfolio is likely to contract significantly in 2009. Also, in October the Hungarian bank OTP—parent of the largest bank—came under pressure amid a sharp selloff in its equities, increasing public nervousness about the banking system and contributing to significant deposit outflows.

- While a substantial portion of the current account deficit is covered by FDI inflows, this coverage is declining, and private external borrowing, particularly by banks, is rising rapidly (Table 5). Although euroization shields Montenegro from currency crises, the scale and pace of the deterioration in the current account could indicate eroding competitiveness. From a savings-investment perspective, the main counterpart of the current account deficit is high private sector dissaving (-10 percent of GDP in 2008).



Source: WEO databank.

Figure 2. Parent Banks' Equity Performance, 2007-09
(February 1, 2007=100)

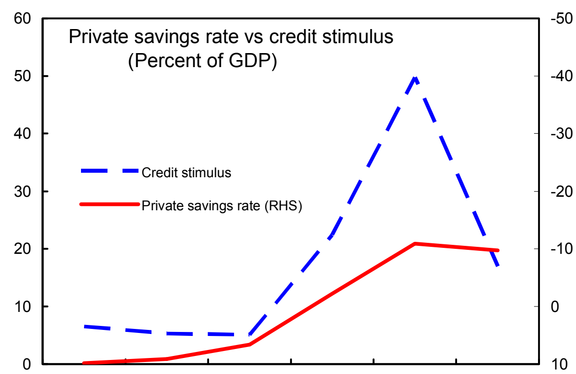


Source: Bloomberg.

- And headline fiscal surpluses primarily reflect surging VAT revenues as demand boomed (Table 6). Fiscal policy has been procyclical, and the structural deficit increased to an estimated 3¼ percent of GDP in 2008. This raises the risk that a fiscal tightening may be needed during a downturn, amplifying the cycle.

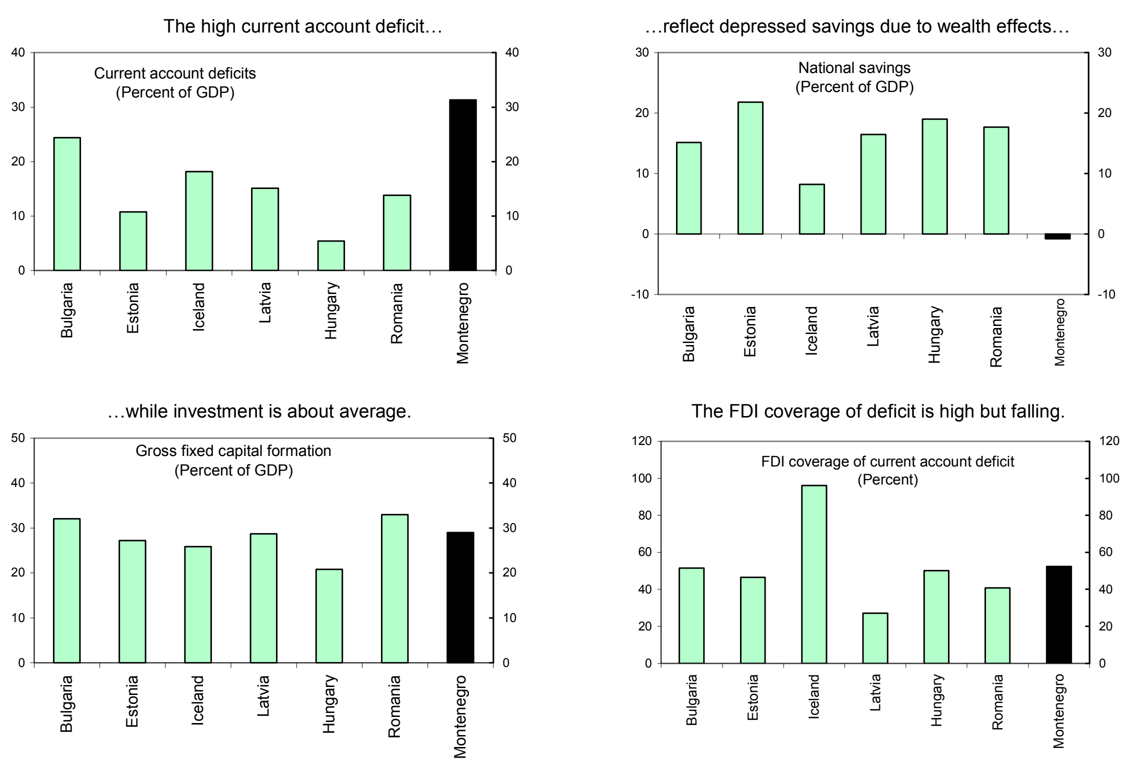
On the other hand, there is a possibility that large FDI projects could be implemented, which would have a significant upward impact on economic activity. Also, the economic stimulus packages worldwide could have a strong effect on foreign demand.

22. **While competitiveness appears broadly adequate currently, it is likely to decline further over the near term (Figure 3, Box 1, Table 7).** Given the strong impact of credit growth on private sector saving, the expected sharp deceleration in credit growth should have a substantial corrective impact on the current account deficit. However, strong wage pressures points to a further deterioration of competitiveness, which will likely limit Montenegro's attractiveness as a destination for FDI.



Source: Central Bank of Montenegro; WEO; and IMFstaff calculations.

Figure 3. Montenegro: Developments in the External Sector, 2008



Sources: Montenegrin authorities; WEO; and IMF staff estimates.

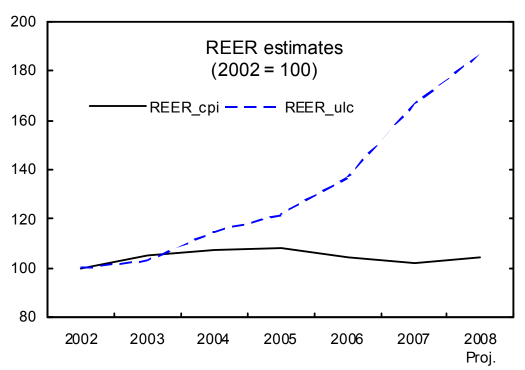
Box 1. Montenegro: Assessing Competitiveness

The CGER methodology yields divergent assessments, but, on balance, finds no substantive evidence of weak competitiveness. Montenegro's high current account deficit primarily reflects transitory demand pressures (stimulated by extremely high credit growth and FDI inflows, and sharp increases in real estate and stock market prices) and should decline as these pressures unwind. Under the macro balance approach, the underlying balance, which adjusts for transitory factors, is currently close to its equilibrium level (which includes FDI among its fundamental determinants), implying a moderate real exchange rate overvaluation of 6 percent. On the other hand, the external sustainability approach implies a 10 percent undervaluation, while the ERER approach—with the largest uncertainty margin due to data problems—suggests undervaluation of 16 percent.

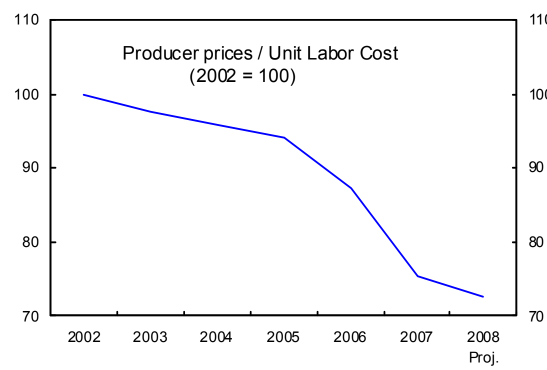
	Macrobalance Approach	External Sustainability Approach	Equilibrium Real Exchange rate Approach [5/]
Equilibrium balance A	-8.0 [1/]	-12.9 [2/]	n.a.
Underlying balance B [3/]	-10.0	-10.0	n.a.
Gap = A-B	**2.0**	**-2.9**	n.a.
Mitigating factor **C**: capital transfers	0.2	0.2	n.a.
Gap net of mitigating factors = A-B-C	**1.8**	**-3.1**	n.a.
Implied misalignment, in percent (+: overvaluation) [4/]	5.7	-9.8	-16.2

1/ Rahman (2008).
2/ Consistent with FDI of 7 percent of GDP at the end of the projection period.
3/ Adjusted for transitory elements in savings and investment.
4/ Calculation based on elasticities reported in Isard and Faruqee (1998).
5/ IMF (2006) http://www.imf.org/external/np/pp/eng/2006/110806.pdf

However, competitiveness appears to be declining. CPI-based competitiveness measures show little movement but ULC-based measures suggest erosion of competitiveness (not atypical in the first phase of convergence). There has been a large decline in the ratio of producer prices to unit labor costs, suggesting deteriorating business profitability.



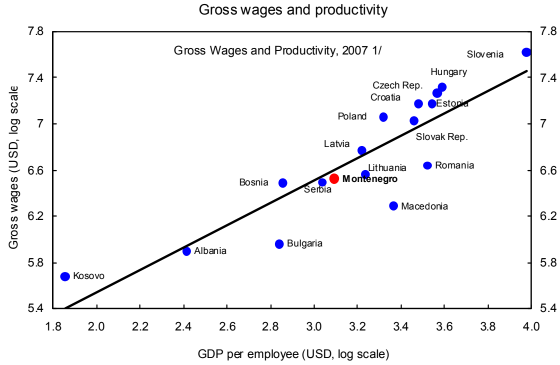
Sources: Monstat, statistical offices of trading partners, and Fund staff calculations.



Sources: Monstat, statistical offices of trading partners, and Fund staff calculations.

The wage level is currently mid-range, compared to neighboring countries, but wages have been rising rapidly. And Montenegro's tourism sector has a low ranking for price competitiveness.

Gross wages and productivity



Sources: National Authorities; and IMF staff estimates.

Travel and Tourism Competitiveness Rankings

	Overall ranking	Regulatory framework	Infrastructure & business environment	Human & natural resources	Price competitive-ness
Cyprus	24	27	17	40	95
Malta	24	13	25	43	100
Croatia	34	39	38	32	108
Slovenia	36	42	33	61	102
Slovakia	38	33	46	51	84
Bulgaria	43	50	52	31	69
Turkey	54	56	57	44	103
Montenegro	**59**	**53**	**68**	**45**	**129**
Romania	69	72	66	73	109
Serbia	78	73	72	88	82
Albania	92	81	105	71	90

IV. Financial Sector Risks Require Careful Management

23. **Financial sector vulnerabilities are substantial, but the central bank has been pro-active in introducing prudential measures**. In addition to rising NPL ratios, key financial stability indicators have been deteriorating, including bank profitability and provisioning. The average banking system solvency ratio is 16 percent, but staff estimate that a 10 percent loan loss will reduce it to 10½ percent, barely above the prudential minimum of 10 percent. Thus, strong prudential measures are needed to strengthen bank soundness. Cognizant of these vulnerabilities, the central bank has taken several welcome steps to strengthen financial sector soundness (Box 2). It has also been pro-active in seeking understandings with parent banks and home supervisors regarding the handling of potential liquidity and solvency problems. Market participants were very supportive of the temporary ceilings on credit growth, which they considered instrumental for taming the race for market share at the expense of loan quality.

24. **And in October 2008, as global financial turmoil intensified, the authorities took strong steps to reduce banking system risks**. As public nervousness about the impact of global financial turmoil on the domestic banking system increased in late September, widespread and significant deposit withdrawals occurred throughout the banking system, prompting the announcement of a package of measures (see Box 2). These measures, particularly the blanket deposit guarantee, helped slow deposit withdrawals. In addition, all parent banks have supported their subsidiaries with additional funding, thus helping to partially offset the decline in deposits, and banking system net foreign liabilities increased significantly in Q4 2008 (see Table 3). However, confidence in the banking system remains fragile, as deposit withdrawals have slowed but not stopped, particularly in the larger banks—in December private deposits declined by a further 5 percent, bringing the cumulative decline over Q4 2008 to 18 percent.

25. **Staff welcomed these measures and urged firm implementation of the planned prudential tightening.** Stronger provisioning and larger capital and liquidity buffers would improve the resilience of banks in weathering any shocks that could occur, and would also help increase public confidence in the banking system. The mission also suggested that excessively high debt to income ratios for borrowers should be discouraged. Staff also recommended that the lag between a bank failure and repayment of deposits be significantly reduced from the current 60 days, in order to increase public confidence in the deposit guarantee system.

26. **The enforcement powers of the central bank could be further strengthened, as recommended in the recent FSAP.** The current banking law does not give supervisors sufficient latitude to impose remedial measures on banks under administration without prior approval by shareholders, or to impose penalties without first obtaining court approval. And legal protections for supervisors could be improved. The authorities considered that the current level of legal protections had been adequate thus far but remained to be tested in

Box 2. Recent Measures to Strengthen Bank Soundness

The rapid credit expansion during the boom has overstretched banks' credit risk management capacity, leading to excesses and the weakening of prudential ratios (Table 4). With a view to safeguarding bank soundness, the CBCG has taken several important measures to improve credit and liquidity risk management at banks and beef up their capitalization:

To reduce credit expansion to more sustainable levels and improve credit risk management:

- Temporary bank-by-bank credit ceilings were introduced in January 2008. Ranging from 30% to 60%, the ceilings were inversely related to each bank's receivables.
- The base for required reserves was broadened in January 2008 to include public sector deposits irrespective of maturity, and the required reserves rate on time deposits with maturity of up to 180 days was increased.
- The credit registry became fully operational and banks were required to use it in assessing and classifying loans.

To beef up capital, reserves, and liquidity buffers and improve the operating environment:

- Tighter rules for asset classification and provisioning were introduced in September 2007. The threshold for "loss loans" was shortened from 270 to 180 days, and reserves for general banking risks linked (positively) to credit growth; and banks were required to review monthly the classification of assets and off-balance sheet items.
- The minimum solvency ratio was raised from 8% to 10% and the new Banking Law allows CBCG to ask for en even higher ratio if warranted by the risk profile of the bank. Banks should comply with the new provisions by March 2009.
- Stricter capital, liquidity and provisioning rules are to be phased in by March 2009.
- The AML/CTF framework is also being upgraded. A new Law has been passed and implementing legislation is being prepared; meanwhile, the FATF-style regional body, MONEYVAL conducted a mutual evaluation, the report of which is expected during 2009.

In addition, the following measures were taken in response to the international financial crisis.

The government:

- Guaranteed all bank private deposits, and on a case-by-case basis, interbank lending until end-2009 (a public contingent liability of about 48 percent of GDP).
- Stood ready to use the substantial government deposits to repay early bank loans to government, and to provide banks with loans for up to one year against collateral of shares of at least equal nominal value, to help boost liquidity. In this context, a collateralized loan of €44 million was provided to Prva Banka in December.
- Pledged up to €100 million for bank recapitalization on a case by case basis at the request of banks or, in the case of systemically important banks, the central bank.

The central bank

- Created a short-term liquidity support facility enabling solvent banks to borrow against prime collateral for up to 30 days, renewable up to three times. It also allowed banks to borrow up to 50 percent of their required reserves for periods not exceeding seven days in each month.

courts, and noted that increasing legal protections further would require changes to the constitution.

27. **The authorities' crisis response preparedness appears to be good**. The authorities have demonstrated strong vigilance and appreciation of the financial sector risks, and have implemented MCM recommendations on contingency planning for emergency liquidity support situations. These recommendations included dialogue with parent banks regarding liquidity support, detailed bank by bank contingency plans, increase in banknote inventory of the central bank, and arranging contingent credit lines. A follow-up MCM mission on crisis preparedness and management is planned for January 2009.

Implementation of FSAP Recommendations [1/]

Measure in Action Plan	Status of Implementation
Change in organizational structure of CBM Increased specialization Integration of on- and off-site supervision Development of portfolio management	Adopted by CBM Council in March 2007, implementation in progress.
Supervision Development Plan	In place and updated annually on a rolling basis.
Improver control of credit, liquidity, FX and operational risks.	Included in the Supervision Development Plan. New tighter regulations are being phased in and the adequacy of the regulatory framework is under constant review
Consolidated supervision	The new Banking Law prescribes consolidated supervision. The implementing regulations are being drafted and expected to enter in force by the end of 2009.
Banking Law and Central Bank Law	Both have been enacted. The Banking Law has tightened prudential standards but limits the central bank's ability to impose penalties and provides limited immunity to supervisors during the discharge of their duties.
Measures to address bank specific vulnerabilities	Several banks have been asked to raise their capital above the minimum requirements.
Credit registry Broaden access to information by banks Include additional information in line with Basel II. Charge fee to access information.	Became fully operationally in 2008 and is used for loan classification.

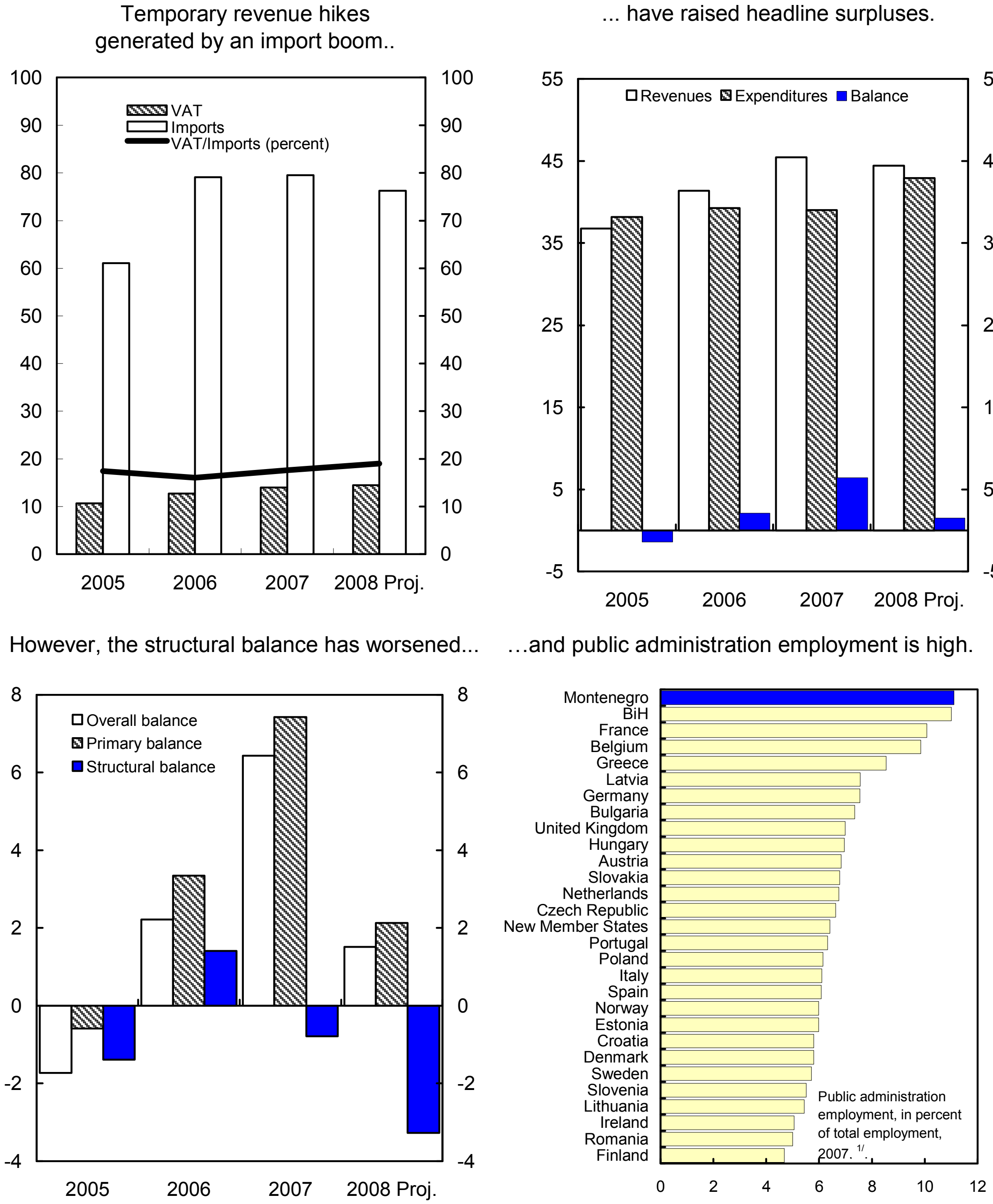
[1/] Status as of December 2008.

V. Fiscal Stability is Coming Under Pressure

28. **Booming domestic demand helped generate a substantial improvement in the headline fiscal balance in 2007**. The fiscal balance improved by 4¼ percentage points to a surplus of 6½ percent of GDP, led by strong VAT revenue from booming consumption and imports. Corporate tax and social security contributions also performed strongly.

29. **But the fiscal surplus likely declined significantly in 2008**. While strong demand kept taxes buoyant, overall revenues declined (in percent of GDP) as a result of cuts to social contribution rates and a decline in non tax revenues. Moreover, expenditures increased significantly, as a result of the 30 percent hike in public sector wages and increased transfers, capital expenditure and net lending. Thus the headline fiscal surplus is expected to have declined to 1½ percent of GDP. Booming demand masked a worsening of underlying fiscal balances, and staff estimate that the structural fiscal balance declined to a deficit of around 3¼ percent of GDP in 2008 (Figure 4).

Figure 4. Montenegro: Fiscal developments, 2005-08
(Percent of GDP)



Sources: Montenegrin authorities; Eurostat (for public administration employment); (and IMF staff estimates and projections.
1/ Data for Montenegro refer to 2008.

30. **And large deficits are projected for 2009 and beyond, undermining fiscal stability**. Announced plans to cut tax and contribution rates by 2010 will substantially weaken revenues.[1] Moreover, sharp increases in capital expenditure and social transfers are envisaged in the proposed 2009 budget. In addition to the tax and contribution cuts, the strong deceleration in demand expected as credit and FDI slowdown will weaken revenues significantly, with much of the revenue loss being permanent. Thus, staff project a deficit of 6¼ percent of GDP in 2009, with the position worsening further over the medium term as additional tax cuts and cooling demand reduce revenues. This would cause net public debt to increase by over 22 percentage points to 45¾ percent of GDP by 2013, raising sustainability concerns.

Montenegro: Fiscal developments, 2006-13
(In percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
			Projection					
Revenues	41.4	45.5	44.4	40.8	37.8	37.3	37.2	36.9
Expenditures	39.2	39.0	42.9	47.0	45.7	45.0	44.3	43.6
Fiscal balance	2.2	6.4	1.5	-6.2	-7.9	-7.7	-7.1	-6.7
Primary balance	3.3	7.4	2.1	-5.5	-7.1	-7.0	-6.3	-5.9
Structural balance	1.4	-0.8	-3.3	-8.9	-9.1	-8.3	-7.6	-6.7
Privatization receipts	3.7	3.8	0.4	1.0	0.7	0.5	0.4	0.2
Gross public debt	34.8	27.5	32.4	36.0	41.6	46.1	49.3	52.3
Government deposits	6.7	9.0	9.2	8.8	8.4	7.9	7.3	6.7

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

31. **Moreover, the planned fiscal stimulus is not likely to have a significant impact on activity**. The fiscal multiplier is likely to be low, given a narrow production base, a large share of imports in GDP, the sharp ongoing deceleration of credit, and the fact that a rapid rise in public debt could cause some households to increase saving.

32. **Staff pressed for adherence to a medium term net debt target of 20 percent of GDP**. During the 2007 Article IV consultations there was agreement that a medium term gross debt target of 30 percent of GDP would be appropriate. However, given large government deposits, staff argued that a net debt anchor—with a corresponding target of 20 percent of GDP—would be a better guide for preserving the net worth of government, and would help reduce pressures to draw down deposits. Achieving this target would require a cancellation of the tax and contribution cuts and capital expenditure increase, plus restraint on current expenditure, sufficient to reduce the structural deficit by a modest 0.2 percent of

[1] Personal income tax, pension contribution, and health contribution rates are to be cut from the current 15 percent, 21 percent, and 12 percent, respectively, to 9 percent, 20 percent, and 9 percent, respectively, by 2010.

GDP in 2009 and a further 0.1 percent of GDP in 2010. Alongside, automatic stabilizers would widen the headline deficit by about 2 percent of GDP in 2009 and 1½ percent of GDP in 2010. Given large contingent liabilities linked to the blanket guarantee of bank deposits, potential recapitalization of banks, the lossmaking aluminum company, and longer term aging pressures this consolidation should be considered the minimum needed.

Montenegro: Structural Balance and Net Debt 2007–13

	2007	2008	2009	2010	2011	2012	2013
		Projection					
With current policies							
Structural balance (% of GDP)	-0.8	-3.3	-8.9	-9.1	-8.3	-7.6	-6.7
Net debt (% of GDP)	18.6	23.1	27.2	33.2	38.2	42.0	45.5
With maintaining 2008 level capital expenditure, and without personal income tax and contribution cut							
Structural balance (% of GDP)	-0.8	-3.3	-5.8	-5.5	-4.8	-4.2	-3.5
Net debt (% of GDP)	18.6	23.1	24.2	26.6	28.1	28.6	28.9
With maintaining 2008 level capital expenditure, and without personal income tax and contribution cut, plus additional measures							
Structural balance (% of GDP)	-0.8	-3.3	-3.1	-3.0	-3.0	-3.0	-3.0
Net debt (% of GDP)	18.6	23.1	21.4	21.3	21.0	20.2	20.0

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

33. **Public administration reform has significant potential to reduce expenditure**. Public administration employment is well above European norms, and there is scope for efficiency gains from reforms (see Figure 4).

34. **However, the authorities insisted that with the economy cooling rapidly they could not remain passive.** They noted that limited possibilities for financing large deficits would act as a natural check, and that as financing options tightened they would reduce capital expenditure alongside. They also observed that plans for large public infrastructure projects to be financed using Public-Private Partnership agreements would have to be curtailed given the dimming outlook.

35. **There was broad agreement on the need for a medium term expenditure framework to help entrench countercyclical policy.** Given the absence of monetary policy, countercyclical fiscal policy is the main instrument available to help alleviate the buildup of macro imbalances. Implementing this would require a sound medium term expenditure framework to provide a more structural approach to fiscal planning, allowing automatic stabilizers to work freely while strengthening consolidation efforts. Staff noted that the credibility of the framework would need to be backed by tangible measures and expenditure reform.

VI. Further Structural Reforms are Critical for Sustained Growth

36. **Given euroization, a flexible labor market is critical for maintaining competitiveness and stimulating sustained growth**. Significant employment protections and a centralized collective bargaining system with little firm level flexibility have helped keep wage growth and the unemployment rate high, and limited the buoyancy of the corporate sector. Reflecting these rigidities, despite high unemployment seasonal surges in labor demand by the tourism industry are typically met by large inflows of foreign workers rather than from domestic sources. A new labor law, passed in mid-2008, reduces some of the rigidities but still contains substantial employment protections, discouraging job creation and longer-term employment contracts. The authorities however noted that the new law represented a social compromise, and it would be difficult to revise it so soon after its adoption.

37. **Electricity sector reform is also needed to alleviate shortages that constrain growth.** After a promising start, the unbundling of the lossmaking state owned electricity company (EPCG) appeared to stall in late 2008, following the authorities' announcement that they were seeking a strategic investor to take up a minority stake in EPCG (with the government retaining a 55 percent share). The announcement created uncertainty about whether the authorities remained committed to unbundling, or were contemplating keeping EPCG as a single entity. The situation was further complicated by the failure of EPCG to pay its licensing fee to the electricity regulator, which undermined the regulator's financial viability and ultimately resulted in a lawsuit against EPCG. The authorities however assured staff that the unbundling process would be re-energized in early 2009, and that at least part of the licensing fee arrears would be paid to keep the regulator going.

38. **Staff also stressed the need to reduce the significant bureaucratic impediments to starting and operating businesses at the municipality level**. The authorities acknowledged that red tape at the municipal level remained significant, but noted that a planned elimination of some municipal real estate related taxes would help improve the situation.

39. **Macroeconomic data need further improvement**. While there have been some improvements in economic statistics, there remain significant weaknesses, which hamper policymaking.[2] National accounts and balance of payments data (particularly trade data and credit flows from abroad) are weak, and there are no data on the expenditure side of real GDP.

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[2] For example, official GDP data for 2007, released in December, indicate that nominal GDP grew 30.7 percent. While real GDP growth of 10.7 percent was in line with other indicators, the deflator grew by an implausible 18 percent.

Table 1. Montenegro: Selected Economic Indicators, 2006–10

	2006	2007	2008	2009	2010
		Prel.		Proj.	
Real economy					
Nominal GDP (millions of €)	2,149	2,810	3,292	3,459	3,616
Population (in million)	0.62	0.63			
Gross national saving (percent of GDP)	4.9	2.2	-0.8	3.6	9.6
Gross investment (percent of GDP)	25.4	28.0	27.0	22.0	21.0
		(Annual percentage change)			
Real GDP	8.6	10.7	7.5	2.0	2.0
Industrial production	1.0	0.1	2.8	...	...
Tourism					
Arrivals	16.3	18.8	...	...	...
Nights	13.9	22.9	...	...	...
Retail prices (period average)	2.1	3.5	9.1	3.6	2.6
Retail prices (end of period)	2.0	6.3	7.4	3.2	3.0
GDP deflator	9.0	18.1	9.0	3.0	2.5
Average net wage (12-month)	15.3	33.2	...	...	...
Money and credit (end of period, 12-month)					
Bank credit to private sector	138.9	175.9	23.4	...	...
Enterprises	112.2	191.0	19.0	...	...
Households	193.0	153.7	31.0	...	...
Bank deposits - private sector	119.5	99.5	-15.2	...	...
General government finances (cash) 1/		(Percent of GDP)			
Revenue and grants	41.4	45.5	44.4	40.8	37.8
Expenditure (incl. discrepancy)	39.2	39.0	42.9	47.0	45.7
Gap/measures	...	0.0	0.0	0.0	0.0
Overall balance	2.1	6.4	1.5	-6.2	-7.9
Primary balance	3.3	7.4	2.1	-5.5	-7.1
Domestic financing (net)	-6.4	-7.3	-2.5	5.0	6.9
Privatization receipts	3.7	3.8	0.4	1.0	0.7
Central government deposits (end of period)	6.7	9.0	9.2	8.8	8.4
Net debt (end of period) 2/	28.0	18.6	23.1	27.2	33.2
General government gross debt (end of period, stock)	34.8	27.5	32.4	36.0	41.6
External debt	24.0	16.4	14.4	13.9	13.6
Domestic debt	10.8	11.1	18.0	22.1	28.0
Balance of payments					
Current account balance, excl. grants (in millions of €)	-517.8	-824.5	-1032.0	-942.1	-696.7
Current account balance, excl. grants	-24.1	-29.3	-31.3	-22.0	-15.0
External debt (end of period, stock)	43.7	65.5	77.2	80.7	85.5
Of which: Private sector	19.7	49.1	62.8	66.7	71.9
REER (wage-based; annual average change, in percent) (- indicates depreciation)	7.4	3.6	...	...	...
Memorandum:					
Aluminum price (€ per tonne)	2,051	1,929	1,833	2,077	2,231

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

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

2/ Gross debt minus deposits; projected path dependent on privatization receipts and restitution compensations.

Table 2. Montenegro: Macroeconomic Framework, 2005–13 1/
(Percent of GDP, unless otherwise noted)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
						Proj.			
Real GDP	4.2	8.6	10.7	7.5	2.0	2.0	4.0	4.5	4.5
Retail prices (end-period)	1.8	2.0	6.3	7.4	3.2	3.0	2.9	3.5	3.0
Gross domestic savings	0.2	-0.7	-0.5	-2.6	1.7	7.7	12.7	12.7	13.7
Non-government	-2.0	-7.7	-13.5	-11.5	-2.5	5.6	10.7	10.2	10.9
Government	2.2	7.0	13.0	8.8	4.2	2.1	2.1	2.6	2.8
Gross domestic investment	17.7	25.4	28.0	27.0	22.0	21.0	22.0	22.0	22.0
Non-government	13.6	20.4	21.3	19.6	11.3	10.9	12.0	12.2	12.3
Government	4.1	5.1	6.7	7.4	10.7	10.1	10.0	9.8	9.7
Gross national savings	9.2	4.9	2.2	-0.8	3.6	9.6	14.6	14.6	15.6
Non-government	6.9	-2.2	-10.9	-9.7	-0.9	7.3	12.3	11.8	12.6
Government	2.3	7.2	13.1	9.0	4.5	2.3	2.2	2.7	3.0
General government finances									
Revenues and grants	36.8	41.4	45.5	44.4	40.8	37.8	37.3	37.2	36.9
Expenditures	38.5	39.2	39.0	42.9	47.0	45.7	45.0	44.3	43.6
Current	34.4	34.1	32.4	35.5	36.4	35.6	35.1	34.4	33.8
Capital	4.1	5.1	6.7	7.4	10.7	10.1	10.0	9.8	9.8
Overall balance	-1.7	2.1	6.4	1.5	-6.2	-7.9	-7.7	-7.1	-6.7
Structural balance	…	1.4	-0.8	-3.3	-8.9	-9.1	-8.3	-7.6	-6.7
Public debt (gross)	40.9	34.8	27.5	32.4	36.0	41.6	46.1	49.3	52.3
Current account	8.9	24.1	29.3	31.3	22.0	15.0	11.0	11.0	10.0
Foreign direct investment (net)	21.0	21.7	18.7	16.4	13.0	8.5	8.0	7.0	7.0
External debt (estimate)	43.9	43.7	65.5	77.2	80.7	85.5	86.8	86.0	84.8
Memorandum items:									
Net export of goods and services	-17.5	-29.7	-32.1	-33.2	-23.9	-16.9	-12.9	-12.9	-11.9
Current account balance (before grants)	-8.9	-24.5	-29.6	-31.5	-22.1	-15.1	-11.2	-11.2	-10.2
Nominal GDP (millions of €)	1,815	2,149	2,810	3,292	3,459	3,616	3,873	4,189	4,509

Sources: Statistical Office of Montenegro, Ministry of Finance; and IMF staff estimates and projections.
1/ Fiscal projection reflects the authorities' plan.

Table 3. Montenegro: Summary of Accounts of the Financial System, 2005–2008

(Millions of euros)

	2005	2006	2007	Mar-08	Jun-08	Sep-08	Oct-08	Nov-08	Dec-08
					I. Central Bank				
Net foreign assets	173	310	468	463	504	551	456	422	313
Net domestic assets	-172	-308	-462	-456	-495	-541	-445	-411	-301
Net credit to the nonfinancial public sector	-39	-57	-97	-134	-160	-196	-158	-126	-11
Net credit to the banking system	-99	-233	-342	-294	-308	-316	-258	-256	-262
Other assets net	-33	-17	-23	-27	-27	-29	-29	-29	-28
Central bank fully backed liabilities	1	3	6	7	9	10	11	11	12
					II. Banking system				
Net foreign assets	42	-31	-457	-604	-752	-888	-943	-992	-1,015
Net domestic assets	455	1,049	2,521	2,684	2,947	3,074	2,988	2,944	2,905
Net assets held in the central bank	100	233	342	294	308	317	258	256	262
Net credit to nonfinancial public sector	26	24	-14	-13	-11	-14	-23	-33	-65
Credit to the private sector	326	780	2,151	2,356	2,591	2,712	2,698	2,665	2,651
Other domestic assets	3	12	42	46	60	60	55	56	57
Liabilities to the private sector	497	1,018	2,062	2,078	2,193	2,184	2,043	1,950	1,888
Deposits	400	878	1,752	1,749	1,835	1,814	1,670	1,564	1,485
Other	97	140	310	329	358	371	373	386	402
					III. Consolidated system				
Net foreign assets	215	280	11	-141	-248	-337	-488	-570	-702
Net domestic assets	283	741	2,059	2,228	2,452	2,533	2,543	2,534	2,603
Net credit to the nonfinancial public sector	-13	-33	-111	-147	-171	-210	-181	-159	-76
Credit to the private sector	326	780	2,151	2,356	2,591	2,712	2,698	2,665	2,651
Other net domestic assets	-29	-5	19	19	33	32	26	27	28
Liabilities to the private sector	498	1,021	2,068	2,085	2,202	2,194	2,054	1,962	1,899
					Annual changes (in percent)				
Net foreign assets	420	30	-96	-157	-197	-242	-327	-427	-6,510
Net domestic assets	9	162	178	129	94	65	54	47	26
Credit to the private sector	33	139	176	123	83	57	45	38	23

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

Table 4. Montenegro: Financial Soundness Indicators of the Banking Sector, 2004–Sept. 2008

	2004	2005	2006	2007				2008		
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sept.
Capital adequacy										
Regulatory capital as percent of risk-weighted assets	31.3	27.8	21.3	18.5	18.7	16.4	17.1	17.2	16.6	15.6
Capital as percent of assets	20.4	15.3	10.4	10.4	9.5	8.3	8.0	8.3	8.2	8.1
Asset composition and quality						(Percent of total credit)				
Distribution of bank credit by borrower										
Central government, local government, government agencies	...	7.0	4.2	3.2	2.4	1.8	1.4	0.4	1.3	1.3
Funds	...	3.1	2.1	1.8	1.4	1.1	0.6	0.7	0.5	0.5
State-owned companies	...	5.2	2.7	2.6	1.4	1.8	1.0	1.2	1.2	1.4
Private companies, entrepreneurs	...	56.5	52.7	54.4	56.6	58.1	60.6	59.7	59.1	58.8
Banks	...	0.0	0.1	1.3	1.0	0.2	0.2	0.0	0.0	0.1
Financial Institutions	...	0.0	0.7	0.3	0.5	0.8	0.9	0.6	0.9	0.9
Citizens	...	27.5	36.3	35.1	35.3	35.2	34.5	35.3	35.6	35.6
Credit cards	...	0.3	0.4	0.5	0.7	0.8	0.9	1.0	1.1	1.2
Other	...	0.3	0.9	0.7	0.8	0.0	0.0	0.0	0.0	0.4
						(Percent of total credit)				
Distribution of bank credit by sectoral economic activity										
Agriculture, hunting, fishing	1.7	1.9	1.0	1.5	1.1	1.0	1.0	0.6	0.4	0.6
Mining and energy	2.2	2.7	1.7	2.4	2.4	3.9	1.0	1.2	1.8	1.7
Civil engineering	5.1	5.0	7.3	9.6	10.5	9.2	9.0	8.4	7.7	8.9
Trade	41.5	34.4	31.3	23.3	22.4	26.0	26.1	25.9	25.7	25.2
Services, tourism	6.0	7.7	7.8	7.8	7.9	8.2	8.6	10.8	8.5	8.0
Transport, warehousing, communications	2.1	4.4	1.5	2.4	2.5	2.6	3.6	3.8	3.2	3.0
Finance	3.4	3.0	1.1	2.3	2.1	2.4	2.8	1.4	2.4	2.3
Real estate trading	0.3	2.9	0.8	3.5	3.6	1.8	3.6	3.2	1.9	2.0
Administration, other public services	4.6	5.3	4.5	6.9	4.9	3.3	2.9	3.4	2.4	2.6
Consumer loans	26.2	26.3	36.6	35.4	35.6	35.6	35.1	35.4	36.1	35.6
Other	6.8	6.6	6.6	5.0	7.0	6.2	6.3	5.9	9.8	9.2
Asset quality										
Non-performing loans (NPL), in percent of gross loans	5.2	5.3	2.9	2.0	1.9	3.3	3.2	3.0	3.9	4.5
Provisions, in percent of NPL	77.3	67.4	78.8	99.0	104.1	68.9	73.6	85.3	68.5	63.7
Provisions, in percent of total loans	4.0	3.6	2.2	2.0	2.0	2.3	2.3	2.6	2.7	2.8
NPL net of provisions, in percent of capital	3.6	6.1	3.5	0.1	-0.6	8.7	7.9	4.2	11.9	16.4
Earnings and profitability										
Gross profits, in percent of average assets (ROAA)	0.0	0.9	1.2	1.6	1.5	1.1	0.8	0.3	0.7	0.4
Gross profits, in percent of average equity capital (ROAE)	-0.1	6.1	11.6	15.0	15.9	13.6	10.5	3.7	8.3	4.3
Net profits, in percent of average assets (ROAA)	-0.3	0.8	1.1	1.5	1.4	1.0	0.7	0.2	0.6	0.3
Net profits, in percent of average capital (ROAE)	-1.2	4.2	6.8	12.5	11.6	8.4	6.2	2.6	6.4	3.5
Net interest margin 1/	6.9	5.4	3.5	4.0	1.8	2.4	3.0	0.9	1.8	2.8
Gross income, in percent of average assets	12.3	11.1	8.9	7.6	3.9	7.6	7.0	5.9	5.7	5.4
Net interest income, in percent of gross income	49.8	48.3	50.6	53.5	53.6	54.4	55.4	61.2	63.1	67.7
Non-interest income, in percent of gross income	50.2	51.7	49.4	46.5	46.4	45.6	44.6	38.8	36.9	32.3
Net fee income, in percent of net interest income	84.3	75.8	75.6	63.0	62.0	58.3	57.1	53.1	50.7	43.5
Trading income, in percent of gross income	8.3	15.0	11.1	12.8	13.3	13.8	12.9	6.3	4.8	2.8
Aggregate overhead expenses, in percent of gross income	69.3	70.0	71.9	61.1	56.1	55.2	57.3	49.5	52.2	55.4
Liquidity										
Liquid assets, in percent of total assets	24.2	38.4	30.3	23.4	20.0	20.5	18.1	14.6	14.3	12.9
Liquid assets, in percent of short-term liabilities	41.0	58.7	53.6	39.9	33.7	35.4	32.0	27.6	27.3	24.0
Deposits, in percent of assets	61.5	70.1	75.2	75.0	74.5	71.9	70.3	68.5	66.8	66.3
Loans, in percent of deposits	103.0	77.1	78.8	88.6	95.0	99.5	107.4	115.3	119.5	122.6
Sensitivity to market risk										
Off-balance sheet operations, in percent of assets	...	12.3	13.3	96.4	98.4	100.9	109.4	237.7	234.0	256.9
Original maturity of assets (in percent of total)										
Less than 3 months	...	56.8	45.3	37.3	34.3	33.7	31.1	26.9	25.5	27.3
3 months to 1 year	...	17.4	18.1	18.9	19.9	17.6	20.4	21.0	23.1	21.7
1 to 5 years	...	22.0	25.6	34.1	31.5	34.6	34.0	36.9	35.8	34.3
Over 5 years	...	3.8	11.0	9.8	14.4	14.2	14.6	15.1	15.6	16.6
Original maturity of liabilities (in percent of total)										
Less than 3 months	...	60.4	46.4	39.9	41.8	39.2	35.0	31.8	27.3	31.2
3 months to 1 year	...	16.0	22.5	27.7	24.6	25.1	27.3	26.2	30.2	28.0
1 to 5 years	...	19.1	24.6	25.0	25.4	27.1	28.7	34.7	35.1	32.4
Over 5 years	...	2.9	6.5	7.4	8.3	8.6	9.1	7.3	7.4	8.4

Source: Central Bank of Montenegro

1/ Net interest income in percent of interest bearing assets

Table 5. Montenegro: Balance of Payments, 2006–13
(Millions of euros)

	2006	2007	2008	2009	2010	2011	2012	2013
		Prel.			Proj.			
Current account balance	-518	-824	-1,032	-761	-542	-426	-461	-451
Trade balance	-855	-1,341	-1,539	-1,309	-1,195	-1,196	-1,330	-1,429
Exports f.o.b.	627	660	642	613	658	720	794	888
Imports c.i.f.	-1,483	-2,001	-2,181	-1,922	-1,853	-1,917	-2,124	-2,318
Services Balance (non-factor services, net)	216	440	445	483	585	698	791	894
Receipts	434	674	774	773	865	987	1,111	1,244
Expenditure	-217	-234	-329	-290	-280	-289	-320	-350
Net factor income	31	17	-8	-8	-9	-9	-10	-11
Current transfers, net	90	59	70	73	76	82	89	95
Capital and Financial account balance	675	873	883	761	542	426	461	451
Capital account	-14	-1	-2	-2	-2	-2	-2	-2
Financial account	689	874	885	763	544	428	463	453
Foreign direct investment, net	467	525	550	450	307	310	293	316
Portfolio investment , net	-4	5	-15	-16	-16	-18	-19	-21
Other investments	227	344	350	329	253	136	189	158
Errors and omissions	-20	103	169	0	0	0	0	0
Overall balance	137	151	20	0	0	0	0	0
Memorandum items:								
Current account balance	-24.1	-29.3	-31.3	-22.0	-15.0	-11.0	-11.0	-10.0
Merchandile trade balance (percent of GDP)	-39.8	-47.7	-46.7	-37.9	-33.1	-30.9	-31.7	-31.7
Export (percent of GDP)	29.2	23.5	19.5	17.7	18.2	18.6	18.9	19.7
Export growth (percent)	36.2	5.2	-2.7	-4.5	7.3	9.5	10.2	11.9
Import (percent of GDP)	69.0	71.2	66.2	55.6	51.3	49.5	50.7	51.4
Import growth (percent)	52.2	35.0	9.0	-11.8	-3.6	3.4	10.8	9.1
Service balance (percent of GDP)	10.1	15.7	13.5	14.0	16.2	18.0	18.9	19.8
Tourism revenues (percent of GDP)	12.6	16.4	16.0	15.2	16.3	17.4	18.1	18.8
Tourism revenues growth (percent)	22.2	69.3	14.8	-0.1	11.8	14.1	12.6	11.9
Foreign Direct Investment (percent of GDP)	21.7	18.7	16.7	13.0	8.5	8.0	7.0	7.0
Gross external debt (millions of €)	939	1,841	2,541	2,791	3,091	3,361	3,604	3,823
Percent of GDP	43.7	65.5	77.2	80.7	85.5	86.8	86.0	84.8

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

Table 6. Montenegro: Consolidated General Government Fiscal Operations, 2006-13 1/

(In percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
	Act.	Act.	Proj.					
Total revenues and grants	41.4	45.5	44.4	40.8	37.8	37.3	37.2	36.9
Total revenues	41.2	45.4	44.3	40.6	37.7	37.1	37.0	36.7
Current revenues	40.7	45.4	43.9	40.2	37.3	36.7	36.6	36.4
Taxes	25.8	27.9	29.0	26.4	24.1	23.5	23.4	23.2
Personal income tax	4.3	3.8	3.9	3.2	2.5	2.5	2.5	2.5
Corporate income tax	0.6	1.4	2.1	2.3	2.1	2.1	2.1	2.1
Taxes on turnover of real estate right	1.2	1.4	1.3	1.1	0.9	0.9	0.9	0.9
Value added tax	12.7	14.0	14.5	13.1	12.1	11.5	11.4	11.2
Excises	3.4	3.4	3.6	3.3	3.1	3.1	3.1	3.1
Taxes on international trade	2.6	2.4	2.5	2.2	2.1	2.1	2.1	2.1
Local government taxes	0.8	1.2	1.0	1.0	1.0	1.0	1.0	1.0
Other republican taxes	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2
Social security contributions	9.3	9.4	8.1	7.7	7.3	7.3	7.3	7.3
Nontax revenues	5.7	7.4	6.8	6.1	5.8	5.8	5.8	5.8
Capital revenues	0.4	0.7	0.4	0.4	0.4	0.4	0.4	0.4
Grants	0.2	0.1	0.1	0.3	0.1	0.2	0.2	0.2
Total expenditures and net lending	39.3	39.0	42.9	47.0	45.7	45.0	44.3	43.6
Total expenditures	38.9	39.5	42.5	46.7	45.4	44.8	44.1	43.5
Current expenditures	18.7	18.6	19.9	19.8	19.7	19.2	18.7	18.2
Gross salaries	9.6	8.8	10.3	10.2	10.1	9.7	9.3	8.9
Other personal income	1.3	1.2	1.0	0.9	0.9	0.8	0.8	0.7
Goods and services	6.0	6.7	6.9	6.7	6.7	6.7	6.7	6.7
Interest payments	1.1	1.0	0.6	0.7	0.7	0.7	0.7	0.7
Rent	0.1	0.2	0.3	0.4	0.3	0.3	0.3	0.3
Subsidies	0.3	0.5	0.5	0.7	0.7	0.7	0.7	0.7
Other outflows	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Social security transfers	11.0	10.6	10.6	12.6	12.2	12.2	12.2	12.1
Other transfers	3.4	2.9	3.9	2.8	2.8	2.8	2.8	2.8
Capital expenditure	5.1	6.7	7.4	10.7	10.1	10.0	9.8	9.7
of which : capital expenditures of current budget and state funds /2	0.0	0.0	0.0	1.4	1.4	1.4	1.4	1.4
Reserves	0.8	0.7	0.6	0.8	0.6	0.6	0.6	0.6
Net lending	0.4	-0.5	0.4	0.3	0.3	0.2	0.2	0.1
Overall Balance	2.1	6.4	1.5	-6.2	-7.9	-7.7	-7.1	-6.7
Financing	-2.2	-6.4	-1.5	6.2	7.9	7.7	7.1	6.7
Domestic financing	-6.4	-7.3	-2.5	5.0	6.9	7.0	6.7	6.8
Banking system	-3.4	-3.8	-1.6	7.4	9.4	8.4	7.5	7.6
Nonbank	-0.9	-0.3	-0.4	-0.8	-0.8	-0.8	-0.8	-0.8
Domestic arrears	-1.8	-3.2	-0.5	-1.6	-1.6	-0.6	0.0	0.0
Foreign financing	0.5	-2.9	0.6	0.2	0.3	0.2	0.0	-0.4
Privatization receipts	3.7	3.8	0.4	1.0	0.7	0.5	0.4	0.2
Memorandum items:								
Primary balance	3.3	7.4	2.1	-5.5	-7.1	-7.0	-6.3	-5.9
Gross Domestic Product (millions of euro)	2,149	2,810	3,292	3,459	3,616	3,873	4,189	4,509

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

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

2/ Reclassification of current to capital expenditure in 2009

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

	2004	2005	2006	2007	2008 Prel.
Financial indicators					
General government debt	45.4	40.9	34.8	27.5	32.4
Deposits (percent change, 12-month basis)	23.0	84.2	119.5	99.5	-15.2
Private sector credit (percent change, 12-month basis)	46.5	33.3	129.7	164.0	23.1
External indicators					
Exports (percent change, 12-month basis)	67.1	1.9	36.2	5.2	-2.7
Imports (percent change, 12-month basis)	52.0	53.7	69.0	71.2	66.2
Current account balance	-7.2	-8.5	-24.1	-29.3	-31.3
Capital and financial account balance	4.1	16.8	31.4	31.1	26.8
Of which: Foreign direct investment	3.0	21.0	21.7	18.7	16.7
Gross official reserves (in euro million)	60.1	172.9	310.3	467.9	313.0
Official reserves in months of imports of goods and services	0.8	2.1	2.5	2.6	1.4
Total external debt	40.0	43.9	43.7	65.5	77.2
Of which: General government	29.2	28.5	24.0	16.4	14.4
Exchange rate (US$ per euro, period average)	1.2	1.2	1.3	1.4	1.5
REER appreciation (-) (RPI based, 12 month basis)	2.6	-2.8	-5.0	0.7	0.5
Financial market indicators					
Stock market index (MOSTE index, end-2004 = 100), end of period.	100.0	402.6	364.3	1415.7	408.7

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

Appendix I: Montenegro—Debt Sustainability Analysis

I. Fiscal Sustainability

1. The monitoring of general government debt continues to improve with regular and transparent reporting of public debt by debt management unit in the Ministry of Finance. IMF has provided technical assistance over the last two years through a peripatetic advisor. In addition, the authorities now also include reporting of government deposits, making monitoring of net debt possible.

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 also included. Parliament has limited the overall liabilities stemming from restitution to a maximum of 10 percent of GDP through amendments to the restitution law, and the plan is that the government repay 0.5 percent of GDP per year over 20 years. As of 2008, €325 million had been assumed. In 2008, approximately €105 million is added on account of pension arrears, stemming from 2002-03. The government has also decided to compensate confiscated foreign savings of Montenegrin citizens in banks outside Montenegro[2] and for losses incurred during the pyramid-schemes (additional €17.6 and €9.5 million euro). Debt of municipal governments is now estimated at €42.4 million, including domestic payment arrears of €20.5 million). On the external side, The discussions between Serbia and Montenegro on the division of external debt are not yet final, and under the current scenario, debt equivalent to €29.8 million is added in 2009 on account of assumed debt from the former State Union.[3] As regards Paris club debt, bilateral agreements have been signed with United States and Switzerland, while negotiations are ongoing with France, Spain, and Holland, and premature debt repayments are planned with Great Britain and Japan. Of the larger Paris club creditors, only an agreement with Russia remains to be concluded. 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. Net debt is estimated at 23.1 percent of GDP at end-2008, with general government gross deposits reported at €304.3 million (9.2 percent of GDP).

3. Under the baseline scenario, reflecting the authorities' fiscal plans, Montenegro's gross debt-to-GDP ratio would increase to 52.3 percent of GDP by 2013 (Table A1). The

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[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.

[2] 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.

[3] Debt expected to be assumed by Montenegro is toward Kuwait, Libya, Czech Republic, Slovakia and UBS bank (API bonds).

primary balance is projected to worsen substantially as the current boom dissipates, and planned tax and contribution rate cuts and capital expenditure increases are implemented. Nominal interest rates, while low due to the high share of relatively cheap domestic and foreign debt, are projected to reach 2 percent on account of the government taking on a higher proportion of debt on non-IDA terms, and declining real economic growth will moderate 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 modifications due to data constraints. Relevant economic information for Montenegro prior to 2002 does not exist, and estimates for 2002–07 are used for historical averages and standard deviations.

5. The standard stress tests exacerbate the baseline trend of increasing gross debt (Figure A1), and the debt path is particular sensitive to growth shocks and contingent liabilities shocks. Montenegro is, furthermore, 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. The relatively high sensitivity to changes in growth and fiscal policy reinforces the importance of continued structural reforms and a prudent fiscal stance.

II. External Sustainability

6. It has benefited from a debt restructuring by Paris Club and bilateral donors in 2003 (which almost halved external public debt to around 33 percent of GDP) and another debt write-off by Paris Club creditors in 2006 (which contributed to total external public debt falling to about 24 percent of GDP). The evolution of external debt has also benefited from favorable debt dynamics over the entire period.

7. The statistical information 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 20 percent of GDP in 2006 to 63 percent in 2008. Commercial bank debt accounted for the bulk of the increase, with banks resorting increasingly to foreign financing and subsidiaries of foreign banks borrowing increasingly from parent institutions. The remainder of the increase may partly reflect hidden FDI (driven by tax considerations), with this debt converted later into equity.

8. The macroeconomic framework projects real growth to slow down, while the current account situation improves with the weakening of FDI related imports and the rebound of private savings. Under the baseline scenario, the external debt-to-GDP ratio increases from 77 percent in 2008 to 87 percent in 2011 and declines gradually thereafter as the external

current account deficit drops below its debt-stabilizing level. During this period, the external public debt declines gradually from 14 percent in 2008 to 11 percent in 2013. Meanwhile, the private sector external debt is projected to rise to 63 percent by 2008, peak at 78 percent in 2011 and decline gradually thereafter.

Table A1. Montenegro: General Government Debt Sustainability Framework, 2003–13
(Percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1 **Baseline: Public sector debt 1/**	47.8	45.4	40.9	34.8	27.5	**32.4**	**36.0**	**41.6**	**46.1**	**49.3**	**52.3**
o/w foreign-currency denominated	4.8	4.5	4.1	3.5	2.8	3.2	3.6	4.2	4.6	4.9	5.2
2 Change in public sector debt	-37.8	-2.3	-4.5	-6.1	-7.2	4.8	3.6	5.6	4.5	3.3	3.0
3 Identified debt-creating flows (4+7+12)	30.2	-1.7	7.2	-2.9	-4.7	3.1	4.2	5.8	4.5	3.1	2.7
4 Primary deficit	3.4	1.1	0.6	-3.3	-7.4	-2.1	5.5	7.1	7.0	6.3	5.9
5 Revenue and grants	38.6	37.4	36.8	41.4	45.5	44.4	40.8	37.8	37.3	37.2	36.9
6 Primary (noninterest) expenditure	42.0	38.5	37.4	38.0	38.0	42.3	46.3	45.0	44.3	43.5	42.9
7 Automatic debt dynamics 2/	-4.6	-3.4	-1.7	-5.7	-7.6	-3.4	-0.8	-0.8	-2.0	-2.7	-2.8
8 Contribution from interest rate/growth differential 3/	-3.1	-3.0	-2.5	-5.2	-7.2	-3.4	-0.8	-0.8	-2.0	-2.7	-2.8
9 Of which contribution from real interest rate	-1.1	-1.1	-0.7	-2.3	-4.3	-1.7	-0.2	-0.1	-0.5	-0.8	-0.7
10 Of which contribution from real GDP growth	-2.0	-1.9	-1.8	-3.0	-2.8	-1.8	-0.6	-0.7	-1.6	-1.9	-2.1
11 Contribution from exchange rate depreciation 4/	-1.6	-0.4	0.8	-0.5	-0.4	...	...	...	...	...	...
12 Other identified debt-creating flows	31.4	0.7	8.2	6.1	10.3	8.7	-0.4	-0.5	-0.5	-0.5	-0.5
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	2.4	4.5	8.7	-0.4	-0.5	-0.5	-0.5	-0.5
15 Other (Paris club reduction, prepayment)	29.2	0.0	0.0	0.0	2.1	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3) 5/	-68.0	-0.6	-11.7	-3.2	-2.6	1.7	-0.6	-0.2	0.0	0.1	0.3
Public sector debt-to-revenue ratio 1/	123.8	121.5	111.2	84.0	60.6	72.8	88.2	109.9	123.5	132.6	141.6
Gross financing need 6/	4.4	2.5	1.4	-2.9	-9.5	-2.2	5.4	7.2	7.0	6.5	6.1
in billions of U.S. dollars	74.6	52.3	32.1	-77.8	-364.7	-106.4	244.4	337.1	353.5	356.6	360.4
Scenario with key variables at their historical averages 7/						**32.4**	**27.6**	**23.6**	**20.1**	**17.2**	**14.6**
Scenario with no policy change (constant primary balance) in 2008-2013						**32.4**	**29.9**	**27.1**	**23.6**	**20.1**	**16.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	2.5	4.4	4.2	8.6	10.7	7.5	2.0	2.0	4.0	4.5	4.5
Average nominal interest rate on public debt (in percent) 8/	1.3	3.6	2.7	3.2	3.7	2.6	2.4	2.1	1.9	1.7	1.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.2	-2.3	-1.6	-5.8	-14.4	-6.4	-0.6	-0.4	-1.1	-1.8	-1.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	20.4	7.8	-13.4	11.6	11.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.5	5.9	4.3	9.0	18.1	9.0	3.0	2.5	3.0	3.5	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	25.5	-4.4	1.2	10.6	10.7	19.6	11.7	-1.0	2.4	2.7	2.9
Primary deficit	3.4	1.1	0.6	-3.3	-7.4	-2.1	5.5	7.1	7.0	6.3	5.9

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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

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

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

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

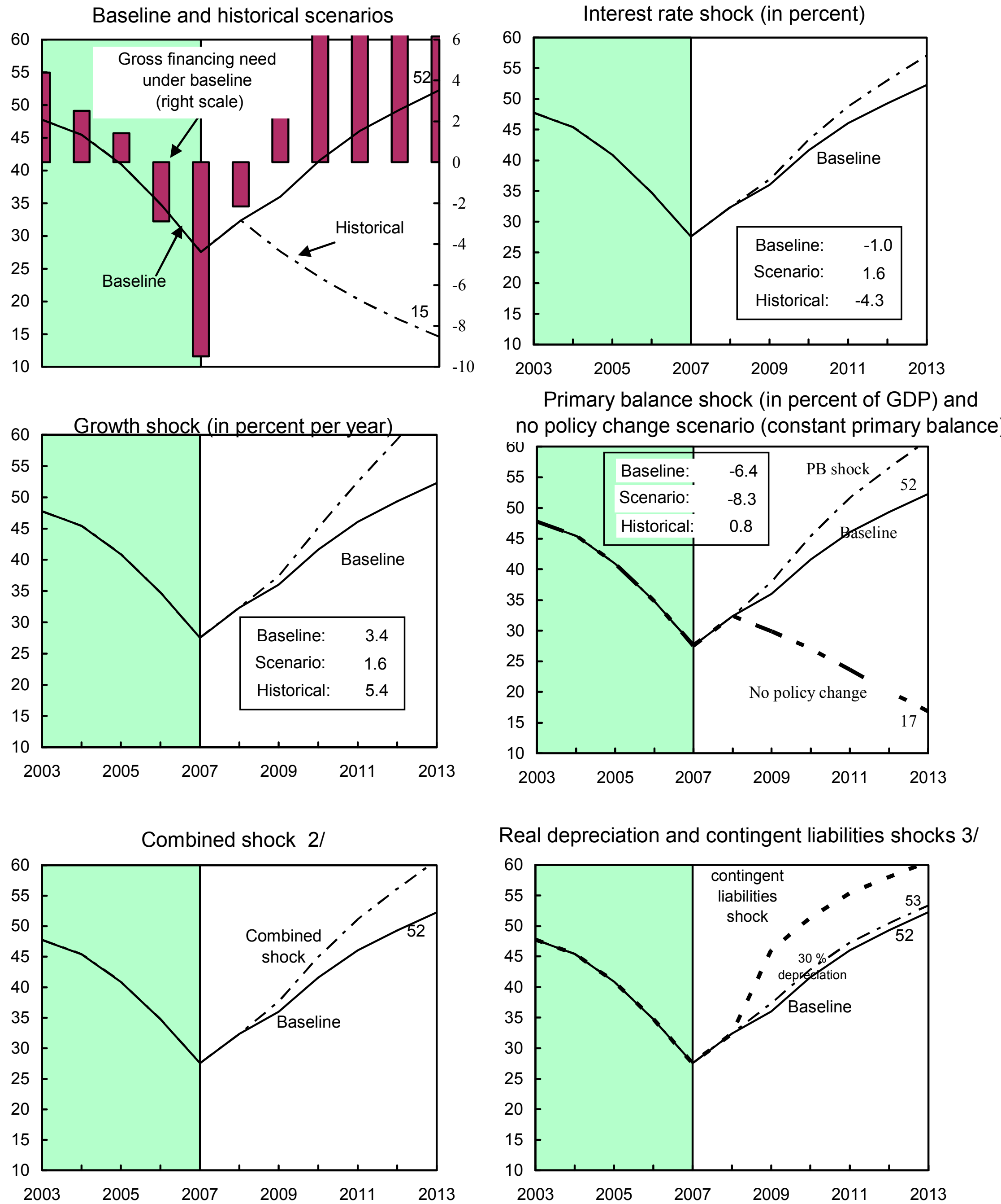
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

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

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



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Montenegro: External Debt Sustainability Framework, 2003–13

(Percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	40.0	43.9	43.7	65.5	**77.2**	**80.7**	**85.5**	**86.8**	**86.0**	**84.8**	**-11.4**
Change in external debt	2.0	4.0	-0.3	21.8	11.7	3.5	4.8	1.3	-0.7	-1.3	
Identified external debt-creating flows (4+8+9)	-2.6	-15.8	-4.8	-2.4	10.8	7.3	5.0	-0.2	0.4	-0.6	
Current account deficit, excluding interest payments	6.0	7.4	23.0	27.9	30.1	20.3	13.0	9.0	9.2	8.3	
Deficit in balance of goods and services	16.1	17.5	29.7	32.1	33.2	23.9	16.9	12.9	12.9	11.9	
Exports	42.0	43.5	49.4	47.5	43.0	44.7	47.0	49.5	51.3	53.3	
Imports	58.1	61.1	79.1	79.5	76.2	68.6	63.9	62.4	64.2	65.2	
Net non-debt creating capital inflows (negative)	-3.0	-21.0	-21.7	-18.7	-16.7	-13.0	-8.5	-8.0	-7.0	-7.0	
Automatic debt dynamics 1/	-5.6	-2.2	-6.1	-11.6	-2.6	0.0	0.5	-1.2	-1.8	-1.9	
Contribution from nominal interest rate	1.2	1.1	1.1	1.4	1.2	1.7	2.0	2.0	1.8	1.7	
Contribution from real GDP growth	-1.4	-1.5	-3.2	-3.3	-3.8	-1.7	-1.5	-3.2	-3.6	-3.6	
Contribution from price and exchange rate changes 2/	-5.4	-1.7	-4.0	-9.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	4.6	19.7	4.5	24.2	0.9	-3.8	-0.2	1.5	-1.1	-0.7	
External debt-to-exports ratio (in percent)	95.1	100.9	88.5	138.0	179.4	180.6	181.9	175.2	167.7	159.0	
Gross external financing need (in billions of US dollars) 4/	148.8	191.6	709.3	1533.2	2296.3	2146.7	1816.0	1790.2	1948.5	2037.7	
Percent of GDP	7.2	8.5	26.3	39.9	46.7	47.7	38.6	35.6	35.8	34.8	
Scenario with key variables at their historical averages 5/					**77.2**	**55.5**	**47.9**	**42.5**	**36.6**	**31.6**	**-21.1**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	4.4	4.2	8.6	10.7	7.5	2.0	2.0	4.0	4.5	4.5	
GDP deflator in US dollars (change in percent)	16.5	4.5	10.0	28.8	19.0	-10.4	2.5	3.0	3.5	3.0	
Nominal external interest rate (in percent)	3.8	3.0	3.0	4.7	2.4	2.0	2.6	2.5	2.2	2.1	
Growth of exports (US dollar terms, in percent)	67.2	12.8	35.4	37.2	15.9	-5.1	10.0	12.9	12.0	11.9	
Growth of imports (US dollar terms, in percent)	50.4	14.5	54.7	43.4	22.6	-17.8	-2.6	4.7	11.2	9.4	
Current account balance, excluding interest payments	-6.0	-7.4	-23.0	-27.9	-30.1	-20.3	-13.0	-9.0	-9.2	-8.3	
Net non-debt creating capital inflows	3.0	21.0	21.7	18.7	16.7	13.0	8.5	8.0	7.0	7.0	

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, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-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).

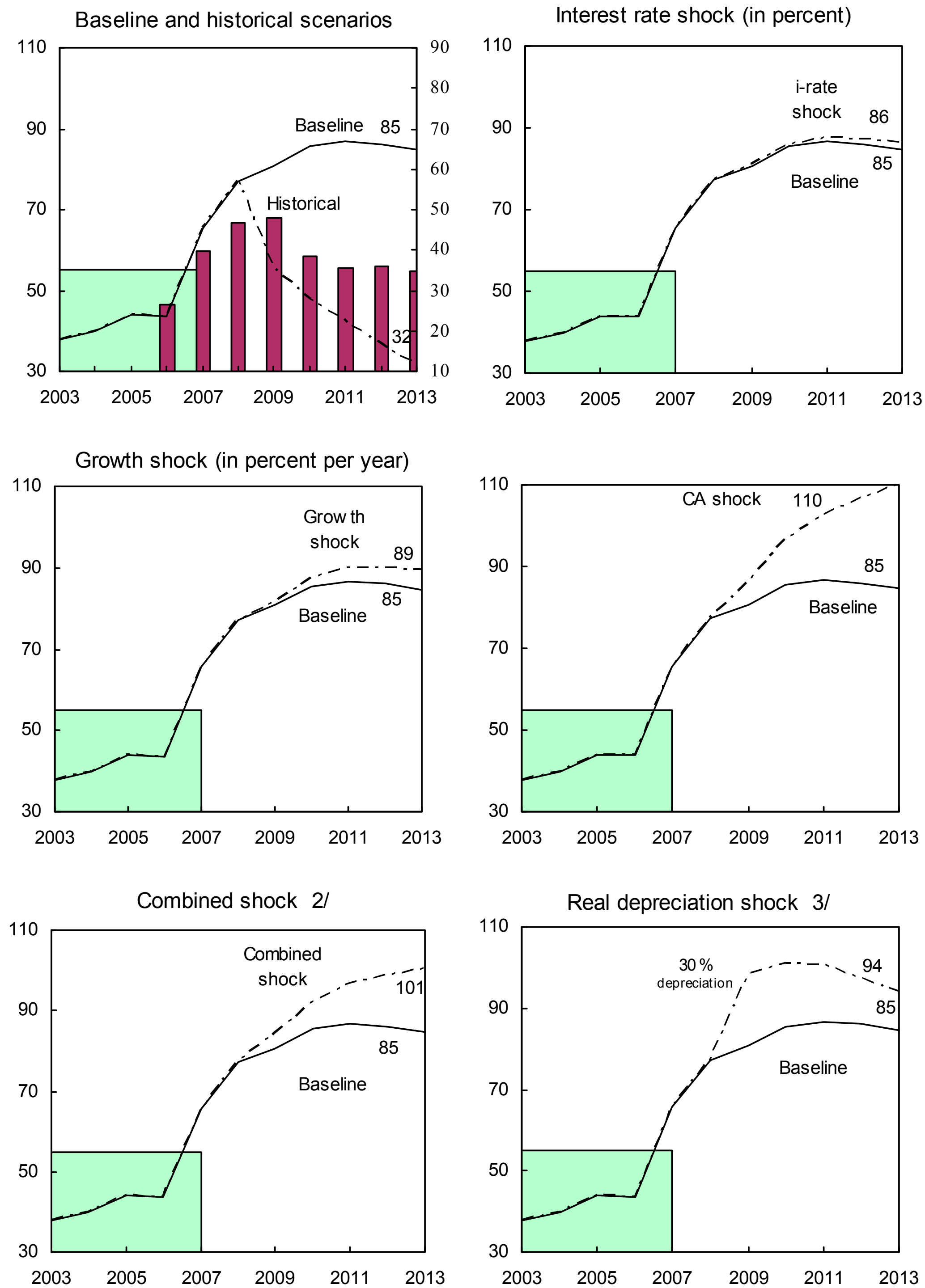
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure A2. Montenegro: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

Staff Report for the 2008 Article IV Consultation

Informational Annex

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

February 5, 2009

Contents Page

Annex I. Fund Relations[1]

(As of December 31, 2008)

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

		SDR Million	% Quota
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	0.29	N/A

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

V. **Financial Arrangements**: None

VI. **Exchange Rate Arrangement:** The euro is the sole legal tender. A joint LEG/MCM mission is scheduled to undertake a review of Montenegro's exchange system in early February 2009.

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

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

[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).

STA	June 2006	Monetary and financial statistics
FAD	January 2007	Peripatetic advisor on debt management
FAD	March 2007	Fiscal risk assessment of Private Public Partnership
FAD	April 2007	Tax administration
STA	April 2007	Real sector statistics
MCM	October 2007	Emergency liquidity management
MCM	March 2008	Enforcement of securities regulation
MCM	January 2009	Crisis preparedness and management

X. **Resident Representative:** None.

Annex II: Statistical Issues

(As of January 16, 2009)

A. Assessment of Data Adequacy for Surveillance

General

Data provision has serious shortcomings that significantly hamper surveillance. Shortcomings are most serious in national accounts statistics. While the quality and timeliness of data reporting vary across sectors, international reporting standards have been adopted for monetary and balance of payments statistics. Reporting of fiscal data has recently improved but coverage is limited. The quality of the labor and wage indicators is good.

The authorities have created a statistical council to coordinate efforts to improve data quality. These efforts need to focus on developing comprehensive source data for national accounts, improving concepts and classification of government finance statistics, strengthening the coverage of balance of payments transactions, and introducing sound classifications in compiling monetary and financial statistics.

National Accounts

The Statistical Office of Montenegro (MONSTAT) compiles real sector data. MONSTAT has started to adopt the *1993 System of National Accounts* as a framework for compiling national accounts estimates. However, the scope of the accounts is limited to compiling annual production account in current and 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. The coverage of the unincorporated sector is not exhaustive. On the expenditure side, there are no data on changes in inventories, and the quality of investment and merchandise trade data is unsatisfactory. National accounts data is also undermined by the lack of sound techniques to account for unobserved activities. Some work has been done on measuring informal activity in construction, retail trade, hotels and restaurants, but a more comprehensive approach needs to be developed. Statistical techniques for deriving volume measures of GDP are constrained by the lack of suitable price and volume indices.

Price Statistics

MONSTAT compiles and disseminates monthly consumer and producer price indices, which broadly follow international standards. In both indices, the “carry-forward” technique for treatment of seasonal goods, new goods, and missing items are used.

Government Finance Statistics

Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include data for the social security funds and local governments. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications, especially, at 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. Montenegro does not report government finance statistics for publication in the *Government Finance Statistics Yearbook* or *IFS*.

Monetary Statistics

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

Significant progress notwithstanding, there is need for further improvement. A 2006 mission made recommendations 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). The recording of Fund Accounts in the CBM's balance sheet also needs to be reviewed for consistency with the recommendations on accounting for transactions with the Fund that were issued by the IMF Finance Department. Appropriate recording of Fund Accounts will permit an enhanced compilation of monetary accounts for the CBM.

Balance of Payments

Balance of payments statistics are compiled by MONSTAT (trade statistics) and the CBM (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.

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

In mid-2004, a STA mission assisted CBM staff with the adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)*. The mission also provided recommendations to improve international trade and external debt statistics through the international transactions reporting system (ITRS). The authorities have implemented many of the mission's recommendations. 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. The mission recommended changes on the estimates for merchanting, transactions involving foreign assets and liabilities, and reserve assets, while additional data needed to be collected for travel and direct investment.

B. Data Standards and Quality

Montenegro does not participate in the GDDS, but may benefit to join the GDDS and use its framework for the overall development of the country's statistical system.

No data ROSC is available.

C. Reporting to STA (Optional)

A page for Montenegro in *International Financial Statistics* (IFS) was introduced in the March 2007 issue.

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's balance of payments data are not yet included in *International Financial Statistics* or *Balance of Payments Statistics Yearbook*.

Montenegro: Table of Common Indicators Required for Surveillance

(As of January 14, 2009)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
International reserve assets and reserve liabilities of the monetary authorities[1]	June.2008	Aug.2008	M	M	M
Reserve/base money	Dec.2008	Jan.2009	M	M	M
Central bank balance sheet	Dec.2008	Jan.2009	M	M	M
Consolidated balance sheet of the banking system	Dec.2008	Jan.2009	M	M	M
Interest rates[2]	Dec.2008	Jan.2009	M	M	M
Cost of living index	June 2008	Aug.2007	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Sep.2008	Nov.2008	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.2008	Nov.2008	Q	Q	Q
External current account balance	Jun.2008	Aug.2008	Q	Q	Q
Exports and imports of goods and services	Jun.2008	Aug.2008	Q	Q	Q
GDP/GNP	2006	Mar.2008	A	I	A
Gross external debt	Jun.2008	Aug.2008	Q	Q	Q
International Investment Position[6]	...	...	NA	NA	NA

[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] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Annex III: Relations with the World Bank Group

Montenegro's Development Goals

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.

The World Bank's support complements Montenegro's socio-economic development and politico-economic integration goals, including those spelt out in the Stabilization and Association Agreement (SAA) signed with the European Union (EU) in October 2007. Montenegro is in the process of developing and/or updating its development and sectoral strategies and integrating those into the overarching national integration program outlined in the 2008 National Program for Integration (NPI), superseding Montenegro's medium-term development strategy, as contained in the 2004 Development and Poverty Reduction Strategy (DPRS)[2] and the Economic Reform Agenda.

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, the government should overcome quickly the delays in implementing the structural reform agenda.

World Bank Group Strategy

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, supports 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 institutions and the rule of law; and (iii) improve the standard of living of citizens, through efficient education, health and social protection systems. A CPS progress report is scheduled to be presented to the World Bank Boards of Executive Directors in early 2009.

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

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 in mid-2007 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. The Fund has been part of the review process for the second volume of the Public Expenditure and Institutional Review (PEIR), scheduled to be published in late 2008.

Total outstanding debt of Montenegro towards the various part of the Bank, as of November 12, 2008, was US$314.9 million (US$68.4 million for IDA and US$246.6 million for IBRD). In 2007, the government prepaid €60 million.

World Bank Activities

The 2007 CPS envisages a total lending envelope of US$70–90 million (see table below). 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 Project Portfolio, End-September 2008

(In millions of U.S. dollars)

	Principal development objective	Board approval	Lending envelope committed	Lending envelope disbursed
Active projects (previous country assistence strategies)			24.0	15.2
Environment (MESTAP)	Sustainable solid waste management along coast	Nov. 2003	7.0	2.4
Health (MHSIP)	Initiating reforms in health system (financing, delivery)	Jun. 2004	7.0	6.4
Pension administration	Improving financial sustainability and efficiency	Jun. 2004	5.0	1.9
Education	Strengthening capacity, improving quality of teaching	Mar. 2005	5.0	4.5
Active projects (current country partnership strategy)			19.0	9.6
Sustainable tourism (MSTDP)	Environmental protection, regional water supply system	Jun. 2007	10.0	8.0
Energy (APL3)	Improving supply security, closer regional integration	Jul. 2007	9.0	1.6
Projects in preparation (base-case scenario)			51.0	0.0
Land administration (LAMP)	Improving registration, cadastre, preparing urban plans	…	16.2	0.0
Energy efficiency (MEEP)	Improving energy efficiency in public sector buildings	…	9.4	0.0
Agriculture (MIDAS)	EU consistent sustainable agriculture, rural development	…	…	0.0
MSTDP–additional financing	As above (extension of water pipeline)	…	…	0.0
MHSIP–additional financing	As above (scaling up of project to the entire country)	…	…	0.0

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.

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.

With the *Pension System Investment Administration Project*, Montenegro seeks to improve the financial sustainability, effectiveness, and efficiency of the pension system—by (i) developing a unified contribution collection and reporting system and establishing central registries that are based on modern information technology and processes; (ii) modernizing and restructuring, as needed, the organization, processes, and technology in the Department of Public Revenue and the Pension Fund; and (iii) developing capacity for better policy design and analysis of the pension system and improving the readiness for future pension reforms.

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.

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.

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.

In addition, the Bank approved in May 2008 a US$4.6 million Global Environment Facility (GEF) grant—US$2.0 million for Albania and US$2.6 million for Montenegro—for the joint Albania-Montenegro Lake Skadar/Shkodër Integrated Ecosystem Management Project. The funds are to help both countries to manage Lake Skadar/Shkodër more efficiently and in a more environmentally-safe manner by promoting sustainable development, with a special focus on tourism and fisheries that are to help to encourage action on some priority pollution sites. Two further GEF grant applications have been made by Bank teams within the context of the MIDAS and MSTDP projects, respectively. A PRS Trust Fund has been implemented during 2008, while one study financed by the Public-Private Infrastructure Advisory Facility (PPIAF) has been prepared and another is in preparation.

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* (2006), a *Debt Sustainability Analysis* (2007), a *Poverty Assessment Update* (2008), two *FSAPs* (2006, 2008), and an Accounting and Auditing *ROSC* (2007) were completed. A second *PEIR* is scheduled to be published in late 2008.

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.

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).

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.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/28
FOR IMMEDIATE RELEASE
March 4, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with Republic of Montenegro

On February 23, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Republic of Montenegro.[1]

Background

Montenegro has made significant progress in overhauling its economy, and has been rewarded for this by strong foreign investor interest. As a result, the economy has boomed in recent years, stimulated by large foreign direct investment (FDI) inflows and high credit growth, with GDP growth averaging 7 percent from 2004–08. However, the boom has also generated large macroeconomic imbalances, and the country is highly exposed to the rapidly dimming global environment.

The current account deficit is estimated to have risen to 31 percent of GDP in 2008, driven primarily by very low private sector savings and facilitated by rapid credit expansion. Gross FDI inflows moderated in 2008 as investment opportunities narrowed while the share of private external borrowing, particularly by banks, has risen rapidly. Strong wage growth has also been eroding external competitiveness.

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[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.

Financial sector vulnerabilities are substantial. Banks' non-performing loans have been rising strongly, and there is a substantial exposure to the rapidly cooling construction sector. Banking system dependence on foreign financing inflows from parent banks is also high. Public confidence remains fragile, and bank deposits are declining. Private sector credit growth decelerated to 23 percent in 2008 (compared to the record high 173 percent in 2007) reflecting prudential tightening measures, lower risk appetite and declining deposits.

However, the authorities have taken several welcome steps to help strengthen financial sector stability, beefing up banks' capital and liquidity buffers, introducing a blanket deposit guarantee, providing liquidity support and pledging public funds for bank recapitalization. Also, all parent banks have supported their subsidiaries with additional funding thus far, thus partly offsetting the drain on deposits.

On the fiscal side, after substantial improvement during the boom years the surplus is estimated to have declined considerably to 1½ percent of GDP in 2008. While strong demand kept taxes buoyant, the surplus shrank due primarily to cuts to social contribution rates, a 30 percent hike in public sector wages and increased transfers.

Plans for cuts in tax and social contribution rates and increases in capital and social expenditure will substantially increase the deficit in 2009 and beyond, implying a risk of rapidly rising public debt. Moreover, there are substantial contingent liabilities linked to the blanket guarantee of bank deposits, potential recapitalization of banks, the lossmaking aluminum company, and longer term aging pressures.

Executive Board Assessment

Executive Directors welcomed the structural reforms implemented over the past few years and financial integration that have helped Montenegro attract substantial foreign direct investment and generate rapid growth with moderate inflation. Fiscal surpluses were achieved in past years, allowing a decline in gross public debt. Directors noted favorably the recent application for EU membership and negotiations to join the WTO.

Directors observed, nevertheless, that global financial deleveraging and the recession in advanced economies will have a substantial adverse impact on economic activity in Montenegro and cause a rise in financial, external, and fiscal vulnerabilities. Against this background, Directors agreed that it will be important to maintain financial sector stability and fiscal sustainability, while continuing the structural reform momentum. With euroization, the burden on fiscal policy—the only available macroeconomic instrument—is greater to strike the proper balance in supporting economic activity, assisting the financial sector, and securing medium-term sustainability.

Most Directors recognized that the already large structural fiscal deficit and the overhang of contingent liabilities related to the financial sector constrain the scope for fiscal stimulus in 2009. Considering fiscal multipliers to be low in a small, open economy, most Directors called for reconsideration of the planned cuts in taxes and contribution rates. Directors welcomed the authorities' intention to reduce current spending to create fiscal space and, if the economic outlook deteriorates further, to scale back lower-priority capital expenditures. Directors generally encouraged the authorities to better anchor medium-term fiscal sustainability by adopting a target for net public debt and by the welcomed intention to create a medium-term expenditure framework.

Directors supported the authorities' actions to bolster financial system stability and reduce vulnerabilities by intensifying supervisory oversight, tightening prudential regulations, and lifting bank capitalization requirements. They welcomed efforts to improve systemic liquidity management and to reach agreements with parent banks and home supervisors related to possible liquidity and solvency problems. Directors recommended strengthening further the enforcement powers of the central bank.

Directors noted the staff's assessment that the real effective exchange rate was broadly aligned with fundamentals. They also underscored the importance of continued structural reform for raising potential growth and increasing the economy's resiliency to shocks. While welcoming the new labor market legislation, Directors encouraged further measures to make the labor market flexible and to encourage job creation and longer-term employment. They supported efforts to reduce red tape at the central government level to improve the business climate, and recommended that similar steps be taken at the municipal level. They endorsed renewed efforts to reform the electricity sector.

Directors encouraged the authorities to continue their efforts to improve the supply and quality of statistical data.

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, 2004–08

	2004	2005	2006	2007 Est.	2008 Proj.
Real economy	(Percent change; unless otherwise noted)				
Nominal GDP (millions of €)	1,670	1,815	2,149	2,810	3,292
Unemployment rate (in percent)	22.3	19.7	13.5	11.8	10.7
Real GDP	4.4	4.2	8.6	10.7	7.5
Tourism					
Arrivals	17.4	16.6	16.3	18.8	4.8 a/
Nights	14.7	14.3	13.9	22.9	6.2 a/
Retail prices (period average)	3.1	3.4	2.1	3.5	9.1
Money and credit (end of period, 12–month)	(Percent change)				
Bank credit to private sector	43.2	33.2	138.9	175.9	23.4
Enterprises	40.6	30.2	112.2	191.0	19.0
Households	49.4	39.7	193.0	153.7	31.0
Bank deposits—private sector	23.0	84.2	119.5	99.5	-15.2
General government finances (cash)	(Percent of GDP)				
Revenue and grants	37.4	36.8	41.4	45.5	44.4
Expenditure (incl. discrepancy)	40.0	38.5	39.2	39.0	42.9
Overall balance	-2.6	-1.7	2.1	6.4	1.5
Primary balance	-1.1	-0.6	3.3	7.4	2.1
Gross debt	45.4	40.9	34.8	27.5	32.4
Balance of payments	(Percent of GDP)				
Current account balance, excl. grants	-8.4	-8.9	-24.1	-29.3	-31.3
Foreign direct investments	3.0	21.0	21.7	18.7	16.7
Exchange rate regime	The euro is the legal tender				
Exchange rate, U.S./€ (period average)	1.24	1.24	1.25	1.37	1.49
REER (wage-based; annual average change, in percent) (- indicates depreciation)	6.6	7.9	7.4	3.6	…

Sources: Montenegrin authorities; and IMF staff estimates.

a/ As of October 2008.

Statement by Age Bakker, Executive Director for Republic of Montenegro
and Svetlana Cerovic, Advisor to Executive Director
February 23, 2009

The Montenegrin authorities would like to thank staff for the open and constructive dialogue during the mission. The authorities broadly agree with staff's analysis and share staff's views regarding the economic challenges ahead.

Macroeconomic developments and outlook

The Montenegrin economy has achieved impressive results over the past several years. Ambitious structural reforms, substantial capital inflows, dynamic developments in the banking sector, and strong fiscal performance positioned Montenegro as one of the fastest growing European countries. Average annual GDP growth in the last four years was around 8 percent. However, as a small, open economy, Montenegro is not immune to global economic developments. As for the region as a whole, the severe global economic crisis has begun to spill over to the country, particularly since the last quarter of 2008.

Through most of 2008 there have been strong FDI inflows, helped by restructuring of large public enterprises, and passage of several systemic laws (Labor Law, Banking Law). Employment also remained on an upward trend, with the unemployment rate approaching a single digit. Inflation picked up in the middle of the year, but has eased since then, although slowly, because the decline in food and oil prices was partly offset by further liberalization of electricity prices. The application for EU membership was submitted in December, and the negotiations for joining the WTO are in the final stage, confirming the authorities' objective of integrating the country into European-Atlantic structures.

The sudden recent drop in aluminum prices, combined with a substantial drop in global demand, affected production in the largest aluminum exporting company. Capital inflows also slowed down, demonstrating that the economy has started to adjust to new external developments. The banking sector came under pressure in October, when households, still with memories of the financial failure in the 1990s, withdrew some of their deposits. The authorities promptly reacted with a set of measures directed to secure confidence in the banking system.

Noting the difficulties in capturing the total effects of the global crisis, and in that respect the FDI inflows, macroeconomic projections inevitably have a high degree of uncertainty. The difficulties of projections are particularly pronounced in a small economy such as Montenegro, where a few large investment projects can make a significant difference. While recognizing the downward risks, the authorities developed two scenarios, more and less optimistic. The authorities are well aware of the challenges ahead, and economic policy for this year is focused on attracting FDI and avoiding a hard landing and negative effects of the crisis. They are monitoring the situation closely and regularly consult Fund staff.

Fiscal policy

Fiscal policy in 2008 was in line with medium and long-term objectives related to improving the business environment, stepping up public institution reforms and nation building, and improving public infrastructure. In addition, on account of the catching-up process with the private sector, an increase in public-sector wages was observed. A stronger than expected budgetary performance led to a higher than targeted surplus which, even after the intervention to alleviate vulnerabilities in the banking system, reached 1.5 percent of GDP.

One of the issues highlighted in the staff report and extensively discussed during the mission is the scope for countercyclical fiscal policy for 2009. The authorities are of the view that spillover from global markets, liquidity shortages, and limitations of the monetary policy due to the euroized economy, make countercyclical fiscal policy inevitable. In that respect, the budget for this year introduced various stimulative measures against the cyclical downturn. These measures mainly fall into three broad categories:

1) Support to households and individuals: through personal income tax and social contribution cuts that will have multiplicative effects on the economy, subsidies on electricity prices to the most vulnerable population categories, prepayment of internal debt payable by restitution and old savings;

2) Acceleration of investments in infrastructure, including the main national projects;

3) Support the business environment by decreasing the price of electricity for SMEs, through reduction of tax claims to EPCG, and guaranteeing bank borrowing from international financial institutions to support small and medium-size enterprises. The budget also includes the abolition of some fees. Implementation of the project "Job for you" is also envisaged. The project focuses on ensuring easier access to funding sources through an active employment policy for vulnerable categories of the population.

At the same time, in order to create space to support these measures, the budget envisages a cut in current spending for materials and services. Should the economic outlook deteriorate, and downside risks materialize, resulting in significantly lower than planned budget revenues, an alternative fiscal scenario will be implemented. The alternative scenario, with a deficit of 2.4 percent of GDP (significantly lower than staff's projection), envisages the reduction of capital expenditures, based on priorities. In fact, the planned large capital expenditures over the medium term provide room for quick and immediate adjustments. Moreover, tight financial conditions on domestic and international markets limit the possibilities for financing large deficits, and in that respect restrain significant deterioration of the debt-to-GDP position in the medium term.

Financial sector

Montenegro's financial sector has not avoided the global financial crisis, but has so far withstood the turbulence. The authorities' response to the financial crisis has been prudent and systematic since its outbreak. In October 2008, following the intensification of global financial instability, the authorities adopted measures to preserve the stability of the financial system, protect savers, and maintain adequate levels of bank liquidity. With respect to these measures, the government made debt prepayments to banks, in order to boost their liquidity, and a collateralized loan was provided to one bank. Pressures have alleviated, and there were no other requests for the use of measures and mechanisms provided by the Law on the Protection of the Banking Sector. Foreign banks' ownership is dominant in the Montenegrin banking system, and all parent banks have so far provided additional liquidity to their subsidiaries.

The banking sector grew substantially in 2007. To protect the system from risks stemming from rapid credit growth, the CBM implemented a set of prudent measures at the beginning of 2008. The solvency ratio was increased, ceilings on credit growth were introduced, and the reserve requirement base was broadened. Besides, the Credit Registry that enabled banks and micro-credit financial institutions to gain insight into the indebtedness of legal entities and private individuals, became operable. These actions prevented banks from pursuing more risky strategies, and created buffers for the turbulent developments on the international financial markets. Furthermore, the new Law on Banks, adopted in March last year, foresees a compulsory capital increase of banks within a one-year period. The capital increase will additionally strengthen the banking system and increase its capability to face various potential shocks that the system may be exposed to in the future.

The authorities appreciate the Fund's advice on contingency planning. Having implemented the FSAP recommendations, they requested a follow-up mission on crisis preparedness and management. Based on MCM's recommendations, the CBM, the Ministry of Finance and the Deposits Insurance Agency agreed to closely work together, each within their respective roles and with their own responsibilities, in maintaining financial stability. Moreover, by the end of the year, the authorities plan to revise the banking and bankruptcy law to address some of the issues raised by the mission team.

Structural reforms

The authorities remain committed to continuing the structural reform agenda, and ensuring sustainable economic growth in the long run. The adoption of the new Labor Law, which incorporates EU directives and International Labor Organization (ILO) conventions, provides for a more flexible and competitive labor market. While there is still room to increase flexibility and improve legislation in this area, a large seasonal inflow of foreign workers confirms that the labor market in Montenegro is very open.

The authorities attach great importance to comprehensive energy sector reforms, and they remain committed to unbundling the EPCG. The activities in 2008 were primarily focused on establishing preconditions for a full legal and ownership unbundling. As a result of these activities in the unbundling process, a newly established transmission company shall start to operate as of April this year. At the beginning of February this year, the authorities launched a tender for sale and recapitalization of the EPCG, allowing strategic partners to become shareholders of 18 percent of the total share capital. The process is planned to be finalized in the third quarter of this year. The strategic investor will be allowed to acquire majority control in EPCG in the next five years, under the condition of implementing the investment program. The authorities are of the view that this approach will create increased efficiency and profitability of EPCG.